

Investment Outlook 2007: What are the Facts and Who's in Denial?

“Da Nile Is Not Just A River In Egypt”

My wife, Becky, and I have five children. The youngest is 16 and the oldest is 24. As you can tell from their ages, we have spent a great deal of time with teenagers during the last 10 years. One of their favorite expressions these days is, “Da Nile is not just a river in Egypt.” As we look out to 2007 and consider what might happen in the investing world, let's analyze the facts, find out who is in denial and see who might win and lose in year two of the “New Boomer Austerity.”

The “New Boomer Austerity” is the attitude toward finances that I believe will develop over the next 10 to 15 years in the United States as our economy is dominated by an aging group of “baby boomers.”

At the end of 2006, all you hear from the mouths of Federal Reserve Board members is a drumbeat of concern about inflation. Based on recent front-page headlines, the Fed members appear to be in denial.

Fact Number 1: *More people around the world will turn 60 years of age in the next 15 years than at any time in history, and an aging population might lay the groundwork for deflation (falling prices).*

The federal funds interest rate is currently 5.25%, and the 10-Year Treasury Bond yields 4.5 percent.¹ Long term bond rates are the free market's attempt to price in the effect of inflation. You have to go back to 1979-1981 to find a yield-curve inversion — when short-term interest rates were higher than long-term rates — this radical.² The key consideration is total United States debt compared to total

Gross Domestic Product. Federal Reserve statistics indicate that total U.S. debt has grown immensely in comparison to GDP today. Therefore, the risk associated with the inverted yield curve is much higher than it was back then.

Remember how three years ago we were told not to be concerned about rising gasoline and energy prices? The explanation is that energy takes up a small percentage of the GDP pie. In the 1970s, oil and gas was more integral to our economy because it not only fueled cars, but it was also a crucial ingredient for many smokestack industries, which have since died or have moved outside the U.S. The energy experts were correct as our economy stayed fairly strong through a rise in energy prices of magnanimous proportions. With interest rates, though, it's just the opposite. With home equity and credit-card debt dominating our society, the risk continues to climb. If that doesn't worry the Fed, they should consider that as our largest population group ages, our incomes will decline, and as our incomes (and spending) decline, we will be like a wet rag, a dampener on economic growth. As we end 2006, there are nearly 50 percent more workers between the ages of 40 and 60 as there are in the range of 20 to 40.³

Why does the Federal Reserve Board appear to be in denial and keep interest rates on short-term instruments so high? I believe the answer lies in the ages of the members and their educational training and life experiences. Many of today's key policy

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makers (including Fed Chairman Ben Bernanke) were in college or early in their business careers in the 1970s when inflation exploded from around 3 percent in 1972 to as high as 13 percent in 1980.⁴ The high interest rates and uncertainty created by relentless price increases was terrible for business and squeezed retired folks and others on fixed incomes. It was the worst economic problem in the U.S. since the “Great Depression.” Therefore, they are spending their careers trying to ensure that the worst problem they’ve ever seen will not be repeated. Ironically, the young adults during the “depression” years spent the next 50 years trying to make sure that the next recession didn’t turn into the next “Great Depression.” They are always fighting the last war. Among the industrialized nations, Japan’s population has aged the fastest, and it has spent the last 15 years struggling with a deflationary economy.

Why does this matter to us? Because the Federal Reserve’s policy on interest rates has a close correlation with how stock prices rise or fall in the future. When the Fed tightens credit, stocks historically struggle, and when interest rates are lowered, stocks have had a tendency to perform quite well.⁵ Typically, a Fed credit-tightening cycle lasts nine months and raises interest rates by 2.5 percent. We finished a 26-month credit tightening cycle in June that raised the Fed funds rate 4.25 percent from 1 percent to 5.25 percent!⁶

Fact Number 2: *Many Americans are over-invested in residential real estate.*

There is no denial more powerful than denial attached to vanity. We have 25 percent larger homes on significantly smaller lots with fewer people living in them than 25 years ago. Our nation just spent the last five years being excited

about pouring money into assets that produce no income and now have huge fixed and variable expenses. This rampage was led by Baby Boomers, who studies show own a majority of the second homes in the U.S. I’m one of the offenders. We own a home in North Scottsdale, Arizona, as well as one in Shoreline, Washington. They don’t produce income, they eat it. Forgetting the property taxes and other fixed expenses for the moment, we just spent \$1,000 on variable repairs, and after six years, we need some additional landscaping, (Need is a word we are in “Da Nile” about.) which could be a variable cost of another \$7,000.

In 1950, Americans spent around 40 percent of their income on home and automobiles. Now it is over 50 percent, and in some states like California, it’s up to 60 to 70 percent of household income. Is it any wonder that our national savings rate has dropped from 11 percent in the 1982 to the negative savings rates of today?⁷ Not only is the savings rate negative, but a huge number of Americans have compounded the problem by borrowing against the equity in their homes to spend money and live outside their means. In 2005, the Federal Reserve reported that over \$700 billion was borrowed against home equity and spent. And this is all happening because people somehow believe that this is a once-in-a-lifetime market for residential real estate, which will appreciate at double-digit rates of return. It reminds me of the 45-year-old guys in their homes in 1999 outlandishly day trading overpriced tech and dot-com stocks while thinking they were in some new exciting era when economic fundamentals no longer would govern the future.

Why do I call it vanity? Who decided that three people need to ride in seven-passenger vehicles? Who decided that three people need 3,500 square feet to live in? Who decided we need \$150 jeans and \$400 handbags? Who decided that the things we do with the money we borrow is worth it? The answer is "The Joneses" — the people we try to keep up with. We have 500 television stations and a home-equity line of credit, so why not live for today?

As we end 2006, I believe there are two chickens that are coming home to roost, and there is no denying it. First, average folks have hit the wall from borrowing on credit cards and home equity, and their spending is beginning to be heavily impacted. Wal-Mart reported that its sales for the month of November were flat compared to November of 2005, the company's worst sales figure since 1996.⁸ Secondly, home prices have been falling and these "boomers" are quickly finding out that their best-laid plans for the future will not work unless they change their strategy from assets with no income to those which will generate a cash flow in retirement. Savings rates could rise and income investments could prosper in 2007 and in the "New Boomer Austerity."

Fact Number 3: *The boomers' financial behavior shouldn't change much from prior generations as they make the retirement transition. But many live longer and have to shake some bad habits.*

I'm usually asked if people will work longer and later in life to overcome the fact that they are in denial about how much property to own and how much in liquid assets to build up before

retiring. According to a 2006 *Seattle Times* article, there has been a reduction in the percentage of people over 65 year of age working full time over the last decade.⁹ Our friend and leading demographer, Bill Morton, believes that the 78 million baby boomers will divide into three camps. The most affluent third of "boomers" will retire in the traditional way. The middle third will mix in some part-time work or low-stress work to make ends meet. The least affluent third could be forced to work for most of the rest of their lives. A traditional retirement could be a luxury and correlated closely to how much was saved or sacrificed at earlier ages. Or it will be determined by making tough geographical home ownership choices. Unlocking the equity from property ownership will be a key to financial success for many a retiring boomer.

Every year for the next 10 years, the aging boomers will transition from their peak income-earning years to full or partial retirement, and that should have a huge impact on our economy. People living on only 60 percent of their former paychecks don't spend as much — and they spend their money much differently. In 2007, I think the boomer priorities will begin to dominate. Healthcare and inexpensive entertainment could boom, and purveyors of expensive goods and services could suffer as the "New Boomer Austerity" takes hold and begins to dictate the tempo in our economy.

Boomers are likely to live longer than any prior generation. A healthy 60-year-old couple is likely to live into their 80s and beyond. A few years ago chronic illness passed acute illness as the

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leading killer in the U.S. We're going to live long lives and swill a lot of pills. It means that our society will see a larger and larger percentage of our Gross Domestic Product spent on healthcare, and it means that retired investors will need to make their money last much longer than retiree's did before. This means boomers will need to balance some growth and potential income with their investments. In the last three years, investors have chased emerging international stock investments, gold, oil and residential real estate. In 2007, they might chase pill makers and media companies.

Fact Number 4: *Stocks have typically done very well in the third year of a presidential term and historically do well when the Fed lowers interest rates after a long period of credit tightening.*

There has not been a losing year in the stock market in the third year of a presidential election term since 1939.¹⁰ And some of the most spectacular gains in the market have occurred in those years. It is the one year out of four that we don't try to blame someone else for our problems or frame public opinion about our opposition party. It is also the only year that the Fed can bring rates down and not be accused of influencing political races in the process. By the way, in all of the time that I have been in the investment business, I have not seen the public get any more negative about owning quality stocks than in mid-2006, and that coincided with the Fed ending its longest credit tightening cycle in my 26-year career. So we have history and what appears to include positive ingredients for 2007.

Fact Number 5: *Dividends are paid out free-cash flow, and dividends are increased by companies with rising free-cash flow.*

Over long stretches, dividends can make up as much as 40 percent of the return made from stocks. With a large and growing group of aging boomers on the prowl for income-producing investments, companies may be forced politically (shareholder votes and board member pressure) to make wise decisions with the free-cash flows created by their business. Raising dividends and buying back stock should dominate, and shareholder friendliness will mean meeting those income needs. Recession-resistant businesses with strong balance sheets and high levels of free-cash flow could get very popular. And the popularity could be highest for those who make products and services demanded by 45- to 65-year-old citizens.

Fact Number 6: *Borrowing money could get more and more unpopular.*

As the boomers age and unwind their own debts, their "Austerity" will spread to other age groups. Being in debt should become unpopular in a trendy way, just like we set the trends in society during other periods. Boomers have been behind everything from the SUV craze to the 3,500-square-foot home and the current infatuation with "NASCAR." Younger age groups will see how hard it is to retire if you haven't saved enough or if you own too much of your net worth in non-income producing property or choose to live in expensive cities on the two coasts of America. As we boomers make choices to meet our circumstances, younger generations should follow. The result could be short-term interest rates at or below current levels for a long time. Plan accordingly. In 2007, we could see many folks struggle with interest-rate adjustments

on home loans because they will not have any price appreciation to draw on or sell with. As borrowing becomes less attractive and more aging boomers need income, interest rates could move lower over the long haul.

Fact Number 7: *Stick to the facts and ignore everything else.*

A number of recent studies have shown that we are bombarded by what appears to be massive quantities of information. Unfortunately, most of it is useless. Investors who stay invested in quality stocks for long stretches gain the benefit of taking the risk (a potentially higher return than not taking risk), and the people who move in and out typically ruin the process for themselves. Let those of us at Smead Capital Management help you sort through the information, isolate the facts and strive to keep the income flowing just like “Da Nile.”

¹ Federal Reserve Statistical Release; Selected Interest Rates (Daily) – Release Date December 12, 2006

² Federal Reserve Statistical Release; Historical Annual Date

³ US Bureau of Labor and Statistics

⁴ Lawrence H. Officer and Samuel H. Williamson – cofounder, “Annual Inflation Rates in the United States, 1775-2005, and the United Kingdom, 1265-2005,” measuringworth.com, 2006.

⁵ Past performance is no guarantee of future results.

⁶ Federal Reserve Statistical Release, Monthly Federal Funds effective rate.

⁷ Bureau of Economic Analysis & Ritholtz, Research & Analytics.

⁸ Dow Jones News, 11/30/2006

⁹ U.S. Census Bureau

¹⁰ Stock Trader’s Almanac 2007, p.34.

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