

Will 2006 be the start of good things to come?

By Francisco Marriott, CRL Staff

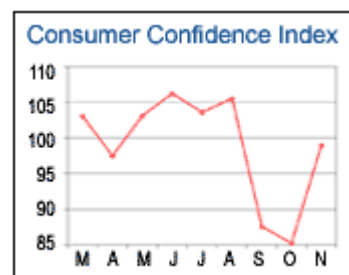
If the factors discussed in this article play out, 2006 could prove to be a very interesting year. We might not see a slowness during the first quarter of 2006, as the signs of distress will start to show up by the second quarter, and the EBIT line will start to shrink after the cookie jar reserves have expired.

The US economy has been growing at a staggering rate. Despite negative beliefs brought about by high oil prices and increasing interest rates, the latest economic forecasts show a healthy 3.5% growth by the end of 2005. The 2006 outlook is even better, showing a 3.6% growth, as the economy recovers from the effects of Katrina and the job market faces a more favorable environment.¹

This growth has been fueled by two main factors: low interest rates and a booming real estate market. Up to not so long ago, the Fed has been keeping interest rates at low levels to “further entice consumers to continue borrowing and spending money.”² Low rates have had a positive effect in the real estate market, allowing consumers to access low financing for their mortgages, and permitting homeowners to get some equity out of their properties. All this extra money has been flowing to the markets, and the US (and world) economy has gotten stronger relying on a heavily indebted US consumer.

But this trend is coming to an end. Consumer spending has put inflationary pressure on prices, urging the Fed to gradually increase interest rates to control inflation. Higher interest rates and soaring home prices are making consumers focus on cutting on spending and paying down accumulated debt. So, the expected US growth won't come from consumer expenditure (at least US consumers), but mainly for corporate and government capital spending.³

Even though consumer confidence has risen in November, we can see the effect of the reduction in spending from the decreasing retailer sales during October and the beginning of November compared to previous months.⁴ If this trend continues, retailers might reduce their product purchases to adjust to the new market environment. Small and medium sized manufacturing companies specialized in consumer products with local demand will be negatively affected and in need of financial (and probably operational) restructuring.



¹ *OECD Raises Global Growth Estimates, Draft Shows (Update1)*. Nov. 24 (Bloomberg).

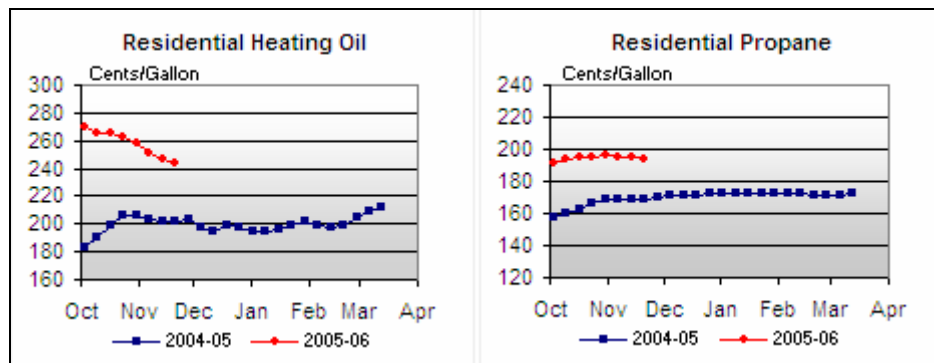
² *Investment Considerations For Your 2005 Rrsp Portfolio*. ClearSight Wealth Management, Inc. 2005. These investments will be focused in upgrading equipment (mostly IT related) and machinery.

³ *Market & Portfolio Update, Third Quarter, 2005*. Forward International Equities Fund.

⁴ *Advance Monthly Sales For Retail Trade And Food Services, October 2005*. US Census Bureau. November 15, 2005.

But, how likely would this scenario be?

We are talking about consumers. True, they have assimilated fairly well the rise in oil prices as temporary phenomena. But now winter is coming and with it some extra expense that is unavoidable: heating. Residential heating oil and propane prices are 40% above their prices compared to 2004 (see figure below). If the reasons for this price hike are due to fundamental changes (such as supply shortage) or to purely speculative reasons (*a la* Enron in the California market), it doesn't matter: people will have to spend more money in heating, and this will reduce their disposable income and purchasing capacity.



Source: Energy Information Administration

Add to this a highly indebted consumer that will try to lower down debt, and we will have even less money allocated to consumption expense. Add to this a slowing real state market, which has also been a source of additional cash, and we might see a similar effect. Add to this a sluggish salary environment, and the scenario seems to be very likely.

So, what might happen?

The impact of higher interest costs on consumers should start to take effect in 2006 taking disposable dollars out of the circulation and into paying debt. The real estate market is starting to slow and inventory is building. This will further reduce dollars in circulation and the income of realtors, mortgage brokers, construction and remodeling firms, and home furnishing retailers. This should prove to be an interesting fulcrum year for the balance of the decade.

So, stick around for some turnaround!