



2005 - A GREAT YEAR

High-income consumers are booking expensive winter vacations in the Caribbean. The hotels are almost at full occupancy and are raising their room rates. After Thanksgiving, they shopped at the upscale stores and bought lots of overpriced handbags and oversized stuffed toys. Low-income consumers woke up early the day after Turkey Day and rushed to all the retailers offering limited supplies of really cheap DVDs and digital cameras. Apparently, consumers haven't heard the news about the housing bubble. Maybe they are getting bored with the story.

Several economists, including Fed Chairman Alan Greenspan, have estimated that "Home Equity Extraction" or "Mortgage Equity Withdrawal" has provided consumers with hundreds of billions of dollars to spend on goods and services. These numbers are the sum of home equity borrowing, mortgage refinancing cash-outs, and capital gains on the sale of homes. That last item is the biggy. We doubt that it has all been spent. Much of it may still be parked in savings deposits and retail money market accounts, which are up to \$4.3 trillion versus \$2.8 trillion five years ago. In other words, consumers are sitting on a ton of cash. So are corporations. The accumulated liquidity is available to keep the economy growing in 2006. Any housing-related slowdown should be offset by a tech-led boom. Other capital spending industries are also likely to continue boosting economic growth, especially aerospace, machinery, and electrical equipment.

- **Home Prices:** The Bubble is more likely to lose air than to burst. This could slow economic growth, but a recession isn't likely as a consequence. New home prices are already coming back down to earth. The year-to-year increase sank to a two-year low of 5.1%, while the straight year-to-year change was just under 1%. On the other hand, the bubble in existing home prices (up 15.7%) is fast approaching the late-1970s peak rate of 17%.
- **Home Sales:** There will probably not be a record high for home sales in 2006. But there could be the big surprise for new homes. Existing home sales are already looking topky. But new home sales surged to a record 1.42 million units in October giving homebuilders record revenues of \$408 billion. The builders may be starting to trim inflated prices to keep their product affordable. There is certainly plenty of demand for new homes.
- **Consumer Confidence:** Consumers were depressed in September and October. In November, they started to swing back towards a more manic frame of mind. Some were so excited by falling gasoline prices and post-Turkey discounts that they trampled one another to grab the bargains. The rebound in the Consumer Confidence Index suggests that gasoline prices are no longer an issue for consumer spending and that jobs are readily available.

This brings us to expectations for 2006. The growing economy should continue well into next year. Stock prices should continue the upward bias. The Federal Reserve should continue being concerned with inflation using the tools it has at its disposal to make sure money growth stays sensible. But our success will continue to be built on choosing the right companies to own. We were very successful doing this in 2005. Our portfolios outperformed the S&P 500 by a large margin. We will stay this course enthusiastically.

We thank you for our support and we value our clients' financial wishes, needs, and desires. We hope this has been obvious throughout our association. Please let us know how we might do it better.

Merry Christmas and prosperity in the New Year is our wish to you. A gift of appreciation has been made in your honor to Wolfson's Children Hospital.