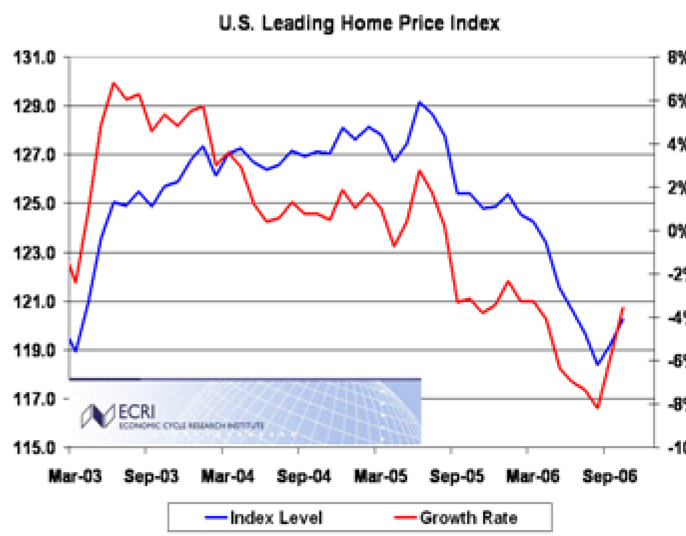
Cales Investments, Inc.

Member NASD / Member SIPC

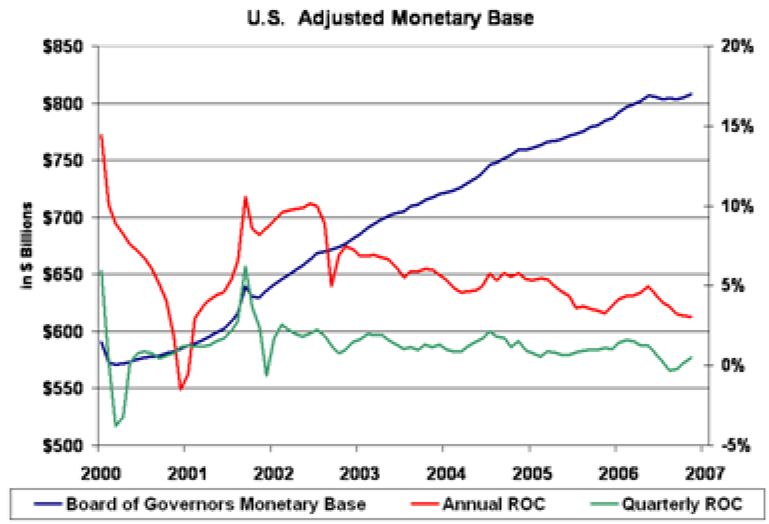
December 15, 2006

Recession Postponed

If the U.S. economy is headed for a slowdown, you wouldn't know it from the employment report for November. The numbers again confirmed the persistence of a Goldilocks economy -- neither too hot or too cold, but just about right.The figures, released a week ago Friday showed that jobs on nonfarm payrolls rose more than is typical in November. Before seasonal adjustment, the overall increase ran 318,000 jobs. After adjusting for normal seasonal variation, the officially recorded increase came to 132,000, above the consensus expectation of 100,000. The change was widely dispersed before seasonal adjustment, depending on the industry. For example, employment in the retail sector always rises faster in November than in any other month of the year. Most of the holiday hires are then laid off in January. This time, retailing employment rose by 395,000. Since that was deemed more than usual, BLS statisticians turned it into a seasonally adjusted increase of 20,000. On the other site of the ledger, the onset of cold weather always brings a decrease in construction employment in November. This time, the decline ran to 139,000. That was thought to be a bigger drop than normal, so it became a seasonally adjusted decrease of 29,000. Overall, however, taking into account revisions to prior months, the cumulative seasonally-adjusted gain recorded in November ran 174,000, well above the consensus expectation. The November unemployment rate was essentially unchanged at 4.5%, still at around a five-and-a-half year low, and signaling a tight labor market. In fairness to those who still anticipate an economic slowdown, the labor market is a lagging indicator but it sure is far from showing any weakness whatsoever. Many economists caution that weakness in the housing market is going to cost us official construction jobs and unofficial “handyman” jobs which then deprives the economy of buying power and thus causes a recession. This may very well come true, certain statistics, however, indicate that time is running out for the economic bears.



The proprietary Leading Home Price Index of the Economic Cycle Research Institute (ECRI) bottomed in August of this year and looks like it wants to climb higher. The Index is designed to lead cyclical swings in real (i.e., inflation-adjusted) median home prices. It is, according to the institute “a summary measure of the best leading indicators of U.S. home prices.” The possibility of a bottom in housing only one year after it reached a peak was also confirmed by the mortgage applications for home purchases, which soared last week, extending a trend begun in early November and providing convincing evidence of a pickup in housing activity. The Mortgage Bankers Association's weekly index on mortgage applications for home purchases increased to 463.8 in the week ended Dec. 8 from 426.6 the previous week. The index is at its highest level since the week ended Jan. 20. It was the sixth week in a row above 400, the most times above that level since January. Last but not least, the action of housing stocks seems to confirm that some kind of bottom (whether temporary or not remains to be seen) has been reached in the housing market. John Mauldin wrote a recent article where he posed the question: When Will the Housing Market Bottom? He consulted a host of very smart people who in the aggregate seem to be of the opinion, that we are only halfway through the current downturn in housing. I will not shrugg off this possibility from so many smart researchers, but I see no evidence that the current weakness is getting worse or that the weakness spreads to other parts of the economy. On the contrary. Look at the two charts below:



The **Index of Leading Economic Indicators** (published by ECRI) is almost booming. It has been productive in the past to heed its messages, even though the individual components are published by their respective sources earlier than the actual index is published by the ECRI. I like the index though, because it graphically shows us in a somewhat timely and intuitive manner what is going on in the economy. Leading the LEI upward in order of influence were the money supply, consumer sentiment and stock prices. If the ECRI's claim is true, that the WLI has an average lead of 10 months at business cycle peaks and three months at business cycle troughs then this indicator is signalling that a recession is not around corner just yet. The chart above on the right shows the **U.S. Monetary Base**, adjusted for changes in reserve requirments. Definition: The monetary base is made up of the currency held by individuals and firms and bank reserves kept within a bank or on deposit at the central bank. After a period of six months when the Fed's injections of liquidity into the banking system had flattened, the injections have started to increase again, probably reflecting an increase in demand for money. The monetary base, which measures the amount of reserves in the banking system, is almost constantly growing, reflecting the steady growth in the U.S. economy and the Fed's facilitation of this growth through liquidity injections. During periods of Fed tightening, the growth in the monetary base normally slows. The monetary base stopped growing in May but it has increased over the past six months, ever since Bernanke stopped raising interest rates. Interestingly enough, that was also the time when the stock market regained its footing and started to rally. They say that the bond market is the bigger and smarter brother of the stock market. If bond traders are so smart, why could they not see, that the economy is doing better than almost anybody expected? Many smart people, especially some very smart money managers, were caught wrong-footed by the resilience of this economy. This week's data definitely put the idea to rest, that the Fed will lower interest rates early next year. Some even expected rate cuts by January. The conundrum of the inverted yield curve (and the concomittant prediction of an impending recession) remains, though. That means unfortunately that everybody is left to their own devices when it comes to explaining the reasons for this peculiarity. I believe that it is Wall Street's creation of $ billions and billions of credit derivatives that created this enormous and at this stage in the cycle unnatural appetite for bonds, thereby causing an inverted yield curve, which fooled many of us into thinking that the economy was about to keel over. That idea was alos put to rest this week.

Hermann Vohs

It is incumbent on every generation to pay its own debts as it goes. A principle which if acted on would save one-half the wars of the world.

Thomas Jefferson