

The Economy Turns: Slower Growth, No Recession

On Monday and Tuesday of this week there was an auction of 300 foreclosed homes in the state of Minnesota. Promoted as the largest auction of its kind, it attracted some 6,000 bidders as well as an untold number of participants on the internet. While such auctions are hardly a proxy for home values (terms are to take the vacant homes as is without warranty), it is estimated that the prices paid reflect a 10-15 percent decline from their original selling prices.

While hand-wringers about the economy will use the mere existence of the auction as yet another example of an economy in peril, the high ratio of bidders to properties (20 to 1) and the overall modest discount to the high water mark in home prices would suggest there is real demand for homes and people with credit who can pay for them (to be eligible to bid a participant had to produce a \$5,000 cashiers check). Both these factors would support the notion that the housing overhang will be absorbed in most markets in the next 12-18 months.

There are of course areas far more overbuilt than Minnesota. The condo canyons along the coastal areas immediately come to mind. However for most of the country the real estate crisis is more transitory than permanent. So long as the population of the country continues to grow and incomes improve, housing will find a floor and go from there.

What housing may not retain is its aura as an investment. For many people the attraction of housing was its appreciation. People bought a bigger house than they needed on the rationale that a larger home would appreciate more. This idea is probably going to be shelved for awhile. In its place will be the idea of housing as a utilitarian item, much like a car. Whether you buy basic transportation or something more elaborate will be a consumer preference but not an investment decision.

Data shows that housing in general (along with other forms of real estate) consistently tracks inflation. The record of appreciation in excess of this for the past few years has been an aberration. After an adjustment the original trend is believed to again be intact.

There have been some families for whom their home was their only retirement investment. This will not be prudent going forward. Nor will the idea of paying interest but not principal on a mortgage and then cashing out the appreciation. Such owners live on the edge and occasionally fall off. The original premise of needing four to six years of appreciation to cover the commissions on a home will return.

The implication of this trend is an economy in transition. Consumer spending of all kinds makes up 72 percent of Gross Domestic Product (GDP). In 1950, arguably the first “normal” economic year after World War II, the consumer share of GDP was closer to 50 percent. This data implies that consumer spending has grown faster than the overall economy for the past 56 years. A retreat of this figure to closer to 60 percent would put us in line with other developed nations.

What will increase in economic activity are exports and capital goods. With the fall in the dollar and the higher growth projected for the rest of the world, it will be time for US producers to supply others as other countries have previously supplied us. The result will be an economy that will not “feel” as good as other economic cycles when consumer spending was more prominent. It will however still generate growth and income opportunities.

Growth of consumer incomes will go into debt reduction and investment rather than saving. Investment will chiefly be the stock market. As stocks have recently done better than real estate, people will flock back to equities just as they left in 2000-02 when real estate outperformed. Those who invest in fads have short memories.

Most individual money nowadays is going into international investing, especially developing markets such as China and India. This is a repeat of a fad that was prominent about 12 years ago. In retrospect, much of the foreign market movement was caused not by superior fundamentals so much as the influx of American money. When the flow of funds shifted the values deflated. Warren Buffett has said as much about the Chinese market. Those who invest following such trends should have a clear exit strategy. As housing has indicated, investment funds can come and go. When they go so do the valuations.

The Economy

Economic activity is symptomatic of a slowing economy. The job market remains tight and income growth is above the inflation rate. On the other hand, the declines in the financial industry indicate an excess or misallocation of capital into loans that were not productive. As a result that capital no longer exists.

While housing and the associated banking industry continue to struggle, opportunities are opening up for exports and capital goods. As the dollar falls more pressure will be brought to bear on importers to open up facilities in the US to offset the dollar's weakness. This will lead to higher employment trends and hopefully will stave off a recession.

Inflation

Inflation is gathering momentum. While government data on inflation is being suppressed by weak housing prices, for those not in the housing market there are higher fuel, food and services costs to contend with.

In the past the decline in the price of goods due to imports offset the increase in the cost of services. With the fall in the dollar this trend will come to an end, and inflation will become more manifest as a result.

Interest Rates

Interest rates have been whipsawed by the decline in interest rates precipitated by the Federal Reserve offset by the decline in foreign demand for US debt due to the fall in the dollar.

While there is much talk of another Federal Reserve interest rate cut, it should be obvious that such cuts encourage dollar weakness which works at cross-purposes to restraining inflation. At some point there will be higher interest rates both to encourage domestic saving as well as attract foreign investment.

The Stock Market

From a macro perspective, the stock market looks a bit vulnerable. Thirty-five percent of the value of the Standard & Poor's 500 is in financial stocks of various descriptions. Thus in the short run what happens to financial stocks will drive the overall averages.

Over time a rebalancing of the stock market should occur. Financial stocks should decline in prominence while manufacturing and export stocks will rise. Stocks of companies with an international component should also do well.

The point of this observation is to not be misled by the averages. There are cross-currents in this market that need to be dissected and opportunities to be taken advantage of. At the same time there are icons of the previous cycle that are slated to underperform going forward. Remember that the stock market is a market of stocks. One does not have to own every stock.

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October 25, 2007

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