

TRICKLE UP AND TRICKLE DOWN

11/20/2006

One can never be sure, but it does appear that the consumer is finally beginning to bow out of the picture. If the September numbers are correct (such estimates generally are materially revised) we have witnessed the first decline in consumer credit since 1992. That, my friends, is a big deal. We have yet to see, however, a reduction in the rate of growth of overall borrowing. Information for the third quarter ended 9/30/06 will be available a month from now.

Another bit of evidence, which seems to indicate a retrenchment in consumers' buying, comes from Wal-Mart, the world's largest retailer. To date, they have reduced prices three times, an unprecedented occurrence this early in the Christmas season. It seems reasonable to assume that if sales were good there would be no necessity to cut prices. What we may be seeing is a trickle up effect in our economy, as it concerns consumer spending. The first to reduce their spending is the lower income population to be followed by middle income and finally the upper income consumer. Sales at upper scale department stores continue to be relatively strong per the most recent results. Keep your eye on JC Penny (middle income) and Macy's (upper income) to ascertain if this is a correct assumption.

Now, back to the housing matter. As you know, the key to the economy is the housing sector of the market, which is rapidly deteriorating. The following chart taken from John Mauldin weekly e-letter tells us why. Every post WWII recession except the tech wreck of 2001 has been preceded by a decline in housing. The drastic reduction in short-term rates by the Federal Reserve which allowed long rates to also decline, permitted the housing cycle to continue its upward path, which of course turned into a bubble. Please note that the percentage of housing expenditures to GDP recently reached a new high since the late 1940's. The demand in that period was "organic", as the veterans returned from the war. This recent bubble has been "inorganic". By that, we mean it has been

driven on the margin by speculation. Under these circumstances what goes up must also come down. Wouldn't you call this trickle down?

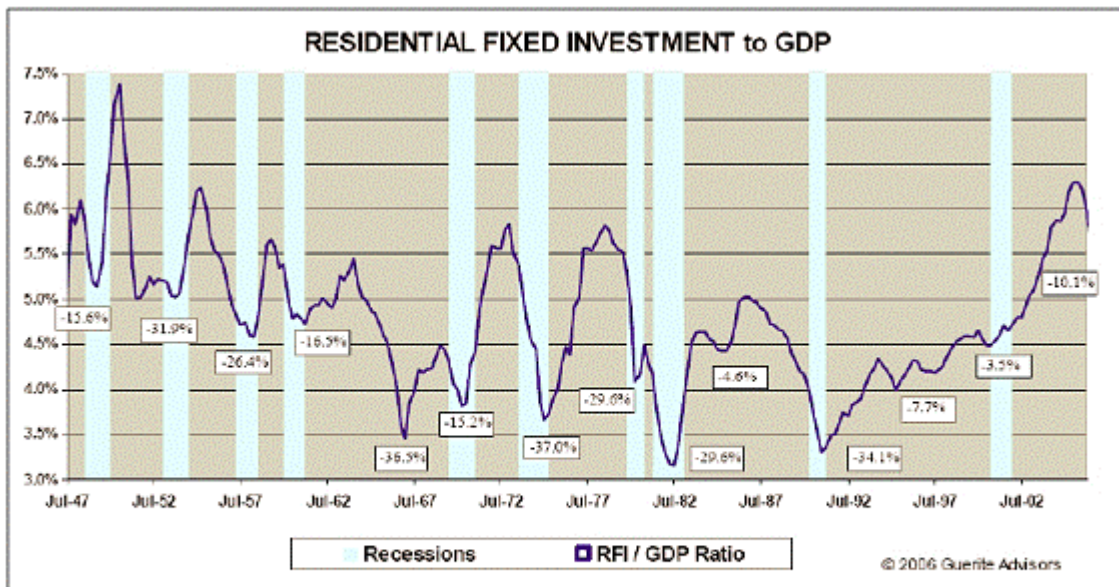


Figure 2 – Graph showing changes in residential fixed investment (RFI) to GDP since 1947 with recessions marked by cyan vertical bands. Chart by Guerite Advisors.

Chart taken from John Mauldin's Weekly E-Letter