



**PROFESSIONAL
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Dear Readers,

What started last summer as, I think, a relatively small, contained problem of overly easy lending standards for “subprime” mortgages has turned into a bout of what I view as indiscriminate selling unjustified by the fundamentals. So far this year equity markets around the world have experienced sizable losses. The big drops overseas on Monday and globally on Tuesday are supposedly related to fears that the U.S. housing slump will expand into a full fledged U.S. recession. Is this fear justified?

I remain firmly in the camp that it is not. Recessions do not just appear out of the blue; they come about because of widespread excesses that have to be corrected and usually require adverse monetary policy actions – interest rate hikes. Now there certainly were excesses in housing. But that correction has, in my opinion, largely been completed. Housing starts and home sales began to fall two years ago and are now at deep recession levels. For that situation to snowball into a recession would require the catalyst of other widespread excesses in the economy that have to be flushed out. I just do not see them.

Most American businesses and workers have engaged in pretty much continuous cost control over the last decade. I do not see the excessive hiring, excessive wages and benefits, excessive inventories or excessive capital spending that would squeeze profit margins, send company earnings down and require widespread corrective action. Households have also been careful. Consumer spending has grown pretty much in line with income, and household net worth is rising and at an all-time high, not falling. Outside of financials, business balance sheets are, in aggregate, at record strength with financial assets exceeding liabilities by \$1.4 trillion.

Cost control by business and labor has worked to keep us very competitive in world markets – hence the boom in U.S. exports. (Exports are more than three times the size of home construction.) Cost control has also kept inflation down and given the Federal Reserve room to cut interest rates sharply. So, with no need to liquidate inventories, slash capital spending, fire workers and cut pay, with generally sound balance sheets (setting aside some big, dumb banks), and with strong exports and the Federal Reserve cutting, not hiking, interest rates, I think the economic outlook is sound.

This looks like panic selling to me, and I would not want to join this crowd. General stock market valuation measures such as the price/earnings ratio look low to me, especially with interest rates down so much. Sellers may look smart for a day or a week or even a little bit longer, yet I think there is not a floor beneath us but a springboard, and I expect a sharp recovery when fear ebbs and the focus returns to the fundamentals. As always, please me with any questions or concerns.

Sincerely,

David S. Waters

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