

# SHARPER ♦ GRANITE



*Optimal Portfolio Management*

**SUMMER**  
**2005**

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**T**he headwinds for stock and bond investments have intensified throughout the year. This quarter we focus on a set of economic factors that have peaked to historical extremes.

Oil reached an all-time high in nominal dollar terms. The Federal Reserve Board hiked interest rates for the eighth and ninth consecutive times, sculpting the flattest yield curve in years. Terrorist violence resurfaced in London. The U.S. trade and budget deficits expanded to extreme levels and housing prices reached record levels in many U.S. markets.

What do these extremes mean to investments short and long? This quarter we review the meaning of these economic data in the "Second Quarter 2005 Economy Review" and specifically examine housing prices in "The Residential Real Estate Bubble".

## Financial Markets Summary

In the second quarter of 2005, the S&P 500 Index gained 1.3%. The NASDAQ gained 0.6%. Long bond yields continued to decline, pushing the Lehman Aggregate Bond Index up 2.2%.



The average of all Sharper ♦ Granite client portfolios gained 2.9% (net of fees) and maintained a risk level 26% less than that of the S&P 500 Index.<sup>1</sup> When calibrated to the same risk as the S&P 500, Sharper ♦ Granite client portfolios gained 3.4%.

This quarter continued a pattern of relatively flat stock and bond markets with significant churn across industries and geographies. Sectors that performed well included Asia, Latin America, REITs, health care, energy and utilities.

Total return (stock price change + dividend) of typical investments representing these sectors in Sharper ♦ Granite portfolios are shown in the chart to the right.

Sharper ♦ Granite tilted portfolios toward the energy, utility and Asia sectors this quarter. These tilts contributed to a total return performance that comfortably beat the market. See Sharper ♦ Granite's recommended tilt toward energy and utilities in "Tilting Portfolios to Improve Performance", *Fall 2004*. ●

Sector	S♦G Investment	Quarter Change
Asia	EWH	+7.9%
	EPP	+4.5%
Latin America REIT	ILF	+13.7%
	VNQ	+13.3%
	RWR	+13.7%
	NXL	+8.2%
Health Care	SPG	+19.7%
	IYH	+4.5%
	VHT	+5.0%
Energy	XLE	+3.7%
Utility	XLU	+8.3%

## The Residential Real Estate Bubble

One of the economic "extremes" of today concerns whether we are experiencing a residential real estate bubble that could soon collapse. And if this occurs, how painful will a housing price decline be?

While it is difficult to measure asset bubbles within an economy, an overwhelming number of studies, looking at real estate prices from different angles, are showing that housing prices in many parts of the country are at unsustainably high levels.



Analyzing the national real estate market in general terms is challenging since markets vary significantly by geography. Each region is subject to local industries, demographics, and land availability. And while interest rates certainly have an impact, Sharper ♦ Granite research shows that this relationship is complex. For example, housing price declines correlate only loosely to the level and direction of interest rates. They are tied more to the velocity of the rate change and other economic factors. Several real estate booms have in fact ignited when rates were high, such as the 60% jump in real home prices in Los Angeles between 1975 and 1980 when interest rates were 15 to 20%.

One study by Yale economist Robert Shiller builds a home-price index based on same-home sales in order to filter distortions from changing mixes of house sales. This data, shown below, implies an extraordinary housing bubble. The increase in real prices (after inflation) since 1997 dwarfs even the post-World War II housing surge.

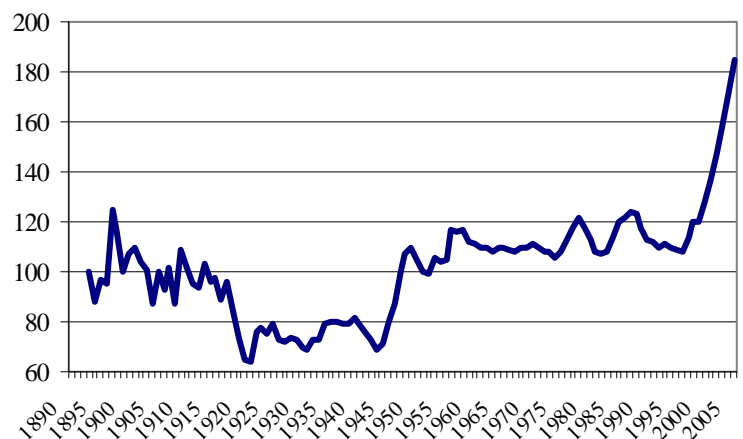
Shiller and others have found no fundamental driver of the increase. None of the traditional underlying forces behind price increases, such as interest rates, population, income, or building costs are spiking along with home prices.

Another lens through which real estate prices are analyzed is the rent to own differential. Costs to rent vs. own tend to move in tandem over time with the direction of rents a leading indicator of ownership costs. The chart on the following page shows how declining rents presaged ownership cost declines in the early 80's and early 90's. But now, as rents have declined over the last three years, home ownership costs have skyrocketed.

Rents are the fundamental underlying factor guiding property values, just as corporate earnings drive stock prices. A divergence between rents and home prices is unsustainable.

Another study by Bear Stearns shows that the so-called creative mortgages, aimed at making home buying so affordable in recent years, are abating. Despite increasing home prices, the average initial payment on new loans has actually decreased since 2001. This trend, however, reversed this quarter, signaling that a housing price reversal may be near.<sup>4</sup>

*Same Home Price Index 1890 - 2005<sup>2</sup>*



In addition, riskier adjustable-rate mortgages accounted for 35% of all mortgages in 2004 vs. 18% in 2003,<sup>5</sup> and home prices in several areas, especially on the coasts, are growing faster than per-capita personal income.

Finally, many of today's buyers are not purchasing homes in which to live. 40% of house and condo purchases today are not used for dwellings but as investments or second homes.

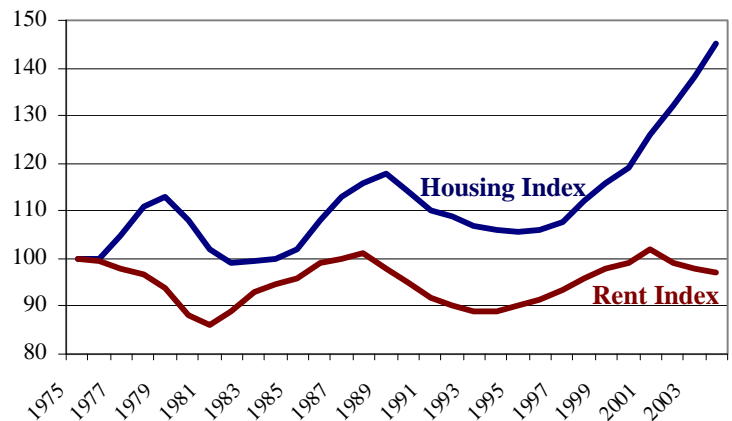
The evidence of high relative house prices is strong, but how drastic would be the effect on our economy if prices did decline?

The pain may be less than many think. First, a home-price bubble "pop" will not decline as dynamically as the internet bubble "pop". Houses are much more illiquid than stocks and are fundamentally needed as homes (for the most part).

While a home-price decline will be painful to some who are highly leveraged or forced to sell, Americans as a whole have experienced tremendous wealth gains over the past decade. Even a 10% national home price decline would leave a 50% net real wealth gain (after inflation) by Americans over the past ten years.

Australia recently underwent a housing bubble pop which has since stabilized. Home prices declined 20 to 30% in Sydney and Melbourne. Despite this, Australia's stock market is near an all-time high today and unemployment is low behind a strong economy.

*Rent Index vs. Housing Index Costs<sup>3</sup>*



## Second Quarter 2005 Economy Review

Our global economy today faces several extremes, in order of economic importance: oil prices, interest rate behavior, residential real estate prices, the U.S. trade deficit, and the uncertainty associated with war and terror.

Oil remains the biggest threat to the economy and to equities. Oil prices reached an all-time high this quarter in nominal dollar terms of over \$60/barrel. Oil prices will remain high for some time due to strong world-wide demand during this global growth phase. This season's hurricane damage report will also nudge prices up or down. Scientists are predicting one of the most severe hurricane seasons ever.



On both May 3rd and June 30th the Federal Reserve increased short-term interest rates by 0.25%, raising the federal funds target rate to 3.25%. Long-term rates, as defined by the 10-year Treasury bond, actually decreased to below 4% based on low inflation expectations and the increased potential for a slowing economy. The current consensus (as defined by the Fed Funds futures market) is for two more 0.25% rate hikes at the next two Fed meetings before pausing indefinitely. 3

This quarter the media continued its frenzy around the "flat yield curve" (similar short-term and long-term interest rates) and concern that the yield curve might invert. Six of the last eight occurrences of an inverted yield curve were followed by recession. While the shape of the yield curve is important, the chart below shows that the current position is not so unusual by historical standards. Moreover, it is equally important to observe the *level* of the yield curve, and interest rates are still historically low at both the long and short end of the curve. This accommodates economic expansion as it makes borrowing for investment easier. In short, current predictions of an inverted yield curve are overblown, and the yield curve is unlikely to invert. See "Impact of Current Monetary Behavior", in the *Winter 2004* letter for a more detailed analysis of recent interest rate behavior.

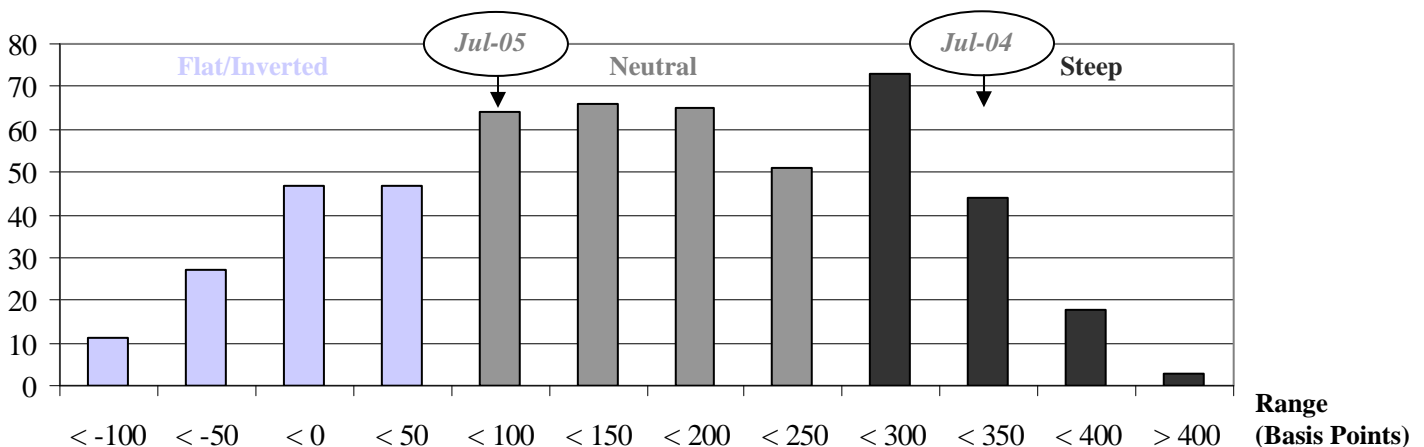
As discussed earlier, several studies from reputable sources presented convincing evidence of a pending real estate price decline. This effect should have varied impact across different U.S. geographies and will represent a painful but not lethal setback in the current phenomenal accumulation of wealth by Americans.

Finally, there is the rising U.S. trade deficit. U.S. trade deficits are normal due to the high wealth of Americans relative to the rest of the world. Further, deficit expansions are typical when the U.S. leads the world out of recession as is the case currently. However, the U.S. current account deficit is currently near 5.5% as U.S. companies and citizens import 65% more than they export. Economic problems such as currency volatility have occurred frequently in countries that have had current account deficits rise above 5%. In addition, the deficit could rise as the U.S. need for foreign capital is likely to grow at the same time that U.S. Treasury demand from China declines.

While the U.S. trade deficit appears frightening, America's wealth is growing fast enough that it should cover its increasing debt. This situation is like a family whose credit card debt is growing slightly but holds a future of improving salaries and bonuses that will more than offset the debt growth. Net real wealth (inflation factored) per person has risen 57% in the last 10 years -- the second largest 10-year increase on record. This wealth expansion was fueled primarily by increases in productivity, that is, improved innovation, technology, and efficiency in U.S. business processes. U.S. annual productivity growth has averaged 2.9% over the past 10 years.<sup>7</sup>

### Rate Spread Occurrences Since 1962

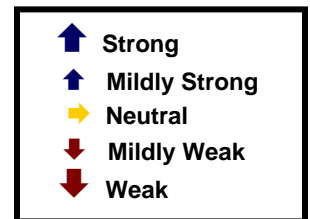
Number of Months Since 1962 that the Rate Spread between the 10-Yr and 6-Mo Treasury has been in this Range



The Sharper ♦ Granite index of leading economic indicators turned this quarter from slightly positive to neutral; however, any economic slowdown should be short-lived. Corporate earnings are strong, inflation is in check, and there is an end in sight to the interest rate hike cycle. ●

## Leading Economic Indicator Summary

- ↓ **Market Cycle:** Summer stock market performance, as measured by the Dow Jones Industrial Average peak to trough, trails that of every other season. While summers on average do show market improvement, it is less than during other seasons. Since 1965, winters average 13.6%; springs, 10.9%; falls, 10.6%; and summers, 9.4%.<sup>8</sup> September, the final month of our upcoming quarter, is historically the worst month of the year for stocks.



As discussed above, stock, bond, cash and real estate markets all continue to battle a period of increasing interest rates. Stock market returns since 1970 have averaged only 8.7% in calendar years of increasing interest rates as compared to 18.5% in years of declining interest rates.<sup>9</sup>

- ↓ **Political Cycle:** We are in the first year of President George W. Bush's second term. Historically, the first year in the presidential cycle is the weakest. Since World War II, the first year of the cycle has seen the S&P 500 Index post an average gain of 9.1%, and only 3.4% under Republican presidents. Only eight of the 15 post-WW II first years have been positive. When the data is reviewed back to 1888, first years are still the worst performers. However, the market has performed better during times of a Republican-controlled Congress, which we have currently.<sup>10</sup>
- ↑ **GDP Growth:** Gross Domestic Product (GDP) is the official economic measure of the U.S. economy. It is a measure of all goods and services produced in the United States. First quarter 2005 GDP was revised to 3.8%. This continues a trend of solid, steady growth and is in line with a healthy, growing economy. It was the 14th consecutive quarter of expansion, or positive economic growth, since the official recession of 2001.<sup>11</sup>
- **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, expanded through May for the 24th consecutive month albeit at a declining rate.<sup>12</sup>

Meanwhile, the Philly Fed Index, widely observed as a leading indicator, unexpectedly showed its first negative reading since May, 2003.<sup>9</sup> A negative reading indicates declining manufacturing activity in that sector.<sup>13</sup>
- ↑ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The core CPI, which excludes volatile food and energy prices, increased only 0.1% in June, indicating continued tame inflation. However, the longer oil prices stay in the \$50 to \$60 range, the greater the threat of inflation.<sup>14</sup>
- ↑ **Consumer Spending:** Economists keep a close eye on consumer spending because it accounts for two-thirds of all U.S. economic activity. U.S. retail sales fell 0.5% in May, a bigger decline than had been expected. It was the first drop since August. However, the overall retail sales trend continues to be strong.<sup>15</sup>

The increase in short-term interest rates by the Fed continues to take its toll on consumer spending. For each 1% that the Fed raises short-term interest rates, consumer spending falls about 0.6%.<sup>16</sup>

Consumer sentiment rose significantly in May. This was the first increase since December, 2004, and sentiment is now at its highest level since January, 2005. Views of both current and future conditions improved this quarter.<sup>17</sup>

↑ **Capital Spending:** Orders for capital goods rebounded in April, indicating no letup in capital spending. Businesses are showing confidence in the future based on the rising trend in capital equipment orders.<sup>18</sup> Banks reported stronger demand for business loans.<sup>19</sup> Additionally, demand for high-tech gear, which makes up over 50% of all equipment outlays, accelerated.<sup>20</sup> Finally, small business capital spending and sentiment indexes continued their trend upward.<sup>21</sup>

On a cautious note, a recent Duke University study showed that CFO's, who typically manage corporate budgets, expect capital spending to grow at only 4.5% over the next year.<sup>22</sup>

↓ **Investor Sentiment:** According to Investors Intelligence, investor sentiment has remained high since September, 2003. In June, 2005, sentiment reached its most exuberant point yet. This extreme situation cooled a bit during the first five months of the year but then rebounded in June, indicating that professional investors, who first place their bets, then tell the world their opinion, have already pushed much of their available capital into the market.<sup>23</sup> This reading was confirmed by other indexes as well, including Consensus,<sup>24</sup> AAIL,<sup>25</sup> and Market Vane.<sup>26</sup>

However, Smith Barney's Panic/Euphoria Model<sup>27</sup> indicates more bearishness in the market (which is good), and the UBS Index of Investor Optimism<sup>28</sup> declined over the quarter to the neutral point.

Another poor indicator for stocks is that the initial public offering (IPO) market has cooled. 24 of 72 IPO's issued through June 15th opened trading below their offering price. The average IPO opened trading 1.2% below its offering price.<sup>29</sup>

On a positive note, the short interest ratio peaked in May, a bullish sign that many traders have already speculated a lower market.<sup>30</sup>

↑ **Corporate Earnings:** 1st quarter profits for the S&P 500 companies increased 14% over last year. This is slower than last year's 20% 1st quarter increase but well above the 7.6% expected when the year began. The price-to-leading-earnings (P/E) ratio for the S&P 500 now sits at only 16.<sup>31</sup> This implies stocks are at relatively good value.

↓ **Insider Trading:** Insider buys peaked in early May, especially in the energy sector, but declined in June.<sup>32</sup>

#### Notes and Acknowledgements:

1. Arithmetic average used for return measurement. Asset-weighted average beta used for risk adjustment to market-risk level. Performance includes assets tracked for clients that lie outside Sharper ♦ Granite direct management, which amount to less than 4% of total assets. All client portfolios weighted equally in calculation
2. Robert Schiller, Professor of Economics, Yale University, and Karl Case, Wellesley College, *Irrational Exuberance*, March, 2005
3. Torto Wheaton Research, June, 2005
4. Bear Stearns Co., June, 2005
5. SMR Research, June, 2005
6. Merrill Lynch, April, 2003
7. Bureau of Labor Statistics, May 23, 2005
8. Stock Trader's Almanac
9. TDWaterhouse Research
10. Jeremy J Siegel, Professor of Finance, Wharton School of Business at Penn University
11. U.S. Commerce Department, June 20, 2005
12. Institute for Supply Management (ISM) – Chicago, April 1, 2005
13. Philadelphia Federal Reserve Bank, June 16, 2005
14. U.S. Department of Labor, June 18, 2005
15. U.S. Commerce Department, June 14, 2005
16. Merrill Lynch, May, 2005
17. University of Michigan Consumer Confidence Survey, June 17, 2005
18. *BusinessWeek*, June 6, 2005
19. *BusinessWeek*, May 23, 2005
20. Bureau of Economic Analysis, Global Insight, Inc., May 16, 2005
21. National Federation of Independent Business (NFIB)
22. Duke University Professors Campbell Harvey and John Graham in cooperation with CFO Magazine, June 27, 2005
23. Investors Intelligence, June 13, 2005
24. Consensus, Inc., June 13, 2005
25. American Association of Individual Investors, June 13, 2005.
26. Market Vane, June 13, 2005
27. Smith Barney U.S. Equity Strategy, June 13, 2005
28. UBS, June 2005
29. CNBC, June 15, 2005
30. CNBC, May, 2005
31. Thompson First Call, May 7, 2005
32. InsiderCow.com, June 29, 2005

Questions?  
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