Worst Is Probably Over For This Schizophrenic Economy Dec. 15, 1987

Significant changes in ASC economic factors and market indexes during the past month are summarized as follows expressed in standard deviations around the norm:

	December '87	November '87	Change
Consumer Confidence	.08	1.29	-1.21
Delinquencies	-.14	2.08	-2.22
Consumer Spending	-1.10	.02	-1.12
Real Income	.20	-.64	.84
Demand for Credit	-.17	.46	-.63
Big Cap Market Index	-.59	1.15	-1.74

Indications of consumer activity after October 19 reflect significant weakness. The consumer confidence index fell sharply from 115.1 in October to 96.3 in November. Retail sales at $125.8 billion represent the third month in a row that sales have been soft. Recent releases in nominal terms are misleading because the precious months have been restated downward significantly. Savings increased to 4.9% up from 2.2% in August. It appears that the consumer has started to pull back in earnest. Recent indications of December spending activity point to a firming. The "sort of" recession that we discussed in August 1987 suggesting a "Semi- consumer, semi-tight money, and semi-trade" type has arrived. The percentage of economists looking for a slowing has increased to 35% up from 8% in September. Our August position now seems to be a consensus. The Optimists take encouragement in strength in employment, production and improvements in international trade. The first two series provide little comfort since these are lagging indicators that cannot remain strong unless the consumer picks up soon. Significant near term improvements in trade in normal terms are being delayed because of the weak dollar but should be a significant positive in 1988. The Federal Reserve eased to provide liquidity on October 19 but has subsequently resumed it's somewhat restrictive course. The Fed probably will not ease significantly until inflationary expectations are dampened which should occur with evidence of a weaker economy. The risk of a recession worse than a "sort-of" type is being increased by the Fed's reluctance to follow through. Net, net taking into account ASC's leading indicators which fell and ASC's lagging indicators which were steady and the importance of each, it appears that the overall economy weakened last month.

There are several scenarios being circulated suggesting that improvements in international trade and increases in non-auto inventories are enough to keep the economy out of a recessional in

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1988. Such could be the case technically, that is we might not suffer two quarterly declines in real GNP, confidence will be lacking. The only way to get past the recession, whether real or perceived, is for the consumer to cooperate. The consumer needs a rest to reliquify. For the current over-extended consumer to get back to normal, it would appear that the savings rates might have to exceed 6%, up from 4.9% currently. Real income is picking up and delinquencies are down. Based on current levels of income, with consumer spending flat, the savings rate should soon exceed 6.5%.

Key factors to watch regarding the consumer are confidence and initial unemployment claims. While we have seen confidence decline considerably, employment outside of autos and brokerage firms has continued firm. Nonetheless, claims are slowing increasing. There has not been a sharp break in consumer activity; it has been a gradual pull-back that started in the first quarter of 1987. Adjusted for inflation, retail sales are declining at an annual rate of 4%. The first signs of weakness in areas outside of the consumer have been weak spots in the paper industry and disappointing orders for IBM's new mid-sized computer. The question now is whether the lagging areas start to weaken along with consumer. One cannot rule out the latter.

Many investors who got back in early paid too much attention to some of the strategists that were right for the wrong reasons. There were many saying that the problem with the market and earnings-driven groups was that the economy was overheating and soaking up liquidity needed to keep the marketing healthy. Such strategists advocated avoiding bonds and jumping into the cyclicals because with a strong economy those groups would do well with higher inflation, higher interest rates and weaker dollars. It has been difficult to make money by buying stocks of any type at any time since September 1987. For those following SAR, in August we pointed out the risk of a recession, in September we said "cash was king", in October we favored bonds, and in November we urged staying with a disinflation defensive strategy. To be right for the right reasons before and after October 19, one needed to see the problem the Fed was going to have in getting caught between the dollar and the economy and advise moving into defensive groups such as electric utilities, telephones and gas utilities. The SAR model demonstrated its ability to anticipate since we saw the problems in advance and selected the groups to benefit even in these extraordinary times. It is evident that the pain of being early and uncomfortable by following SAR is preferable to the pain of being too late and uncomfortable in ignoring SAR. If advice is comfortable, it is probably wrong. We have frequently discussed the benefits of using SAR's risk-adjusted approach to help one stay ahead of the market in good times and avoid giving back those gains in bad times. The recent period should have demonstrated to our subscribers and to their clients the benefit of a risk-adjusted approach.

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One might ask how can all those analysts, who were bullish on earnings-driven groups because they foresaw a booming economy and no problem with a recession, face themselves and their clients with a confident demeanor after what we have seen over the past three months. It is very simple, just change your forecast because of the market. With the reduced wealth effect, analysts are lowering earnings estimates and lowering their forecasts on GNP growth in lock step. There seems to be a little basis for their lowering an earnings estimate for many U.S. industrials because of the market declined (unless the industrial was a significant holders of securities). Our work shows that the same stock prices rise or decline, street estimates follow in the same direction on a lagged basis for whatever the reason. If one had been tuned in on SAR, one would have had a recession mindset in August looking for signs of problems with consumer spending, tight money effects and problems with the dollar. Over the past four months, declines in housing, auto sales and disappointing retail sales were occurring before, during and after the market decline. Remember the early disappointment at Gao, Limited and Liz Claiborne? Those in our camp saw through the excuses for lack of sales such as product shortages or errors in styles. These were signals that fitted into a pattern of slowing. The analysts that missed what was happening and are now trying to blame it on the market are trying to hide their mistakes.

Where do we go from here? There are some hopeful signs that point to an improvement but it is somewhat early to call at this point. The worst is probably over. Although there may be little improvement over the next few months, there probably will not be major disappointments either. The officials have been put on notice and are actively trying to avoid a recession before the 1988 elections. The odds of avoiding a significant downturn now appear favorable. At some point in 1988 possibly by the second quarter, a strong industrial economy paced by recovery in exports, capital spending, and agriculture may be underway. For the near term, Japan’s trade surplus is diminishing without directly helping the U.S., and the German economy is slowing. Japanese and Germans are not rushing out to buy U.S. products because of the lower dollar.

Economic observers seem to be falling into a two conflicting views of the economy. There are those in our camp that are worried about a recession because of the weakness in leading indicators such as consumer confidence, retail sales accompanied by tight money and high interest rates. The other camp that is looking at industrial production, employment and international trade is seeing an economy that appears to be accelerating. How can we have both? Is the economy schizophrenic? How long can these opposing forces last? The link between the two is confidence. The last of confidence evident in small cap cap stock price behavior and corporate buy backs suggest that there is no future being in business in the long term in America. We need to see renewed confidence in the future so that capital investments and inventory

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increases will lead to increased real personal income which would give the consumer a boost and help keep the economy on a sustainable growth trajectory.

Based on the current economic climate we would use our cash to buy good long term disinflation growth companies, hold onto our bond position and positions in the following equity groups; gas utilities, electric utilities, regional phones, insurances, foods, and commercial banks. For those followers of SAR that have a cushion over the S&P 500 and can afford a bad month or a bad quarter, now is the time to accumulate solid long tern companies that had gotten too expensive before October. On our list we favor the following: Tyson($13.875), Loews ($68.25), Dayton Hudson ($26.25), Deluxe Check Printer ($23.50), Lowes Cos ($16.375), Pepsico ($30.375), Farmers' Group ($40.00), Shoney ($21.25), Kellogg ($51.00), GPD ($24.875), Borden ($45.375), American Home Products ($68.625), Wal Mart ($23.125), Disney ($54.75), Kaufman Broad ($11.50), and House of Fabrics ($12.375).

Note: On a production basis we have decided to start producing the SAR book and newsletter after the first two weeks of the month instead of at the beginning of the month. The quality of our work should improve somewhat by avoiding the end of month activity and by incorporating key economic series when that are fresh.

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