

# Market Timing

## Inflation confirmed: rate hikes likely to continue

Last week Alan Greenspan, the Chairman of the US Federal Reserve testified on the state of the economy to the Joint Economic Committee of Congress. Interestingly, the bulk of his speech was dedicated to the housing market. In a recent issue of our newsletter we criticized Greenspan and company for not being more vocal and cautionary when they see potential bubbles on the horizon. In this case, wording was relatively strong. Although Greenspan would not concede that there was a national housing bubble, he stated that some key areas were “frothy” and at risk and likened them to Silicon Valley in the tech bubble. A number of the regions that are looking on the “frothy” side also happen to account for a large chunk of economic activity—California, Nevada, many Northeastern states and Florida. This means that a decline in real estate values in those areas would have a magnified impact on the rest of the country, making the notion of localized impact misleading.

Up until now, cash flow generated through refinancing and cashing out of home equity have been critical underpinnings to the consumer-spending arm of GDP. While lien refinances are projected to total \$112 billion in 2005, this is about \$30 billion or 21% less than in each of 2004 and 2003. In 2006, these same refinances are only expected to total \$70 billion as the cost advantage to homeowners deteriorates under a higher rate environment. To put this into perspective, a 2002 study found that 25% of the funds from refinances went into discretionary spending (ie, clothing, autos and vacations); about 43% went into home improvements. In the past three years, one can contemplate how much more of this money has gone back into real estate speculation itself, as homeowners are encouraged by soaring house prices to use their home equity to lever up their real estate exposure. Leverage cuts both ways, and on the way down, leverage magnifies capital losses.

All tolled, this expected big drop in refinancing activity in 2006, coupled with an over-levered consumer and higher interest rates, is likely to produce a period of below potential spending growth next year. This means economic expansion would become more reliant on growth in business investment. After a three-year period of solid profit growth, corporate America has been investing its share of profits at multi-decade lows. This means they have the cash to invest in their own productivity should they have the commitment. Time will tell whether or not global demand and sentiment is sufficiently upbeat to entice companies to stop saving and get back to the forward-looking preoccupation of re-investing in themselves.

The May Industrial Production report released today suggests that the softness in the US economy may be firming up. This means the Federal Reserve will continue its focus on raising interest rates to combat inflation.



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**Greenspan also intimated that pricking the housing bubble would not be a reason to deter the Fed's from making the rate hikes required should economic growth warrant.**

### **Market Update:**

Our buy alerts on technology and the broader market indices have yet to confirm, in fact, the recent activity clearly shows prices rolling over, possibly to test previous lows. If previous lows are tested and hold, this will be construed as a good sign and we will eventually get a green light. The largest complication in this, as noted in our previous updates, is the still high price of oil. If oil continues its ascent, it will diminish economic re-acceleration. History shows how often higher oil prices can lead a market higher. The answer has been-- never. The higher input cost of oil is inevitably friction that weighs on corporate profits.

Continuing to keep our fixed income maturities short with limited market exposure has proven a prudent course of action in recent months. And while equity market indices have done little to nothing, interest sensitives have proven highly volatile. Once prices fall further, we will be able to purchase income-producing investments with less risk and some capital gain potential.

Some of the defensive sectors may also rise to the occasion, with the pharmaceutical sector testing support at current levels as well as consumer staples.

As always we remain vigilant and review every day opportunities with real market support and conviction. Until then we continue to favour safety at this time.

***Good people strengthen themselves ceaselessly. -- Confucius***

***Well-arranged time is the surest mark of a well-arranged mind. -- Sir Isaac Pitman***

***I am an artist at living—my work of art is my life. -- Suzuki***

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