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THE
VIEWPOINT

A DELICATE BALANCE

Fall 2006

In our previous newsletter we predicted a slowdown in the housing market. This was based on two factors: higher mortgage rates and rising home values. We then touched on how the slowing housing market would affect the economy.

So far our predictions have come true. For the first time since 1995 existing home sales have declined on a year over year basis. New construction has also slowed down with August 2006 housing starts 21% below August 2005.

The effect this will have on the economy is what worries stock market investors. As we have said in the past, the market goes the way of the economy. When the economy grows, earnings grow. If companies' earnings grow, prices will follow.

So the real question is whether the economy is going to have a soft landing or a hard landing. A hard landing would mean we enter into a recession and the stock market pulls back until it sees signs that the economy is picking up. This is what happened in the early 1990's. If we have a soft landing the economy will continue to grow but at a slower rate than it has during the past few years. The stock market will likely continue to rise. This would be similar to what happened in the mid 1990's.

There are three indicators that are pointing to a soft landing: commodity prices are falling, company balance sheets are strong and the Federal Reserve's ability to lower interest rates.

There has been no escaping the rise, and now fall, in oil prices. We see it at the pump every week when we fill our gas tanks. From early 2005 until the peak this year, oil prices climbed 74% crimping consumer spending and slowing the economy. Since oil's high in July it has dropped 26%. This helps lower the burden on individuals and allows them to spend on other items which will help buoy the economy.

We are seeing a similar situation in manufacturing. The CRB Index, a compilation of raw materials used in manufacturing, has increased 30% from early 2005 through May of this year. Since then it has dropped 16%. This drop in price will allow manufacturers to either lower prices or increase profits, both of which will help the economy.

During the last few years the strength in the economy has been due to consumer spending, not industrial spending. Companies have been using their profits to strengthen their balance sheets. This has been accomplished by paying down debt and/or refinancing debt at lower rates. Balance sheets now have record amounts of cash which will be put to use in many ways such as: increased dividends, improve factories, employee benefits or to purchase competitors. This renewed industrial spending should help keep the economy growing

If increased consumer and industrial spending are not enough to keep the economy growing the Federal Reserve can help by lowering interest rates. Over the last 2 years they have raised interest rates 17 times trying to slow the economy. Increasing evidence of a slow down convinced them not to raise rates at their last meeting. Their risk at this juncture is slowing the economy too fast and pushing it into recession, or stimulating the economy too much and pushing inflation up to painful levels. This is the tight rope they will need to walk going forward. To do this they will need to be very proactive in managing rates. If it looks like the economy is slowing too fast they will begin to lower rates. This will decrease both individuals' and companies' cost of doing business thus giving them more money to spend and help keep the economy growing.

The markets seem to be telling us that the economy is going to have a soft landing. The stock market is rising, something it would not do if a recession was imminent. The yields on long term bonds are falling with expectations that the Federal Reserve will lower rates in the future. Let's hope they are successful in their balancing act and the economy continues to grow while inflation remains in check.

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Year End Tax Minimization

The volatility of the markets this year gives us the opportunity to manage taxes. If managing your capital gains/loss would help your financial situation please contact us so we can customize a strategy for your individual situation.