Atlantic Equity Research
Independent Research

April 28, 2006

High house prices or high gas prices: we have reached the "non – exquisite" moment

The goal of our monthly commentary is to discuss events or issues that are not being discussed in the mainstream financial press that we think are important to our clients. This month we have to break our mandate and discuss two issues that have been relentlessly discussed in the mainstream press because housing and oil pricing issues are two important to ignore.

In March of '03 world famous market commentator, investor and former hedge fund manager Jim Cramer described that period in stock market history as the "exquisite moment". He felt that a combination of low interest rates, the Fed Funds rate was rapidly being lowered toward 1% at the time, and soon to be passed lower tax rates on dividends and capital gains, as well as a stock market that was bottoming, would create a potent cocktail of explosive market growth. Others, such as Lawrence Kudlow, his partner at the time, said that wars are good for the stock market, in reference to the war drums that were loudly beating at the time. Mr. Cramer, as far as I know, didn't go as far as actually saying that wars are good for the stock market. But, Mr. Kudlow had no problem with letting people know how he felt. Mr. Cramer was right we were at an exquisite moment, as all three major U.S. market indices rose above 20 % in '03.

I believe that we have now reached the non - exquisite moment, by this I mean that a combination of negative financial market realities have reached a head at the exact same time. Oil touched above $ 75 a barrel during the week of April 15 to 21st, and gas prices are now around $3.00 in many areas of the country. At the same time that gas prices soared the housing sector started to show more signs of cracking, as on April 26th three public home builders; Pulte Homes, Centex and Beazer Homes all lowered guidance.

It is very important to read between the lines about what Wall St. and the Fed are saying about inflation and the housing markets. The three negative earnings reports from the aforementioned home builders came after an announcement earlier in the week from the National Association of Realtors about new home sales for March. The announcement, and how it was worded, is very important for investors to understand. The headline stated the following about new home sales for March, " the increase in new home sales was the highest since 1993, and represented a rebound from a 10.9% drop in sales in February". You would think that the housing market was rebounding by that comment. What the headlines didn't point out was that sales were down 7% from last March, and that inventory was up to 550,000, a 5.5 month supply up from a 4.3 month supply a year ago. You would think that it would be more important to compare a seasonal business like housing with the same month from the previous year, seasonal adjustments aside. And the market interpreted the new home sales number as good news with many home builders stock up for the day.

In an article I read earlier today, a reporter from Bloomberg made the following comment in regard to Benjamin Bernanke's telling Congress on April 27th that he would pause raising rates in the near future," In the past, the Fed was comfortable pausing when inflation was hotter than it is now. Under Greenspan, the Central Bank stopped a string of rate increases in June 2000 even though consumer prices were up 3.7% over the previous year, compared with just 3.4% today". Can you imagine that the powers to be are actually trying to say that inflation is less today than it was in 2000? Health insurance, electric bills, food, gas, heating oil, education are a few of the many things that have absolutely skyrocketed in price over the last few years. Yes, according to the beloved, twisted, rigged “core” inflation rate, inflation is lower. Gold is well over $600, silver has skyrocket over the last six months, and copper and other raw materials have also realized huge appreciation. At this point, anybody that tries to say that inflation is contained in America should be met with scorn and repugnance.

The non – exquisite moment is that when Bernanke does pause in the rate increases, he will cause oil prices as well as other raw materials to continue to explode. And, as everybody that follows the world markets knows, the raising of the rates over the last few years in small baby steps has done nothing to slow down the ramped speculation in real estate and other risky assets. As an example, the stock markets for Indonesia are up over 25%, Morrocco is up over 40 %, Russia is up over 30 % and Brazil is up over 25%. These are just a few examples of the massive increases in stock markets worldwide in just four months, and the more emerging, or third world the country, the better. The Russell 2000 has vastly out shown the S&P over the last several years, and the more risky or indebted the small companies within the Russell 2000 are, the better they have done. Private equity firms are making billions whipping around pieces of poorly performing companies to each other or to other unknowing victims. All of this speculation revolves around massive liquidity and money creation. The stock markets have shown no aversion what so ever to the tightening of rates. And long bonds have barely flinched. The only people that have been affected by the raising of short term rates are people whose adjustable mortgages have recently reset or people with high credit card debt or home equity lines.

It is interesting that Greenspan stopped raising rates in June 2000 when the stock markets really began to crack, and Bernanke is pausing now when the real estate markets are starting to crack. It would seem that they were adjusting policy toward the stock and real state markets. But what is really interesting is that given all the attention Americans are paying to higher gas prices Bernanke is still going to pause in raising rates. Obviously trying to save the housing market is more important than worrying about people complain about higher gas prices. But, I guess because the core inflation rate is stable, there is no need to worry about higher gas prices.

We believe that inflation will continue to skyrocket, and that there is nothing that can be done to save the housing market. The end result will be falling housing prices and high gas prices. The non – exquisite moment is that there is nothing that Bernanke can do to save the housing market, and he is about to do the absolute worst thing he could do to control ramped inflation in raw materials.