Kimura Dreamvisor Newsletter summary 21st September 2006

What if the US housing bubble burst?

That would give a heavy blow to US individuals; US rate increase cycle would end.

Two big events took place on the 20th: Japan LDP election and FOMC. Whatever event did not have any impact on the market. However analysts and economists started the scenario guess game and I believe the market will soon over-react in some way therefore it is best not to take substantial positions for now.
As forecasted US economy is slowing down due to housing falls. Housing starts statistics announced last week were under market expectations, consequently a lot of fund managers considering that future growth prospects will soon be revised down sold the US $ ,commodities and bought bonds. These investors are quite large and invest in a wide range of products therefore this have quite an impact. Another consequence is oil price fall.

If the slowdown becomes pronounced then US rate increase cycle will end. US 10 years treasuries yield 4.75 %, 0.5 % below FF rate and discount future financial easing. The Dow closed near 2000 year historic high. Consensus is that companies' earnings won't be impacted by the slowdown, in addition for next year S&P 500 EPS is expected to raise two folds. I believe this is somewhat too optimistic and that earnings will decline.
Compared to that Japanese equities are not performing well. Although the macro environment is improving (: oil price declined, Yen weakened and real estate prices have turned up) the market weight of shares benefiting form high oil prices is important in Japan therefore such stocks were sold. New growth markets are not pulling out from the stalemate; individual investors have not yet recovered from their wounds. As foreign investors mostly look at Japan as a cyclical play they lowered Japanese equities weighting in light of forecasted worldwide slowdown. In addition we are entering the period when US investment funds have to sell for tax avoidance purpose.
It may look unlikely to most Japanese people but in the US there are a substantial number of people who remortgaged their home to consume in a flamboyant way.
Even if there are individuals with savings total US households saving rate is negative and the housing boom had a kick start effect on consumption.
However with the housing boom close to reversal consumption will slow as net debt

ratio is increasing. The bigger the fall in real estate prices the harder the slowdown. Sooner or later this will have an impact on companies' earnings and employment. At that stage FRB will reverse its hawkish stance.

Will the US twin deficit finally go down?

In august the new housing starts went down 20 % at 1 million 665,000 which is a low since April 2003. Although Japanese population is only 40 % of US population Japanese housing starts are 1million 200,000. Housing construction only represents 6 % of the whole GDP and direct impact of housing slowdown should not be that important. In addition US house price rise was not steep and the mortgage debt level is not at critical point therefore backlash should be limited.

Medias always splash stories like part of the real estate investment schemes will go bankrupt leading to personal bankruptcies and solvency problems for the mortgage lenders but I believe this cannot be overlooked. Individuals consumption is 70 % o GDP that is 12 times the weight of housing therefore backlash of excess consumption cannot be neglected.
US current account deficit was 838,1 billion US $ up to June on a yearly basis (nearly 100 trillion Yen). Five years before it was just 422,5 billion US $, ten years before 103,1 billion US $. From Clinton presidency to Bush presidency US registered a historic deficit expansion which triggered the excess consumption; the main beneficiary has been China.
US current deficit expansion is the multiplier effect of real estate bubble and consumption boom. Considering developing countries explosive growth and natural resources price explosion I believe US massive demand spreaded to the world. Consequently the fall of equipment and cyclical related equities becomes understandable in the context of worsening US housing statistics, energy prices fall.

Finally if the US current deficit starts to decrease the growth rate of countries like China, which expanded on the back of exports to US, will weaken. However even the US at standstill is minor compared to the spectacular developing countries growth wave. There is no change to the basic scenario through which developed countries current economic lead weakens and developing countries rank goes up the ladder.
US $ exchange rate is a concern for mid term investments. I am concerned about the income balance deficit (income earned from foreign based assets interest payments and

dividends – interest payments and dividends earned from domestic assets). Huge liabilities are piling up every year therefore deficit expansion is accelerating.

In the near future unless US expand considerably its exports it will not be possible for the dollar to keep its value on the basis of low growth and current deficit. What could trigger US exports expansion? Developing countries food production capacity should soon reach its limit. Cereals demand will become tight implying a surge in worldwide prices. Should we reach that stage, very much like current overpoweringly oil producing countries, US is the undisputed agricultural nation's leader.