

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Analytic Systems Corp.



JOHN M. MOFFATT is President of Analytic Systems Corp. Prior to establishing the firm in 1982, he was an analyst with Citicorp, Arnhold and S. Bleichroeder and Blyth Eastman Dillon. At Bleichroeder, he worked with George Soros on the forerunner of the highly successful Quantum hedge fund. He has provided Sector Analysis Research, professional advice on sectors, to some of the leading portfolio managers in the US for over 25 years. He graduated from the University of Texas at Austin and has a Master of Science degree from New York University.

TWST: Would you please give us an overview of Analytic Systems?

Mr. Moffatt: We provide a strategy service on industry selection. We basically focus on trying to help portfolio managers with their industry bets, whether they underweight or overweight a specific industry. One might characterize our service similar to a fishing guide in a lake. It's a lot easier to catch fish if you are fishing in the right part of the lake. Of course, there are a lot of variables, such as wind direction, water temperature, ridgelines, that influence where the fish are. We analyze macroeconomic factors to determine which industries stand to benefit from current macroeconomic trends. It is a lot easier to be a good stock picker if one is looking in the right sectors. I think the most important point to remember about our approach is that it is fact based. We have a factor model that is fact based, that has a long track record of making significant calls early, well in advance of their occurring, for over 25 years — since we founded our company in 1982.

TWST: When you say fact based, what does that mean?

Mr. Moffatt: There is no economic forecast involved. A lot of the analysts are trying to get an advantage by making better economic forecasts, and then based on the economic forecast, they are

trying to determine which industry groups are likely to benefit. Our approach does not require a forecast; it's a lot easier working with facts than with forecasting. Forecasting is difficult, very difficult. So what we've found is that there is a kind of pipeline effect before abnormal changes in economic factors affect the relative return of stocks and industry groups.

In other words, the relationships that we work from are with lagged stock price returns in relation to changes in economic factors or leading economic factors as compared to stock prices, so it's fact based. We provide the model with the latest facts; the model ranks our 41 industry groups to arrive at the industries that are most favored over the next six to 18 months. These rankings are based on how industry groups have responded to macroeconomic changes in the past. We are basically making the assumption that history has relevance and that if you examine what has occurred in the past and you look at the facts today, we have a good inkling of what is likely to occur in the future, which groups stand to benefit and which groups stand to be adversely affected by current fact-based trends.

TWST: How many factors go into this calculation?

Mr. Moffatt: Twenty macroeconomic factors that are drawn from 45 key economic series; there are 12 domestic factors

and eight international factors. What we've done is come up with the best subset of macroeconomic factors to produce alphas, excess returns in a portfolio. What we've been seeing in recent years is that international factors are taking on increased importance. For example, in April 1997, Japan imposed a consumption tax and people bought ahead and then subsequently consumption fell sharply, which put their economy into a tailspin. The fact that Japan went into a tailspin (in our economic factor model) changed the global supply and demand balance from reflation to disinflation. The slump in Japan, along with the other Asian countries that culminated in 1998, took out about a million barrels a day of demand for crude oil. So we got a reading on US companies based on what happened to Japan. The US shifted toward disinflation as opposed to commodities and inflation plays — primarily based on what happened in Japan.

data isn't as clean. It's a real challenge to come up with proxies for what is going on in China.

TWST: I guess what they tell us isn't necessarily accurate.

Mr. Moffatt: Sometimes that is correct. They tell us what they want us to hear.

TWST: What do you do in a case like that?

Mr. Moffatt: We have other measures that you can use to try to get a sense. Commodity prices are a good proxy for what's going on with supply and demand. Dry bulk rates show us shipping rates. We kind of have to go around the edges because there is not a direct link into China as to their inventory levels or their order rates because they are just not available. So you have to be somewhat creative, such as with steel scrap prices, copper prices and those types of series.

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TWST: Has this been back-tested?

Mr. Moffatt: Yes. We have done a series of tests to determine which factors are most robust in producing alphas. Every factor that we have included has shown to be robust in producing alphas. There are many series that investors pay a lot of attention to that they shouldn't. For example, consumer confidence we have found to be useless. There is no value in the survey of consumer confidence. It is not what consumers say they are going to do, it's what they actually do. We have eliminated consumer confidence as a factor, and we have replaced that with one of the most significant single series, initial unemployment claims. Initial unemployment claims results come from state governments and they are not as subject to revision as the establishment survey or the household survey. Claims are one of the best series to watch as opposed to consumer confidence.

TWST: So it's been sorting out and testing and figuring out what works?

Mr. Moffatt: That's correct and also incorporating new factors that try to keep in sync with the evolving world economy. As we know, Japan and India and China are taking on increased importance in a world economic climate; the challenge now is to add factors for China. They are not as transparent, are not as open, and the

TWST: So you have to look at other numbers to find out what's happening in a market like that?

Mr. Moffatt: We have to look at the effects on the markets and of course there are other sources of demand besides China, but increasingly the growth is coming from China, so we can get some kind of a direction. I'd say on that note that we made a significant call in March 2008. The headline on our report was “On Commodities Crash Alert,” and at that time, people were enthralled with commodities, and crude oil in particular. Crude oil peaked at around \$148 a barrel. On industry group weightings we went to an underweight in energy. We were talking about a crash in commodities. We advised our clients to be careful because the US economy was slowing and as the US goes, so goes the rest of the world. There were services that countered, with the idea of “don't you know that the rest of the world is decoupled from the US?” That's one of those assumptions like it's different this time, which our model doesn't buy. Our model is based on past macroeconomic relationships, which held true once again. Crude oil has gone from \$148 to below \$50 a barrel, and copper and other metals have come down sharply also. If you look at the commodities chart, we were in a boom phase and now we've been in a bust phase. So we have had a crash of sorts in commodities.

TWST: At least it's not a collapse.

Mr. Moffatt: That's not the only thing. We've had crashes in a lot of markets.

TWST: As you look at it today, what is it that your information is telling you, given the unsettled nature of this economy?

Mr. Moffatt: In our latest report, we had the greatest negative change that we have seen since I've been doing this processing in the late 1970s. We have normalized our factors, and so they are unitized so we can sum them up. The range of the sum of the factors had been between 80 and 120, 80 was in 1982 when we had 10.7% unemployment and 120 was in 2000 when we had a booming economy. Last month the sum fell to 73. So we had the largest negative change we have ever seen; it's unprecedented. The economy hit the wall and hasn't had a bounce yet; we are in somewhat of a tailspin.

sent out didn't help much and there is nothing in the pipeline to help the economy over the next several months. So we are between Presidents and we are in a dead spot. The economy is going to do what it is going to do.

There are positives. One is the decline in oil prices, which will help our trade deficit and also help consumers; a lower price of gasoline will take some of the pressure off on the cost of necessities and reduce the trade deficit. The import component of the trade balance should decline, and we should see progress in imports net of exports. Those are the only two positives that we can see currently, but that's the call that everybody is expecting us to make, and we think we can make it. We've typically been early, but the model and the data, as we stated previously, have not given us the signal that the economy is starting to turn for the better even by a diminishing of negatives.

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TWST: As your data indicate, when is it going to stop?

Mr. Moffatt: We have to see the depth of the decline. I mean, the big call that people are looking to us to make is when do we go from a contractionary deflation to a recovery. And what we've talked about in the last several months is that the economy is decelerating so sharply that you have to get a sense of where the bottom is before you can see the bounce, see the recovery on the other side. So far there is no sign of any deceleration in that decline. We are falling off rapidly. Our model will be influenced as the rate of change diminishes — in other words, when we go from an economy that's having negative growth of 4.5% to 5% to negative growth of 3.5%. Our model will pick that up as a positive change, but we haven't seen that yet. It's too early to make that call. It was too early in October and so far in the November data, the latest data that we have available, there are some scattered signs in improvement. They are very slight, and not enough to offset the large declines that are taking place.

The basic deal everybody knows is that the consumer is deleveraging, the public sector is leveraging and the banks and the corporations are deleveraging. And so there is massive deleveraging going on, and the government is focusing on bailouts and hasn't done much to help the real economy yet. The rebate checks they

TWST: As things begin to line up, what would you be telling investors to do at this point?

Mr. Moffatt: Right now we are kind of hunkered down and keeping our powder dry and waiting to see how the economy evolves. However, we have an inkling already that the other side of this deflationary contraction is a reflationary recovery, and so whereas equities and bonds are discounting deflation, the inflation protected five-year Treasury is yielding more than the five-year Treasury bond, which is saying in effect that we are going to have a deflation for the next five years by a small amount.

TWST: Did you say deflation?

Mr. Moffatt: Yes, the Treasury spreads are telling us that we are going to have deflation. The point we made in our latest report was that it's highly unlikely that we are going to have deflation in the next five years because food and energy only make up about 24% of the CPI, 42% of the CPI is housing. The housing component is based on rental equivalence. Rents are fairly stable. Other components such as transportation, education, and health care are not likely to decline either. So we believe that the current hysteria that we're seeing in the bond market with a 10-year yielding 2.55%, well below the inflation rate, is creating another bubble. The next bubble will be in Treasuries; that's where we are seeing the bubble develop right now. So the

thing to be mindful of is, these bubbles all burst eventually. I wouldn't want to be over-committed to Treasuries when that bond bubble bursts.

On the other hand, there are evaluations that are compelling if one assumes that the economy recovers and that we have a normal rate of inflation once again. Inflation protected Treasuries are one area, but there are many others that will benefit going from deflation to reflation, but we haven't made that call yet either. That call is in the wait-and-see attitude, wait to see the end of the sharp downdraft in the economy because it's all tied in together. When we have a severe downdraft and the expectation is it's going to lead to another severe recession or possibly a depression, the question becomes, is the downdraft going to have a self-reinforcing nature in which weakness leads to further weakness? Weakness in consumption leads to employment cutbacks and lower jobs growth, which leads to lower real income growth, which in turn leads to lower consumption and so forth. So it's a type of reinforcing cycle that gets going that's hard to stop. If, however, we have a pattern where weakness leads to strength in which we have a tremendous implosion, and a mean reversion in which the economy gets its footing and people start investing in areas that make sense in a reflationary environment, then there will be opportunities there.

TWST: What's going to be the signal of which way things are going?

Mr. Moffatt: There is not a single signal, but instead the industry group rankings of our model. Our model has been very helpful in calling these turning points in the past, and so we watch the groups. When the defensive groups such as utilities and foods move up in rank, we become more defensive. When economic sensitive groups, such as technology, electronics, materials, rails, those move up in rank, then we become more positive. We watch our industry group rankings. There is a mean reversion nature to our model, and so the worse things get, basically the better things will get subsequently, so we watch our groups.

The one scenario that would put us in a hole would be if we had a halfhearted recovery that wasn't sustainable, such as we had in 1980. We had a V-shaped recovery in 1980, but inventories were still high when we finished the recovery and so it led to a long

and drawn out recession in 1981 and 1982. Eventually the Federal Reserve had to raise short rates up to 22% to kill inflation. So the V-shaped recovery that we had in 1980 did not turn out well. We don't have that case today because the trend of inflation is a lot lower than it was then, and the consumer is highly leveraged. So we are unlikely to have a repeat of that environment. We watch our industry group rankings. We make changes based upon that, so that our group ranges stack up.

TWST: At this point, are they saying sit on your hands and keep an eye out?

Mr. Moffatt: There are some positive indications. The group rankings turned quite negative in September with the defensive groups moving up in rank, and since then we have been going back and forth, it's not clear which way we are going to go. There are indications that we could have a V-shaped type of recovery in the middle of 2009, but we are generally early and so we can wait on seeing how sustainable those increases in the industry groups are. If we continue to see the rankings improve for groups that usually lead us out of a downturn, then we will become more positive. There are inklings of positive signs, but they just haven't yet gelled to the extent that we are committed to make a more aggressive move.

TWST: So stay tuned.

Mr. Moffatt: That's correct.

TWST: Thank you.

Note: Opinions and recommendations are as of 12/8/08.

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