An O-Shaped Recession For U

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, and you won't do well in the markets." – Peter Lynch

AUTHOR'S NOTE: All of the data used below are real; much of the content is in deliberate year-end jest. My actual outlook for 2010 is for much higher interest rates, a stronger dollar, a stock market shocked by both after an initial rally and inflationary pressures rising once the banking system gets out of its own way.

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I entitled a July 2003 column, "These Aren't GDP Futures You're Trading;" this was written in the aftermath of the first Federal Reserve declaration of war on deflation in May 2003 when the question before the house was whether you could revitalize the financial markets and the economy via a combination of monetary and fiscal stimulus and whether investors should have been taking the bait.

A subsequent boom and bust followed by a spectacular rally from this past March onward indicate we have moved in a full circle. This is why all of the talk whether this was a V-shaped recession, one characterized by a sharp drop followed by an equally sharp rebound, or will be a W-shaped recession, one characterized by a second decline sometime in 2010 or even 2011, or even an L-shaped recession, one where the downturn will be followed by a long period of low-to-no growth is misplaced. What we have been in and will continue to be in is an O-shaped era: We are just going to go around and around in circles in a never-ending cycle of bubbles and their aftermaths.

The Story Of O

Is there an indicator we can use to navigate the surely treacherous markets of 2010? If you do not think they will be treacherous, find a precedent for any time when the yield curve is at record steepness, when short-term interest rates have been pegged near 0% even though the macroeconomic crisis has passed and both inflation and growth expectations are moving higher and when the Federal Reserve has $2 trillion or so of such garbage on its balance sheet they are fighting a Freedom of Information Act to disclose what it is they own. Toss in rising sovereign credit risks in places such as Greece, Spain and Dubai, the prospects of rising taxes to finance incredibly out-of-control federal finances and a financial system trying to wean its way off the federal dole and we will really be entering terra incognita.

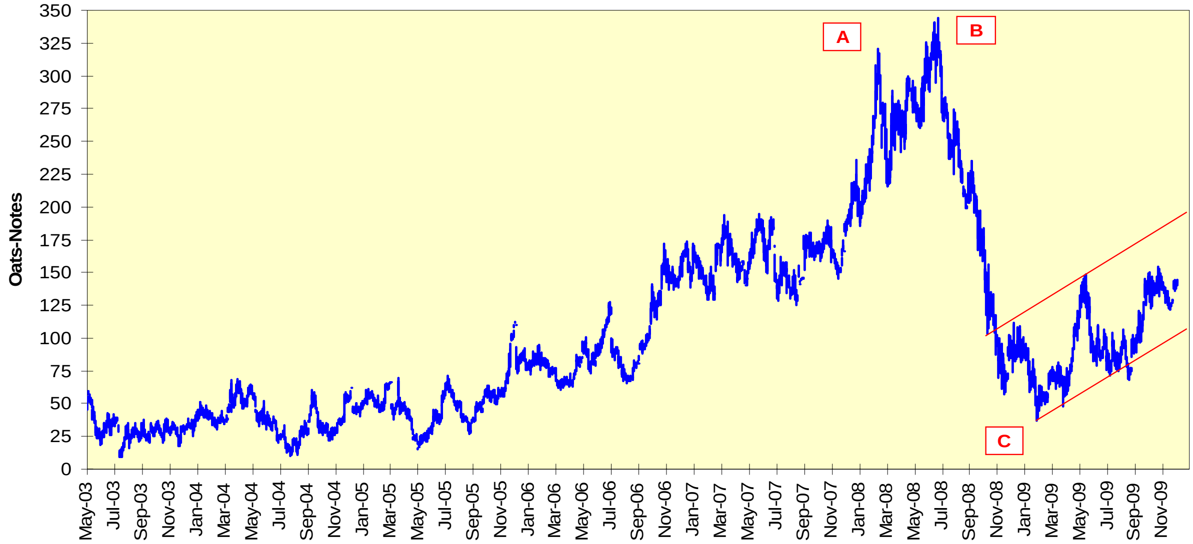
Yes, there is one indicator that has provided reliable guidance ever since its history began in May 1982, the oats-notes spread. Its construction is simplicity incarnate; all you do is subtract the front-month futures contract for ten-year notes from the front-month contract for oats (Example: March oats at 260 cents minus March ten-year notes at 115.71875 = 144.28125). Nothing more, nothing less; complex financial engineering sticks the taxpayer with hundred-billion losses and you with multi-million dollar bonuses, and who in good conscience could do that? Moreover, the contract symbol for oats is the single letter O. Coincidence? We think not.

But it is performance that counts when the rubber meets the road. You have to step up to the plate, catch a falling knife, put a little skin in the game and call out, per Senator Al Franken, *Lies and the Lying Liars Who Tell Them*. And here is where the oats-notes spread leaves the remainder of modern market analysis in the dust.

Consider the history of the oats-notes spread since the Federal Reserve's first declaration of war on deflation. The oats-notes spread moved higher with the bull market into 2007, hit a peak on March 3, 2008, two weeks ***before*** the demise of Bear Stearns (marked with an A), and then hit its actual peak on July 3, 2008, two weeks ***before*** the de facto nationalization of Fannie Mae and Freddie Mac and the re-pegging of the Chinese yuan (marked with a B). Let's emphasize this: ***Two weeks before*** a major event, the oats-notes spread was giving you a chance to pack up your belongings and head to higher ground.

But did it stop there? No; superheroes cannot take off their cape and tights and pop open a cold one. On February 20, 2009 the oats-notes spread bottomed twelve trading days ***before*** the stock market did (marked with a C). We are still smack-dab in the middle of that long-term bullish channel. Best of all, the oats-notes spread has not generated any false sell signals or classified every 20-point move in the S&P 500 as overbought or oversold during this interval. Steady as she goes.

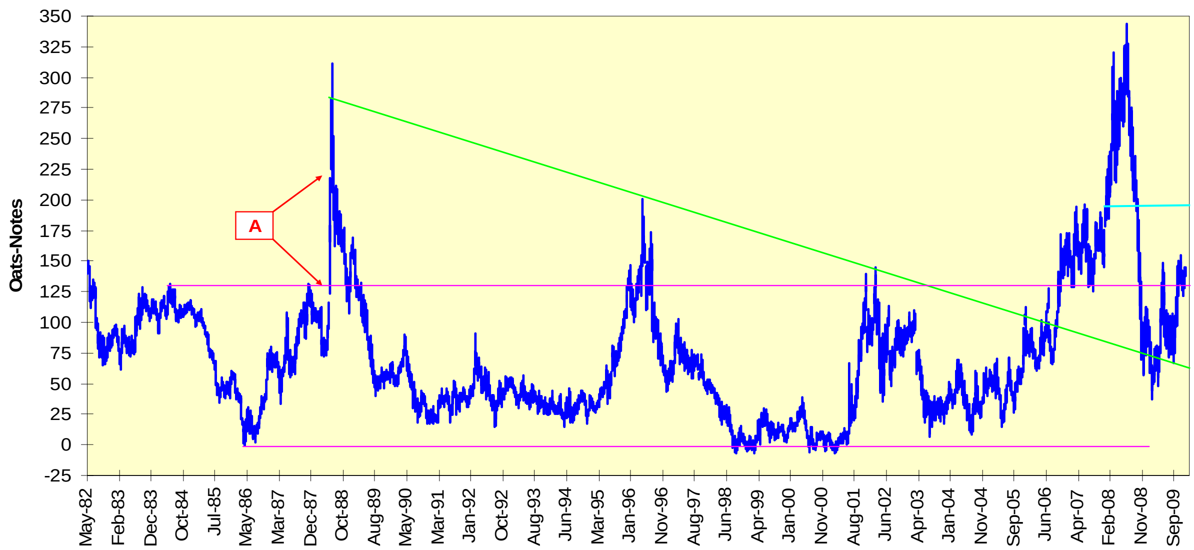
Oats-Notes Declares War On Deflation



You Frame The Timeframe…

…Don't let the timeframe frame you. If we step back to May 1982 and use a weekly timeframe for the oats-notes spread, the grand perspective of technical analysis shines forth. We see breakaway and continuation gaps, marked with the red A and arrows, a long-term horizontal support and resistance channel marked with magenta lines, a downward-sloping overhead resistance green line that broke out to the upside just as the stock market broke out to the upside in September 2006 and, of course, numerous spike tops confirming the embedded call option in the oats-notes spread. The 50% Fibonacci retracement level from July 2008's high to February 2009's low comes in at 192.90; this is marked with a turquoise line.

Oats-Notes Provides A Technical Analysis Primer



Left On The Cutting Room Floor

Is there anything the oats-notes spread cannot do? Probably not, and this is said in full knowledge of the spread's remarkable seasonality, skewed distribution of returns and links to dependent variables other than the U.S. stock market.

The oats-notes spread started as a tongue-in-cheek play on spurious correlation by a nameless commodity trader on a July day in 1988 when *The Wall Street Journal* ran an article we can summarize as, "Ladies and gentlemen, we are running out of oats." The thinly traded coarse feedgrain, which had been rising in a series of locked limit-up days, collapsed in a series of locked limit-down days shortly thereafter. Into every life a little rain must fall, just so long as you are not long oats.

Over the next twenty years in which unimaginable computing resources, massive databases, the efforts of PhD's in every quantitative and behavioral discipline and a dazzling array of esoteric mathematical techniques brought us no closer to the Holy Grail of buying low and selling high, the oats-notes spread persevered. Bankers Trust, Enron, Kidder Peabody, Long Term Capital Management, Fannie Mae, Freddie Mac, Bear Stearns, Merrill Lynch, Lehman Brothers, Amaranth and others have promised you serious indicators you could use. They are gone. You are here, reading this. You won. Enjoy 2010.