

E.Q Trendwatch™

No, stock markets have not bottomed yet!

We thought we should lead off in answering this most important question off the top.

As you are aware, we at VP have been cautious about the market for the past year. Finally over the past 2 months, a lot of others have started to see reasons for caution as well. In our work, the extent of this recent decline, although nasty in many markets over the past few weeks, has more downside.

Beside the technical indicators that we follow, there are some large structural concerns that even the most optimistic souls are starting to acknowledge. Mr. Bernanke, the new Chairman at the FOMC (Federal Open Market Committee in the US), and other federal bank heads around the world, must continue to reign in the stubborn spending habits of consumers. This means governments must over-tighten short-term rates to slow building inflation, intentionally inflicting economic slow-down. The further they tighten the longer and more severe the downturn. Although, it was previously thought that the FOMC would not have to tighten further than 4.75% in the US, they are today at 5% and now expected to go to 5.5% and possibly 6% before year-end. Recall that rates started this up-trend from 1% in 2004. These dramatic rate increases will be felt.

Creative credit products issued by lenders over the past few years have convinced consumers that they can afford nearly everything. The focus is no longer on what items cost, but rather how affordable the monthly payment. As we've touched on before consumers have been gutting their equity for the sake of consuming larger and larger amounts of depreciable goods (no wonder there is inflation pressure).

Ok, what if the consumer just keeps spending? Where is the proof that the consumer will ever slow?

Actually the stock market has been showing us for a while and some vivid evidence can be found in the shares of U.S homebuilders like Lennar Homes, Pulte Homes, KB Homes and Hovnanian. These titan builders cover the gamut, from multi-million dollar homes to starters.

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The reason we look at the homebuilder stocks is the insight they provide about the willingness of consumers to commit to their largest purchase—homes. As homebuilders report inventory levels, the number of permits and cancellations of commitments to build, we get a helpful picture of how comfortable builders are feeling about their profits going forward.

At the start of this year and coming off of record earnings, homebuilders were quite upbeat. In the past few months they have become more and more dire, lowering revenue and earnings targets with each successive quarter. Their pessimism will bottom eventually, but not until the excess capacity has been worked out of current home inventories. This is going to take some time.

We must remember that current stock prices are not about what's happened in a sector, but rather what is expected to happen looking forward. So what is the stock market saying about homebuilding? Well since the sectors high in Jul '05, homebuilder stocks are down an average of 45% year over year. Most are continuing to report positive earnings, but it is the dramatic effect of the slow down in projected earnings that is causing the trouble for investors.

Real estate investors, especially speculators, are just now feeling the squeeze of owning an asset they can no longer quickly flip at a big profit. The wise speculators have already been sneaking out the backdoor. Excess supply is continuing to build and existing home prices are starting to retrace. Homes that are selling, are on the market longer, and longer, and are being sold at lower prices.

For now, the real estate ATM is closed and Bernanke and other central bankers hold the key. Before they re-open the doors they must be convinced that consumers are behaving themselves and paying down their debt. Unfortunately some consumers will file for bankruptcy in an effort to clear the slate and start fresh. This too will be hard on our economy.

Our work suggests that a second down-leg is coming and that the opportunity we have been waiting for is around the bend. Stock markets have now taken back all of the gains for 2006 and are currently chipping away at the over-payment given to investors through 2005. Reversion to the mean can be a very rewarding thing when we are ready for it.

In a nutshell, it is our fiduciary duty to control risk to the capital we manage, and it is a client's duty to remain vigilant against human impulses driven by greed. If we both do our jobs, together your money will endure and prosper handsomely through the ups and downs of every business cycle.

Best wishes for fun in the sun in July (with big hats and sunscreen of course!)

REPORT ON BUSINESS TELEVISION (ROBTV- Channel 64 on Cable)

Some clients have been asking us to advise in advance of any of our upcoming appearances on business television.

For those that are interested, Danielle was the guest Portfolio Manager on AM Business at 9:20am on June 28, and her **next appearance will be at 9:20am on Wed July 26**. The clips can also be viewed for the week following the appearances on the ROB website at http://www.robtv.com/shows/past_archive under past video archive for the date and time in question.