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2007 Outlook

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Quote to Ponder

"The two chief enemies of the free society are intellectuals on the one hand, and businessmen on the other. Every intellectual believes in freedom for himself, but he's opposed to freedom for others...he thinks...there ought to be a central planning board that will establish priorities. The businessmen are just the opposite – every businessman is in favor of freedom for everybody else, but when it comes to himself that's a different question. He's always the special case. He ought to get special privileges from the government, a tariff, this, that, and the other thing."

Milton Friedman, Nobel Prize (Economics, 1976);
Professor of Economics, University of Chicago;
Author, *Capitalism and Freedom*, 1962;
Columnist, Newsweek, 1966 – 1984;
Died, November, 2006, age 94

Quote from *reason* magazine, February 2007 www.reason.com

2006 Thank You

Let me start with a quick thank you to all my clients for 2006. Nobody panicked in the quick drop in May and June (although some of your friends did), and since we didn't have any Income Trusts, we avoided that bullet as well.

I am very grateful for the significant number of new clients referred to me in 2006, as that is how my business grows. If you would like information on how to refer someone, please call, and I'll be happy to discuss it with you.

2007 Crystal Ball

In this issue we look ahead to 2007 and beyond. I apologize in advance for the number of pages in this issue, but I am going to argue against economic gloom; and optimism is in such short supply these days that it's going to take some time. One of the chief worries, the US trade deficit, even gets its own essay.

My points will be:

- Housing will not kill the economy
- Interest rates will not kill the consumer
- The greenback is not the peso

Housing

The big worry on many people's minds these days is the housing market. It goes something like this: after a decade of overbuilding, US house prices look like internet stocks in 1999. US consumers, using home equity loans like ATMs, are totally tapped out on debt and full to the eyeballs with overpriced monster houses. Rising interest rates will crush house prices and push consumers over the brink into disaster … Foreigners will stop 'financing the deficit', leading to a currency meltdown and global economic crisis …

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"Tis the set of the sails not the gales that determines where we go."

Reality, however, is not so bad. Here's why.

Interest rates are about 5%, and with inflation steady at about 3%, it is difficult to see the disaster there. After all, ten years ago a 5% mortgage rate would have sounded pretty sweet. (If you borrowed a truckload of money because you could afford it at 2%, and now you can't afford it at 5%, it's hard to blame anyone but yourself.)

Although consumer debt is at historical highs, individual balance sheets (debts vs. assets) are in the best shape in a generation. This is because people have been investing in important assets like a house or recreational property.

Another reason is that although total household debt has been increasing, much of the borrowing has been to refinance older, higher rate mortgages at lower current rates, according to Abby J. Cohen, a highly respected strategist at Morgan Stanley. This is a normal, and good, thing to happen when interest rates have been the lowest in 35 years.
So the affordability of the household balance sheet is better than it might seem.

[Part of the perception may be semantics, which the media love to play on. The term 'consumer' to an economist is just an individual household or person. However, the word 'consumer' has strong connotations of credit-card happy ditzes buying armfuls of things they can't afford…]

A third reason is demographic: the *median* baby boomer is only 45 years old, and in the peak income-earning years. It is quite reasonable for a 45 year-old to be moving into a nicer house in the city or buying a cottage at a lake. According to David Foot, the Canadian demographer, (Boom Bust and Echo www.davidfoot.com) if you think recreational real estate prices are high now, watch out, because the Boomers are only half-done buying cottages.

In other words, high debt levels and high house prices are, to a large degree, simply natural results of low interest rates and demographics.

Boomers also have jobs. With jobs, they make their mortgage payments as planned. The more important factor affecting the US housing market is employment, not interest rates, according to the *Bank Credit Analyst*, a well-respected research firm.

What if the price of homes falls? Mightn't that put a dent in consumers' net worth and stop their spending?

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Housing Crash?

Well, it might, but a disaster isn't likely, for 3 reasons. First, banks and other lenders have been more careful this time, requiring higher levels of advance selling for condo projects, for example, and higher levels of equity by the developers and home buyers before qualifying for loans. These moves limit the degree of speculation, and keep the *banks*' balance sheet healthy – so they don't have to curtail lending in a downturn, which would make things worse (as we saw in Japan).

Second, history shows that if house prices are 'too high', they correct over a period of time. We saw this from 1981-86 and again from 1990-98. During these periods, house prices declined (30% in Toronto) before recovering, taking 7 or 8 years to complete the cycle.

In these housing corrections, the general economy rebounded and continued to grow long before the housing cycle had run its course.

Third, according to the *BCA*, there is no empirical evidence linking house prices with spending (the so-called 'wealth effect'): people don't spend more just because their house price goes up, and they don't spend less when it goes down.

House prices and the general economy are both influenced by interest rates. Rising interest rates will slow the housing market and the economy, and for similar reason, too. But it is a mistake to think that housing drives the economy. This explains why the housing market and the economy respond so much differently to interest rate changes.

So, since house prices have had big runs in the US (also in the UK and Australia), you could well see sharp price corrections there. But, since the economies aren't overheated, a mild increase in rates shouldn't run consumers (and therefore the economies) into a brick wall.

It is highly unlikely, according to the *BCA* and other analysts, that the US Federal Reserve will *sharply* raise interest rates. The spikes in interest rates in 1981 and 1990 that killed inflation and the housing market are still in our minds as the bad news scenario, however, it is yesterday's story, and yes, 'it is different this time'.

The Fed is very aware that the world economy is growing nicely with no inflation (see "Greenspan's Conundrum" July 2005, www.chrishoran.ca). He is also sensitive to the fact that consumer debt is high. Chairman Bernanke does not want to begin his tenure with a policy error that causes a recession. Look for interest rates to change very little, and very gently when they do.

What if Boomers lose their jobs?

RSP Reminder

The deadline for 2006 RSP Contributions is Thursday, March 1st, 2007. The limit is $18,000 for the 2006 tax year and for 2007 it rises to $19,000. (Please call Barb McKenzie to make arrangements!)

Your personal limit is on your Notice of Assessment from your 2005 Tax Return; your contributions to-date are on your Assante RSP statement.

If you know someone who would be interested in this newsletter, I'd be happy to add them to my mailing list. Just let me know.

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US Value Rally

Economic Armageddon makes great newspaper copy, but it is an unlikely scenario.

Companies are in very good shape: corporate profits are very strong, and balance sheets in the US and Canada are in excellent shape, giving business a lot of maneuvering room to handle a slowdown.

US companies' profits have doubled since 2002, according to the *BCA*. It seems that the efficiency improvements from technology are finally kicking in, allowing businesses to improve customer service and grow without adding as much cost as in the past. This is a good thing, too, since unemployment is very low; it is hard to complain that it's difficult to find a job.

Since the major US equity markets have recouped the great declines of 2000/03 and now stand at about where they were 7 years ago (except tech) while profits have doubled, the result is the *value* of the US markets has also doubled.

Over the past 7 years the Price/Earnings (P/E) ratio in US markets has fallen from 30 to about 15 today. In fact, the PE ratio has only been this low one other time (1994) in the past 17 years. (BCA January 2007)

This is what Nick Murray, a 30-year industry veteran, calls 'The Great Value Rally' (www.nickmurrayinteractive.com); the *value* of the US market is as good as its been in 17 years.

World Growth Healthy

World economic growth has averaged over 3% per year since 2000, on track to surpass even the golden decades of the 1950s and 1960s, according to the *Economist* (OK, so there's 3 more years to go…)

Europe is coming out of its funk, while Germany – struggling to bring East Germany from the Gulag into the 21st century after the Berlin Wall fell - has reclaimed its spot as the world's #1 exporter.

Strong economic growth worldwide, combined with the decline of the US$ (the greenback has fallen about 20% vs. its trading partners since 2002) provides a boost to the US economy. A lower currency makes US goods cheaper for people in other countries to buy, which boosts the fortunes of companies that export things.

Strength in the export sector should therefore offset a consumer slowdown to some degree. This cyclical rotation from strength in the consumer sector to strength in the export sector is very normal for a modern diversified economy. It is a typical natural cyclical process, never the same twice, and never exactly predictable …

So consumer spending could indeed weaken; to the extent that consumer spending was encouraged by low interest rates, we would now expect a slowdown as rates normalize. However, a slowdown does not necessarily mean a deep US recession.

The Longer Term Trend

The longer term economic trends today are as good as they've ever been. Very simply, we continue in a world of low inflation, low interest rates, lower barriers to trade, and healthy growth. It is therefore likely that a short-term cyclical slowdown, either in markets or economies, will be mild and brief because of the strength of the underlying trend, according to the *BCA*.

Global trade (see "China- Dragon Awakening" – www.financialtailor.ca) is driving a non-inflationary worldwide boom similar to the emergence of the United States in the 18th and 19th centuries.

Looking out over the next 10 and 20 years, if the underdeveloped countries are able to develop civil societies and trade freely with the world, it could be the best thing for the poor people of the world since the Industrial Revolution.

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Storm Clouds?

Do we have clear sailing? Alas, no. There are, as always, storm clouds around.

One short-term storm cloud that bothers investment pros is the anomalously low price difference between low-quality and high-quality assets. Normally, riskier assets are priced lower than blue-chips, to compensate investors for the higher risk. This difference is known as the risk premium, or price spread.

These narrow risk premiums indicate that some investors may be underestimating risk and paying too high a price for risky assets. Investors are probably complacent after 3 good years, and markets tend to punish complacency harshly. Markets are therefore susceptible to a shock, such as the Asian/Russian currency meltdown in 1998.

I would not be surprised to see a 20% correction in the markets sometime this year, however, I wouldn't be surprised if it *didn't* happen either – all we need is for the housing slowdown to appear less of a disaster than people fear – and that storm cloud will safely pass.

Book Review

'America at the Crossroads: Democracy, Power and the Neoconservative Legacy'
By Francis Fukuyama
Yale University Press, 2006

If your views of international politics and the economy are one-phrase slogans, this book is not for you. If, however, you are interested in how a country like the US that believes in checks and balances to restrain political power can find itself in the catastrophe that is unfolding in Iraq, you will find this book interesting.

Francis Fukuyama is a Professor of International Political Economy at John Hopkins University, a former neoconservative who worked for then-Deputy Secretary of Defense Paul Wolfowitz, and author of the award winning book 'The End of History and the Last Man'.

Fukuyama writes in a clear and concise way (the book is only 195 pages), but the thing I like is that he discusses both sides of the questions before arriving at his views. He argues that American Foreign Policy under George W. Bush, marked by the pre-emptive and unilateral war exposes 'the fatal flaw lying at the heart of a world order based on American hegemony'.

The flaw is that 'the hegemon has to be both prudent and smart in its exercise of power': not only has Bush been neither, but the war goes strongly against the core US belief that political power requires checks and balances to maintain control.

US Trade Deficit

There is a lot of talk and concern about the US trade deficit. The popular media are making hay out of the prospect of an 'unsustainable deficit'; they refer particularly to trade with China.

A trade deficit occurs when a country such as the US buys more goods from China than it sells to them. In this case, US consumers send US dollars to Beijing in exchange for all the stuff they buy. The Chinese people take the US dollars, and as it happens, deposit them as savings in US banks or more correctly, buy US Government bonds. It turns out that the Chinese prefer to keep their savings in a currency they trust – the US greenback. So the US trade deficit is offset, or *balanced* if you are an economist, by a surplus of Chinese savings flowing back into the US. So the US has a very large surplus in currency flows with China (called a capital account surplus).

If this exchange worked some other way, say the Chinese preferred to save Canadian Loonies, then they would sell their US dollars and buy Loonies. The result would be that the price of US dollars would go down, and the demand would push the price of Loonies up.

Another way it can work is if the Chinese bought more goods or services from the US, then the flows of goods balance each other, and you don't get a trade deficit. In fact, if the Chinese used their US dollars to buy for example oil from the Arabs or BMWs from Germany, and then in turn the Arabs and Germans bought wheat and Boeings from the US, then the global circle of trade and money would balance and a deficit with China could go on forever!

Unfortunately the words 'imbalance' and 'deficit' have a strongly negative connotation to normal people that is different from their meaning to economists. A trade imbalance isn't necessarily as negative as it sounds … it isn't like the US owes the Chinese a debt that is incurring interest and has to be paid back. So a trade deficit is not at all like a deficit in your chequing account. It just means the US is buying more goods than they are selling to the Chinese, and (in this case) the Chinese are sending more US dollars to the US than they are getting goods in return. It is all just part of the incredibly complex but beautifully functioning international economy, and isn't that big a deal.

It is true that large trade deficits don't usually go on forever. Eventually, the currency values adjust: in our example, the Chinese currency will rise, making Chinese goods more expensive to US consumers. This is happening now - the US dollar has declined against all major currencies by about 18% over the last 5 years (trade-weighted basis, *Economist* April 2006).

The stronger Chinese currency also makes US goods more affordable to the Chinese consumers, so they buy more things from the US, like airliners, computer systems, and rapid transit engineering. When this happens the trade flows will be more balanced. It happened this way in the 1980s, you might recall, when the Japanese Yen was relatively low and Tokyo was selling lots of cars to the US. But the Yen eventually appreciated, in large part because of strong demand for Japanese goods.

According to the Bank Credit Analyst, a highbrow research service, the Asian savings surplus has peaked and will begin to decline over the next few years as the big Asian economies, Japan and South Korea, recover and begin to spend. The modernization of the Chinese economy will eventually produce Chinese consumers, who will buy more things from the US.

The final word? According to the BCA, the US dollar will remain weak until the trade flows are better balanced. 'There is no precedent for a country with such a large trade deficit to have anything other than a weak currency' says BCA managing partner Chen Zhao. So look for the Loonie to remain strong against the US$ over the next few years.