Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

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Investment Newsletter – January 2007

Trends Analysis and Forecast for 2007

This month's newsletter gives my forecasts for what to expect from investment opportunities in 2007. Whatever good fortune we had in 2006, we must look forward to predict the places to put our money in 2007. The world is constantly changing and we must keep up. First we'll talk about residential real estate, then fixed income and stocks markets, and finally a quick look at investment property.

Residential Housing

By now almost everyone can see that residential house prices are coming down as market conditions are finally being reflected in the closing statistics. Keep in mind that the numbers you see in this market are in the rear view mirror. By this I mean the contracts now showing up in the data were signed many months ago. The data are always far behind what is actually happening today. Soon too, the distress in the markets driven by speculative investment will start showing up in foreclosure statistics. In Alameda County for example, monthly notices of default (the prelude to foreclosures) have almost tripled since this time last year.

While the media focuses on the direct economic impact of slowing construction spending and everything connected to the homebuilding industry, the more important effect on the economy is the end of the home as a source of income (via refinancing) and therefore spending power. Many people have prudently set aside these funds to consume over the rest of their lives so it does not mean a huge drop off in purchasing power. But it does mean this will no longer drive *growth* in spending. This *will* most definitely reduce economic growth going forward compared to the last 5 years.

Many pundits predict a quick turnaround but this is unlikely. First of all, real estate prices are notoriously slow to adjust when demand changes. This is why we see a huge buildup in inventories when the market changes direction. Sellers are unwilling to accept the new pricing and so houses stay on the market at prices that are too high for buyers. Eventually, those that must sell (the builders) reduce prices indirectly (credit towards closing costs, etc.) to reduce inventory and stop the losses. Others take their houses off the market and wait. Eventually they come back into the market. This is why it could take years for prices to adjust. If buyers know there is an overhang of sellers waiting to put houses on the market at the first sign of an up tick, it discourages those planning to make money on their investment. Of course many buyers will buy no matter how bad the timing. Thus you may see some up-ticks in volume and pricing from month to month. Overall, the most expensive markets (relative to rents) will take years to work back to prices that are low enough to equate true demand and supply after the exit of the speculators.

Despite my seemingly gloomy outlook for residential real estate, all is not lost. Real estate is, after all, a local market; generalizations will never apply to every such local market. In particular, we believe New Mexico will suffer much less of an adjustment because supply there has been more in line with fundamental demand. Because rent rates in New Mexico are more in line with capital costs, there is much less pressure on the few speculators buying there. I.e. values never got that out of line with incomes. Thus we see good prospects for continued appreciation in this market over the next 4 years - though short term pull backs are certainly possible. Likewise, I do not expect any significant drop in real estate values on Big Island in Hawaii. There is simply not enough supply there to keep pace with the increases in demand that will naturally occur as the baby boom retires to sunnier climates.

Investors with some time, cash, and entrepreneurial spirit should prepare themselves for the coming opportunities buying distressed properties. Banks do not like dealing with foreclosed properties and this will provide opportunities for profit as more and more speculators and first time buyers stop paying on mortgages that exceed the property value. But be careful, although the returns are potentially great, this is a high risk and low liquidity business. Don't do it unless you are prepared mentally and financially.

Fixed Income Markets

The inverted yield curve tells us that market participants are predicting a recession. Typically investors in longer term bonds require higher interest rates than money market investors since they take more risk and have less liquidity. The exception is when they believe money market rates will decline well below current levels. The Federal Reserve controls the short rates (not the long rates) and will only cut them to save the country from recession. This is balanced against their desire to raise them to save the country from inflation. The bond market is essentially saying that the Federal Reserve has raised rates too high and that the housing induced slowdown has a significant chance of turning into a recession in 2007. I put the odds at roughly 50% for a recession in 2007 - triggered by the fall in consumption. This would likely cause the Federal Reserve to cut short rates by .75% to 1%.

Given my views of how the market reads the economy and the Fed, I see only a 10% chance that long bond prices could actually go up (yields down) in a serious recession. If a mild recession happens I think long bond prices and yield will stay where they are - at about a 40% likelihood. Finally, there is a 50% chance that the Fed is right, there is no recession and inflation pushes rates higher - thus knocking down long bond prices. The bottom line - don't buy long term bonds.

Stock Markets

The possibility of a recession, even if not realized, will also impact the stock market. Volatility of prices will increase as earnings visibility declines. The difficulty of predicting earnings follows from the uncertain effects of changes in monetary and fiscal policies. Confiscatory tax legislation may lead to market sell offs even though the legislation would face a veto by the current Administration. In December, the Chicago Board of Trade Volatility Index (VIX) reached a low of 9.39 – very near its record low of 9.31, last seen in 1993. It is very rare for this market volatility forecast to fall below 10. Since then it has risen to 10.4 (as of January 19th) – still very low by historical standards. This indicator tells us that the market sees little to fear and an optimistic mood is permeating trading decisions. This environment leads investors to value stocks using more favorable assumptions (with regard to discount rates in particular). Therefore, we can expect an increasingly volatile and uncertain market environment to lead to generally lower stock prices.

Energy Sector Analysis

The above generalization does not, however, preclude gains in undervalued stocks. Indeed, the entire energy sector looks undervalued when one considers the precarious balance between supply and demand. Since July, oil and gas inventory levels have been too high because market participants built up reserves to protect against a damaging hurricane season that did not materialize. The excess inventory knocked prices down when no supply disruptions materialized. These inventories will be worked down. While there currently is excess capacity, the Organization of Petroleum Exporting Countries (OPEC) has demonstrated its discipline in restricting production to induce reductions in oil inventories.

Meanwhile demand for oil continues to grow rapidly in China, India, and other emerging markets. These economies are far less energy efficient than the U.S. and thus shifts in production to these places (to reduce labor costs) pushes up worldwide energy demand. Also, both countries start with very low percentages of households owning cars. As trade brings more prosperity to China and India, they increase purchases and use of cars and motorcycles. This will be a significant contributor to incremental energy demand growth over the next 10 years.

For 2007 we are likely to see oil prices in the $50 to $65 per barrel range before resuming their upward trend in 2008. In the long run suppliers will need higher prices to increase reserves and production from current levels. Companies always pursue the cheapest oil first: marginal costs increase as the easiest oil to reach is pumped and producers must increase exploration and development budgets to go after the more difficult prospects. If governments impose additional "windfall" taxes, this will drive marginal costs higher still. The high cost of new incremental production needed to meet demand implies that overall oil prices will get higher still and this should produce robust profits for oil companies.

On the natural gas side, the U.S. market remains isolated from international demand and supply. As oil prices increase, more electrical generating capacity switches to gas. This is a slow process and therefore weather will be a bigger factor in the short to medium term. Still, major players such as Chesapeake Energy have unilaterally restricted production in periods when prices dropped below that needed for their wells to be profitable. I expect gas prices to firm, adding to long term (company) value.

I also expect energy sector earnings to show the effects of smart hedging. I.e. Chesapeake sold large portions of gas production in the futures market when prices were much higher.

International Stock Markets

Getting back to Asia, I expect China to pull along the whole region as Chinese domestic consumption takes off. This will reduce these economies' reliance on U.S. exports and therefore reduce correlation with the U.S. business cycle. The implication is that investment in Asian stocks will reduce risk and probably increase returns.

The Value of Value Investing

While I expect an overall flat stock market in 2007 because of the uncertainties mentioned earlier, our value oriented strategies should outperform the market. Low price-to-earnings ratio (P/E) stocks do not need any significant earnings growth to generate solid shareholder returns; they only need to avoid reductions in earnings. By choosing carefully, we can earn good returns in a sideways market. In fact, this is the most favorable environment for out-performance by our Long Term Value portfolio.

Investment Real Estate

Turning to the real estate market, we find that U.S. real estate is still selling at historically low capitalization rates despite the worries in the bond market about generally higher long term interest rates. It seems likely that this market will play out similarly to the bond market with much more downside potential than upside. Still, as before, there are properties and areas that will buck the overall market trend.

Resort/retirement areas will continue to appreciate as capital flows into the sector from the Baby Boom generation. Property in Asian resort areas near China (i.e. Thailand) will continue to go up in price rapidly – gaining on more expensive places such as Hawaii.

Conclusion

While there is much uncertainty in predicting how events will play out in 2007, careful analysis and valuation can still earn investors good returns in 2007. Berkeley Investment Advisors is here to help our clients preserve capital first and still earn a good return.

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