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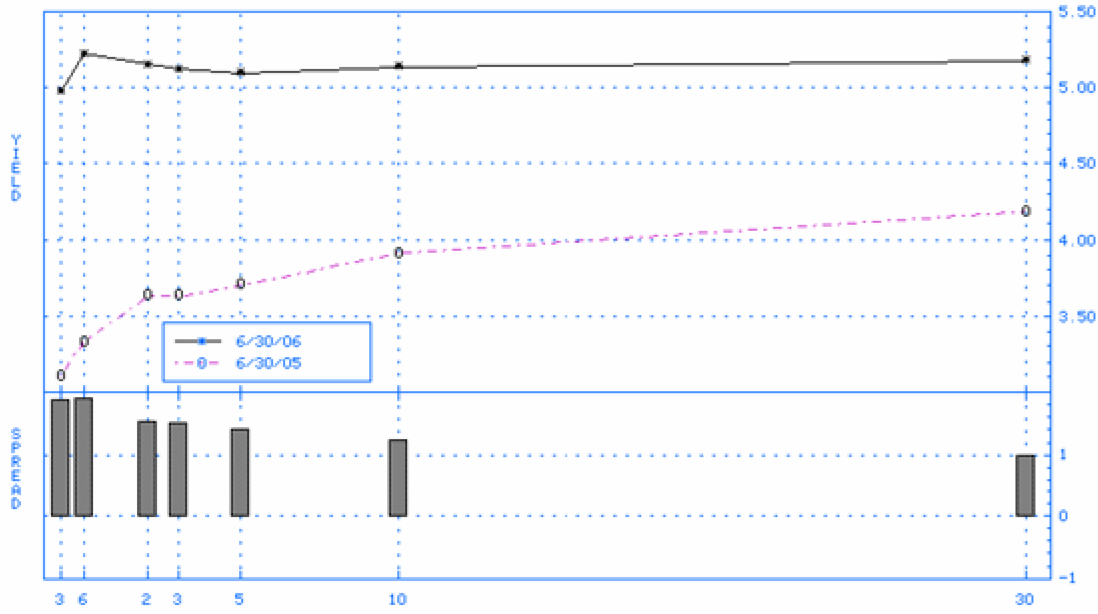
By William W. Priest, CEO

A Slowdown in the Making?

In the second quarter of 2006, inflation worries seemed to dominate the news more than any other investment consideration. The effects of these inflation-related jitters are clearly evident when one compares today's yield curve to the yield curve from a year ago (see figure1). Today's yield curve is the result of 17 consecutive rate increases by the Fed, which has led to an overall upward shift versus last year, with the short end of the curve showing the most dramatic rise. It is this upward shift in the curve that has caused stock markets to pause despite strong gains in earnings and dividends.

Figure1

Historical Yield Curve
Date Range: 6/30/05-6/30/06



Source: Bloomberg L.P. 2006

Frankly, we are not particularly worried about inflation. Inflation is driven by two sources- financial liquidity and wages – and, in each case, the evidence points to a fairly

inflation-resistant financial landscape. First of all, the central banks of the world are draining liquidity from the global economic system. According to Joachim Fels, a Morgan Stanley economist: "For the first time since 2000 the growth of GDP in the world's top five economies is outstripping the growth of the money supply, so that less excess liquidity is available to 'churn asset' prices." Secondly, wage gains remain low relative to productivity gains. Furthermore, the U.S. has seen almost no growth in median family income since 2000. Inflation is not the bugaboo many pundits believe it to be.

If inflation is not a concern and earnings and dividends are strong, what is wrong with the stock market? In our view, the real issue concerns the U.S. consumer. He accounts for 20% of world GNP. When he stops buying, the world stops selling. But is this likely to happen in coming quarters? Our answer is a qualified yes.

One of the first casualties of this the rise in rates and decline in liquidity will be the housing market. The hissing sound one hears is the air coming out of the housing bubble. House prices have been falling since last summer and the stock of unsold homes has grown rapidly. According to Wachovia Securities analyst, Carl Reichardt, the number of homes for sale today is 35% higher than a year ago. On a year-over-year basis, which is the most accurate way to compare sales given seasonal disparities, new home sales are down 5.9% from May of last year. The median price for a new home decreased to $235,300. Inventory of existing single-family homes has increased from a 4.3 month supply in May 2005 to a 6.5 month supply in May 2006. This represents the most months of supply for existing single family homes on the market since July 1997. This change in supply/demand is aggravated by higher mortgage rates, which are now 6.7% versus 5.5% a year ago. Moreover, homes remain very expensive in relation to incomes. And because this bubble is bursting in virtually every area of the country, we will soon witness the widespread demise of the consumer's home ATM machine, which will do much to temper the exuberance of US consumers.

Nevertheless consumers still head to the shops. But their willingness to keep their wallets open does not come from real income growth but, rather, from the dangerous and temporary financial cushions of falling savings rates and rising debts. The personal savings rate continues to remain negative. This is the twelfth straight month in which the savings rate has been negative decreasing to -1.7% from -1.6% in April. Add the pressure of rising energy costs and the prospects of mortgage interest rate re-sets coming later this year, and one may very well conclude that the pace of consumer spending will show a significant decline.

All things considered, we believe the most important effect of the global liquidity boom for consumers over the past decade has been the rising property price to income ratio. If this ratio were to fall back down to its 1996 level, the global economy would suffer a recession. Will that happen? This time, our answer is a qualified maybe. A recession could certainly be in the cards, but, if one does come to pass, it would not be sudden and the central banks of the world would exercise their considerable powers in hopes of preventing its occurrence.

In summary, our view is that interest rates are probably peaking and the economy is probably slowing. Bonds will gain some traction as earnings growth loses some momentum. So, our advice is to stay balanced, own quality companies with growing cash flow, and enjoy the summer.

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