

Crossroads Ahead?

October 2, 2006

Many financial observers are fascinated by the action of having both the stock market and bond market advancing at the same time. A common misconception, however, is that a strong stock market indicates a strong business climate, and a strong bond market indicates a weak business climate. A careful analysis of history indicates that there is a positive correlation between the two markets. History will also show that a strong bond market and good business are not contradictory. Be that as it may the myth prevails. We hear it repeated day after day.

In our opinion the recent strength in the stock market reflects a definite belief in the “Goldilocks” economy. This is reminiscent of the market in early part of 2000 and should be treated as such. The slowing of the real GDP to 2.6% in the 2nd Quarter, down materially reduced from the 1st quarter, are both consistent with the business future we see unfolding. High consumer debts, coupled with meager to non-existent real income advance, is weighing heavily on this sector of the economy.

Bulls on the economy point to the impressive net worth of many households as a sign of consumer strength, thereby dismissing the debt income scenario we pointed out above. Please see the chart below. Our conclusion is that debt is fixed and may be paid back by only four methods of which we are aware.

- 1. Income**
- 2. Sale of assets**
- 3. Additional borrowing**
- 4. No payback at all – default**

The key question is “when will additional borrowing cease to exist?” We don’t know, but it must be close.

In the chart below please note the period from 2000 to 2002, which halted the positive net worth advance. We expect that will happen again. These questions still remain:

- Will monetary and fiscal policies come to the rescue again?**
- Can we blow another asset bubble using near zero interest rates?**
- Will tax cuts do the trick?**

We conclude that is exactly what it will take to do the job and keep the consumer in the game. Otherwise look out below!

**Households' Asset to Liability Ratio vs. Total Absolute Net Worth (\$ Billions)
(1Q 1952 to 2Q 2006)**

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