

## Outlook- Fourth Quarter 2006

The U.S. and Canadian economies continue to lose momentum as 2006 draws to a close. In the U.S., second quarter GDP grew by only 2.6% and most economists are predicting a decline to a pace of 2% for the balance of the year. The three-month trend in Canadian GDP also remains at a lackluster 1.1% annual rate. This is down from the 2% pace recorded in the second quarter.

North American GDP is biased lower in the final three months of this year, due to large production cuts and layoffs by automakers and a decline in U.S. housing activity. More importantly, the consequences of a housing slowdown and its effect on consumer spending will determine the extent of this economic downturn. As we have noted in our previous commentaries, housing and consumer spending have played a large role in the current expansion. According to Northern Trust, these two factors alone have accounted for 76% of real GDP growth in recent years.

Housing affordability has fallen to its lowest level since August, 1986. The primary factor behind the drop in affordability has been a rapid increase in the prices of residential real estate compared to household after-tax income. On a nation-wide basis, the median home value in the U.S. has jumped 32% from 2000 to 2005. This decline in affordability has resulted in a sharp decrease in sales and a subsequent increase in the supply of houses for sale. New home sales are down -17% from the same period last year.



This sharp increase in housing supply has impacted housing starts, which are now down -20% from August last year. Housing starts have been down six of the last seven months. As predicted in economic textbooks, a large gap between supply and demand has resulted in a downward adjustment in prices. In September, U.S. new and existing home prices decreased together for the first time in 14 years. The decline in house prices may have a lot further to go. According to

Merrill Lynch housing prices must decline by a further 16% to bring affordability back to its trend.



The impact from the downturn in residential real estate on the broad economy is already affecting appliance and furniture sales (down five of the past six months) and employment. Residential construction employment has fallen by 38,000 jobs since April. This is in sharp contrast to the 2004/2005 period, when according to Goldman Sachs, residential construction added 20,000 jobs per month.

Stocks and bonds appear to be looking at two different economies. Bond yields dropped lower across the curve during the third quarter indicating a possible slowdown. The stock market rallied with the S&P 500 advancing 9% in just over three months indicating continued economic growth. There appears to be a disconnect between the “pessimistic” bond market and an “optimistic” stock market. This optimism may be due to the drop in commodity prices. Oil declined by almost \$16 in the last quarter. However, the drop in commodity prices may portend a slowdown. Historically the bond market is a better indicator and we believe that to be the case again this time. We believe that the stock market has it wrong.

**Bottom Line:**

There is obviously a lot of risk in the assessment that markets are perfect at forecasting the future, as a rebound in commodity prices or a further significant slowing in the U.S. housing market would provide stock prices with a negative surprise. As we move into the historically volatile last quarter of the year with the knowledge that North American equity markets have experienced a sharp decline every autumn for the past nine years in a row, we will continue to monitor economic and financial markets as they react to the unfolding economic environment.