

# **C** *Economic & Market* o m m e n t a r y

## **Are we there yet?**

Whether you are a news addict or only an occasional user, you may be wondering when we will see an end to the relentless flood of bad news coming from the real estate and banking sectors. The “bad news” runs deep but remains quite narrow with respect to the overall economy and policy makers are attempting to contain the problems. If their attempts are successful, our economy will emerge from this most recent crisis a bit leaner and hopefully everyone will be a bit smarter.

We are all aware of the issues: a dramatic decline in demand for real estate; corresponding declines in values; leading to past-due and default problems for lenders; resulting in slowing U.S. economic growth; a weak U.S. dollar; and increased odds of a recession. The Federal Reserve is stuck in the middle, attempting to stoke economic growth without re-igniting inflation. The resulting impact on the stock market (as we expected and have mentioned in many previous *Commentaries*) was increased volatility.

Here are some recent statistics that are worthy of review. New home sales reached a 12-year low in September without any sign of stabilization, and unsold inventories of homes hit a 17-year high, reaching 9.3 months. In the banking and investment banking industry, large and multiple write offs related to asset-backed lending have curtailed new lending inside and outside the real estate industry, and cost a few CEO’s their jobs. The value of the U.S. dollar has dropped about 25 percent against a trade-weighted basket of currencies since its peak in 2002, with almost a quarter of that drop occurring in the last four months. Net new job creation in 2007 slowed to about 118,000 jobs a month, well below the 189,000 per month levels of 2006, which has contributed to an increase in the unemployment rate, from a cyclical low of 4.4 percent in March to 5 percent in December. This is about in-line with most economists’ calculations for the domestic economy’s “natural” unemployment rate (NAIRU). These low levels of unemployment have supported a 6.9 percent year-over-year growth in retail sales (8 percent without autos) in the face of a complete elimination of home equity based spending. In addition, sales growth has been exceeding inventory growth, which has driven inventory levels to historic lows. At present, the current economic dilemma seems to be more of a balance sheet item for consumers (reducing net worth) than an income statement item (reducing income and spending).

As commercial banks and investment banks “write off” or “re-value” certain debt holdings, and/or suffer outright defaults on these loans, their capital base shrinks, and their ability to make additional loans shrinks as well. This shrinkage causes the economy to “de-leverage” as less money supply is created by the banking system. Highly leveraged companies may have difficulty during these periods, as financing is both harder to come by and more costly, which disrupts normal business flow and shrinks margins. In real estate related businesses, curtailed financing at the developer level reduces demand for development property, and curtailed financing at the ultimate buyer level reduces final demand, which drives project

values lower, further reducing the demand for development property. This cycle takes its toll on developers and builders as equity in projects can evaporate and/or go negative, leaving financiers with less attractive, or negative loan-to-value ratios and pending defaults. We are likely to be in the middle part of the current cycle.

Where does this leave investors now? Perplexed may be an understatement, but this is the hand that has been dealt to investors. During the last four to six months, 2008 growth estimates (sales, earnings, GDP, etc.) have been revised lower in anticipation of continuing problems in the real estate and banking sectors, and continued pressure on the net worth and disposable personal income of consumers. One of our biggest concerns is how the economy and markets will handle the de-leveraging process.

Over the last two years, the financial markets have produced positive results. The S&P 500 has logged returns of 15.79 percent and 5.49 percent respectively, while bonds have produced 4.08 percent and 7.23 percent. As compared with money market yields of 4.45 percent and 4.65 percent, and inflation rates of 3.24 percent and an estimated 2.85 percent for 2007, the financial markets have generally added to investors' real net worth. Outside of the problems of some finance companies, real estate related firms, and consumer cyclicals, which weighed heavily on the major averages this past year, earnings growth and stock performance was fine.

Looking ahead, we start the year with very elevated price levels in most commodities, and near record lows in the trade weighted value of the U.S. dollar. Will the trends that got us to this point continue at the same pace, or have we overshot the boundaries? There are many important global political issues that can and will have an impact on stock and bond markets around the world, but -- in our view -- none are as critical as the U.S. real estate market and the U.S. banking sector, as the ripple effects from the fallout of "sub-prime loans" and "structured investment vehicles" are being felt around the world. At least the "made in the U.S.A." tag has renewed meaning.

The old saying that no one rings a bell at the top or bottom of the market is true. If you were invested in a few select industries, your investment performance was either terrific or terrible. We continue to believe that managing a prudently allocated portfolio with some strategically placed investments produces an "all weather" portfolio that will typically produce less volatility while garnering market based returns. In practice, this approach has worked well for our clientele over the past two decades.

As always, we will keep a close eye on the economic and market developments and make portfolio adjustments accordingly.

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