

## From FAMILY WEALTH REPORT

# Long view: Of housing and a prolix ex-Fed chairman

Ron Brounes - 6 April 2007

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First quarter 2007			
Market/Index	Year close (2006)	Q1 close (03/31/07)	Qtr change
Dow Jones Industrial	12,463.15	12,354.35	-0.87%
NASDAQ	2,415.29	2,421.64	0.26%
S&P 500	1,418.30	1,420.86	0.18%
Russell 2000	787.66	800.71	1.66%
Fed Funds	5.25%	5.25%	0 bps
10 yr Treasury (yield)	4.71%	4.65%	-6 bps

### Subprime

Until this year, few investors had heard of subprime loans (unless they had poor credit). Today, hardly a day passes without another defunct lender lurching toward bankruptcy, more "misled" borrowers crying foul, panicked investors unloading mortgage-related stocks, and tough talking regulators and politicians threatening harsh actions.

With companies like **New Century**, **Novastar**, **Fremont**, and **Accredited** becoming household names (and that's not a good thing for them), the subprime fiasco has undoubtedly contributed to negativity in the overall markets, while hindering any potential rebound in housing. Stay tune: this one may not be ending any time soon.

### Housing

On a related note, many analysts had expected the housing sector to pull itself out of its recent doldrums. After all, several top homebuilders have seen their market values plunge by over 40% during the past two years. In recent weeks, however, **Toll Brothers**, **KB Homes**, and **Lennar** each reported a decline in profits of over 65%, while **Beazer Homes** is facing new shareholder lawsuits. As for the immediate future of the industry, perhaps **DR Horton** CEO **Tom Tomlitz** said it best: "2007 is going to suck."

### Oil

Volatility was the name of the game in the energy sector this quarter, as the unseasonably warm winter contributed to an early pullback in oil prices from last summer's elevated highs. In January, prices briefly moved below \$50 a barrel and economists began reducing their expectations for inflation. Enter Iran (again). In February, the UN Security Council expressed concerns about its uranium enrichment program. A month later, the detainment of British soldiers by Iranian officials threatened an international incident. By quarter-end, prices has surged back into the mid \$60s, gasoline was averaging over \$2.60 a gallon, and those inflationary concerns were back in full force.

### Transactions

Despite the housing and energy concerns, business execs seemed confident about the current investment climate. **KKR** continued its buying spree (buying **Dollar General** for \$6.8 billion), **Blackstone** planned an \$4-billion IPO to fund future acquisitions, and **ABN Amro** and **Barclays** announced merger plans to form a global financial superpower.

## Markets

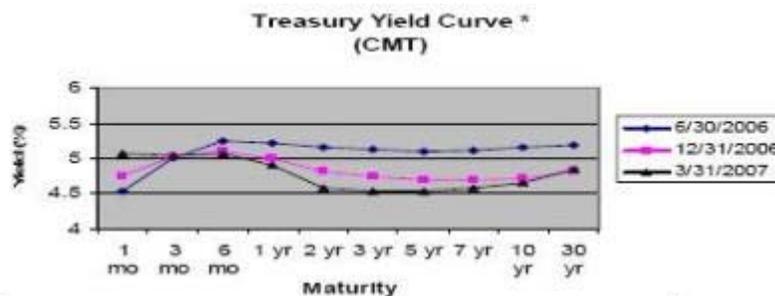
Equities began the year on a strong note with global markets (particularly in Asia) reaching record levels. The major domestic indexes roared into February with the Dow Jones and Russell 2000 hitting new highs, and the S&P 500 reaching its best level in six years.

Then one day late in February the Shanghai Composite fell by 9% and the rest of the world followed suit. The Dow lost 416 points in its worst day since the immediate aftermath of 9/11. This generally bearish tone still holds sway.

Subprime and oil woes haven't helped. The major indexes ended the quarter close to where they began -- but the mood is now darker than it was in early January.

Steel and mining companies were among the top sector performers with **Alcoa** leading Dow stocks and -- to no one's surprise -- builders and mortgage lenders performing poorly. Bonds benefited from a "flight-to-quality," though inflation talk -- and an occasional ill-timed comment by **Federal Reserve** chairman **Ben Bernanke** -- ruined the optimism about a near-term rate cut.

Oh, and can someone please get ex-Fed head **Alan Greenspan** to shut up?



## Fedspeak

"When you get this far away from a recession invariably forces build up for the next recession, and indeed we are beginning to see that sign," Greenspan told a gathering of business leaders in Hong Kong late in February.

It had been a while since a big-name economist had uttered the R-word -- and now here was Greenspan re-opening the debate and setting current Fed officials scrambling to refute him. Even Treasury secretary **Henry Paulson** got into the act, saying that, despite the challenges to the housing market, the domestic economy remains "quite healthy."

And just when it seemed that fear of a recession was receding, Barnanke got the I-word discussion going again. "Recent readings [of core inflation] have been somewhat elevated and the level of core inflation remains uncomfortably high," he told the Joint Economic Committee of Congress late in March.

The Fed left interest rates unchanged at 5.25% (for the sixth time in a row) and even removed the "additional firming may be needed" line from its recent policy statement. While most economists expect the next move in rates to be lower, the jury is still on about the exact timing.

## Housing (again)

Optimists expecting a rebound in housing may have to wait just a bit longer -- like maybe a few years. New home sales saw its sharpest decline in 13 years in January, then fell another 3.9% in February. Building permits, long considered a leading predictor of future construction activity, hit a nine-year low. The construction industry shed 62,000 jobs in February.

## Labor

Overall though, the job market was the economy's saving grace. The unemployment rate fell to 4.5% in February. A strong labor sector contributes to enhanced retail activity and other consumer-driven markets. The downside to (near) full employment is the pressure it places on wages. This year, Congress passed its first minimum-wage increase in 10 years. So buyers beware: companies will try to pass along their higher compensation cost to the consumer.

### **Inflation**

Bernanke's unsettling comments may turn out to be prophetic. Recent pricing trends could mean additional inflationary pressures. On the wholesale level, food costs skyrocketed in February and experienced their largest monthly gains since October 2003. Energy prices soared as well and seem primed to continue. Gasoline costs may be on the rise just as we head into the summer vacation season. On the retail front, winter freezes have affected seasonal citrus crops which will translate into higher prices at the grocery store.

### **Overall**

The economy as measured by GDP grew by 2.5% in Q4 2006 and by 3.3% for the 2006 as a whole. While hardly recessionary numbers, many economists expect to see a slowdown in coming quarters as a sluggish housing market and rising oil prices roll into other sectors of the economy.

The U.S. trade deficit set a record for the fifth straight year. -FWR

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