The Delta Group

A FINANCIAL ADVISORY FIRM

Volume 23, No. 1, Jan 2007, Eric Drew Dahl & Patricia J. Williams, Editor

Overview

For the first time in this decade, housing prices rolled over in 2006 after an incredible four year run brought on by record low interest rates. The doubling of home prices (and tripling in some) created another market bubble as investors drove prices to extreme over-valuation. Experience shows that all things about money go to excess. Real estate has shown it is no exception.

And, speaking of the previous stock market bubble, this past year the broad market recovered all of its 50%+ losses sustained during the bear market that started the decade. At its conclusion in 2002, the stock market was at best viewed as a money-pit played by fools.

As far as residential real estate goes, recovery will depend on location and price level. The hot condo and Sunbelt markets will take the longest to recover, as will both the lower and upper level price ranges. Markets represented by the middle class will fare best as the supply/demand equation remains fairly constant.

Economists' concern over the real estate downturn lies with both evaporating equity as a source to borrow and fund lifestyles as well as construction job loss and its adverse affect on the overall economy. Major cookie cutter developers have scaled back many large projects in the go-go markets. The construction downturn has been a subtraction of ~1% from GDP in the final two quarters of 2006.

In addition to the real estate downturn, economists also point to the inverted yield curve as a catalyst for a slowdown. The "inversion", a condition where short term rates are higher than long term rates, has been present in all recession since 1960. The Fed's efforts to curtail real estate speculation have lifted the Fed Funds rate to 5.25%, while longer term treasury rates are a shade below 5%.

Economic

Chicken Little risk avoiders missed 2006 completely. In fact, they've missed the entire four year expansion. Deficits, war, low savings rate, housing bubble, rising interest rates and energy prices, etc. have been the focus that fueled their negativity. No doubt these people are right about the details, but investing is not about details. This myopic view is totally oblivious to the big picture. Globally, we have been in the midst of the greatest synchronized economic expansion the world has seen.

The deflationary fear of a post stock market bubble panicked the Federal Reserve into record low interest rates. The easy monetary policy, designed to stimulate consumer spending, also boosted industrial production, most notably in China, whose demand for raw materials sent commodity prices soaring, benefiting the economies of the Middle East, Russia and Latin America. Their new found wealth created a demand for imports from Europe and Japan in the form of luxury and capital goods. Meanwhile, dollars circulated back into the US to finance our spending addictions.

This is the new and expanded version of the "Goldilocks" economy, evident in the US in the raging 90's of growth, low inflation and interest rates. We have now gone global.

The worriers, like weather forecasters, will some day get it right. Expansion does create excess liquidity as consumers borrow against rising asset values. When values rise too high and borrowing becomes too great, imbalances are created. Bubbles form, prices fall, and ultimately the economy contracts as consumers repay debts. Our dependency on the re-circulation of our dollars returning via the largess of our foreign trading partners is critical to our economic merry-go-round. To this end, we have lost control of our destiny. Our perch on our granite mountain top is turning into an eroding sand pile.

In 2004, the Fed took dead aim on the bubbly real estate market and vowed not to end rate increases until signs of a market slowdown were evident. Market observers fretted over the Fed being too aggressive, and subsequently squashing both the real estate market and the economy as well. So far, the Fed has gotten high marks for taking a very pragmatic approach, having put off any additional changes to rate policy until conditions warrant.

Speculators and second, third (etc.) home buyers now regard property as the new money pit and consequently, housing demand has slowed significantly. The economy though remains resilient with retail sales in December exceeding the previous year's figure.

Investment

Over the past four years, our investment objective has been simple and successful. Our thoughts relating to an expanding global economy has been to remain broadly diversified with the intention of achieving long term gains in markets worldwide.

2006 witnessed the blue chips regaining favor, as questions regarding the economy's strength brought the durability of the large stalwarts back into favor. The Dow Jones Average returned 17% in 2006 while the smaller stock segment, winners over the previous six years, returned slightly less.

International markets had another stellar year with the world index rising 26%. Emerging markets did slightly better. Gold and commodities, darlings since the beginning of the recovery, remained popular with the continued expansion of the emerging markets and growing demand of raw materials.

Even the bond market got into the highlight reel posting average, but very decent single digit returns. Treasury rates increased slightly in '06 in sympathy with Fed rate tightening and inflation worries. The corporate bond market fared better with total returns touching 10%.

Common sense dictates we carry our 2006 strategy into 2007, with some minor adjustments. Rising prices have taught us to be wary and cautious, with annoying volatility returning. Last year, 90% of mutual fund flows went to overseas investments. Although there has been a lack of recognition of the virtues foreign share ownership over the years, it appears the buying public has caught on. However, we should not ignore the virtues of US blue chips, which were laggards through 2005. Increasing allocation to capture their safety and predictability makes a great deal of sense.

Conclusion

With a remarkable five month year-end rally, 2006 brought very generous gains to add to our bull market totals. Although many guess that 2007 will be much more volatile than 2006, the stock market will follow the economy, and the economy will follow the Fed.

Much of the rise in last year's rally was due to the increased expectation that the Fed would begin lowering rates sometime in 2007. Lower interest rates are bullish for stocks. Although the Fed squashed real estate speculation, another bogeyman remains: Inflation. Running in the 2%-3% range is not troublesome, but if inflation trends higher, the Fed may be forced to become more restrictive, which will annoy the markets.

After four years of growth (with some borrowed from 2007), don't be surprised to find a challenging year ahead. Regardless of the near term woes, free market economies will grow and markets will follow.

May the New Year bring you peace and prosperity!