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# Quarterly Investment Outlook

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## Liquidity: The Cause of...and Solution for Imbalances

**Few disagree that the boom in the global economy has created a surplus of capital that has allowed the US to finance its record deficits, keep interest rates low by historical standards and, so far, avoid a hard landing for its economy. This liquidity glut has also spurred lenders and investors to migrate toward riskier investments in search of outsize returns. It's also noteworthy that the bull market in stocks has extended into its fifth year amid inflation fears and concerns about the housing market. When things are this good for this long, it's inevitable that strong divergent opinions emerge surrounding the economy and its markets. Yes, the Goldilocks Economy appears to remain intact, but for how long? And what could trigger the return of the bears?**

Last quarter, we concluded that we were witnessing an expansion of the global economy that was unprecedented in our lifetime. We opined that the glut of aggregate liquidity washing over the globe would continue to boost the US economy for an extended period due to foreign investment and low interest rates while inflation remained in check. Consequently, we assessed a very low probability for recession, instead predicting an orderly slowdown that would precede the next leg up. That said, common sense prompts us to look to at what could upset the applecart and make our prediction look like wishful thinking. After all, it's difficult to recall a "boom" that wasn't followed by, at the very least, a reversion to the mean and in many cases a "bust". Is there anyone who doesn't remember what followed the tech bubble of the 90s? Looking ahead, the next cycle has to include a consolidation of the gains of the past half-decade. The depth and breadth of that remains a question mark for investors and a widening divergence of opinion accounts for the recent roiling of the global equities markets.

Most economy and market watchers agree on what usually follows directly on the heels of a boom. It's safe to say it's not another boom. The debate centers on what type of consolidation will take place in advance of the next cycle of expansion. These pundits divide into two camps: those who predict a healthy slowdown (the much-heralded "soft landing") and those who foresee a recession or worse. We count ourselves among the first but have great respect for many of those who disagree. While both camps concur on much of what could happen, there is considerable debate over the timing of and to what degree these developments will affect the US economy and the markets. For us, the list of potential problems falls into two categories: those that can happen and those that will. The first category includes major changes in fiscal and monetary policy, imprudent government regulation or oversight, a default by a major financial institution or hedge fund, a disruption caused by a currency imbalance, or a terror event. In short, anything that can reduce liquidity, inhibit capital flows or restrain trade in the global economy. However today, we will focus on the second category, those that will most certainly occur. There are two at the top of our list: the US housing market will contract and China's growth will slow from current levels. In this installment we'll take a look at housing in the US.

### The Housing Bubble, Something's Gotta Give

By definition, all bubbles must either deflate or burst. While the bubble in housing creates proximate risk for the US economy, the second order effects could have negative implications for the rest of the world. We believe the housing bubble will deflate rather than burst and assign a very low probability to the US economy toppling into recession as a result. That opinion rests on our assessment of the aggregate asset base and liquidity currently available from the financial services sector. In recent weeks we've seen the beginning of a long-predicted shakeout in the mortgage banking industry. A rise in defaults and foreclosures in the sub-prime lending market has, in just a few short months, driven several major lenders into receivership or into the arms of opportunistic buyers while others have seen their share prices shrink as dramatically as their lending standards. Industry analysts say it's just beginning and we agree. However, we disagree with those who liken this to a market-shaking event such as the tech-bust of 2000 or 9/11.

Why? It's estimated that the sub-prime lending market represents roughly 12% of all mortgage lending with total delinquencies currently at 4.95%. If one makes the bold assumption that half of the entire sub-prime segment rolls into default and ultimately foreclosure, that would still be just shy of 10% of the home lending market. That's no small amount, but remember that there is still a significant amount of residual value underlying those obligations. That is a far cry from the dot.com implosion of 2000-2002 when companies' values plummeted to zero. The properties securing these bad loans have tangible value and there are a number of investors waiting in the wings to take advantage of a bargain. Enter the major investment and commercial banks. We expect those with healthy balance sheets to take advantage of the shakeout and add to their existing portfolios. In short, we estimate there is more than sufficient liquidity to absorb the losses that will accrue to the sector. In the end, much like the S & L crisis in the 80s, we'll see weak and unscrupulous lenders culled from the ranks and expect a healthier and wiser mortgage lending industry to reemerge.

The second order effects of the housing shakeout will have broader implications for the US and global economies. Housing weakens, construction slows, demand for services and materials slackens, wage and job growth stagnate, and finally, consumer spending slows. This chain reaction acts as a headwind for the US economy and, since we are the world's largest consumer, for the global economy as well. However, does that spell "recession" and major trouble for the markets? We don't think so. Liquidity is the fuel that drives economies and there are currently record levels of surplus capital around the world. This has allowed the Fed to apply the brakes with 17 interest rate hikes and still see long treasury rates near historical lows. The reason? Asia can find no other market to absorb the vast amounts of capital it has on hand. Should our estimates regarding the housing shakeout prove too optimistic, we might see private sector lenders withdrawing liquidity from the system thereby increasing the probability of recession. However, we see the Fed standing ready to replace that liquidity by cutting key rates. They would do so in response to slowing growth in the economy or a major financial disruption, not a decline in the housing market. Our view is that a requisite level of global liquidity can be produced and maintained by the private sector and the Fed will cushion any slowdown.

It's difficult for us to envision a housing-triggered recession where economic conditions are stable and wages and employment are growing. However, timing is everything. Current conditions have increased our vulnerability to the effects of an event or disruption of the capital markets. Obviously, this would be a very poor time for China to stumble and reduce its lending to the US. And any of the items on our "could happen" list might turn a normal stock market retrenchment into something worse. However, absent any of these occurrences, we foresee a stable policy environment (at least until 2009) and no looming imbalances outside of US housing. Despite the buzz about all-time stock market highs and record corporate profits, growth rates and market multiples remain at the lower end of their historical ranges. From our perspective, the equities market still presents good value with its modest multiple. Goldilocks may be shaken but she is still in the house. In our next installment, we'll discuss the global economy, the symbiotic relationship between China and the US, and the risks we see ahead for the markets.

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