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SAFE MONEY REPORT

RECESSION 2016-2017?

6 Red Flags That Point to First Contraction Since 2009 ... 4 Ways to Protect Yourself and Profit ... and 1 Alternative Scenario


Mike Larson, Editor

Exercise clothes for my wife. Baseball gear for my stepson. Soccer cleats for my oldest daughter. Miami Dolphins-themed gifts for my nephew and my wife's brother in Chicago (inexplicably a fan, despite where he lives). We've bought a little bit of everything from our neighborhood Sports Authority store over the years.

But by this August, its shelves will be bare. The lights will be turned off. And the empty space will be up for re-lease. That's because the retail chain just went broke, and is liquidating all 460 of its stores.

Is Sports Authority alone? Not at all. Several other prominent retail chains have filed for Chapter 11 in the last year, while overall sales have slumped at those left behind. At the same time, business investment is plunging ... commercial real estate prices are starting to fall ... unsold inventories are piling up at the fastest rate since the last recession ... and even formerly hot sectors like autos are running out of gas.

The most logical conclusion? ***Recession 2016-2017 is right around the corner!*** So this month, I'm going to share the six recessionary red flags I see out there. I will also give you four ways to protect yourself and profit. And finally, I'll tell you if there's anything that can get us off this path ... as well as present an alternative scenario to prepare for "just in case."

Recession Red Flag #1: When the Consumer Conks Out, it's Bad News for a Consumer-Driven Economy

Seventy percent. That's roughly how much of U.S Gross Domestic Product (GDP) growth comes from consumer spending. So I pay close attention to news coming out of the retail sector, and lately, it's been anything but good.

In May alone, the list of retailers who missed sales and earnings targets, or warned about future weakness included **Macy's (M)**, **Nordstrom (JWN)**, **Kohl's (KSS)**, **Target (TGT)**, **Gap (GPS)**, **DSW (DSW)**, **Tiffany & Co. (TIF)**, **Best Buy (BBY)**, **L Brands (LB)**, **Express (EXPR)**, **Guess (GES)**, **Abercrombie & Fitch**

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(ANF), and **Fossil Group (FOSL)**.

That covers everything from general merchandise to clothing to shoes to jewelry to electronics to watches and wallets. Shares of those companies responded by plunging to two-year, three-year, or even seven-year lows.

But shareholders in several other retailers have fared even worse — because they filed for bankruptcy. Sports Authority is one of the most prominent. But other recent victims include Aeropostale, Quiksilver, and Pacific Sunwear.

Government regulators also just blocked a planned merger between struggling office products retailers **Office Depot (ODP)** and **Staples (SPLS)**. That caused their shares to plunge toward levels we haven't seen since the 2009 and 2002 recessions, respectively. While they're closing a few hundred stores in an attempt to right the ship, their futures don't look very encouraging.

Even some of the best-performing retailers are starting to stumble. At **Home Depot (HD)**, same-store sales jumped 10.2% from a year earlier in February. But that growth rate slowed to 6.7% in March, then 4.3% in April. Warehouse chain **Costco Wholesale (COST)** also reported that domestic same-store sales stagnated in the most recent quarter. That was the worst performance in six years.

Some of the sales weakness likely stems from the migration of business to online retailers like **Amazon.com (AMZN)**. But it's not like online shopping is some new thing America just discovered this year. And it's not like the weakness is in just one or two product categories. It's across the board. So retail weakness is a significant recessionary red flag.

Recession Red Flag #2: Businesses Just Aren't Spending Like They Used to, Either

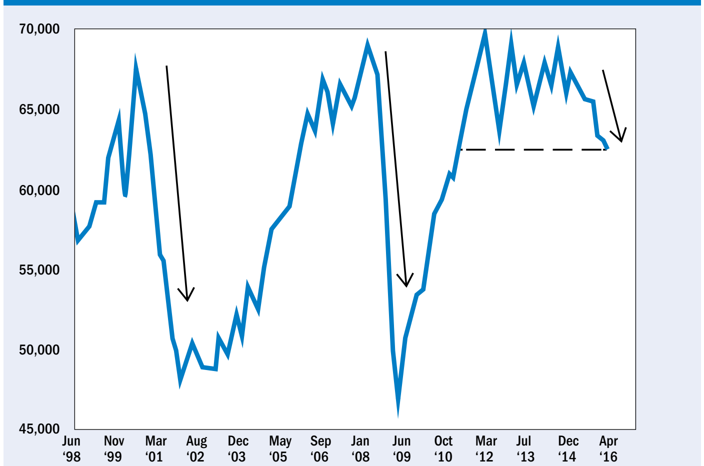
Weak consumer spending alone isn't enough to crush the economy. But when you pair it with lackluster business investment, you have a real problem. And last quarter, business investment plunged at a 6.2% rate. That was the single-biggest drop in almost seven years.

Then there's a monthly data series called "non-defense capital goods ex-aircraft" orders. I know it's a mouthful. But suffice it to say that these figures track core corporate spending — rather than orders for government defense gear or commercial aircraft, which swing around wildly.

These core orders dropped 0.8% in April. That followed a 0.1% decline in March and a 2.1% fall in February. We haven't seen three consecutive declines like that since the summer of 2013.

Now take a look at the chart below. It tracks the value of these core orders.

Core Business Orders Slumping Again – Is Another Recession Looming?



Data Source: Bloomberg

You can see the late-1990s boom, which was followed by a recessionary collapse in 2000-2002 ... and the mid-2000s boom, which was followed by a recessionary collapse in 2008-2009. This time around, the value of these orders just slumped to a five-year low. Could the next sharp decline be right around the corner? Absolutely. And even if all we get is further steady, persistent weakening, that in itself is another red flag.

Recession Red Flag #3: Job Market Starting to Run Out of Steam

When it comes to expansions and recessions, no one factor is more important than the job market. So the long stretch of steady monthly payroll gains of 200,000 to 300,000 since 2010 has kept the economy growing, if not exactly blowing the doors off.

But in April, the Labor Department said the U.S. economy added only 160,000 jobs. That was the weakest reading in seven months. The ADP Research Institute produced a worse reading of 156,000, the lowest in three years.

Meanwhile, we just saw the single-biggest rise in weekly jobless claims since January 2015. Corporate layoffs are running at over 250,000 so far this year, the most since 2009.

The *Wall Street Journal* also reported in late May that temporary employment is topping out, with just over 27,000 temp jobs actually lost since December. That proved to be a leading indicator of recession the last two times around.

Bottom line: We're not seeing terrible jobs figures ... yet. But the labor market is definitely fraying around the edges. Another red flag? You bet.

Recession Red Flag #4: Interest Rate Markets Signaling Skepticism About Long-Term Outlook

It sure seems like the interest rate markets are paying attention, too. The difference in yield between 2-year Treasury Notes and 10-year Treasury Notes just collapsed to 94 basis points, the least since November 2007. That's right around the time the last bull market topped out.

Other indicators of yield curve flatness or steepness are also headed lower. That's a sign bond investors believe policy is getting tighter in the short term … but that the longer-term growth outlook is diminishing.

Just a couple short weeks from now on June 14 and 15, the Fed will meet to decide its next interest rate move. Several Fed members and regional bank presidents have hinted they're ready to raise rates again -- if not in June, then at the next meeting July 26-27.

The real risk? The same one I've been stressing for a while. The Fed waited too long to start its rate-hiking cycle, and now it might be hiking right into the teeth of an unfolding recession.

Recession Red Flag #5: Earnings Trends, Duration of "Correction" Also Troublesome

The first-quarter earnings season is now over, and the results were anything but encouraging. FactSet Research says profits for S&P 500 companies dropped 6.7% from a year earlier. That marked the fourth straight decline, something we haven't seen since the Great Recession in 2008-2009.

It wasn't all energy either, no matter what the Wall Street apologists claim. Six out of 10 major sectors showed year-over-year profit declines.

What's more, analysts expect profits to drop again in the second quarter. We have *never* seen five straight quarters of falling earnings outside of a recession.

Revenue is harder to "massage" than earnings, and the message there is grim, too. Sales dropped 1.5% year-over-year in the first quarter, the fifth straight decline. FactSet has never seen that happen since it started tracking the data in 2008.

Meanwhile, for those pundits arguing this is just another garden-variety market "correction," consider this: The stock market hasn't made a new high in more than a year. The longest correction going all the way back to 1900 lasted 379 days.

Since we're very close to passing that milestone, the "correction" argument looks weaker and weaker with each passing day. I believe the reality is that we're in a new bear market, and that the risk of a more significant downturn is growing.

Recession Red Flag #6: Are the World's Biggest Billionaires on to Something with Their Bearish Calls?

Speaking of which, remember the series of commercials from the late 1970s and early 1980s? The ones that said "When E.F. Hutton talks, people listen"?

Well, I listen to (and read) a ton of commentary as part of my job — but it's the comments coming from Wall Street's biggest billionaires that merit the most attention.

Take Carl Icahn, the corporate raider and activist investor worth an estimated $20 billion. The multi-billion-dollar fund he invests in with his personal wealth — and with money from his publicly traded firm, **Icahn Enterprises (IEP)** — just finished the first quarter with a "net short" position of 149%.

Or in plain English, when you net out all of his short and long positions, you end up with a large, leveraged bet on a stock market plunge. That was a huge swing from a year ago, when the fund was net long to the tune of about 4%. It also appears to be his largest net short position ever.

Stanley Druckenmiller, a hedge fund legend worth more than $4 billion, was practically apocalyptic at a recent investor conference in New York. He called out the "myopic" Federal Reserve for having "no end game" ... said the "bull market was exhausting itself" ... and that investors should "get out of the stock market."

A few days later, investing legend George Soros (estimated net worth of $25 billion) revealed that he's now massively short the S&P 500 via a large put option position. He also slashed his holdings of individual U.S. stocks by 37%.

Finally, real estate magnate and multi-billionaire Sam Zell warned in late May that we were in the "ninth inning" of the economic expansion, and that "things all over the world are telling us we're near the end of the cycle." His recommendation? Raise cash, and lots of it.

You know from my issues over the past year that I believe the cycle began to turn last summer. You can also look at any chart of the Dow or S&P 500 and see that the broad market hasn't made any net progress since November 2014 — 18 long months ago.

Now, some of the richest men in the U.S.

About the Editor

For **Mike Larson** biographical information, go to www.moneyandmarkets.com/experts/mike-larson are warning that we're not only topping out ... we're on the cusp of a potentially significant economic and/or market downturn. There's no guarantee they're right. But they didn't amass tens of billions of dollars by making stupid investment decisions either. I'm paying attention to what they have to say.

What Can Counter the Recession Threat, and Bring About Better Times Ahead?

You don't get anywhere in this business by being dogmatic and intractable. You always have to examine the arguments that run counter to your own beliefs, and constantly reassess whether you're on the right track.

So with that in mind, is there anything that can counter the recession threat, and bring about better times ahead? An improvement in domestically focused industries like housing is one.

We saw pending sales of existing homes and new homes both rise sharply in April, signaling a decent start to the spring selling season. While I believe the commercial real estate sector is in trouble for all the reasons I outlined last month, a lasting rebound on the residential side would certainly help out the U.S. economy.

Then there's the credit market. I have argued for months that the widening of credit spreads, and nascent tightening in bank lending standards, stems from much more than energy market stress.

Specifically, companies in sectors like communications, retail, gaming, and consumer durables are also running into more trouble paying off their debts.

The overall corporate default rate is also running at its highest level since 2009, while the ratio of cash-to-debt on corporate balance sheets is at its lowest since the tail end of the last recession. That means companies have much less financial wiggle room than in recent years.

Despite all of that, corporate credit spreads have fallen somewhat in recent weeks along with the rebound in crude oil. If oil continues to rise, that could continue to put downward pressure on spreads — and give the economy an unexpected boost.

So as confident as I am in my outlook, and as much as I believe we're on the right track with our positioning, I will closely watch developments in residential real estate and in the credit market. If we get unexpected firming in either, then that would cause me to adjust my stance and add a bit more stock exposure.

What to Own, What Not to, in This Environment

But again, until such time as I see a reason to change our stance, I'm going to stick with what has been working and/or should continue to work. That means:

1. "Safe Yield" companies that offer generous dividends, relatively low volatility, high Weiss Ratings, and less economic sensitivity
2. A hefty allocation to cash, spread around between short-term Treasuries, shorter-term government bond ETFs, and select foreign currency or foreign fixed-income funds
3. Specific hedges that target vulnerable stocks and sectors, including financials, real estate, and technology
4. "Disaster/Chaos insurance" in the form of a handful of out-of-the-money, long-term put options and/or gold and gold mining shares

You can find my specific recommendations in the Strategies column on page 9. I suggest you follow them to the letter, as this evolving economic environment is looking dicier by the day.

SAFE MONEY BAROMETER

Modest Improvement: Is it Live or Is it Memorex?

Is it live or is it Memorex?

You probably remember that slogan if you're of a certain age, or a stereo aficionado. The gist of the 1970s/1980s ad campaign: Memorex's recording products were so good, that listeners couldn't tell if they were hearing a live performance or one captured on tape.

I thought of that campaign this month while reviewing the latest Weiss Market Barometer readings. If you look at the table to the right, you can see that the Weiss Ratings Buy/Sell ratio has improved over the last month.

The percentage of stocks in bear territory has also perked up from where we were three and six months ago — and some of the deterioration we had been seeing in credit markets has flattened out.

So is that "live" improvement? Or is it just the "Memorex" variety? Does it stem from an authentic turn in the credit and economic cycle?

Or is this just the spillover impact from China's epic, short-term stimulus splurge in the first quarter, as well as the European Central Bank's plan to add corporate bonds to the list of assets it can buy?

If you look at the commodities market, you'd be hard-pressed to find a lasting impact from China's big debt-fueled spending boom. Virtually every commodity outside of oil that soared as a result of Chinese stimulus is now falling back to earth. One example of the "roundtrip" frenzy: Iron ore prices in China soared 23% in April … then plunged 24% in May.

As for credit spreads, we're getting mixed signals. The yield spreads between corporate bonds and Treasuries have come in ... but spreads between short-term and long-term Treasuries have also shrunk sharply. Collapsing Treasury spreads are a warning sign of shrinking growth and/or future recession, which leads me to believe the decline in corporate spreads is more of the "Memorex" variety and courtesy of the ECB's Mario Draghi.

The vast majority of our other indicators — from gauges of manufacturing and services activity to payroll gains and industrial production — are stuck in neutral.

So we're getting neither strong "buy" nor strong "sell" signals from the Barometer. That actually makes a lot of sense when you consider the stock market has been spinning its wheels for the last 18 months.

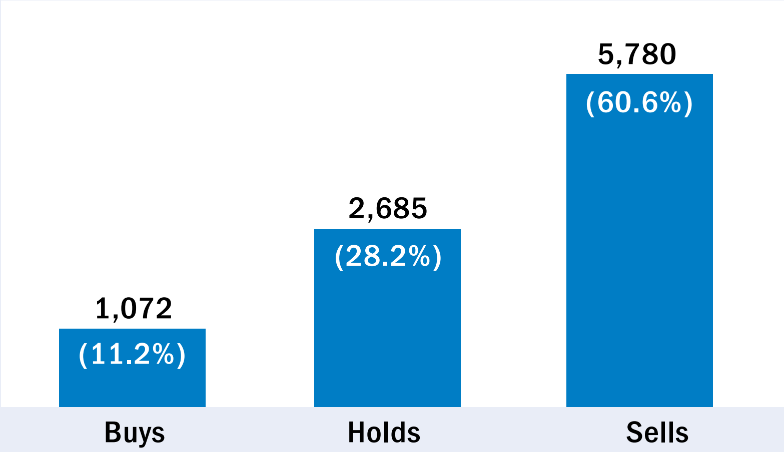
Meanwhile, let's talk briefly about the Weiss Ratings grade distribution. Our stock analysis model objectively weighs the risk and reward of investing in 9,537 stocks traded on U.S. exchanges. It generates and updates ratings that range from "A+" to "E-" each trading day of the year.

As with all our ratings, "A" = excellent, "B" = good, "C" = fair, "D" = weak, and "E" = very weak. Moreover, among our stock ratings, "A" and "B" are equivalent to "buy," "C" can generally be interpreted as "hold," while "D" and "E" are akin to a "sell."

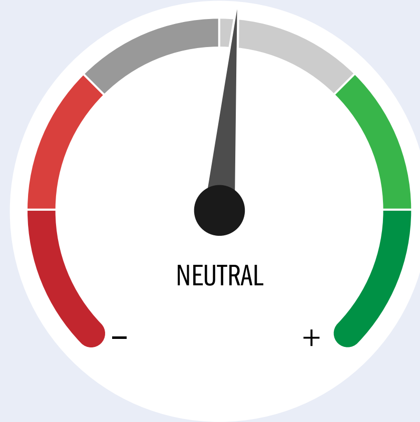
The model identified 1,072 buys (11.2%), 2,685 holds (28.2%), and 5,780 sells (60.6%) as of late May. That was the second month of modest improvement. But we're still only talking about around 11% "buys" in our coverage universe.

It'll take much more widespread improvement and convincing action on the fundamental front for me to get more aggressively bullish. So continue to stick with the "best of the best" stocks my research and our proprietary Ratings system identifies.

RATINGS DISTRIBUTION

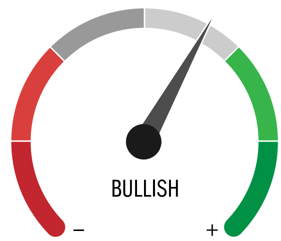


WEISS MARKET BAROMETER

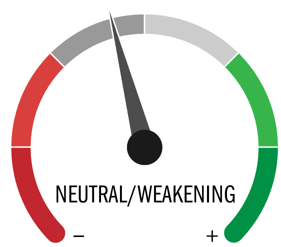


Indicator Type	Name	Last	1 M	12 M
Financial	S&P 500 Index	2,097	●	●
	VIX Volatility Index	14.7	●	●
	Commodities Index	184.5	●	▼
	Stocks In Bear Territory	62.7%	●	●
	Weiss Buy/Sell Ratio	0.19	▲	▼
Credit	High Yield Spread	3.85%	●	●
	Treasury Spreads 2/10 Year	0.94%	▼	▼
	Treasury Spreads 3 Month/10 Year	1.49%	●	▼
Economic	AAII Investor Sentiment Ratio	0.60	▼	▼
	GDP	$18,230B	●	▲
	Leading Economic Indicators Index	123.9	●	●
	Retail Sales	$453B	▲	●
	ISM Manufacturing Index	51.3	●	●
	ISM New Orders Index	55.7	●	●
	ISM Services Index	55.7	●	●
	Unemployment Rate	4.9%	●	▲
	Average Weekly Hours	41.9	▲	●
	Non-Farm Payrolls	160K	●	●
	Consumer Confidence Index	92.6	●	●
	Industrial Production Index	104	●	●
	Capacity Utilization	75.4%	●	●
	Building Permits	1130K	●	●
	Housing Starts	1172K	●	●

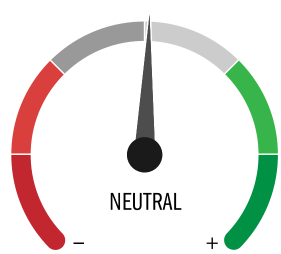
Legend (▲ = Bullish, ● = Neutral, ▼ = Bearish | M = Millions, B = Billions, K = Thousands)



FINANCIAL INDICATORS



CREDIT INDICATORS



ECONOMIC INDICATORS

SAFE MONEY WISE INVESTOR

If Everyone is Selling, Who's Left to Buy?

I told you earlier how billionaires like Carl Icahn, Stanley Druckenmiller, George Soros, and Sam Zell are selling or shorting stocks. But here's the thing Wise investors need to know: It's not just the billionaires running for the hills. Consider the following stats ...

▶ Stock funds around the world bled another $9.2 billion in assets in the week ended May 25, according to tracking firm EPFR. That raised total 2016 outflows to more than $100 billion. European stock funds just saw 16 straight weeks of withdrawals.

▶ U.S.-based equity funds alone clocked outflows of $4.8 billion, according to Lipper. That boosted total U.S. outflows to $76.4 billion for the year. What's more, stock funds have NEVER seen so many assets walk out the door as they have in the last 22 weeks.

▶ Here's another problem: Fund flows often follow performance. Investors usually dog-pile in at market highs and run for the hills at market lows.

But lately, investors have been yanking their cash out regardless. Domestic equity mutual funds bled $23.8 billion in assets in April after losing $9.5 billion in assets in March, according to the Investment Company Institute. Those were both strong months for the S&P 500. Indeed, as you can see in the chart to the right, investors have been consistently withdrawing money from U.S. stock funds for the last year and a half.

▶ Lastly, investors are pulling money from hedge funds – including $15.1 billion in the first quarter alone. That was the biggest quarterly withdrawal since Q2 2009.

A Contrarian "Buy" Signal? Not to Me

So if billionaires and average Joes and Janes are yanking money from hedge funds, mutual funds, and individual stocks, it raises a simple question: "Who's left to buy?"

The answer used to be companies themselves. They bought a record $569 billion of their own shares in 2015, using borrowed money in many instances. But operating cash flow is falling even as net debt is rising, and that's putting the squeeze on Corporate America.

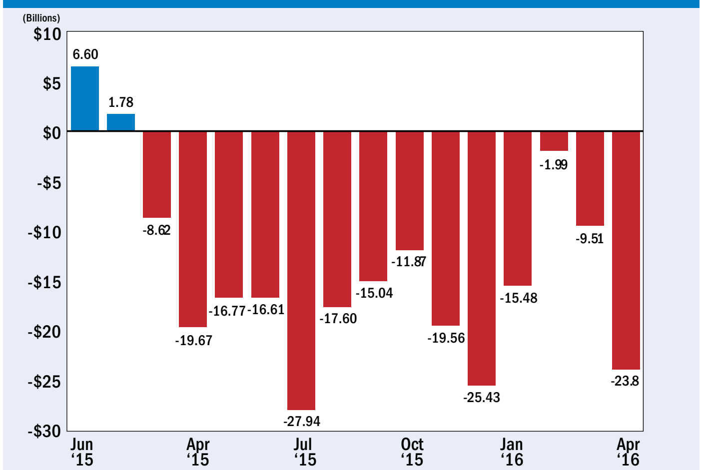
Buyback announcements plunged 38% from a year earlier in the first four months of 2016, according to *Bloomberg*. So you can add cumulative outflows and slumping buybacks to my long list of issues with this market.

What about the contrarian argument? The one that says you have to buy stocks when everyone else is selling? The fatal flaw there is that we have no evidence of fearful liquidation, only a long, slow bleed of cash. The SPX Volatility Index, or VIX, just sank to around 13. That's far below the 25-plus level that signals fear and revulsion.

The S&P 500 P/E ratio was also recently around 21 times trailing profits, and 17.5 times forecast earnings. That's way above its historical average, meaning stocks aren't cheap the way they get in times of panic.

Bottom line: Wise investors know to keep an eye on fund flows. Right now, they suggest stocks are falling out of favor with a wide swath of investors. That raises the risk of a potentially sharp move lower.

Bull or Bear, it Doesn't Matter – Investors Want OUT of U.S. Stock Funds



Data Source: Investment Company Institute

SAFE MONEY READERS' Q&A

Q: If the Federal Reserve raises rates, doesn't that cause U.S. companies to earn less money due to a stronger dollar? – J.D.

A: Yes, all else being equal, multinational U.S. companies earn fewer U.S. dollars for every unit of foreign sales when the dollar appreciates. The large run up in the dollar in 2014 and early 2015 definitely hurt overall corporate profits, and the general belief on Wall Street is that a tighter Fed will pressure the dollar higher. So I'll be keeping a close eye on what the Fed does later in June or July, and how the dollar reacts.

Q: What is your opinion on investing in preferred stocks or preferred funds like the Flaherty & Crumrine Preferred Income Opportunity Fund (PFO) – H.I.

A: Preferred shares tend to trade like stock/bond hybrids because they share characteristics of each. PFO has traded higher so far in 2016 right alongside many other higher-yielding income vehicles and dividend-paying stocks.

One potential drawback for PFO is that it has a high concentration in the financial sector, with almost 78% of its holdings issued by banks and insurance firms. It also invests almost 25% of its portfolio in junk-rated securities. So it could experience significant volatility if credit stress increases again.

Q: Will oil prices resume their decline, or have we seen the lows? – A.C.

A: Falling exploration and production in the U.S., coupled with a weaker dollar and a big bout of Chinese economic stimulus in the first quarter all combined to give oil a boost recently. But prices have already roughly doubled off their lows. OPEC is also continuing to produce oil at an elevated rate, and Iranian exports are ramping up. Throw in the likelihood of a U.S. recession and it leaves me somewhat skeptical about further, significant gains.

Q: I hear a lot of bullish talk about financial stocks. You have recommended put options on the Financial Select Sector SPDR Fund (XLF). Why? – C.R.

A: The XLF LEAPS options are very long-term contracts, with an expiration date all the way out in January 2018. They also represent only a small portion of the model portfolio (just over 1% at the time of recommendation).

I look at them as "disaster/recession insurance," and recommend you stick with them. A move down toward $15 in the XLF, along with a surge in volatility, is entirely possible in a bear market/recession environment.

Just look at how XLF collapsed from $38 to $6 in the Great Recession, an 84% wipeout. Even in the relatively milder 2000-2002 bear market, XLF dropped from around $30.60 to $18.50 peak-to-trough – a decline of around 40%.

Q: How do you pick good, safe stocks with nice dividends? – K.S.

A: I look for companies in non-economically sensitive sectors, given the potential for a U.S. recession. Then I use the Weiss Ratings to screen out those with lousy grades or excessive risk. Finally, I evaluate the specific underlying fundamentals of each potential candidate. Only those who pass all of those screens make it into the *Safe Money* model portfolio.

Q: What is your view on high yield bonds and municipal bond funds? – G.L.

A: High yield bonds have rallied in price along with crude oil over the past few months. But I question the sustainability of that rally, given where we are in the credit cycle. Munis are a better bet, because they generally trade in line with U.S. Treasuries. Just be sure your muni bond fund doesn't have too much exposure to riskier credits, such as bonds issued by overly indebted states, towns, or territories.

The help you need to KEEP what you earn.

Safe Money Report has the distinction of accurately warning readers of every major economic crisis and market decline for over the past 37 years:

Far in advance, we warned investors about ...

- The S&L crisis of the 80s ...
- The failure of our nation's major life insurers in the early 90s ...
- The dot-com crash of 1999 ...
- The housing bust and credit collapse of 2007-2008 ...
- And more.

These are the kinds of warnings that could have made you richer even as the average S&P 500 stock tanked between 2007 and 2009.

Even while other investors lost their shirts, those who owned the types of investments I typically like to recommend could have grabbed big profits — including ...

- A 50.7% gain in ProShares UltraShort Consumer Services ...
- A 63.3% gain in SPDR Gold Shares ETF ...
- A 86.9% gain in S. Global Investors World Precious Minerals ...
- Trinity Industries: A 62.8% gain ...
- And more!

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