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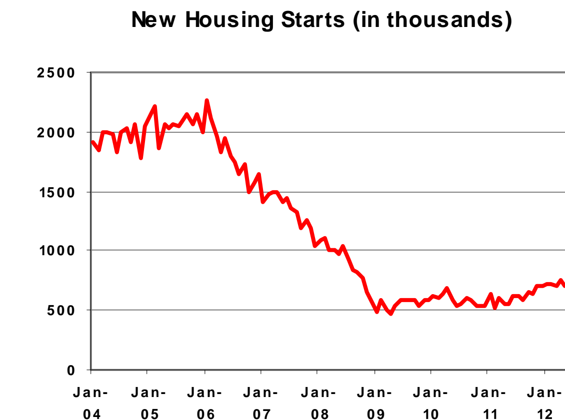
Investment Matters

For the quarter ended June 30, 2012

Will a Housing Recovery Re-ignite Economic Growth

Housing is looking up lately. New housing starts, which had been running around 600,000 units per year, have recently advanced to a 750,000 unit annual rate and are projected to reach 900,000 this Fall. Median home prices, which fell more than 30% from 2005 to 2011, were up 8% in the last year. Housing affordability, a measure which combines house prices and mortgage rates, is at record levels. It is now cheaper to buy than to rent. Even though foreclosure related problems continue to plague the industry, it is clear that housing is bottoming.



NEW HOUSING STARTS HAVE BOTTOMED

Housing is a leadership industry in economic recoveries. During a recession consumers are less likely to initiate large purchases, such as a house or new car. As the recession continues, demand for these items grows. At some point, after prices and financing costs have declined enough to overcome consumer resistance, pent-up demand bursts forth in a surge of buying and the rest of the economy quickly follows.

But the recent recovery has been different. In mid-2009, at the time other industries were starting to recover, millions of consumers were upside down on their mortgage and in no position to trade houses. And though mortgage rates were falling, fearful bankers were unwilling to lend. Home prices continued to slide. There can be little doubt that continued housing weakness is an important reason people feel we are still in a recession.

> "This deleveraging process is unlikely to reverse until the recent housing tragedy is a distant memory."

But if housing is bottoming, is it possible that there is a second leg to the recovery which will soon return us to normal rates of economic growth? Sadly, the answer is, probably not.

Although there exists some pent-up demand for housing based on normal population growth, and housing affordability is high, consumer resistance is also high. Many potential buyers are still trapped in upside down mortgages. Others, even those with good credit histories, are unable to get a mortgage. Many people are still unemployed. More are under-employed or have lost crucial employment skills from lack of use. U.S. consumers, unlike any period since the Great Depression, are reducing rather than adding to their debt levels. This deleveraging process is unlikely to reverse until the recent housing tragedy is a distant memory and economic confidence has returned to near normal levels.

Baby Boomer Bust

A recent paper by researchers at the San Francisco office of the Federal Reserve Bank blames retiring baby boomers for weak stock market returns over the past dozen or so years. This is only the latest of the outsize economic effects which baby boomers have had on the economy since the strong wave of births in this country from 1946 to 1964.

The researchers note that the baby boom generation is accelerating the aging of the U.S. population. In fact, the ratio of people in their 40's relative to people in their 60's peaked in 2000 and has been declining precipitously ever since.

People in the 40-49 year age group are not only close to the peak of their productive years but they have a strong tendency to save money for their children's college education and their own retirement. With two more decades before they can retire, 40-somethings tend to seek the higher returns historically associated with stocks.

People in the 60-69 year age group are slowing down or retiring. Not only is this age group less productive but they are beginning to draw down their savings. Even before cashing in investments to support their lifestyle, they

Continued on page 2.

Bust: continued

often sell stocks to move money into less risky investments.

More sellers than buyers is the classic prescription for a bear market.

The researchers note that a similar but less pronounced decrease in the ratio of 40 year olds to 60 year olds in the 1970's was also accompanied by weak stock market returns. The good news is that most of this trend is behind us. The ratio of young to old will begin to rise around 2021.

Around three-quarters of the world's inhabitants now have access to a mobile phone.

By some estimates, the United States has more oil than Saudi Arabia, Iraq and Iran combined

What Determines Stock Prices?

It is often said that, "Profits are the mother's milk of stocks". With so much attention given to company earnings reports and overall corporate profit growth, most people probably assume that stock prices move in near lockstep with profits. This is far from true.

In the 1990's, stock prices rose an average of 15.3% per year, but profits for all U.S. corporations advanced at only a 7.6% annual rate. Other periods have shown similar divergences of stock prices from profits, with prices and profits sometimes going in opposite directions.

To better explain the relationship between stock prices and earnings, analysts began to factor interest rates into the stock valuation equation. When long term interest rates go up, expected future profits become less valuable and when they go down, future profits become more valuable. When so-called discounted profits were compared to stock prices over time, the match with the historical stock price movements was very good.

But, around the turn of the century something changed.

While discounted earnings soared based on strong profit growth and a decline in long term interest rates, stock prices languished. In fact, if stock prices had kept pace with discounted earnings, the stock market today would be 2-3 times its current value and the last ten years would have been one of the best in stock market history. How can we explain the difference?

An obvious candidate for the shortfall in stock prices is lack of confidence in future profit growth. If stock investors believe that future profit growth will be significantly slower than the 7% historical average, they would be unwilling to pay a normal multiple of current earnings to own stocks.

But low confidence in future growth is not a new phenomenon. Confidence was very low in the 1970's with high inflation and economic juggernaut Japan in ascendency. And the level of confidence in the 1930's was certainly much lower than it is today. While the current low level of confidence may explain part of the stock price shortfall from calculated values, it does not seem sufficient to account for the entire difference..

In all probability the calculation is wrong because long term interest rates are not what they seem to be. Most of the decline in interest rates since 2000 was not the natural result of market forces but was engineered by the Federal Reserve using extreme and untested methods. Analysts agree that without this extreme intervention long term interest rates would be at least double what they are today. Current long term interest rates are artificial and probably unsustainable. Inserting the presumed natural rates of interest into the calculation, discounted earnings drop to a level which is consistent with the long term pattern of stock prices.

This suggests that stock prices, while low, are probably rational but that bonds and other interest bearing securities are priced irrationally high.

For a complementary review of your investment portfolio please call our office at (716) 633-6555 to schedule an appointment at your convenience.

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The Bottom Line: 6/30/2012

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1362	5.5%
Small company stocks *(S&P Small Cap Index)*	445	0.0%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	1.7%	From 3.2%
Inflation *(Consumer Price Index)*	228.5	1.7%
Energy *(West Texas Intermediate Crude Oil)*	$84.82bbl.	-11.1%
The economy *(Inflation adjusted GDP)*	$15.5 trillion	2.0%

QUOTABLE

"Although it's easy to forget sometimes, a share is not a lottery ticket…it's part-ownership of a business."

Peter Lynch

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