PREDICTABLE INVESTING
HISTORY LESSON – July 2007.
MIDYEAR INDICATOR UPDATE

1.0 INTRODUCTION: The first half of 2007 is now history, a period that saw the S&P500 and the DJIA hit new all time high record levels, before finally pulling back slightly. This History Lesson presents the current state of our five indicators as of midyear 2007, and discusses what they are saying about the current health of the stock market.

2.0 TREASURY YIELD SLOPE (%): Is the difference in interest rates between the 20 year T-bond and 3 month T-bill. A “normal yield curve” has a positive slope, where longer term bonds pay higher rates of interest than shorter-term bills. On the other hand, a “negative yield curve” is an abnormal situation where the long-term interest rates are lower than the short-term ones. This unusual condition indicates that bond investors believe that there is high risk of a recession, and that the Fed will be forced to lower short-term interest rates to kick-start the economy. Negative yield curves are very often followed by a recession that starts about 6 to 9 months later.

The Treasury yield slope curve as of June 29 is shown below:

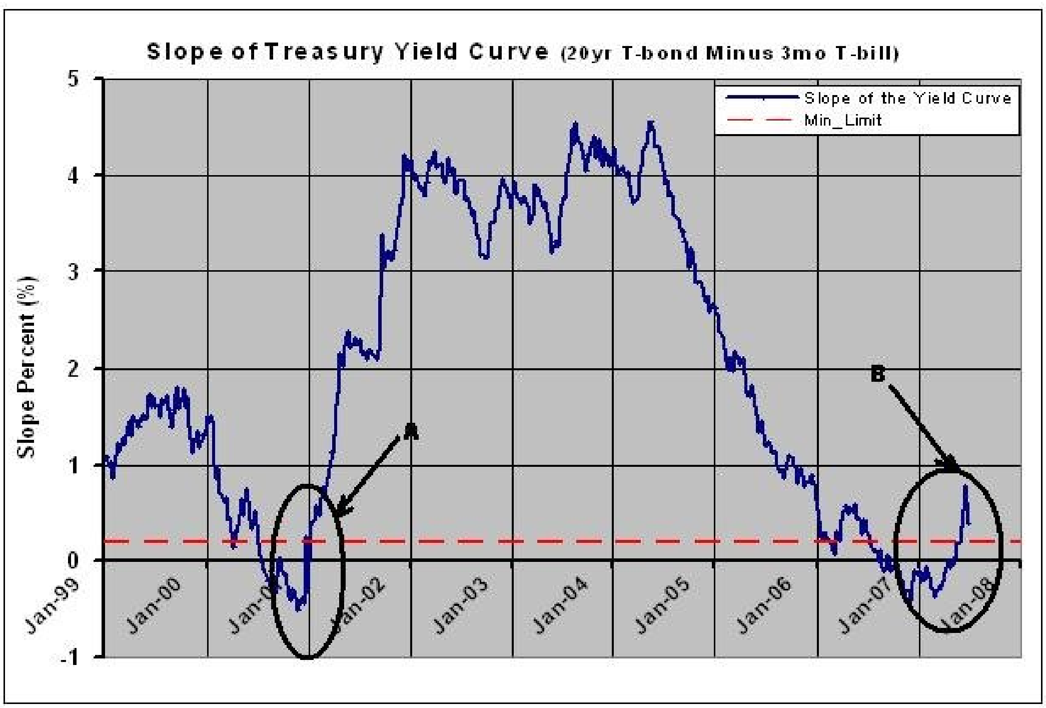

Fig 1. Treasury Yield Slope (%).

A = Negative Yield Slope mid to end of year 2000
B = Negative Yield Slope mid-2006 to Apr 2007

There were two periods with negative yield slopes during the last 10 years, and these are marked with black ovals A and B. The negative yield slope period A was followed by a recession that started in March 2001 and lasted for 8 months.

We have just recovered from the negative yield slope in period B, and will not know for a few more quarters as to whether it is the harbinger of another recession. The current yield slope is positive, indicating that conditions are right for future expansion of the economy. What is unknown is whether this 8.5 months of a negative yield slope will cause sufficient slowdown in the GDP to drive it into another recession.

3.0 FORWARD PE RATIO: PE(FWD) of the S&P500 is the price per share "P" divided by the **estimated** Earnings per share "E" (EPS) over the next 4 quarters. The current Fwd PE ratio is shown below.

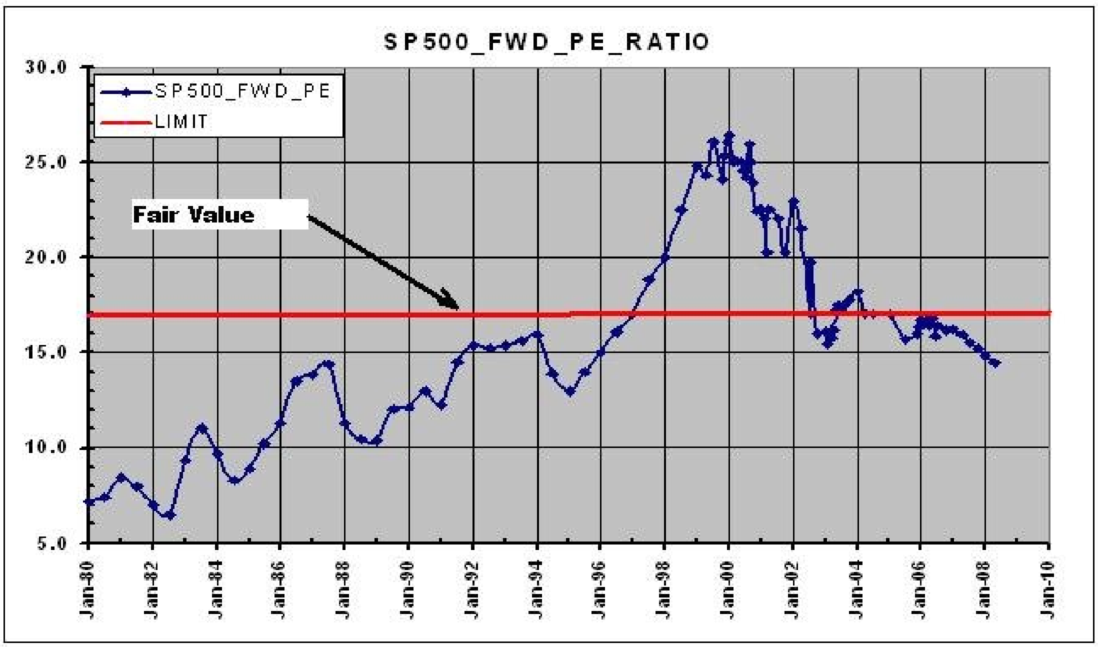

Fig 2. S&P500 - Forward PE Ratio.

Fair Value = 16.89

Note that the PE(Fwd) has been dropping steadily from early 2006 to the present day. Even though the stock market price "P" has increased significantly during this period, the corporate Earnings "E" has grown even faster and consequently the PE(Fwd) continues to decline.

The **Fair Market PE** Ratio is the average PE ratio of the S&P500 over a period of many decades, and from historical data, we currently estimate it to be 16.89 (red horizontal line in Fig 2). If the forward PE ratio is lower than the fair market PE, then the market is undervalued, while a higher ratio indicates it is overvalued.

The current forward PE ratio as of June 29, 2007 is 16.25, which is lower than the fair PE ratio of 16.89. This means that we are currently undervalued by 3.94%, and we therefore expect to see continued gains in the price of the S&P500 index.

4.0 PUT/CALL RATIO (PCR): This indicator measures Investor Sentiment. When sentiment is extremely negative (bearish), the market is usually forming an important bottom. This is because bearish investors expect the market to go down even further, have already sold all their stock, and there are no sellers left to drive the market even lower.

Conversely, when investor sentiment is extremely positive (bullish), the market is usually forming an important top. Bullish investors expect the market to go up further, have already bought all the stocks they can, and there are no buyers left to drive the market even higher. ***We count on the fact that investor sentiment is almost always wrong, and therefore this is a contrary indicator.***

Puts are stock options that bet that the market is going down (see Ref [5] on the Links page). Calls are options that bet on a rising market. Bullish investors buy Calls, and bearish investors buy Puts. A high volume of Puts relative to Calls (high PCR) indicates extreme bearishness, while a low volume of Puts relative to Calls (low PCR) indicates extreme bullishness.

The current chart of the PCR as of June 29, 2007 is shown below:

Fig 3. CBOE Put/Call Ratio as of June 29, 2007.

The S&P500 may be establishing a bottom at 1491.

Recall that peaks in the PCR correspond to bottoms in the S&P500, and that this parameter has had a great record of picking out market bottoms in the past. Three weeks ago the S&P500 (blue curve) hit a peak and then fell sharply, recovered, and has been bouncing around as investors wait to see if the current rally will continue or not. The fact that the PCR stayed at almost the same value of around 1.00 during this entire process probably means that this was just a quick down-up blip, and not the start of a new trend.

The market appears to be trying to establish a bottom at 1491 (horizontal green line), but we cannot be sure since the PCR is persistently hanging around the midrange of around 1.00. The PCR will have to reach a peak showing that investors have thrown in the towel and then pull back for a bottom in the market to occur. The vertical green line on the right with the "???" shows that we are not there yet.

5.0 REAL GDP (Annual % Growth): The Gross Domestic Product (GDP) is the sum total of all the economic activity that takes place in the country. **Real GDP** is defined as the GDP minus the effects of inflation, i.e., Real GDP = (GDP – CPI), where CPI (Consumer Price Index) is the annual headline inflation rate.

The chart of the Real GDP over the last 52 years is shown below:

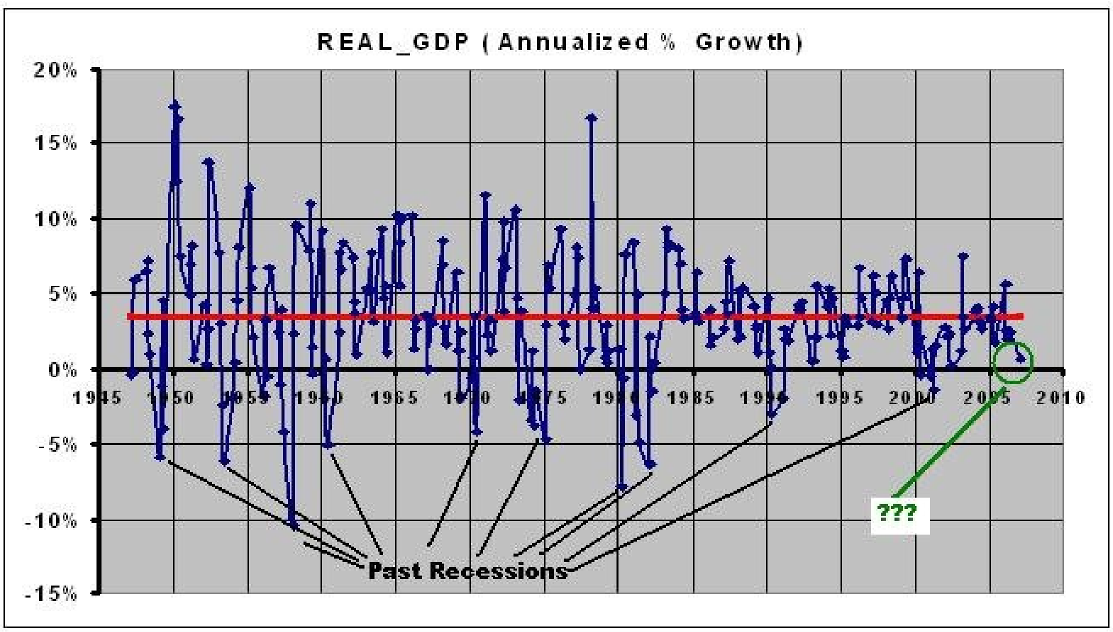

Fig 4. Annual Growth of Real GDP over the last 52 years.

??? - Are we headed for a recession?

During this period there have been a 10 recessions (marked in black), and the average drop in the S&P500 during each was a whopping -26.7%. It is therefore imperative for any market timing system to be out of the market during a recession. The big question remains as to whether the current low values of the Real GDP (circled in green and marked "???") will continue to trend down to negative values, or will recover. This indicator is the only one that is presently negative, and needs to be carefully watched for further deterioration.

6.0 CORE CPI (Annual % Growth): Inflation is measured by the Consumer Price Index, CPI, which is also called "headline CPI". This is the rise in the price of a predetermined basket of goods and services from month to month (reference [7]). Since the prices of food and energy fluctuate wildly from month to month, it is customary to track the "core inflation rate", which is the "headline CPI" minus the contribution of food and energy. The two CPI numbers, headline and core, are shown in the chart below:

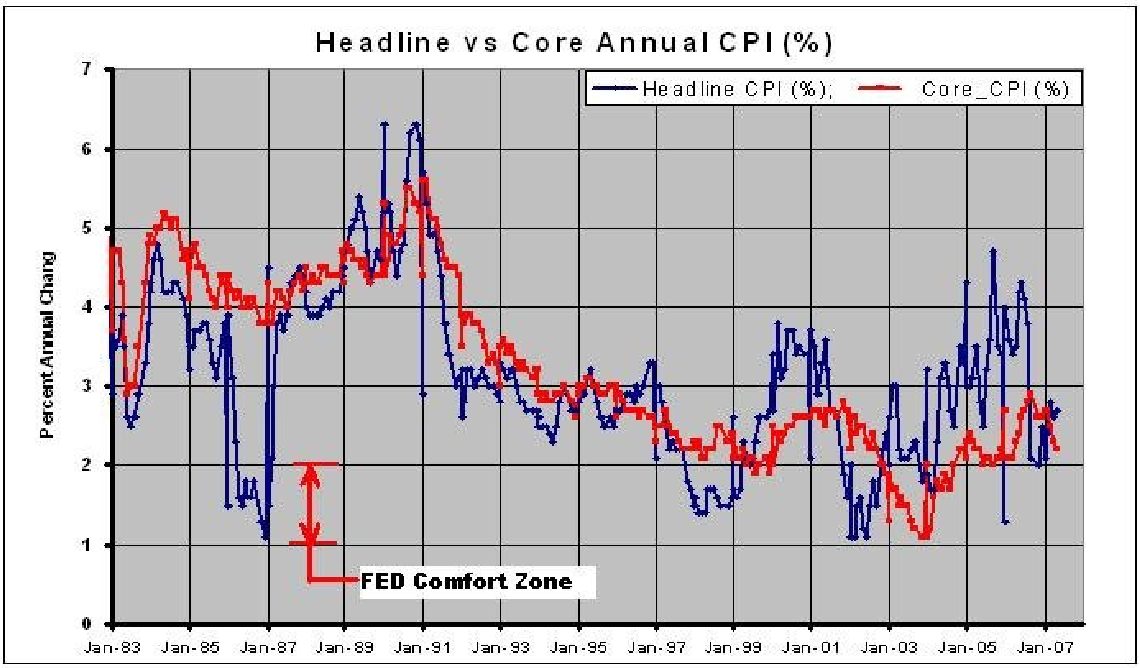

Fig 5. Compare "Headline" and "Core" CPI (Annual % Growth).

Note: Federal Reserve (Fed) Comfort Zone for Core CPI is 1% to 2%.

Core CPI (red curve) has generally trended lower over the last 24 years, while the Headline CPI (blue curve) has gyrated wildly, mostly due to the rapidly changing price of energy products.

The Core CPI is currently at 2.2% which is at the low of its range by historical standards. However the Fed in its infinite wisdom has decided that a range of 1% to 2% is its "comfort zone", and they seem to be driving the GDP growth lower and lower to achieve this. We point out the obvious, that the only previous time that core CPI was this low was in the 2003 timeframe, when we were just coming out of a recession. We hope that the obsession of the Fed with “inflation mania” will not drive the economy into another period of negative growth and a recession.