

Tea Leaf

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Self Correcting

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

It's clearly no secret that American and global stock markets have been gyrating wildly during the past two weeks. Many financial market historians—particularly those who remain optimistic (bullish) as to expected stock market gains over the next few years—would actually like to see the Dow Jones Industrial Average, as well as other major market indices, decline further in coming weeks.

Such market players would ultimately prefer to see the Dow decline 8% to 10% from its prior high. Why? An 8% to 10% market decline would meet history's "need" for just such a correction to occur. In the eyes of stock market optimists, this desired decline would 1) finally stop market naysayers from arguing that this correction needed to occur, and 2) help establish a base for stock prices to move higher...

...As before, we remain optimistic as to stock market performance over the next few years

The American economy has certain offsets which can take place to help counteract other developments in the economy. For example, as of March 5, 2007, the Dow average had declined by 5.8% from its all-time high of 12795 set last month. Such a market decline reflected volatility in global markets (especially in Shanghai), more signs of U.S. economic slowing, and a related expectation that such slowing would lead corporate profit growth to slow.

Offsets?

Two come to mind. Stock market volatility has also led to a surge in U.S. bond prices, with a corresponding drop in bond yields (rates). For example, the yield on the 10-year U.S. Treasury Note declined from the 4.75%-4.90% range of early-to-mid February 2007 to a range near 4.45%-4.55% in recent days.

This decline in yields has led 30-year fixed-rate mortgages down from the 6.375%-6.50% range of mid-February to

the 6.00%-6.125% level of recent days. Such a move provides greater support for the U.S. housing industry as financing costs are lower.

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At the same time, more signs of U.S. economic slowing announced in recent weeks have led to rising expectations that the Federal Reserve will be more likely to reduce its key interest rate in coming months, another form of U.S. economic stimulus. The Fed's federal funds rate has been stuck at 5.25% since late June 2006, following 17 consecutive 0.25% boosts in the rate over the prior two-year period.

Expectations of Fed ease in 2007 were limited a few weeks ago, with a modest consensus that the Fed might reduce its key rate during the fourth quarter. A small but noisy group of economists were suggesting that the Fed would actually push its key rate higher later this year to deal with inflation pressures.

In contrast, financial markets have now priced in a strong chance that the Fed could trim its key rate in late June 2007, with nearly a 100% probability that such a rate cut will occur no later than the August 7 Fed meeting. Such Fed flexibility can also act as an offset to signs of U.S. economic slowing.

Russia

A quick question: Which nation's economy is the least similar to that of Russia: Saudi Arabia, Canada, or the U.S.?

The correct answer would be the U.S. Given the realities of today's global energy markets, you can think of Russia as perhaps most closely identifying with the Saudi Arabian economy as far as the critical nature of oil revenue and oil reserves.

You can also think of Russia as identifying closely with Canada as far as the vastness and reach of its geographic landscape. Even after the breakup of the former Soviet Union, the country of Russia today still expands over 11 time zones and is the largest in land mass on the planet.

While vast in geographic scale, the nation is much less an economic power. Even with the surge in oil production and oil revenue, Russia fails by most estimates to make the "top 10" nations as measured by annual economic output.

The Russian economy has made major economic strides in recent years, even as its versions of democracy and freedom have sharply retreated. Volatility of the past 15 years has not been for the faint of heart. Political corruption, economic chaos, bribery, violence, and money laundering are all taken for granted in the former Soviet Union.

Doing business in Russia is a major challenge, with the rule of law limited in many cases. The Kremlin has been more than willing to bend rules in order to restrain the influence of many internal rivals.

Today's Russia is a vibrant economy, which enjoys the intoxicating effect of enormous oil and natural gas revenue. Russian oil exports now trail only those of Saudi Arabia. Russia is deemed to have substantial untapped reserves of oil and natural gas. The nation could be a critical swing player in oil production in coming years, while Russia's natural gas reserves are the largest on the planet.

Much of Europe is dependent on Russian natural gas to heat their homes. These nations are vulnerable to supply shutdowns if they defy Russian desires.

The Russians may find that natural gas is a more powerful weapon than missiles ever were to achieve their political goals.

Fewer Comrades

All is not well, however, in Russia. The nation suffers from one of the global community's lowest birth rates, an issue that Russian political leadership is trying to address with financial incentives for women to have more than one child. The Russian population declined from roughly 149 million people in 1992 to 142 million in 2006.

The Russian population is currently declining by approximately 700,000 people annually. Over a period of years, such a decline would have a very detrimental impact on generating tax revenue for various government programs, as well as crippling the work force.

Population Dispersion

A quick question. Name any major Russian city besides Moscow and St. Petersburg (formerly Leningrad). Only two Russian cities have more than two million people, while the U.S. has 14 such cities. The other top five Russian cities of Novosibirsk, Nizhny Novgorod, and Yekaterinburg don't exactly roll off the tongue. The point? The Russian economy is significantly rural and smaller city in nature, versus the larger city life so prominent around the world.

The Russian people favor order above all else. The Russian people have seen their standards of living climb sharply under more recent political leadership, with a sharp rise in average per capita income in recent years.

Coming and Going

Russian citizens with money to spend are a major plus for European vacation destinations. Tens of thousands of Russian citizens now travel frequently, with major efforts developing by various European destinations to attract this new source of spending.

In contrast, visitors to Russia are in decline. The high level of crime and violence limits travel interest by millions of Europeans. Various Russian communities are attempting to boost foreign visitation by targeting the criminal element that traditionally focuses on tourists.

"TEA"ser

Ever wonder why sheep don't shrink when it rains?



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