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The *Blue Sheets*®

Our quarterly commentary on the economy and securities markets

Summer 2005

Home Sweet ATM

Investment implications of the housing boom

One of the five global economic themes around which we have designed our investment strategy is Debt Leverage. This summer's issue of the Blue Sheets explores the home equity loan phenomenon that has supported US consumer spending and asks the question, "How much longer can this go on?" We think the answer has profound implications for interest rates, inflation and the attractiveness of stocks and bonds.

Is this a housing bubble?

By now, everyone is familiar with the soaring prices of homes on all three coasts of the United States and select inland metros. Does there remain a homeowner in this land of plenty so innocent, so *Franciscan*, that he has not been tempted to extract large amounts of cash from the ol' homestead by signing a couple of inscrutable forms at the local bank? And of course, millions of us each year, blinking in amazement at the inflated value of our modest abodes, are deciding to cash in our residential chips and move upscale to the spacious digs to which we have always felt entitled, or to that posh retirement residence we thought we couldn't afford. Or maybe we're about to boogie back to the heartland where the price of 3BR 2Ba still makes some sense.

A housing bubble? We don't know for sure, but there are definite characteristics of a bubble: price gains are accelerating (+12.5% this year across the U.S. vs. +8% in 2003 and +5% in 1999; and one-year gains north of 35% in 22 metro areas); house prices are well above indexes to which they usually adhere such as CPI, rents and household income; over 1/3 of homes purchases are for investment or for use as second homes; lending standards are amazingly lax, with prevalent use of adjustable rate and interest-only mortgages, negative amortization loans where the monthly payments are less than the interest due, no down payment loans, and "no-documentation" loans which means the borrower provides no evidence of income or credit history! Many buyers, with 100% leverage and virtually no personal financial risk, are not so much buying a home as they are speculating on further appreciation to make their purchase rewarding. In any asset class, these are classic signs of a bubble. Bubbles eventually end badly.

The potential bursting of the housing bubble, if that is what this is, is particularly dangerous to the U.S. economy because of the industry's enormous size (2 million homes a year worth about \$225,000 each comes to \$450 billion before the multiplier effect and all the decorating and furnishing that follows the purchase); because of its important role in employment (43% of new non-farm jobs are being created by the growth of our

housing industry); and because most of the purchase money is borrowed. If there is a speculative aspect to more than 1/3 of home sales these days, as can certainly be argued, there is a significant risk of an inventory correction, rampant loan defaults, damage to the banking system and a nasty recession when it starts to unwind.

And if the end of the housing boom is dangerous to the US economy, it is also a serious threat to global commerce, because the US consumer is the main reason that the rest of the world enjoys a \$700 billion a year trade surplus with the United States. If the average American consumer should lean away from consumption and more toward saving, economic activity would slow all around the world.

Of late, we've been reading very widely to better understand the drivers of the global housing boom (this is not just a US phenomenon) and its relationship to global interest rates and flows of capital. We recently uncovered a very interesting point of view about the steady house price appreciation; a point of view that deserves serious consideration as we weigh the strategic implications for one of our five long-term economic/investment themes (see March 2005 Blue Sheets)... debt leverage.

Richard Duncan is a financial analyst who lives in Hong Kong, and author of "*The Dollar Crisis: Causes, Consequences and Cures*" which we read two years ago. In a current update of his thinking about the global flows of capital, Duncan helped us to see the house appreciation phenomenon in a broader context and to wonder whether, in fact, it might last longer than most of us have thought possible; or to wonder how it might eventually end.

Credit Cycle instead of a Business Cycle

Most investment managers keep an eye out for signs that a recession may be approaching because past downturns in general business activity have usually been accompanied by certain unpleasant economic and investment phenomena... such as job losses, declining consumer spending, falling corporate earnings, rising government deficits and a downturn in the stock market.

Acknowledging the usual risks of oversimplification, a traditional business cycle recession went something like this:

- Late in a 3-to-5 year uptrend, as optimism spread and business activity heated up, interest rates rose because inflation fears increased and borrowing demand from consumers and businesses became elevated.
- Inventories also rose as manufacturers responded to strong end demand.
- The higher interest rates eventually put downward pressure on demand for credit-sensitive cyclical goods like autos and houses.
- Those industries began to reduce inventories and to lay off workers.
- Layoffs naturally further depressed consumer spending and the downward phase of the business cycle got underway.

A business cycle recession eventually runs its course, typically a few calendar quarters, until inventories are lean again, interest rates are back down (because of reduced borrowing demand and some help from Federal Reserve policy) and hiring stabilizes. Then, like crocuses in March, pent-up demand for postponed purchases, especially houses and cars, buttressed by the availability of reasonably-priced loans, finally tips consumer spending to the upside, hiring picks up and the cyclical recovery begins anew.

The latest economic downturn (2001) and the subsequent recovery, however, have looked very different from the typical cycle... consumer spending barely skipped a beat during the brief recession, even though layoffs were pretty aggressive. And almost four years into the recovery phase, mortgage interest rates have actually *fallen*, even though the Fed was steadily raising short-term interest rates. Federal Reserve Chairman Greenspan,

one of the most respected central bankers of all time, expressed amazement at this phenomenon. A “conundrum” he famously labeled it. What gives?

Well, Richard Duncan has offered a very valuable insight that Mr. Greenspan may do well to ponder. He connects the dots between the various global capital flows that influence the cost of loans in the US and finds that even as the Asian (especially Chinese) *demand* for US bonds is exploding due to the mushrooming US trade deficit which they need to recycle back to Treasuries and Agency paper... the *supply* of top-grade US bonds is not keeping up with this demand, because the federal deficit is shrinking and Fannie Mae and Freddie Mac are de-leveraging (issuing fewer bonds). The growing gap between foreign *demand* for our bonds and the new *supply* of bonds causes demand to spill over into the secondary market, driving bond prices up (interest rates down).

This is really different from traditional economic cycles. A credit cycle has usurped the usual business cycle drivers, and this may mean a different investment experience this time around. Here’s Duncan’s view of this credit cycle...

- China and most other nations build up enormous dollar reserves by running a trade surplus with the U.S.
- They use these surplus dollars to buy our government and agency bonds
- This strong demand drives bond prices up (interest yields down)
- Mortgage rates, which trend with 10-year government rates, also decline
- Mortgage payments become more affordable, so housing demand rises
- New demand drives house prices higher, increasing equity for homeowners
- Homeowners borrow against their equity to spend, raising demand for imports
- Exporting nations (China et al) sell us more *stuff* for more dollars and they buy more bonds...driving down yields...well, you get it!

Several important questions emerge from this view of interest rates and the housing price inflation:

“How long can this go on?”

“What is likely to interrupt it?”

“What happens when it’s over?”

How long can this go on?

A year ago the 30-year fixed rate mortgage was an already attractive 5.7%. Last week it was an almost incredible 5.2% (Bankrate.com), and single-family housing starts are at a record 1.7 million pace, 5% higher than a year ago. Clearly, the decline in mortgage rates has been stimulative, boosting homebuilding-related activity, which is contributing over 40,000 new jobs a month. And when you add in the cash flow from cash-out mortgage refinancings and new home equity loans, all this borrowing is keeping the GDP humming along at a respectable 3.8% real (inflation-adjusted) growth rate.

Duncan’s view is that foreign demand for US bonds will grow apace with our trade deficit as long as 10-year U.S. Treasuries (4.0%) yield appreciably more than European bonds (2.5%) and Japanese government paper (1.3%), since those are the other major currencies typically held by foreign central banks. His theory suggests we could see US conventional mortgage rates fall to 4% or even lower before this housing boom is over... and that it could last for years, unless something interrupts the euphoria first.

What could disrupt the virtuous cycle?

It is a fact that consumer demand is being seriously boosted by homeowners treating their houses like giant cash-dispensing ATM machines. Something like \$365 billion was extracted from home values via home equity loans and cash-out refinancings last year. That is about 4% of *all* consumer spending. It is also the lion's share of annual consumer spending growth. Take away the growth of home values or the propensity to borrow against it and we could have a stagnant economy on our hands. So we thought it might be helpful to look at what could bring this about.

1) Consumer spending could cool. Are there current signs of consumer slowdown? Yes. In May 2005 consumer spending was flat and personal incomes inched ahead just +0.2% from the April pace (+0.1 for wages alone). Air cargo traffic, a classic leading indicator of changes in business activity, dipped in May after slowing for several months. Durable goods orders in May, if you don't count the volatile aircraft category, fell 0.2%. Construction spending was off 0.9%, its third dip in as many months. And a personal favorite of ours, the customer count was down -1.4% at Cracker Barrel restaurants and sales of gift items in their waiting area (which account for 25% of revenues) fell more than that. Retail sales seem to have strengthened again in June, so maybe May was an anomaly? The rest of the world certainly hopes so!

Historically it's been a mistake to bet against Americans' propensity to consume to the max. However, the continuing growth of consumer spending right through the last (capital-spending-induced) recession was clearly aided by outside stimuli, some of which are unlikely to be duplicated going forward. The 2002-04 spending boosters included federal tax cuts and rebates, rising Federal deficit spending, falling interest rates and soaring home equity loans. Without them, consumer spending could cool without any change in China's central bank behavior.

Job growth and wage growth have both been quite tepid by comparison with past business cycles. Wage growth was 1% in May and about 2.5% year-to-date. For the first 6 months of this year new jobs averaged 150,000 a month; to keep up with previous cycles it should be more than twice that. Making these weak numbers downright scary is the reality that 97% of those reported new jobs result from a *guess* as to the net new jobs created by small companies that don't get reported in a timely fashion. The history of these guesses is very volatile. This data is updated every six months, so we are watching for the July mid-year revisions (in early August) with great interest.

Finally, with respect to consumption patterns, the personal savings rate in the US is at an all time low near 0%. The oldest "boomers" will be 60 next year, a birthday that often seems to activate a savings gene. Boomers' needs have dominated US economic trends since WWII, and their approaching retirement could trigger not only a shift from consuming toward saving, but also from stocks to fixed income investments.

On balance, we are not enthusiastic about the outlook for consumer spending, especially the discretionary type. As a matter of fact, when we are able to look back a year from now, we would not be surprised if we were looking back at the start of a recession. And because of the unprecedented debt leverage in the economy (consumer and government) any recession could possibly turn into a stem winder.

2) The Chinese (and other trade surplus nations) could direct their surplus dollars to investments other than our treasuries and agencies. If Duncan's observation is correct that the recycling of China's dollar surplus into US treasury and agency bonds is driving US interest rates lower, we should consider whether they might choose to reinvest those dollars in something else, perhaps reducing that downward influence on our interest rates and disrupting the growth of our home equity borrowing and consumer spending.

One alternative to bond investments might be *energy* investments. It is no secret that China is now the second largest oil consumer after the US and that its oil consumption is growing at a double digit rate. They have

recently made energy deals with Australia, Mexico, Canada and Iran, and a Chinese government-controlled oil company CNOOC, has bid \$18 billion for UNOCAL, a medium-sized US oil company.

While modern China exhibits some capitalist characteristics, it remains essentially a Communist country with a centrally-planned economy. The leaders of this fast growing mercantilist nation are focused on expanding the economy to provide job growth for the roughly 20 million people per year that are flocking to their cities from their failing farms in search of work. The growth of Chinese exports, especially to the US, is key to maintaining this momentum. But so is access to growing energy imports.

For a central bank, another alternative to investing in dollar-denominated bonds is to increase the percentage of its reserves in the Euro, the Yen or perhaps to add a currency basket of some sort. Russia has already moved to reduce its dollar holdings in favor of the Euro, and South Korea has talked publicly about doing the same thing. China has an obvious disincentive to reduce its dollar investments and contribute to rising US interest rates because that could diminish US consumer demand for Chinese exports. However, the lower our interest rates go, the less investment income the Chinese receive on US bonds and the more vulnerable their reserves become to a dollar devaluation.

It is also worth keeping in mind that China's geopolitical power grows along with its economic strength and its foreign reserves. There are areas of tension between China and the United States including Iran's nuclear policy and the independence of Taiwan. Perhaps we should not discount the possibility that China could change its currency behavior for political reasons if they should loom larger than economic motivations.

3) House prices could stagnate or fall, leading to consumer retrenchment. Housing is notoriously a cyclical industry. With activity at a cyclical high, and with a prospect of 76 million baby boomers' housing needs beginning to diminish, it doesn't take a lot of imagination to picture a cyclical decline in starts, even sans a rise in mortgage rates. From another perspective, debt service as a percentage of personal income is also cyclically high; at some point the weight of payments and sluggish creation of good jobs seems likely show up in consumer exhaustion. This may be the most benign of the possible ways that the credit cycle could begin to wind down.

There are some clues that housing demand may be peaking. Price gains have slowed to about 5% in some pricier areas; as buyers are priced out, their interest migrates to more affordable neighborhoods, some of which are now seeing 20% price jumps! Could we be watching the marginal buyers being driven from the market? There are also signs that lending standards may be in the early stages of tightening: rates on adjustable loans have risen significantly even as traditional 30-year rates have declined. This definitely hurts the marginal demand. The buyer who was able to afford a monthly payment when ARM rates were 2.4 % lower than fixed rates (the spread is now only 1.1%) have seen the monthly payment on a \$250,000 mortgage rise 17%! After 4 years of decline in the initial monthly payment for new jumbo mortgages (over \$360,000) due to "creative financing", the average first month payment spiked 15% in the first quarter of this year.

With houses becoming less affordable, and with credit standards apparently beginning to tighten, housing starts will soften soon and so will home prices. On its heels will come a drop in home equity loans and a consumer-led recession.

What happens when it's over?

Before we launch into our assessment of what may be ahead for the economy and various investments, we want to affirm what we have long called, "The First Rule of Investing" which is *Nobody Knows the Future.* That being incontrovertibly true, we have nonetheless found that economic forces and securities prices do influence one another in a broadly dependable fashion, and that understanding these relationships often provides insight into opportunities and risks. In today's environment no major asset class seems to represent the kind of clear

value which one might buy without reference to prevailing economic forces. In such circumstances, we think it is incumbent on a portfolio manager to make every effort to discern forces that may influence the trend of business and prices of securities. To that worthy end we offer these tentative prognoses.

Lenders' profits and, with them, S&P 500 earnings will decline. — Banks are already showing signs that the credit cycle is growing whiskers. In the first quarter of this year, banks' net interest income declined 10% from the fourth quarter of 2004. (The way banks make money is by charging more interest for the loans they make than they pay for deposits and short-term borrowings; the difference is called net interest income.) *However*, banks collectively reported a 10% *gain* in total *profits* because of cost cutting, especially their reduction of loan loss reserves. If the credit cycle begins to reverse, that is if rates rise and loan volumes start to shrink, loan defaults will increase and bank profits will fall. Stocks of major banks have already begun to under-perform the overall stock market, perhaps in anticipation of this very thing.

How important are real estate loans to bank profits? Very important, as it turns out. Commercial and industrial (C&I) loan activity has been shrinking for the past three years while real estate lending has expanded by over 50% and is now twice as important to banks as C&I loans! If real estate lending declines, whether because of rising rates, an inverted yield curve or exhaustion of demand, bank profits will be badly squeezed. A flattening yield curve, if and when it comes to pass, and reduced real estate lending will almost surely put pressure on the S&P 500 index because banks and other financial service businesses account for roughly 40% of the S&P 500 earnings! And many other businesses have been drawing their strength from home equity loan-supported consumer spending; they too will notice the housing downturn.

Inflation will be surprisingly low. — CPI inflation was essentially zero in June, despite a robust housing market and pretty strong consumer demand across the board. Fed governors may be scratching their heads because they have imagined for a year that they are battling the inflation dragon. When long-term rates rise, and/or the housing cycle turns south, inflation will be surprisingly low due to a) the unlimited supply of bargain-priced "stuff" and even services from Asia, and b) because US businesses and labor have lost their pricing power to China and India. An actual recession could be *deflationary*.

Short term interest rates will decline. — Once the Federal Reserve Bank realizes that its inflation dragon is a chimera, our guess is they'll waste no time switching from the brake to the gas pedal by pushing the Fed Funds rate lower to stimulate the economy. We think the Fed has increased short rates mainly to head off a housing bubble, the bursting of which could be traumatic. Frustrating their plan, 10-year rates over which the Fed has little influence, fell, thereby stimulating housing demand. As the overseer of things monetary in a highly leveraged economy, the Governors fear *deflation* even more than *inflation*. If, as we believe, the economy is slowing, the Fed will eventually need to cut short rates. If Greenspan can't make the psychological shift before his term is over, his January successor will. We think short rates will start to fall within 6-9 months.

Will lower rates save us again? Even though the Fed will surely cut the fed funds rate when a downturn is evident, it could be too late to stop the natural retrenchment of consumption and the ascendancy of a saving ethic among our well-housed, graying citizenry. Fiscal and monetary policy moderated the correction in the last mild recession. The next downturn may have to do the heavy lifting of bringing savings and consumption into better balance.

Credit spreads and the difference between short and long rates will widen. — Six months ago the spread between the interest cost of low quality bonds and Government debt was as tight (1.9%) as it's been in years, maybe ever; the spread has since widened (to 3.9%), but has further to go to normalize. A recession usually creates defaults, which hasten the increase in junk rates. A positively-sloped yield curve tends to be restored during a recession, partly by a decline in short rates, where the Fed has a strong influence, and partly by longer rates drifting higher with natural credit market forces.

Long-term rates could rise; we have less conviction here. — Inflation should remain benign, and we think US government rates will remain above competing sovereign bond rates, so these two factors will not cause long rates to rise. But many other factors *could* put upward pressure on interest rates for mortgages and 10-year governments, such as:

Reduced Asian demand for US bonds (diverting surplus \$ into oil, into other currencies, reacting to US protectionism, a “hard landing” in China, or for geopolitical reasons).

Reduced hedge fund demand for long bonds. (As the yield curve has flattened, HFs have tended to leverage more, that is to borrow more short money and buy more long bonds to make up for the narrowing spread. When the short-long spread widens again, they may reduce their leverage.)

A falling dollar may require higher bond rates to limit the (inflationary) damage.

Rate increases by lenders struggling to restore their profit margins

A US recession, raising government deficits, causing “crowding out” in the corporate sector even as availability of credit is shrinking

There will be a US recession, spreading to our trading partners. — Spending by consumers (70% of GDP) has been growing faster than consumer incomes for years. Most recently, borrowing against home values has provided the extra fuel. If the equity loan game runs out of gas, which it eventually must, spending will fall. Because of the enormous debt leverage in not only the US but the global economy, there is a significant risk of a greater-than-average downturn.

A recession is not the end of the world, but it usually damps the “animal spirits”, which would be consistent with our 10-year view that the US stock market is in a long, secular bear market during which waning enthusiasm for corporate earnings prospects is expressed in a slowly shrinking P/E ratio for stocks.

Currency... We don't know! — We think the overarching reality in currency markets is an unspoken beggar-thy-neighbor contest in which each trading nation tries to enhance its competitive position by weakening its currency vs. the others, or by spending their reserves to support the US dollar, which is the same thing. China has become a major actor in this play, having tied their yuan to the US dollar. Will they let it float? Maybe, but we are not convinced that even knowing what they will do would give us an investment advantage. The consensus is that a float, even a managed one, would take the yuan higher. It is actually possible, especially if China should have a “hard landing” that the yuan could *lose* value against the dollar. For lack of insight, we are trying not to make a bet on currency trends. And that is usually our conclusion regarding currency!

Investment Conclusions

The 25-year slide in long government rates (from which our portfolios have profited greatly for 17 years!) is either over or it hasn't far to go. The economy has benefited mightily from the declining cost of credit, and both companies and consumers will miss this stimulant when it is gone! Jobs growth has been sluggish in this cycle, and will remain so as offshoring continues unabated. America's consumption growth has become heavily dependent on borrowing, which in recent years has depended on house price appreciation; we think we are in the final pages of that story.

Which leads us to the \$64,000 question... how should we invest if we think the credit cycle is about spent and we expect a recession within a year, if no asset class stands out as representing good value, and if long term interest rates may start to rise? Good question. Here are some of our ideas.

Moderate our equity exposure & avoid the credit-sensitive S&P 500 index — The proximate end to a very long credit cycle portends a recession, possibly a whopper of a recession, and a decline in corporate profits in the not-too-distant-future, perhaps by early 2006. We don't think equity valuations anticipate a nearby earnings decline. Furthermore, rising long rates can usher in lower P/E ratios for stocks. Hence we continue to have a

lower equity exposure than we might otherwise, and we eschew all the broad equity index funds; as a matter of fact, we like our short position in the S&P 500 via Rydex Ursa (an inverse index fund).

Individual stocks for income and growth plus several focused value funds — Instead of broad indexes, we prefer to target specific stocks that, each for a different reason, we believe represent good value. These include a publicly-owned private equity fund with a terrific 40-year track record and an 8% yield, a little-known information tech company that is revolutionizing hospital care, an electric utility turnaround story, a well-capitalized domestic oil and gas producer that is growing its reserves, and a dominant player in the information and entertainment business. We also maintain significant holdings in a few mutual funds whose managers have a long track record of success in identifying value in all sorts of market conditions. (Most of these funds, it should be noted, have large cash balances, reflecting a paucity of perceived opportunity.)

Sustainable cash income is valuable — As we weigh the risks in the broad market indexes, we are increasingly led to stocks with above-average cash payouts which we expect will constitute a significant part of our future investment return and serve as a buffer against a possible decline in valuations overall. We make an effort to own income stocks which derive their income from diversified sources.

For long bonds, emphasize TIPS (Treasury Inflation-Protected Securities) — The 10 year Treasury trades at 4%. If inflation continues around 2.5%, that's a 1.5% "real yield" on a 10-year investment. We don't think that's a very good compensation for taking the risk that, if rates rise to just 5.5% we stand to *lose* 10% of our principal. So we are sticking with TIPS for our allocation to longer-term bonds. The yield on the 10-year TIP as we write is 2% *plus* an annual CPI adjustment. If inflation is 2.5%, that's a nominal 4.5% yield...better than the straight 10-year bond *and* with inflation protection! A 4.5% nominal yield won't give anyone goose bumps, but it's better than a money market yield and the inflation risk is covered. And if Bill Gross (PIMCO) is right and real yields should fall to 1%, we would experience appreciation as well.

For other fixed income investments, emphasize short (2-5 years), high quality — When recession threatens, be wary of credit risk; a better time to buy "junk" will be when spreads are wider and no one wants them. Two-five year government or high-quality corporate paper may actually offer modest appreciation potential; when short-term interest rates decline, today's coupons will be worth a little extra in the market. If short rates do not fall, you'll get the coupon rate and your money back in a few years.

Oil & gas for the long run — The oil and gas exploration and production business has, in our opinion, the best long-term outlook of any major business segment; we expect to maintain significant investment exposure in this sector. The thesis is one of demand exceeding supply at current prices, creating an expectation of long-term price escalation to the benefit of owners of oil and gas reserves. One-third of the world's population has embarked on a journey from agrarian subsistence to industrial era prosperity. This journey inescapably involves a growth of energy demand faster than the overall growth of economic activity since the early stages of industrialization are far more energy intensive than the information technology stage of the developed countries. Owning oil and gas reserves is our preferred hedge against the long-term devaluation of paper currencies. It is also our main hedge against geo-political destabilization, and our bet that alternative energy sources will only be developed in response to high oil prices.

For the Investment Committee:
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DJIA 10,575 S&P 500 1221 NASDAQ 2144 30-yr Treasury 4.47%