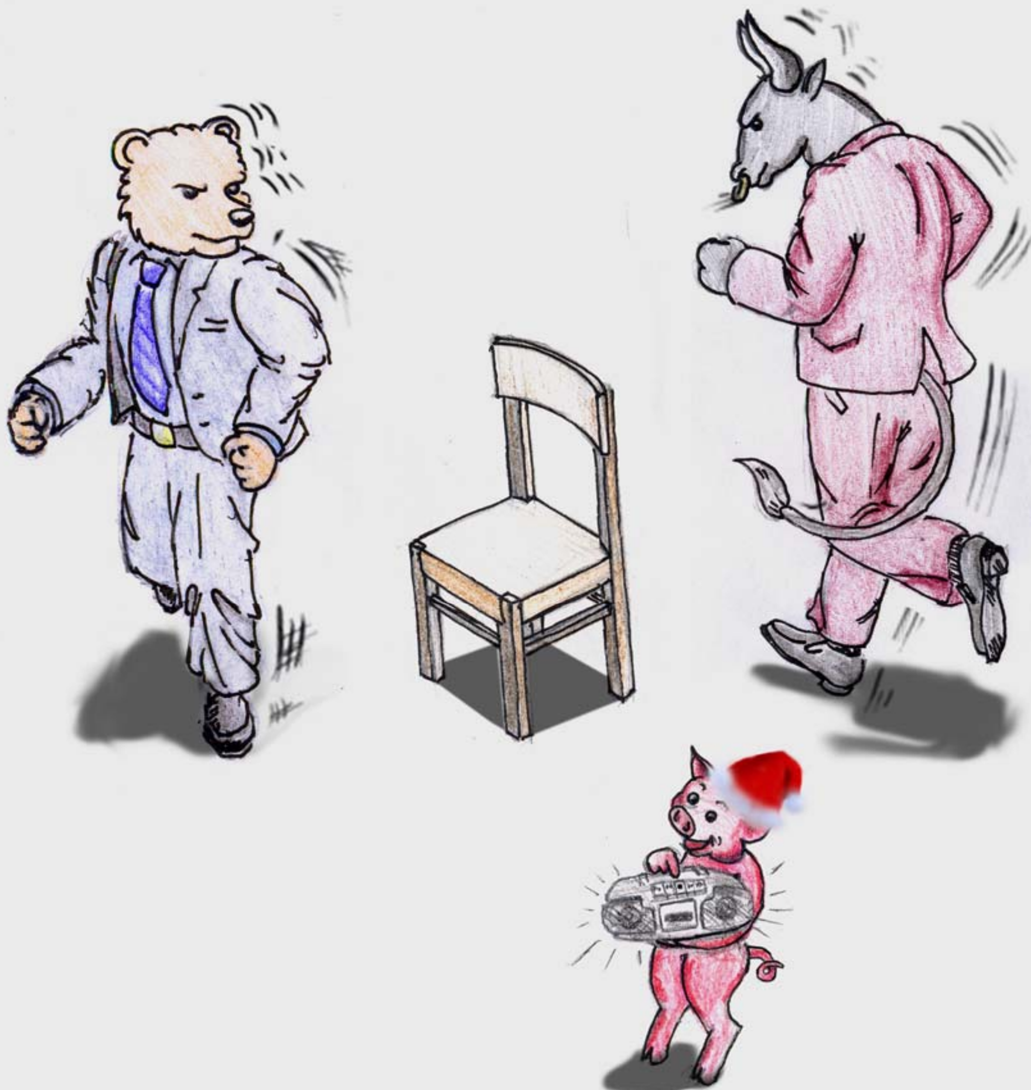
21 December 2006

KAPITAL INVESTMENT GROUP

Strategy 2007

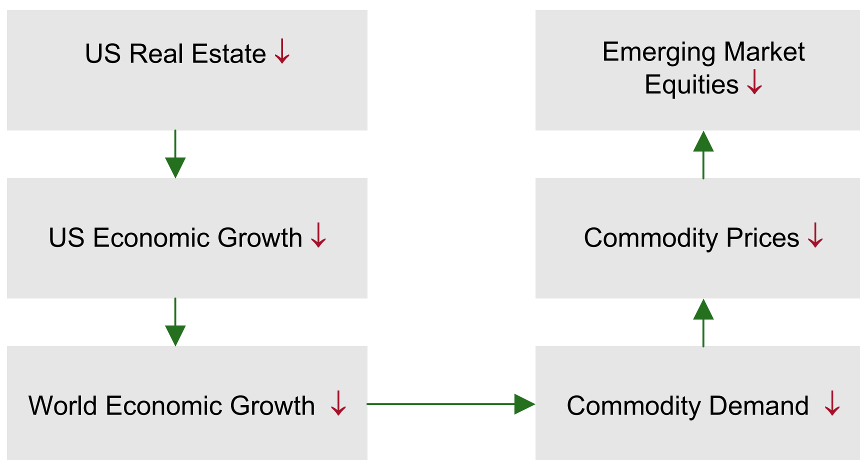
Will the music stop in 2007?



The Big Picture

Just as lower interest rates stimulated the real estate market, higher rates have dampened it. We expect more pain in the US real estate market. This in turn should dampen consumption. Since consumption represents 70% of US GDP, we think the rate of economic growth will slow. In 2007, US GDP growth is likely to come in significantly below the 2.5% consensus estimate, and we would not rule out a recession.

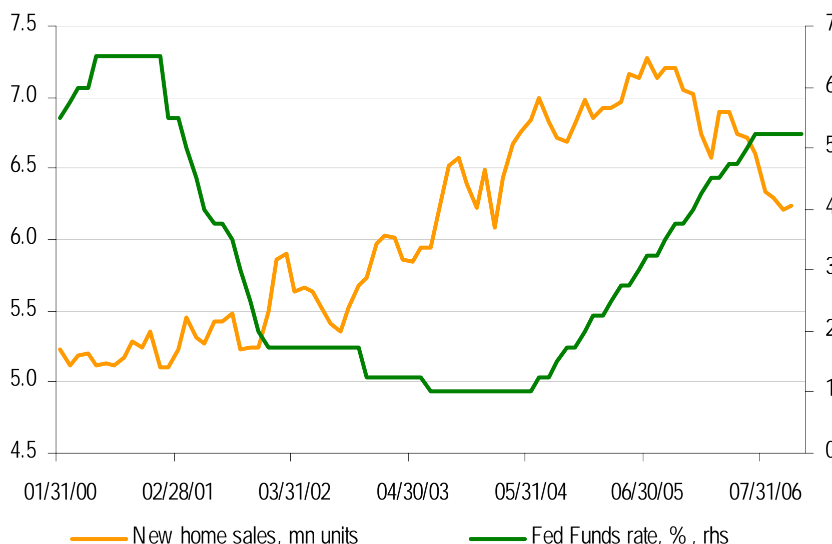
Fig. 1. US Real Estate Market Influence on Economic Processes



US Real Estate

Although home sales have fallen in 2006, we think that there is still a way to go. Sellers have been reluctant to lower prices, leading to a glut of unsold existing homes on the market that has reached 7.4 months. We think that sellers will start to lower prices more aggressively when confronted with hard evidence that the go-go market of the last few years is over. Also, although housing starts started to fall early this year and significantly accelerated only over the last six month, many of these units have not yet hit the market.

Fig. 2. New Home Sales and Fed Funds Rate



Source: Bloomberg

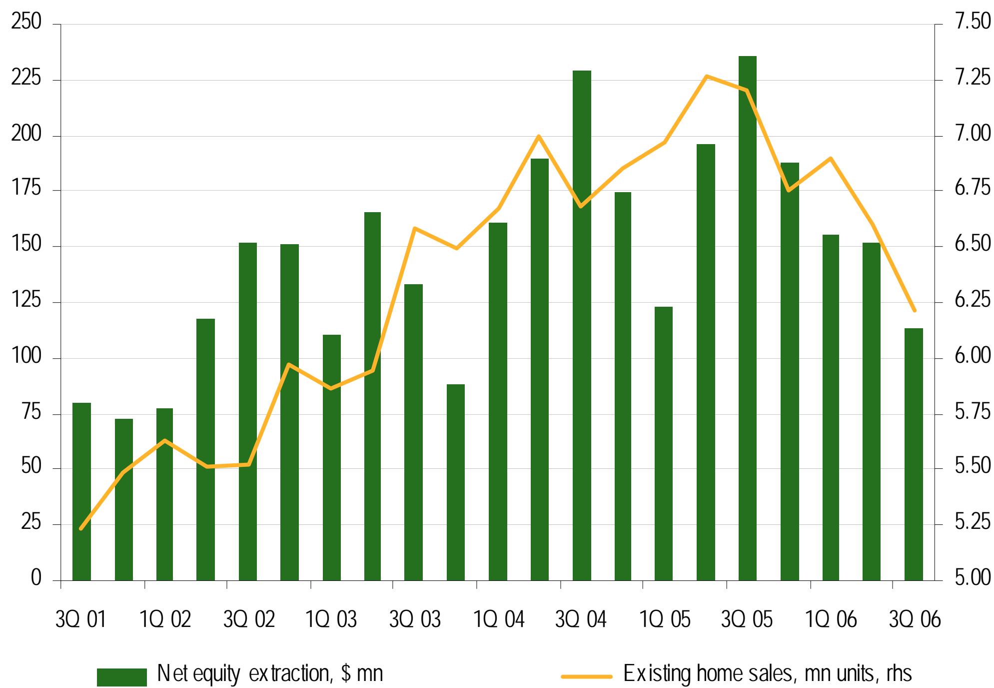
Most importantly, financial stress is on the rise. Already we have seen a sharp increase in delinquency and foreclosure rates on subprime loans. As more negative amortization and interest only mortgage are reset, the problem should get worse. Due to falling prices, some investors faced with the prospect of having to add cash to sell their property, may simply walk away, leaving the bank or MBS administrator to dump it on the market, further pushing prices down.

We do not think that even a drastic rate cut by the Fed will save the situation. The problem is the excess of supply over demand. Only time and less construction will solve it in our view. Recent declines in yields have led to an increase in mortgage applications, but a good chunk of that is refinancing, not increased purchases of real estate.

The US Economy

Besides the direct losses to consumption arising from losses in the real estate market, there are more important indirect effects. Homeowners pulling equity out of their houses have been a major driver of consumption. According to the Fed, in 3Q06, homeowners extracted $113.5 bn in equity from their houses, half as much as a year ago. Assuming that 40% went to consumption, this represents an annualized decline in consumption of $181 bn, or 1.4% of GDP.

Fig. 3. **Mortgage Equity Extraction**

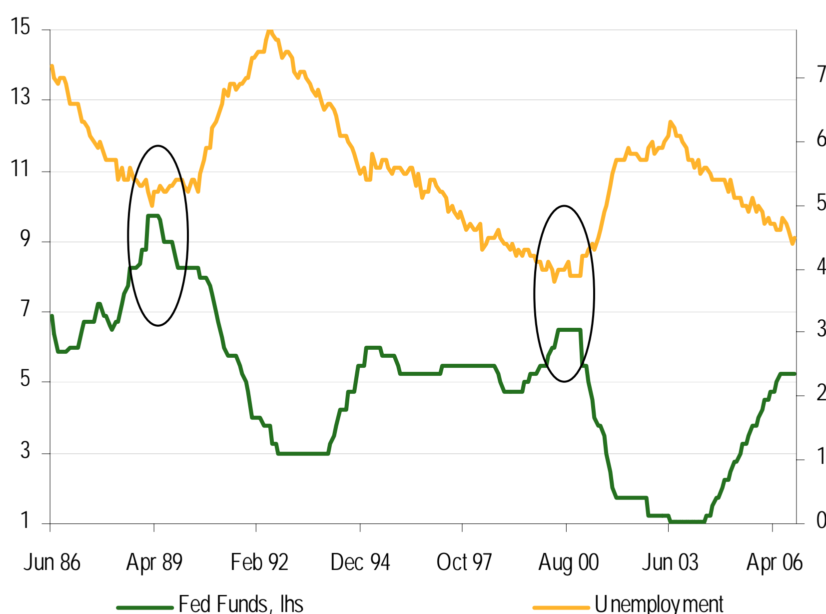


Source: Fed, Bloomberg

Declines in real estate value have a large but subtler effect on the economy. Given specifics of real estate as an asset, namely physical features and that you often live there, declines in its value affect perceptions of wealth and thus how much you spend. A recent NBER study put the decline in long-run marginal propensity to consume at $9 for every $100 of real estate value lost. Thus, given the declines in real estate values that have occurred and we believe will strengthen going forward, consumption should decline appreciably.

Going forward, unemployment looks set to rise. On the most basic level, declining economic activity leads to less demand for workers. Over the last 20 years, unemployment has usually hit a low at about the time the Fed ends its tightening cycle. This is logical, since higher interest rates reduce economic activity, albeit with a lag.

Fig. 4. **Fed Funds and Unemployment, %**



Source: Bloomberg

Rising unemployment should lead to further declines in consumption. Also, lower aggregate household income is likely to increase delinquency and default rates on mortgages fueling the vicious cycle described above. We do not see how US households can solve the problem by increasing debt, since it is already at high levels. Indeed, much of the consumption gains of the past few years has been debt financed. Moreover, slowing economic growth coupled with rising unemployment should lead to less debt-driven consumption, further pulling down GDP.

World Growth and Commodity Prices

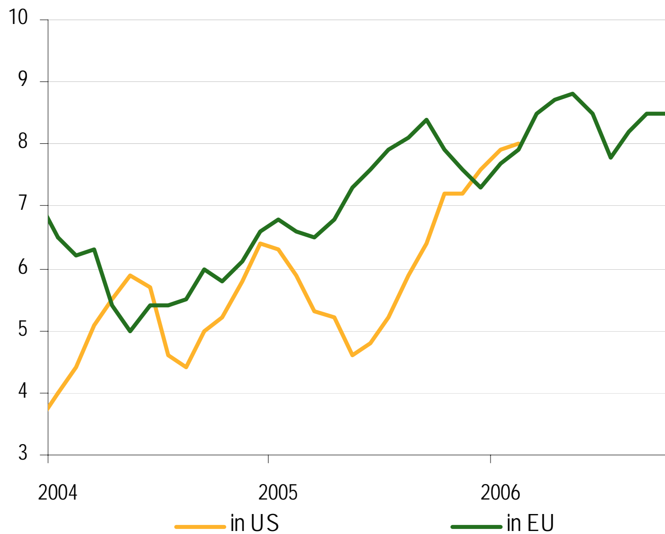
Although the US share of global GDP has declined, it still was some 30% in 2006E. Since the US is such a large consumer of global production, we do not think US economic problems will be contained in the US. Much has been made of growing domestic consumption, particularly in China and India. We do agree that over time, these countries will rely less on exports, particularly to the US. But this is a longer-term story, not one for 2007, when we expect a sputtering US economy will lower global GDP growth.

It is true that India and China have become important consumers of commodities and on the margin affect prices. Still, the US remains the dominant consumer. Moreover, much of the commodities imported by India, China and other EM countries are indirect US imports, i.e., they are turned into final products and exported to the US. Thus, a US slowdown should lead to decline in commodity prices.

We think that the stellar performance of commodities over the last few years will come to an end in 2007. Recent pricing suggests investors are anticipating very high levels of demand growth to be sustained together with supply problems. We disagree with both points in the long run. Although by nature commodities are strategic, higher prices are a stimulus to expand production, and we do not think the world is in danger of running out of commodities any time soon. More importantly, commodity prices are demand driven: Without demand, you can cut supply all you want without affecting the price. Also, over time, high prices lead to lower demand due to improved technology and substitution.

The more important driver of commodity prices has been the excess of cheap money in the world. Although the Fed has raised rates, money supply continues to expand, fueling inflation as well as commodities, EM stocks and bonds and US equities. Similar monetary expansion has been taking place in Europe and real rates in Japan remain near zero.

Fig. 5. **M3 Money Supply, % y-o-y**



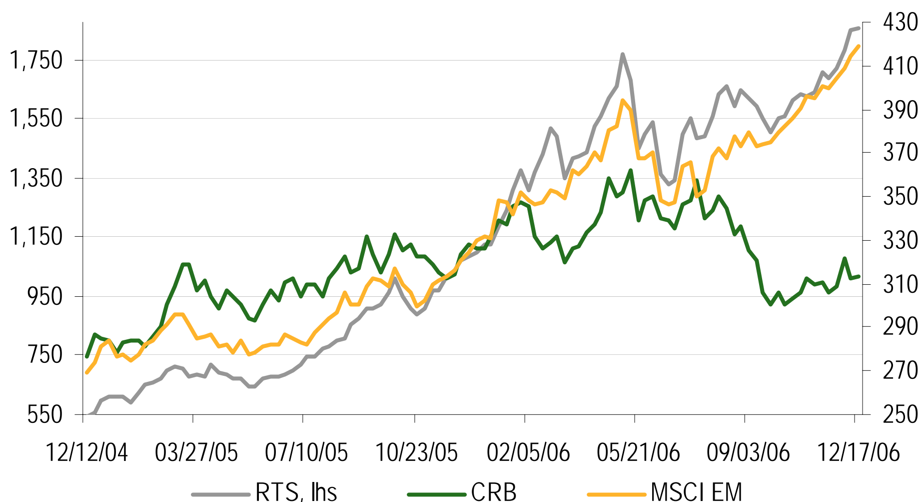
Source: Bloomberg

In our opinion, interest rate hikes have not eased inflation or brought commodity prices down both due to the lag with which they act and the growing money supply. Pulling liquidity out of the system seems the only way to counteract this. (We think further US rate hikes are unlikely but in such an environment do not expect cuts in 1Q07.) Also, the BoJ should be tightening at some point in the future. Thus, going forward, we think liquidity will decline and with it commodity prices. Exploding overleveraged hedge funds could hasten the process.

EM, Commodities and New Paradigms

Declining commodity prices concerns us because historically, emerging market stocks, including Russian, have been highly correlated with commodities. This is logical, since EM countries are a net exporter of commodities. In Russia, comparisons with oil are more common, but a basket of commodities better shows the relationship with EM equities as an asset class.

Fig. 6. Emerging Market Equity and Commodities



Source: Bloomberg

Historically, gaps have opened, such as in 2H02, when commodity prices rose but EM equities declined. However, they have been quickly closed. In May 2006, Chinese efforts to cool economic growth spooked the commodity markets, which fell, dragging down EM equities. Commodities then trended up before starting to fall again in August. Initially, EM equities also corrected, but in September began to rally on flattish commodity prices. Also, the Russian rally came on the heels of oil not moving far from $60/bbl for three months.

One of the reasons for this divergence is cheap money. Another is investor sentiment and psychology. Over the past few years, talk of a new era, a new paradigm, brought on by globalization, increased transparency and ability to hedge risk, has increased. In this new era, growth shifts from place to place, but in general asset prices rise. This flies in the face of logic, especially since correlation among assets classes and geographies has risen. But more importantly it has engendered bullish sentiment, which we think is out of whack with reality. For example, falling rates of GDP growth is taken to be positive, since it means rates will be cut. But it is a safe bet that falling GDP growth means falling corporate profit growth. Since shares represent the present value of future cash flows, how can they rise? In some respects, this talk is reminiscent of the dot com era, with its “end of business cycles” and other such notions. We all know how that ended.

The Upside Risk

We are in general somewhat pessimistic in the medium term, and expect some correction in share prices. Although we do not think globalization and other innovations have changed how the market works, we do think that they will result in short periods of decline. Depending on the timing, it is entirely possible that declines in the middle of the year can start to reverse toward the end of the year.

Except for some refinements, our general view has not changed in six months. Then, as now, we do not expect the market to drop tomorrow. On the contrary, we expect that over the coming few months, Russian equities will rise and accordingly investors should stay long.

We have reiterated and elaborated on our views because over the past six months, the first signs of problems in the US have appeared, suggesting the start of the chain of events outlined above. Thus, investors should watch carefully for signs of further problems in the US real estate market and economy. Declines in commodities should also raise a red flag.

The upside risk is that the US economy is somehow able to muddle through and achieve a soft economic landing and the supply of cheap money in the world is not drastically cut. If this is achieved, then we would be more bullish in the medium term.

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