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THE
VIEWPOINT

HOUSING AND THE ECONOMY

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According to both government and public statistics, the housing market has begun to slow from the record setting pace of the past five years. Nowhere is this more apparent than when you look at publicly traded home builders. KB Home, Lennar, Pulte Homes and Toll Brothers have all lowered their profit forecasts for 2006-2007 because of disappointing spring sales, lower new home orders and higher cancellation rates.

The slowing in the housing market is blamed on two factors: higher mortgage rates and rising home values. Mortgage rates are increasing because the Federal Reserve has raised the federal funds rate from 1% in June of 2003 to 5.25% in June 2006. The rising home values are blamed on the increasing cost of land, labor and raw materials. The slowing housing sector will affect the economy in two major ways: job growth and consumer spending.

From our recent high unemployment in 2003 until today, the largest single source of job growth has been the housing sector, creating 23% of all new jobs during this period. If the housing sector continues to slow so will U.S. job growth and the economy.

The increasing value of the average American home has allowed consumers to borrow against home equity to spend on big ticket items like; remodeling, new cars and flat screen TVs. If the average home value becomes stagnate this source of available cash will dry up slowing down consumer spending. Sluggish consumer spending will in turn slow the economy.

The U.S. economy will not necessarily be pushed into a recession by slower job growth and lower consumer spending. There are a number of things to consider before coming to this conclusion.

During the 1990's we had what were called rolling recessions. While the economy as a whole did not go into a full fledged recession, individual industries did. When one area of the economy declined another portion of the economy improved. This led to the longest period of economic growth in the U.S.

We may be seeing a similar economic cycle now. For example, over the last three years healthcare has accounted for 17% of job growth and does not seem headed for a slowdown. As long as other areas of our economy continue to grow and only a few lag, the economy as a whole can make progress.

Another aspect to consider is how growth outside the U.S. affects our economy. In the past, our economy was so large that the rest of the world followed our economic lead. This is no longer the case. As other countries have industrialized, our economy has become more global. We are affected as much by outside forces as internal factors. As the rapid growth in countries like China and India continues, our trade with them will help boost our economy.

The good news about the Federal Reserve's 17 rate increases is that it gives them flexibility. If the economy starts to slow and move towards recession they have the ability to change course and start lowering interest rates to keep the economy expanding.

What does this have to do with the stock market? The market goes the way of the economy. When the economy grows, earnings grow. If companies' earnings grow, the price will follow. One of the reasons the market has been pulling back from its recent gains (S&P 500 -3.8%, DJIA -3.9%) is the fear that the housing market will slow and drag the economy into a recession. We do not think this will be the case. The slowing housing market may have a negative influence on home owners, depending on their individual situation, but the economy can continue to grow even if the housing sector does not.

The current fear driven market sell-off is similar to three other downturns in the past 3 years and is healthy for the market, but hard on investors' patience. Periods of uncertainty give us an opportunity to buy companies at a discounted price. We will use the cash that has been building in our accounts to do just that.

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