

Investing Environment for the Period Ended June 30, 2006



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"What is a cynic? A man who knows the price of everything and the value of nothing."

— Oscar Wilde
1854-1900
Lady Windermere's Fan

In keeping with our common practice of opening with a quote from a deceased Irish literary figure, we turn to Oscar Wilde, a playwright and novelist known for his sharp wit and flamboyant lifestyle, for insight on asset prices, specifically housing. Ironically, it seems like just yesterday that technology stock prices were the topic du jour. With the NASDAQ still 57% below its March 2000 high, tech stocks seem so 1990's. Today, it is all about housing.

In fact, the second quarter 2005 letter previewed the housing market correction. That paper briefly recounted a modern era history of financial crises beginning with the collapse of Penn Central in 1970 and ending with the NASDAQ collapse in 2000. All nine crises shared one common element: they occurred during a period of Federal Reserve tightening, raising the question of whether a hard landing for housing was presaged.

Certainly there is reason to believe a hard landing is possible. At the time of the previous housing letter, homebuilder stocks were making highs; today the homebuilder's equity index is down 39.5% from its level one year ago. New home sales in July 2006 were 22% below July, 2005 levels. Since the 1960s there have been a half dozen "housing recessions." According to UBS AG (2006), the housing downturns of the late 1970s and late 1980s saw declines in new home sales of 47% and 44% from peak to trough, periods that lasted four and five years respectively. Clearly further weakness is possible. Moreover, a decline in housing has ripple effects throughout the economy. A decline in home sales negatively affects jobs and GDP growth. Concurrently, slower house price appreciation may dampen

home equity cash extraction thereby trimming consumer spending which has been an important prop to the world economy.

It all sounds pretty grim. However, we think a bit of perspective is useful. Consider the structural changes that have driven the housing boom for the last 40 years:

- Strong job growth including the advent of two-income families
- Plummeting interest rates from 1981-2005
- Developments in the credit markets facilitating increased borrowing by more people
- Immigration
- Robust household formation driven by baby boomers, divorce, and now the baby boomer offspring

While the massive fixed income bull market has probably run its course, the other factors are still in place to varying degrees. My conclusion about housing remains the same as it was in the letter in March 2005. At that time I wrote: "My sense is that there is trouble brewing but that the pain may not be as widespread as some fear."

Although the letter did not forecast "widespread pain," I warned about the proliferation of creative financing options that were necessary for some borrowers to cope with soaring prices. Indeed, affordability is a problem. Nationwide, affordability is at the lowest level since 1989 according to the National Association of Realtors (2005). Furthermore, housing affordability is much worse than national averages in hot spots such as California. The previous letter warned about the equity tranches of subprime mortgage backed securities. Not surprisingly, cracks have begun to develop in the subprime market. Last week, H&R Block announced that its Option One Mortgage unit, which sells into the subprime market, was setting aside reserves of \$60 million because of bad credit. Stay tuned for more on this front.

Notwithstanding the concerns about affordability and attendant excesses in certain financing options, we still expect that the economy will be able to withstand these pressures and avoid a housing related recession, which some pundits are forecasting. There are several factors that underpin our relatively sanguine outlook:

- Significant equity cushion. The current housing downturn was preceded by some of the highest real house price gains in the past 50 years. Dramatic past price appreciation has left most borrowers with a significant equity cushion in their homes.
- Income growth remains positive. Real disposable personal income continues in the 2-3% range.
- Labor markets are tight. The unemployment rate stands at 4.8%. Only in two other periods since 1960 (1966-1970 and 1998-2000) has the unemployment rate been this low.
- Energy prices are falling. With oil at \$63.00 per barrel at this writing, the pressure on the consumer at the gas pump has eased dramatically from the highs this summer.

The bottom line is that as long as people have jobs and equity in their homes, they will continue to make the mortgage payment. Accordingly, we view predictions of a consumer sector meltdown to be overblown. This is a matter of great, though somewhat indirect, importance to private equity. The consumer sector is roughly two-thirds of GDP. A consumer sector meltdown would be a clear negative for private equity. Fortunately, we don't think such a meltdown is in the cards.

At a higher level, we contextualize our prediction further by considering the resilience of our economy. The U.S. economy has proved remarkably flexible in managing transitions. Consider the resilience of the economy in the face of recent crises such as 9-11, a tripling of oil prices, Hurricane Katrina, and the NASDAQ crash. For each of these events, pundits predicted gloom and doom. Yet the U.S. economy continued to chug along. The number of forecasted crises always seems to vastly exceed actual crises. The reason, we believe, lies in the flexibility of our economic system. The cumulative effect of millions of economic decisions made each day by our citizens seem to act as an invisible hand (with apologies to Adam Smith) addressing market imbalances and moving back toward equilibrium. In the end, everyone is a fiduciary first and foremost to his/her own family which ensures that behavior, while at times irrationally exuberant (apologies this time to Alan Greenspan), always circles back to equilibrium.

In sum, count us among the believers in the "soft landing" housing scenario. A bigger worry, in our view, is the trend toward slower growth coupled with rising inflation, a phenomenon we call "Stagflation-lite," a reference to the period of stagflation in the 1970s. But that is a topic for our end-of-year letter next quarter.



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*The opinions expressed herein are those of John J. O'Connor and do not necessarily reflect the thoughts, opinions and conclusions of Fort Washington Investment Advisors, Inc. or its subsidiaries, affiliates and or employees.



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