

Monthly Chartbook

May 2005

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Bubble-nomics

Post Tech/Telecom bubble, the financial press has been looking for bubble after bubble.

Any market that is rising double digits with a twinge of speculation is a bubble according to the press.

Read: Real Estate

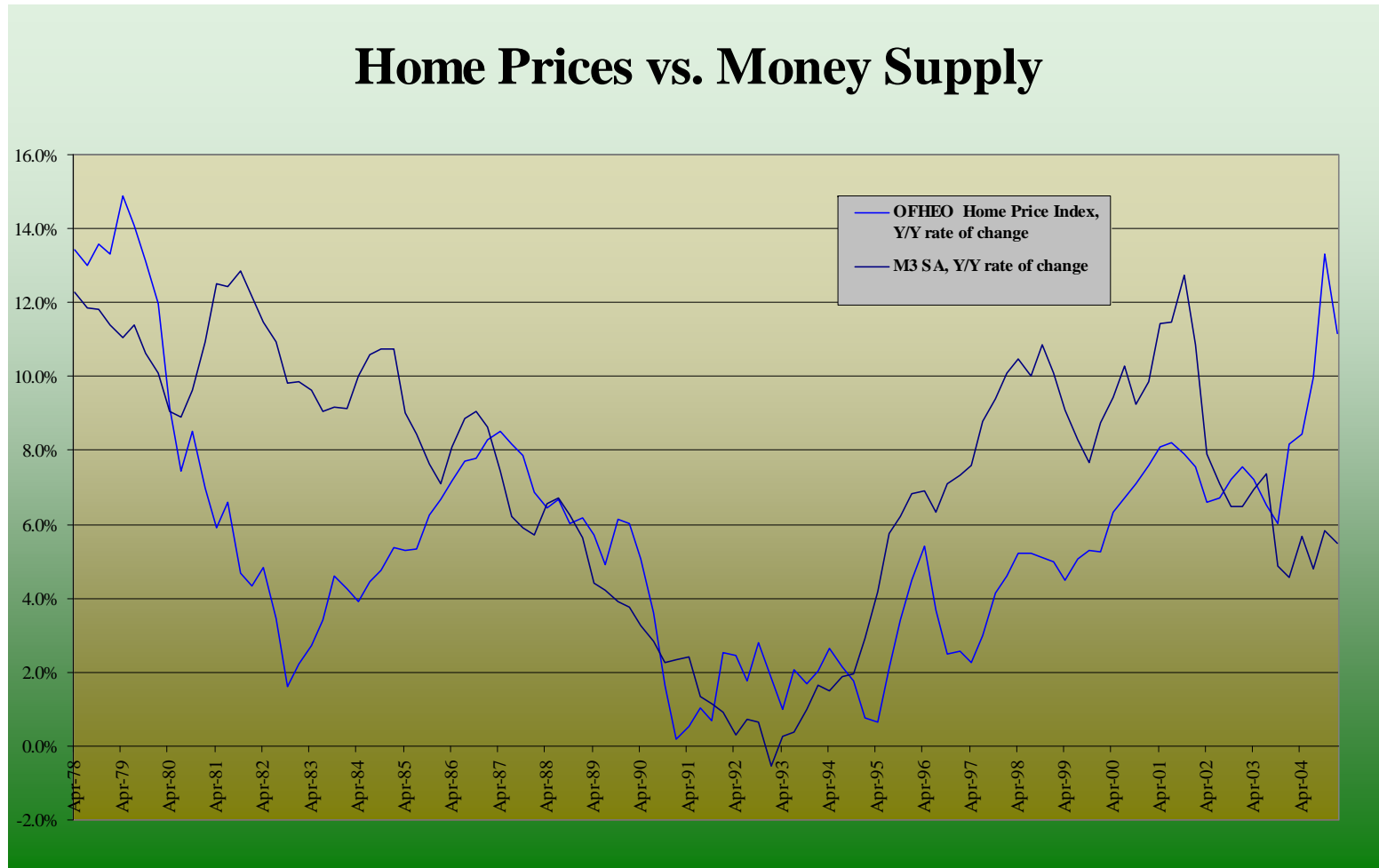
Home Prices: a bubble?

- The current rise in home prices is a function of:
 - Demographics
 - Baby Boomers & Purchases of a Second Property
 - » Great Britain and Australian have participated as well. More evidence of the demographic effect of the baby boom generation.
 - Baby Boom Echo trading up at a younger age
 - Falling Interest Rates
 - Mortgage Rates have fallen (duh!)
 - Real interest rates are at levels not seen since the middle of the 1960's
 - Increase use of leverage
 - Homeowners maintain less equity
 - Increased use of interest only (I/O) mortgages
 - Monetary Policy (Home Prices are highly correlated to the monetary aggregates)
 - Excess liquidity always affects asset prices
 - » Late 70's, early 80's -- Gold, Silver
 - » 1982-early 1987 -- equities

Home Prices: a bubble?

- Residential Real Estate may not be a bubble; but, if the Fed thinks it is, *it does not matter* whether it is or it isn't... it's a problem for us all.
- Traditionally, Real Estate investors have been looking for income, not capital gains
- The Fed's concern is evident due to increased comments from Dr. Greenspan and other Fed Governors
- If the boom has been liquidity driven, it is soon coming to an end.

Macro-economic Research



The OFHEO Home Price Index (HPI) is highly correlated to US monetary aggregates and to personal income growth.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1191.50	Trading range	↔	1130-1270	Next 6 months
Ten Year Treasury	3.98%	?????	↓	4.00%-5.00%	6 months
Inflation (all Urban)	3.46%	3.18%	↓	2.75%-3.375%	6 months
Fed Funds	3.00%	3.00 – 3.25%	↑	3.00 – 3.50%	5 months
S&P 500 Earnings	\$59.33	\$62.01	↑	\$62 - \$65	3Q 2005
	Legend:	↑ Higher	↓ Lower	↔ Indifferent	

Inflation expectations

For now, moderating energy prices are critical if inflation is to slow.

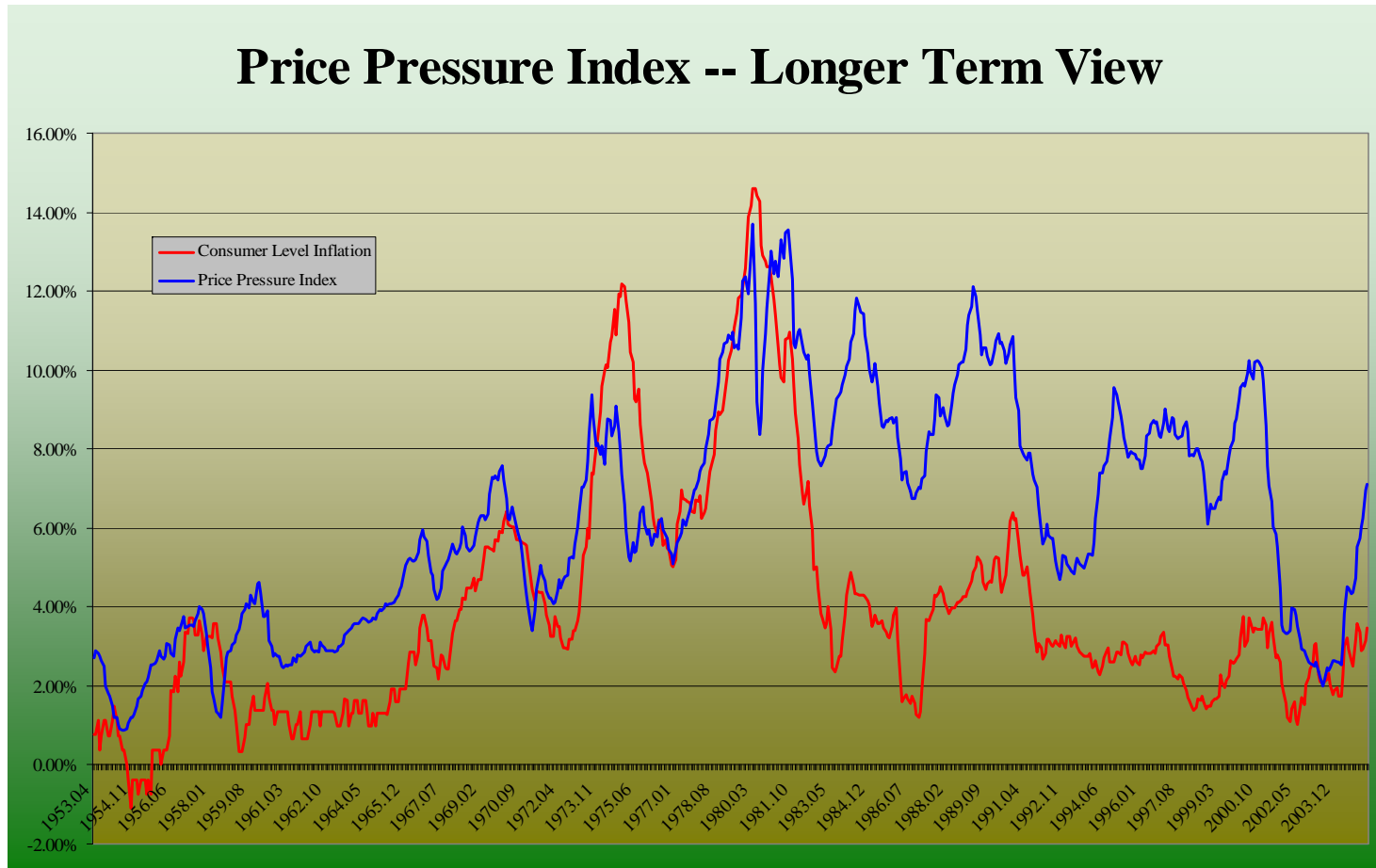
Going forward, the labor markets will be key.

Slack in the labor markets remains, but much less so than just a year ago.

Inflation expectations have been stable as evidenced by inflation indexed bonds.

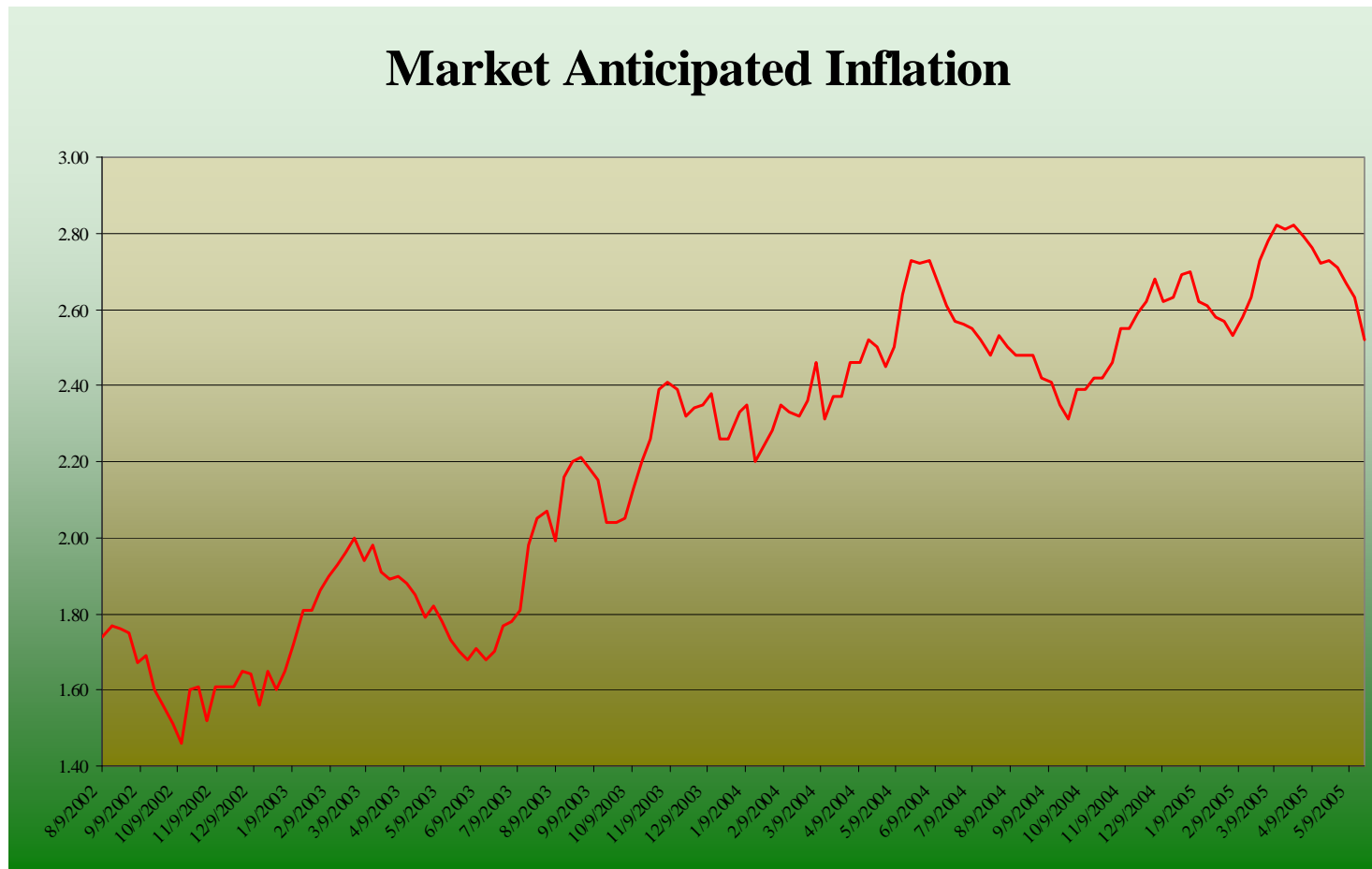
Flattening yield curve anticipates lower future levels of inflation.

Inflation Expectations



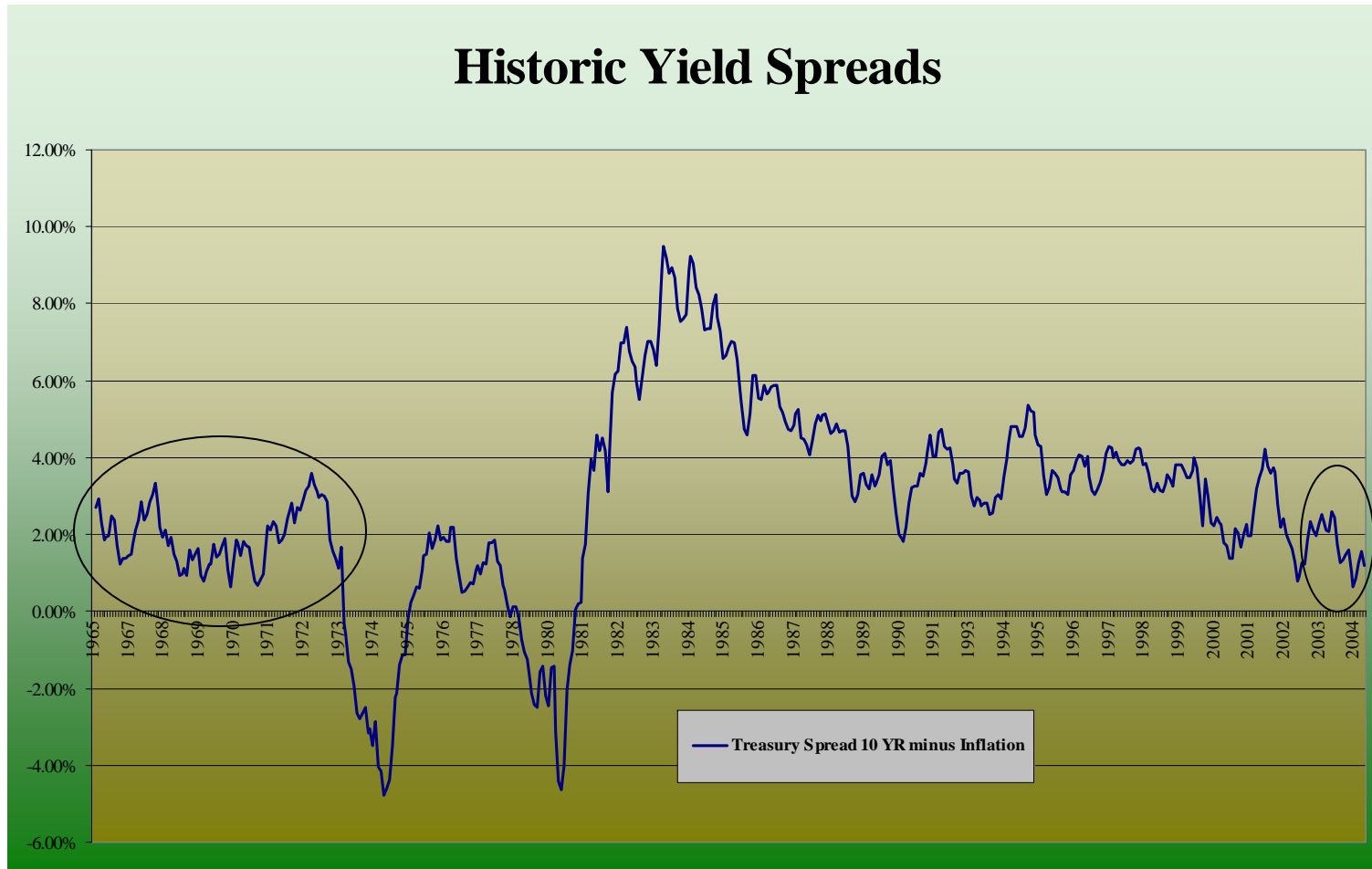
The pricing power the Fed has observed and commented on in the last month is evident in the continued rise of the Price Pressure Index.

Inflation Expectations



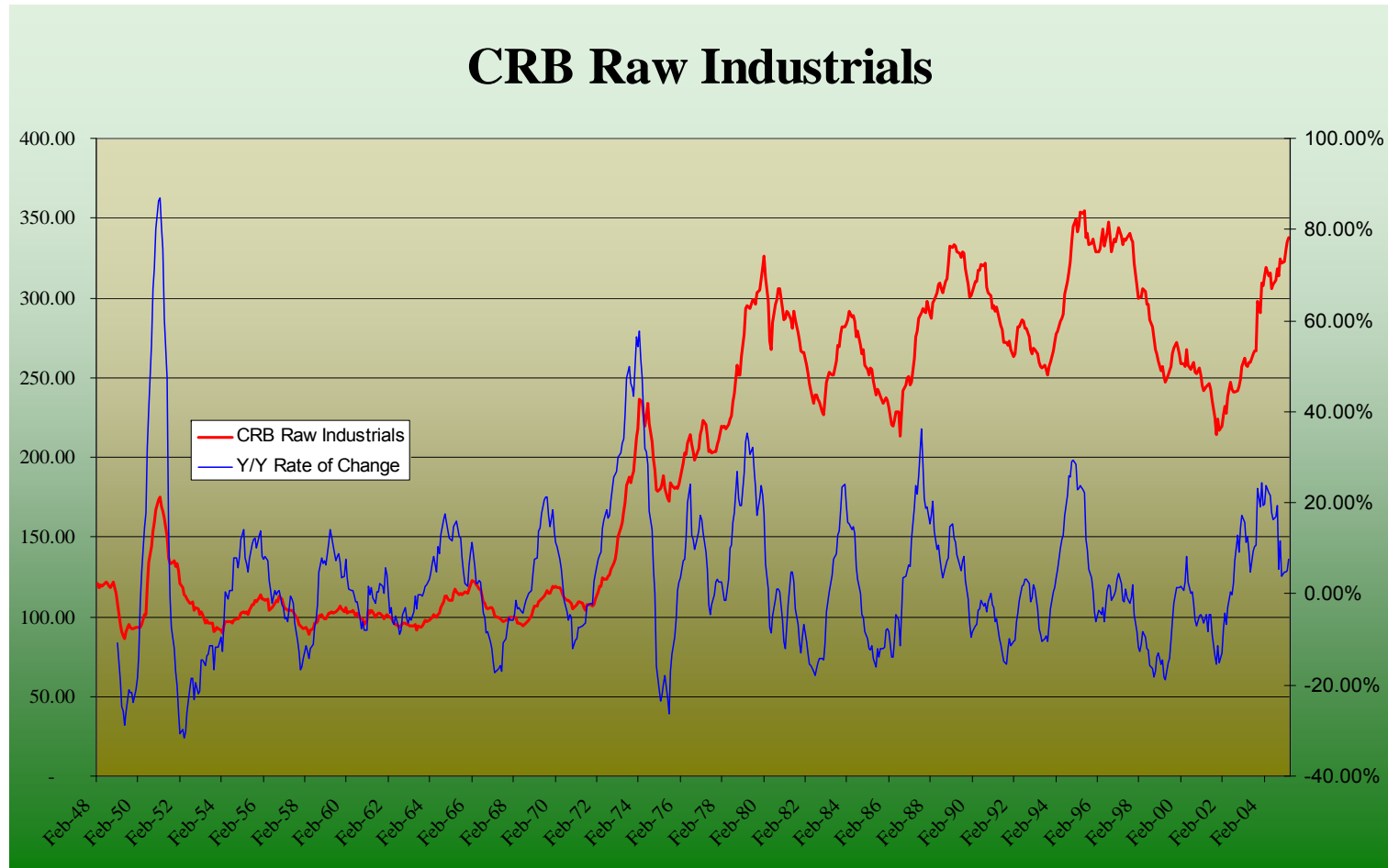
Using TIPS bonds to gauge inflation sentiment over the coming ten year period, the market as a whole is forecasting moderating inflation, with an implicit forecast of 2.52%, down from 2.73% in the prior month. In our opinion, stable and expected inflation levels are as important as the aggregate level of price increases.

Inflation Expectations



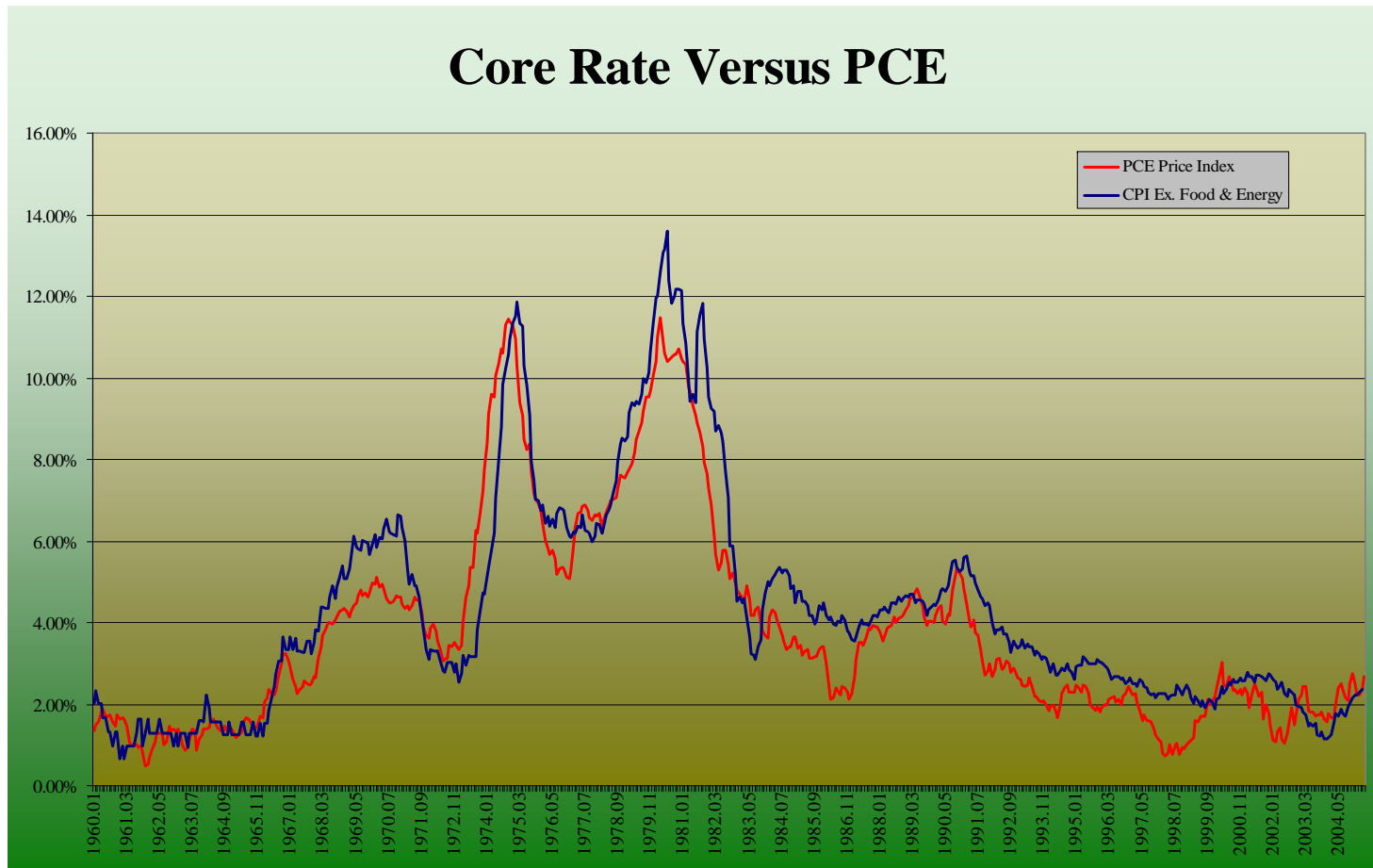
Real Long-Term Interest Rates, as measured by the 10 year US Treasury less All Urban CPI, are at levels not seen since the middle of the 1960's

Inflation Expectations



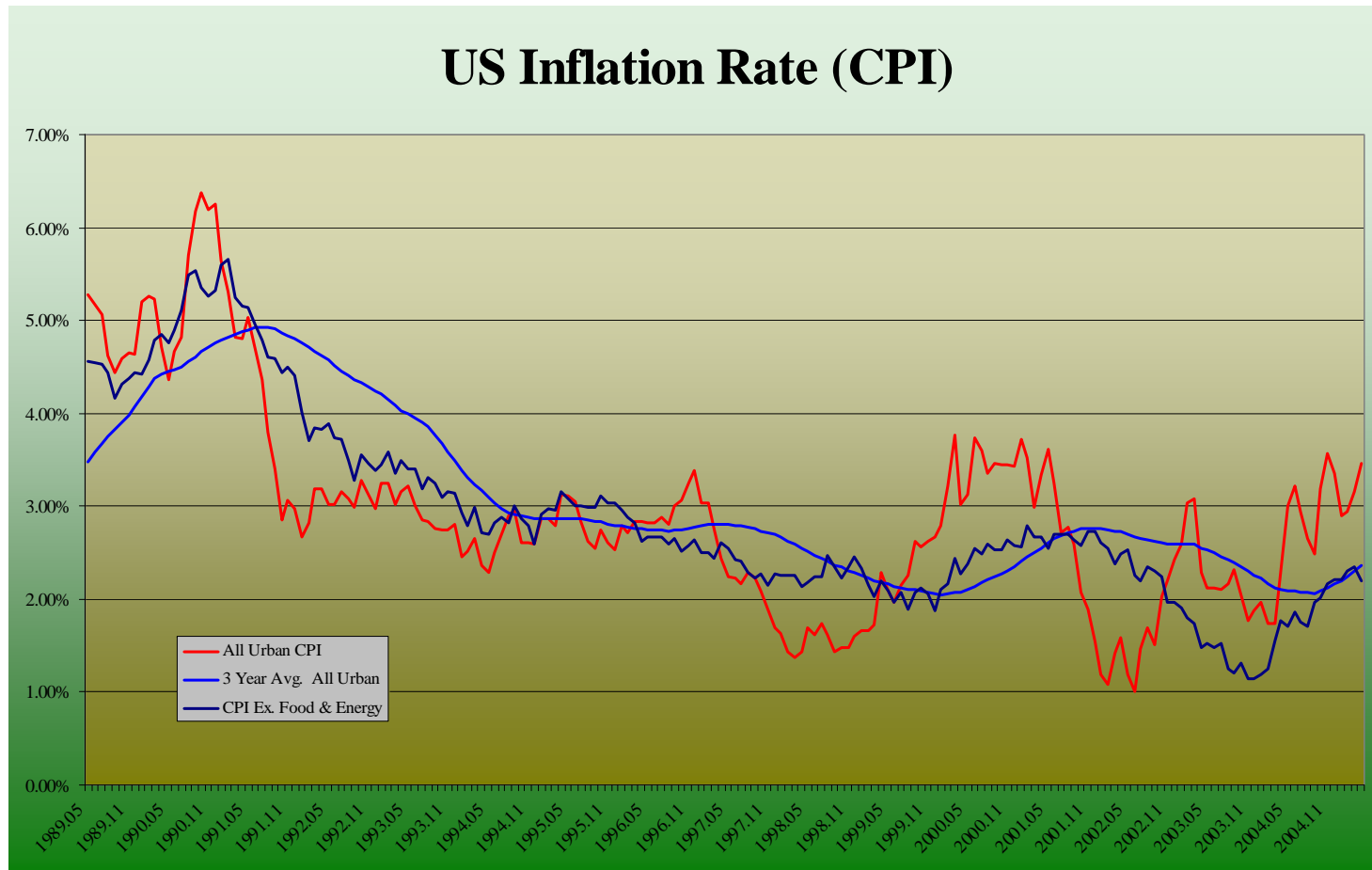
The Y/Y percentage increase in commodity prices continues to moderate. Globally, supply is rising to meet demand.

Inflation Expectations



Dr. Greenspan's professed favorite inflation number, the Personal Consumption Expenditures Price Index (PCE), rang in last month at 2.67%. Hardly run-away inflation.

Inflation Expectations



Broad measures of inflation continue to exhibit a strong, cyclical upturn driven in part by record energy prices. The core rate of inflation continues to follow the lead of All Urban CPI. **Prices must moderate for the expansion to continue.**

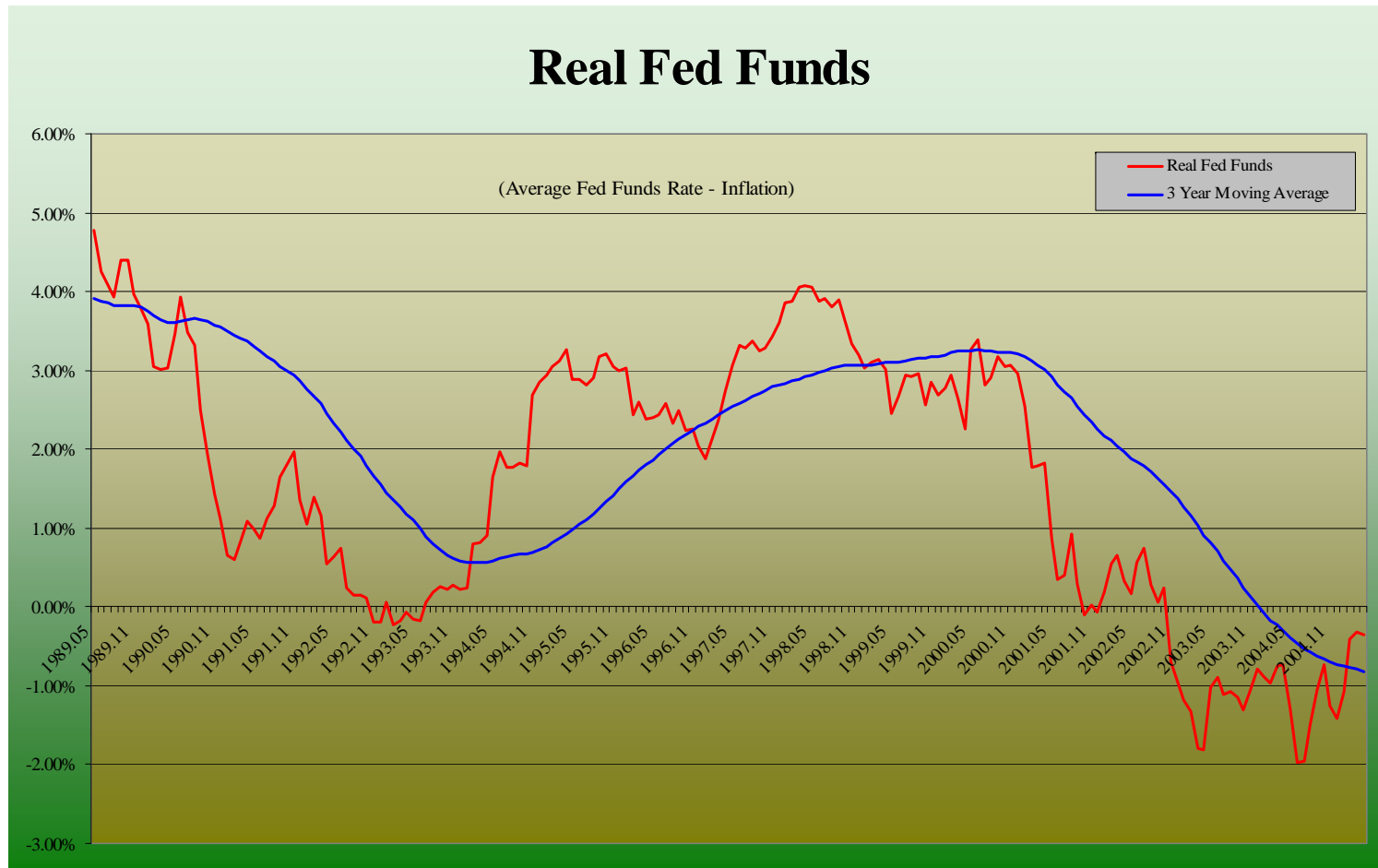
Federal Reserve Watch

If the Fed is working to cool real estate prices with tighter monetary policy, they will succeed... but not without negative effects on stock prices and the broad economy.

The Fed Funds rate has moved up so far this year, but the yield on the 1 year US T-bill has stayed essentially flat.

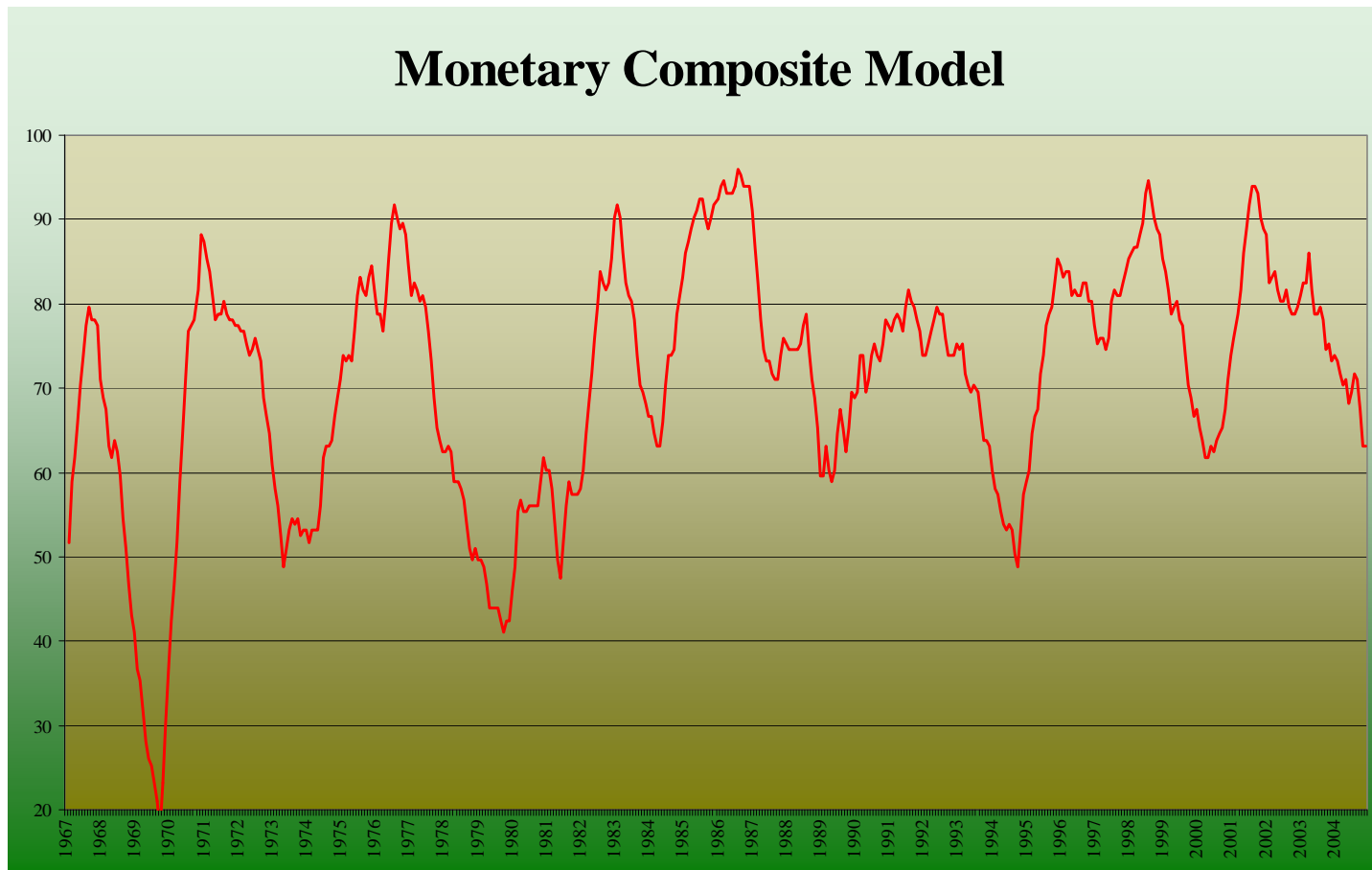
This is a less than ideal time to be replacing Dr. Greenspan. It will take time for the new FOMC Chair to gain credibility on Wall St.

Federal Reserve Watch



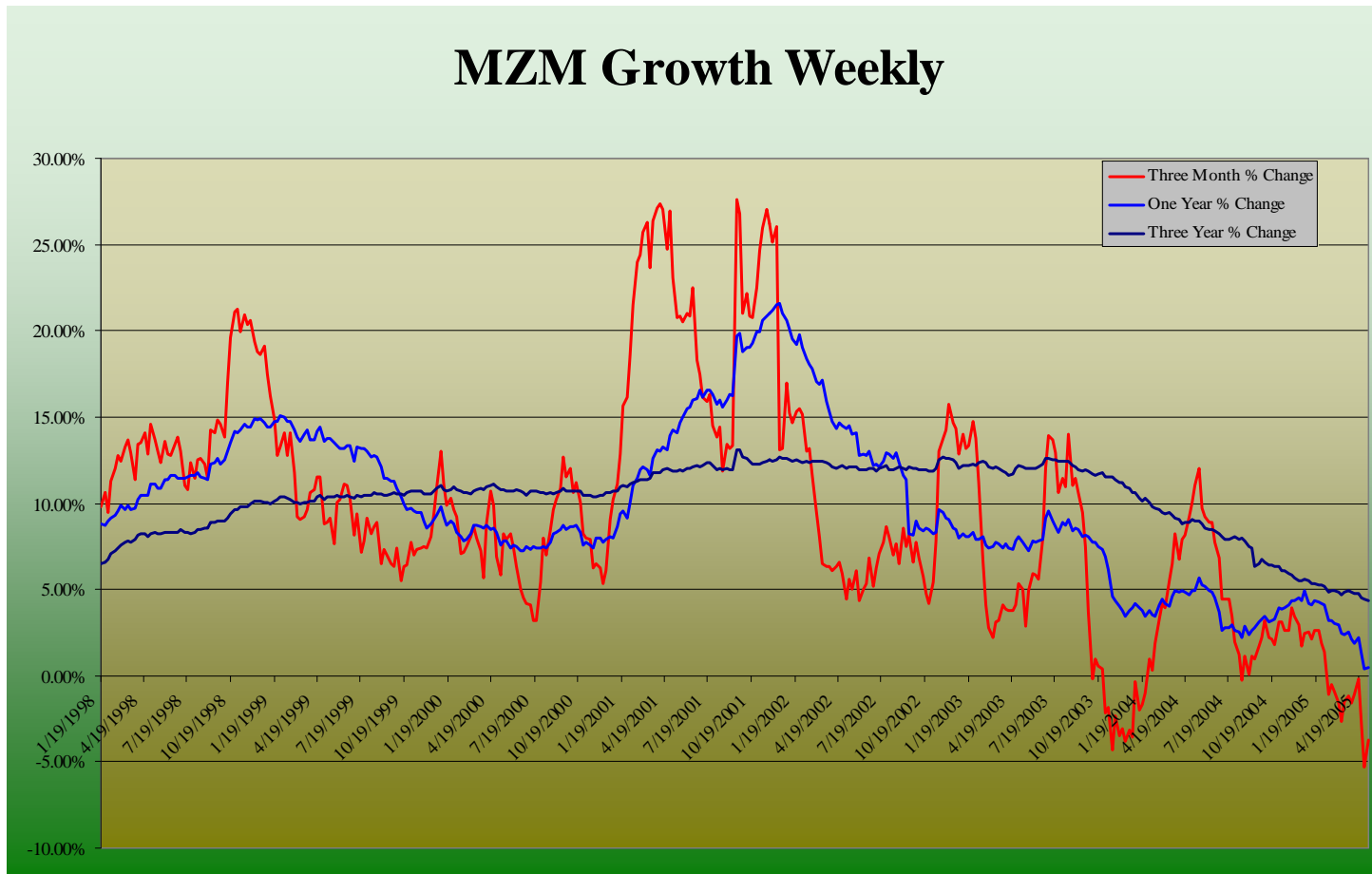
Where is the neutral rate of real short term interest rates? 0%? 1%? 2%?
Only the US Federal Reserve knows, and hopefully they are not feeling
around in the dark trying to find out.

Federal Reserve Watch



A value above 50 indicates the Fed's policies are accommodative, but the trend is just as important.
Monetary conditions & liquidity continue to deteriorate. The April decline in the US Equity market felt like the result of a liquidity contraction, not a contraction in the fundamentals.

Federal Reserve Watch



Money Zero Maturity (MZM) is a broad measure of liquidity that is significant to lending, business activity, and equity prices.

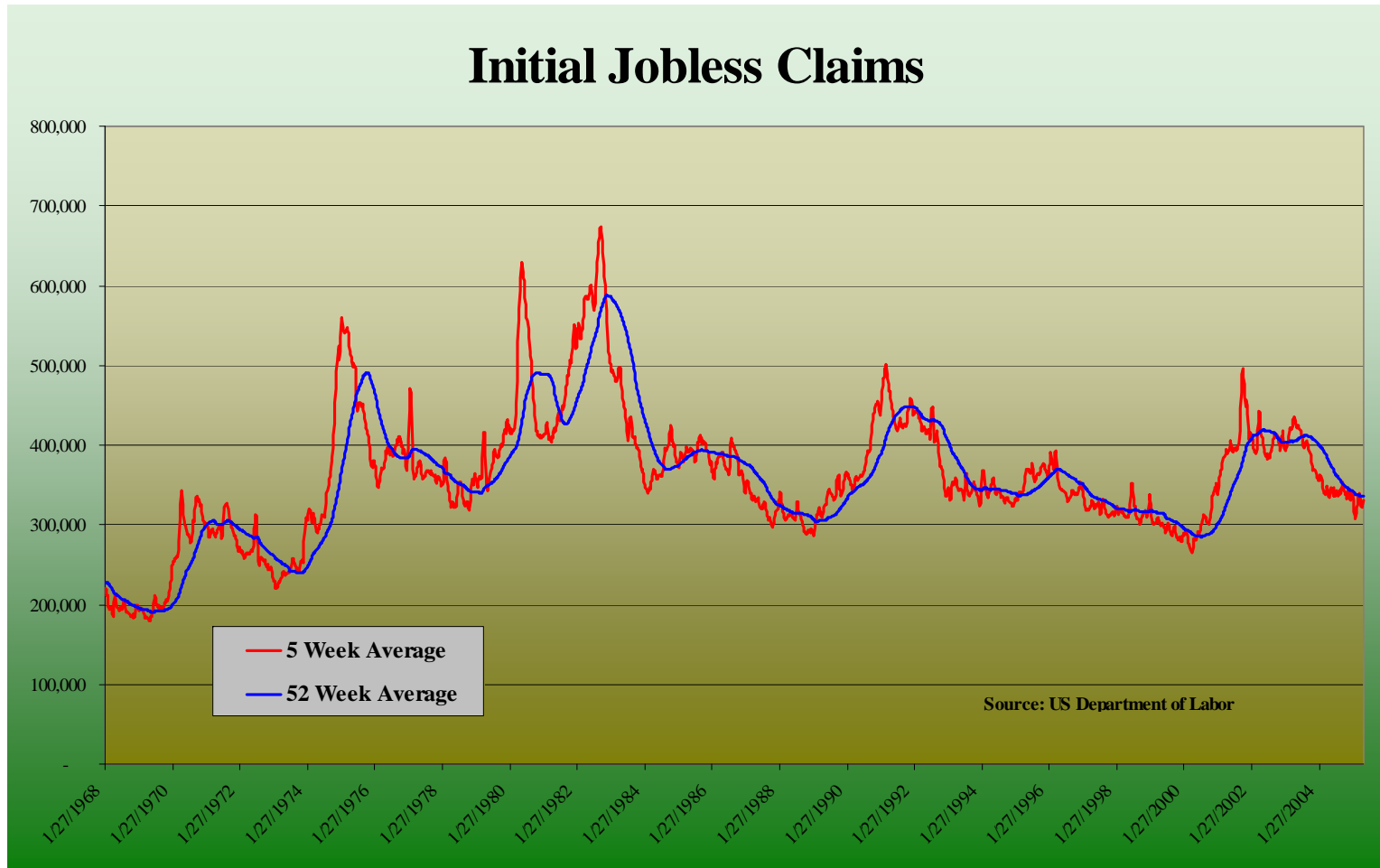
The Monetary headwind is becoming a gale. MZM is contracting.

Outlook

Some believe we are late into the business cycle, we believe that we are mid cycle. As the economy changes gears from recovery to expansion, monetary stimulus wanes as prices recover.

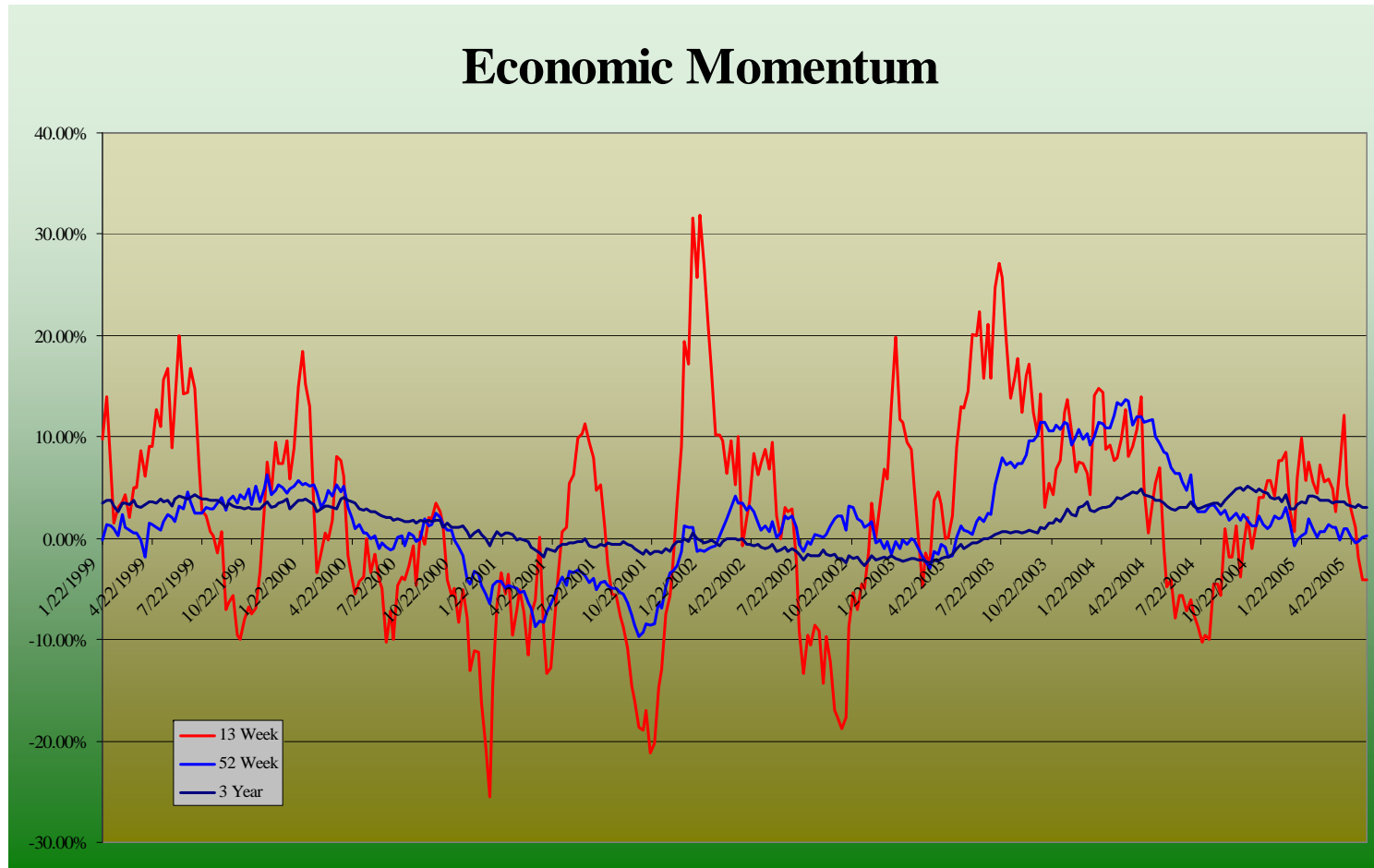
We are in a fragile area of the recovery; the smallest of shocks (terror, energy prices) could tip us into recession.

Outlook & Forecast



Jobless claims continue to be below the 350,000 level consistent with robust labor conditions over past business cycles. Continued labor market/income growth is going to be **critical** with the headwinds of tighter monetary policy and slower growth.

Outlook & Forecast



Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com).
Once again, this leading indicator has stalled out; economic growth is flat at best.