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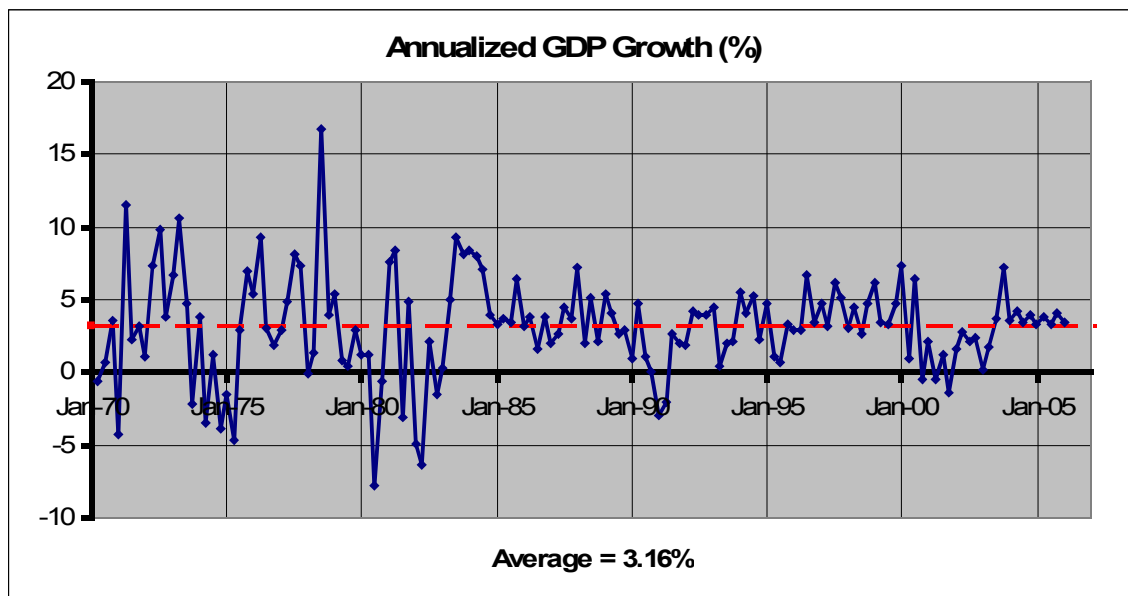
THIS MONTH'S HISTORY LESSON: (MARCH 2006)

GDP, CPI, and MONEY SUPPLY.

Gross Domestic Product (GDP), measures the total amount of goods and services produced by the economy. Last quarter's "Real GDP" (the "nominal-measured GDP" minus inflation), is annualized, and used as the 2nd indicator in the table on page 2.

Inflation, measured by the "headline CPI", is the rise in the price of a predetermined basket of goods (reference [7]). Since the prices of food and energy fluctuate wildly from month to month, we use the "core inflation rate" (the "headline CPI" minus the contribution of food and energy), as the 3rd indicator on page 2.

The target real GDP annual growth rate for the US economy is 3%. The actual average over the last 35 years is 3.16%, shown as the dashed red curve in the Figure below. This indicates that on the average, the Fed has been doing a pretty good job. Also, the fluctuations in GDP have been reduced considerably in recent years, from the very large swings in the '70's and early '80's. Unfortunately, even the smaller extremes of this cycle either cause recessions, or excessive growth and overheating of the economy.



The Fed uses two tools to keep the GDP growing steadily, while keeping inflation at bay. The first is by setting short-term interest rates (the Fed funds rate), as discussed in the December 2005 newsletter. The second is by controlling the "money supply". To increase the money supply, the Fed buys Treasury notes and bonds from the open market, and pays with cash to the selling banks, thereby increasing the amount of money in circulation.

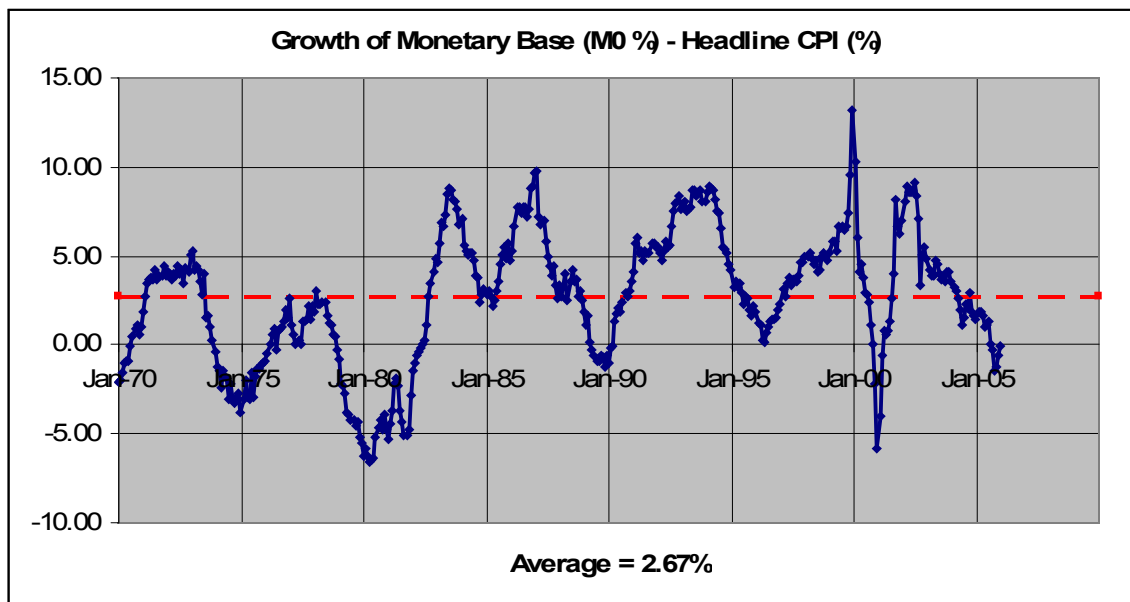
Conversely, to decrease the money supply, the Fed sells treasuries and receives cash, which is then removed from circulation.

Money Supply is the link connecting the GDP % growth rate, and the yearly inflation rate, CPI %.

The Monetary Base M0, is the total of all physical currency (bank notes and coins), plus accounts at the Federal Reserve banks which can be exchanged for physical currency. M1 and M2 are broader measures, which include checking, savings, and money market accounts plus Certificates of Deposit accounts (CD's) (see definitions in reference [6]). We use M0 as the proxy for the money supply, since it is the only one over which the Fed has direct control.

The simplified version of the “basic inflation identity” is:
 $(\% \text{Expected GDP growth}) = (\% \text{Money Supply growth}) - (\% \text{CPI growth})$

This implies that for positive %GDP growth, the Fed has to increase the Money Supply faster than the rate of %CPI growth, and vice-versa. Furthermore, to hit the long-term target %GDP growth rate of 3%, the Fed must increase the M0 at 3% above the %CPI growth rate. Figure 2 below, plots the (M0 % - Headline CPI %), which is the expected %GDP growth, for the last 35 years. The average value of 2.67%, shown as the dashed red line, is slightly lower than the 3% target rate for %GDP growth.



When the curve is above the 2.67% average, the Fed is pumping up the money supply to boost GDP growth, and vice-versa. The largest deviations occurred during the decade of the '70's, and in the period of June '99 to December 2000.

For these two periods:

- The excessive tightening in the decade of the '70's, was the result of “stagflation” (stagnant GDP growth coupled with very high inflation). There was the “oil-shock”, price-controls, and very tight money. As a result, the stock market was in a prolonged downturn during this entire period.
- The wild swings starting in June '99, was the Fed in extreme tightening mode responding to an inflation spike, and also to burst the stock market bubble. They then

sharply reversed course 18 months later, when it was apparent that they had over-tightened, and stalled the economy.

The last positive peak in figure 2, is the post-9/11 infusion of money, as the Fed stimulated growth to avoid an excessive slowdown. They did manage to avoid a recession (see Figure 1), but there was a significant slowdown, and they were forced to reduce the Fed funds rate to a historically low rate of 1.0%. As an aside, this very easy money, along with favorable tax-law changes, spurred the current “real-estate” bull-market.

Currently, as of the end of December 2005, the last full quarter for which GDP data is available, M0-CPI is sitting around zero. This shows the Fed is currently in a strong tightening mode, as they attempt to slow down the economy.

We hope they will not over correct again.....

Until next time...