

BUSINESS CYCLE DEVELOPMENTS

The key litmus test to determine whether the U.S. is entering a slowing or recession, is the peak in 10 year Treasury and Baa yields. In a slowdown, these yields will peak before the peak in the *Industrial Production Index (Index)*. In a recession, they peak after. Another litmus test for slowing vs. recession, is for longer maturity yields to peak before the short end of the curve peaks. In recession, the longer maturity yields peak after the short end peaks. With all the angst about slowing or recession, these yields – particularly the 10 year Treasury yield - are declining before there's any hard evidence of a peak in the *Index*. The **Business Cycle Peak Indicators (BCPI's)** are expecting a peak in September '10 (June '10 thru December '10), so the evidence of the BCPI's - coupled with the action of yields - argues for a slowing ahead. If Treasury yields rise past the previous monthly average high of 3.85% in April, before the Index flattens out, then a recession would be expected. The last litmus test can't be measured until after the *Index* peaks. Should the *Index* decline more than -2.8% from its nominal peak, it's a recession - if less, it's a slowdown.

	SLOWDOWN PEAK: T-N/BAA's		PEAK: INDUSTRIAL PRODUCTION		RECESSION PEAK: T-N/BAA's	
	--		7/53 R		9/53	
Yields Peak Before Ind. Prod.	8/55	←	1/56 SD		--	
	--		2/57 R		10/57	
	--		1/60 R		2/60	
	8/66		10/66 SD		--	
	--		10/69 R	→	5/70	Yields Peak After Ind. Prod.
	--		11/73 R		9/74	
	--		3/79 SD/R		3/80	
	--		7/81 R		9/81	
	6/84		8/84 SD		--	
	3/89		1/89 SD/R		--	
	11/94		1/95 SD		--	
	1/00		6/00 SD/R		--	
	3/02		6/02 SD		--	
	6/06		8/06 SD		--	
	--		12/07 SD/R		11/08	

Four times now slowdowns have flipped into recessions, as seen above (see red text). If the economy is weak then it's very susceptible to the effects of external shock. What started out as a slowdown turned recession, due to Credit Controls in 1980. More on these exceptions later. There's no tax policy in the **BCPI's**, but it should be already discounted and less likely to be an external shock.

The key to timing market reentry is determined by this decision of slowing vs. recession. Only 2 of 6 **Market Trough Indicators (MTI's)** are required to be signaling “buy” when facing a slowdown. Five of 6 **MTI's** are needed, if we're dealing with recession. Currently two of 6 MTI's are signaling and two of the three litmus tests are pointing to a slowdown ahead. The lead-time from the 2nd **MTI** to the S&P low has been 3 months (+/-2 mo.), centering the low in August '10 (6/10 thru 10/10). S&P declines related to slowdowns are -19% (+/-8%). We've already dropped -14%, which is 74% of the average decline (-19%), so over the next few months there's -5% risk (-19% less -14%) and a reward of +30% upside, in one year, in a nominal (vs. real) S&P gains. **Buy stocks on weakness.** For those investors thinking it's recession ahead - stay defensive until 5 of six **MTI's** are positive.

