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How to Form a Long-Term Trading Outlook

I can't speak for other professional traders, but I am always wary of economic indicators produced and released by the government, like GDP and Unemployment. I went to undergraduate and graduate school at the University of Chicago, and on your first day of school, they make you walk through an old stone arch out in the Quadrangles. It's a rite of passage, signaling the beginning of your "Chicago school" education, and engraved deep within the stone arch, in Latin, are the words "And the truth shall set you free."

I studied under some wonderful professors there: Dr. Milton Friedman, Dr. Victor Zarnowitz, Dr. Beryl Sprinkel, Dr. Carl Sagan, David Mamet—I even had an office next to Studs Terkel near the end of my studies in the Graduate Schools. (Studs recently passed away—and we all went out and had a beer to celebrate his life at the local pub we used to hang out at and listen to his stories about the world when he was "young and frisky.") One common thread linked what all these great thinkers taught me: "Believe what *you* know to be true. When someone tells you something is true, take it and examine and prove to yourself that it is indeed the truth."

I spent several years working on a Bureau of Labor Statistics GNP (now called GDP) Revision Study headed by economist Dr. Victor Zarnowitz at the University of Chicago Graduate School of Economics. Dr. Zarnowitz is still one of the world's leading scholars on business cycles, indicators, and forecast evaluations. The Bureau of Labor Statistics study examined the link between a specific GNP number and the revisions released subsequently to that original GNP number, looking for any repeatable patterns. The most important pattern became apparent early on: When the US economy was in good shape, there weren't many revisions following the original release of the GNP data, but when the US economy was heading into a recession, the number of revisions following the initial release soared. And worse, the original revision tended to be followed by further revisions, eventually stabilizing the originally released GNP number at a much worse level. It was as if the government wanted to leak the bad news a little bit at a time.

We stayed away from pointing out the potential political motivations that might have fueled such practices, but the reasons were obvious: If things look bad heading into an election, or if the turn down was becoming particularly severe, it would be easy enough to release a "more robust" GNP number, and then slowly lower the originally rosy GNP number in footnotes that no one pays much attention to as each succeeding set of GNP numbers are released down the line, finally bringing the original GNP number down to the level where it should have been.

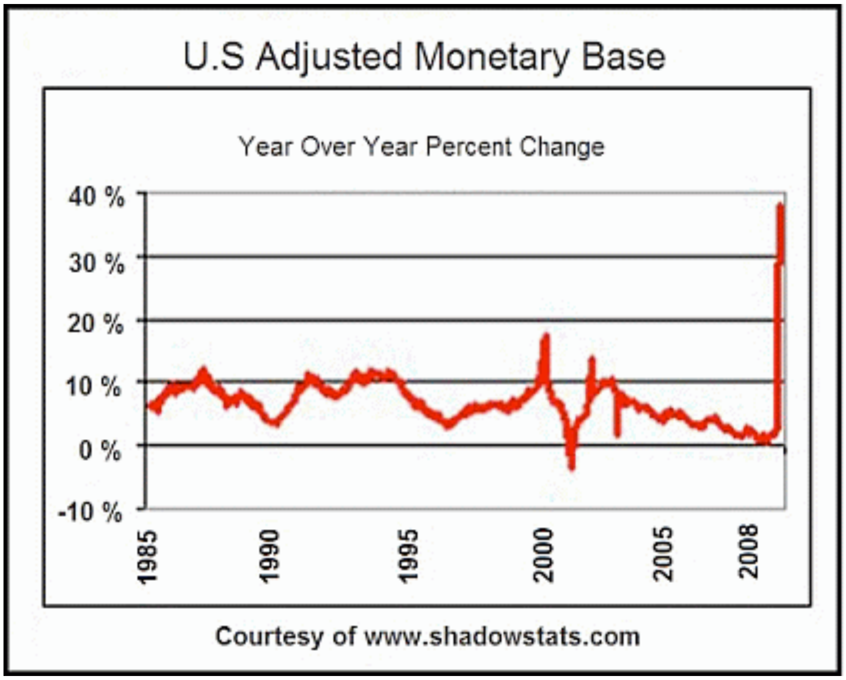
If you pay any attention to the major economic releases in the United States, you'll know that this pattern is even more prevalent now than when we did the original study in 1979-1980. Once you know about this pattern, you never look at the government released economic statistics in the same light. For instance, we have been in a recession for at least the last four months, and you can make the case that if you adjusted the current GDP growth with a realistic rate of inflation (instead of the "massaged" US government GDP measure of inflation), the US has been in a recession since early 2007! How bad are the revisions? The government originally reported in early October 2008 that the economy lost 240,000 jobs. One month later, the negative revisions released in the footnotes of the November unemployment figures increased that same October's job loss figure from a loss of 240,000 jobs to a net loss of 419,000 jobs! And if you don't like these numbers, just wait until they release the numbers next month—they're sure to revise them even lower!

I don’t trust government-produced economic numbers. I have no interest in them. The US government shows inflation running at roughly five percent on an annualized basis right now. While at the University of Chicago’s Graduate School of Business, I was privileged to study under, and then call Nobel Prize winner Dr. Milton Friedman, one of my mentors. Dr Friedman was the “founder” of the “Chicago School” of economics, a form of economic philosophy that stressed the advantages of the marketplace and the disadvantages of government intervention and regulation. He taught that a steady expansion of the money supply was the only wise governmental policy. Steady money supply growth means a stable rate of sustainable economic growth, with a low rate of inflation. In a nutshell, monetarists like Dr. Friedman (and myself) believe that large increases in the money supply lead directly to large increases in inflation experienced by the individuals in any economy.

Before the recent bailout madness, inflation, as measured by the growth of the widest form of the money supply, M3, was running at roughly 17-20 percent in the US on an annualized basis. And given the increases I have seen week in and week out at the grocery checkout, the soaring price of all forms of energy, and the double-digit increases in my health care and health insurance bills each year, I think this number has been just about right. Three years ago, my grocery bill for our family of four was always under $150 a week—now we celebrate if we leave the same grocery store with a weekly bill under $300!

“Bailout mania” has hit our lawmakers. Some of you may feel the bailout package was a good thing, others may think its more government madness. Here’s a very scary statistic: Since the bailout bill was announced, the US money supply has surged an additional 38 percent on an annualized basis! This will translate directly into a tremendous amount of inflation. There are plenty of forecasters telling people the worst is over…The sad truth is that we haven’t even begun to feel the pain yet. We are headed for massive unemployment and a significant dose of inflation, unless the recession turns into such a deep depression that the country’s demand for goods literally collapses—heaven help us all if that is the outcome of this mess.

Let’s take a look at the recent run away growth of the money supply, courtesy of a fascinating web site, www.shadowstats.com:



I keep my own version of M3 on hand-drawn charts, but like all my hand-drawn charts, I keep them private and do not publish them. At some point in 2006, with M3 growing at over nine percent (even after the Fed had massaged it lower through their meaningless seasonal adjustment process), the Federal Reserve decided to abolish the measure and literally forbid the regional Federal Reserve banks from publishing the seasonally adjusted components of M3, as well as the actual M3 number—probably because the government was currently putting out CPI and PPI numbers that showed inflation was in the two or three percent range. Luckily, once you know how M3 is constructed, it's relatively easy to create each month's M3 number yourself, unless you also want to use the government's seasonal adjustment factors—those numbers are not published, nor are they available to the public. I personally do not work with seasonally adjusted indicators—I prefer the raw number series.

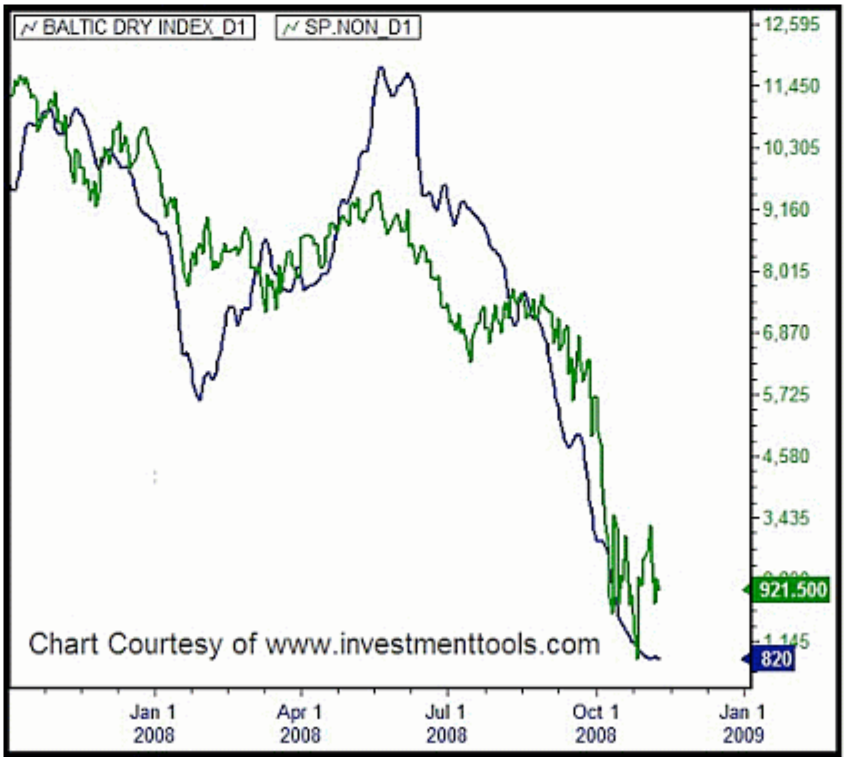
Do I follow the inflation numbers? Yes, I do. I follow them religiously. But I don't follow the government's inflation numbers. Instead, I follow my own calculations of the money supply, done on an Excel spreadsheet, and I thank Dr. Milton Friedman for teaching me the link between the growth of the money supply and the growth of inflation. And I thank Dr. Victor Zarnowitz for teaching me the value of knowing how all these economic numbers were forecast, how they could be manipulated, and as I learned while working on the BLS study, how these economic releases *are* manipulated on a regular basis. I know not to trust any of the numbers released by the government.

Is there a leading indicator I watch on a regular basis, as a measure of economic activity? There are several, but the easiest and cleanest is the Baltic Dry Index, or BDI. According to the Wikipedia, the BDI is "a number issued daily by the London-based Baltic Exchange, which traces its roots to the Virginia and Baltick coffeehouse in London's financial district in 1744. Every working day, the Baltic canvasses brokers around the world and asks how much it would cost to book various cargoes of raw materials on various routes (e.g. 100,000 tons of iron ore from San Francisco to Hong Kong, or 1.000,000 metric tons of rice from Bangkok to Tokyo)."

Because it provides "an assessment of the price of moving the major raw materials by sea," The Baltic "...provides both a rare window into the highly opaque and diffuse shipping market and an accurate barometer of the volume of global trade—devoid of political and other agenda concerns."

Other leading economic indicators—which serve as the foundation of important political and economic decisions—are often massaged to serve narrow interests, and subjected to adjustments or revisions. Payroll or employment numbers are often estimates; consumer confidence appears to measure nothing more than sentiment, often with no link to actual consumer behavior; Gross national product figures are consistently revised, etc. Unlike stock and bond markets, the BDI "is totally devoid of speculative content," says Howard Simons, an economist and columnist at TheStreet.com. "People don't book freighters unless they have cargo to move." *(BDI description and content provided by Wikipedia)*

Here's a fascinating chart of the BDI over the past year with the S&P 500 cash index laid over top of it so you can see the direct correlation between the demand for freighters and the prices of stocks in the United States:



This chart is courtesy of another fascinating website, www.investmenttools.com, and besides this chart, you can find the BDI plotted against the price of gold, oil, or soybeans, among other things. I simply do my own hand charting of the BDI, directly from the Baltic Web site, but if you want to keep an eye on it for a glimpse of future economic activity, investmenttools.com is a nice site with some interesting charts updated on a regular basis.

Even though I mainly make my decisions on technical analysis, I do keep track of a few independent statistics or indicators that I chart myself, and I use them to give me a feeling for whether the economy is expanding or contracting, whether money supply is growing at a reasonable rate, contracting, or growing out of control. I use a handful of these statistics to "frame" the long-term fundamental view I have running somewhere in the back of my head. I would never take a trade based on a change in either M3 or the BDI, but both of them help me know the direction the long-term winds are blowing.

I wish you all good trading!

Best,

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