Global Financial Conditions Look Very Healthy

Arthur A. Micheletti, CFA
Chief Economist and
Investment Strategist

SEPTEMBER 26, 2006

U.S household net worth* faltered in the second quarter, but the long-term trend and balance remain strong

In the second quarter, household net worth totaled $53.3 trillion, up slightly from the first quarter. With stock and home prices showing little gain, total assets grew only $300 billion.

Financial net worth (net worth excluding real estate) fell to $27.1 trillion from $27.5 trillion in the first quarter mostly due to the change in stock prices.

Although quarterly swings in the household balance sheet are interesting, longer term changes should be the focus of attention. Over the last year, household net worth grew $3.8 trillion or almost 40% of disposable personal income (DPI). Financial net worth rose $1.6 trillion or almost 17% of DPI. This is very healthy improvement in the household balance sheet. Consumers holding over $6 trillion in short-term assets, over $11 trillion in home equity and $13 trillion in marketable securities have a lot of potential purchasing power to tap.

Even if there is some shrinkage in household balance sheet, we expect personal consumption to remain robust. In 2000-2002, the last time the consumer balance sheet shrank, personal consumption continued to grow.

Balance sheet shifts are not the primary driver of consumption

Income growth and job security drive consumption. With income growing at a very rapid 7.0% and the unemployment rate at 4.7%, we believe consumption is well supported.

There are a lot of moving parts to the consumer balance sheet and it is not a given that net worth will stagnate. Although home prices are unlikely to appreciate significantly, the consumer balance sheet could improve if stock prices continue to rise. Outside of an implosion in home prices, we believe that jobs and income will determine consumption.

U.S. corporate finances are also in great shape

Corporations are loaded with cash, sitting on $1.9 trillion in liquid assets at the end of the second quarter of this year. This cash hoard is growing, with nonfinancial corporate cash flow exceeding capital spending by $277 billion in the first half of the year. Corporate balance sheets are the most liquid since the 1960's, and short-term debt relative to total debt is the lowest since the 1950's. The combination of a lot of liquid assets and less short-term debt makes corporations less vulnerable to interest rate swings and net beneficiaries of rising short-term interest rates. Total corporate debt continues to shrink versus net worth (assets - liabilities). After peaking at 56% in 1993, debt-to-net worth has steadily fallen, hitting 41% in the second quarter.

The Treasury Budget deficit has improved sharply this fiscal year

The budget deficit for the first eleven months of the fiscal year totaled $304.3 billion, almost $50 billion lower than during the first eleven months of 2005. The Office of Management and Budget has revised the full fiscal year deficit estimate to $295.8 billion, down from the $423 billion estimated in February. Since 1993, the deficit as a percent of nominal GDP has been cut to in half to about 2%. However, outlays are still rising rapidly (7.6% this fiscal year) and will have to be addressed. Over the last few years, robust revenue growth (11.7% this fiscal year) has more that offset spending growth. Unfortunately, the budget cannot rely on large revenue increases indefinitely. We are facing huge unfunded liabilities for Social Security and Medicare.

Emerging economies are in the best financial condition ever

Rising exports and trade surpluses have allowed emerging nations to build up large foreign reserve positions, making them less vulnerable to economic crisis. China has almost $1 trillion in reserves, Asia ex-China and Japan have

continued on back

*Net worth subtracts total liabilities from total assets. Assets include short-term assets, marketable securities, homes, pension funds and unincorporated businesses. Liabilities include mortgages, credit card debt and nonrevolving credit (autos).

continued from front

$1.1 trillion in reserves and the other emerging markets hold $1.3 trillion in reserves. This is one of the reasons emerging stock markets bounced back so strongly after their March to May decline. In the last week, in the face of the turmoil in Thailand and Hungary, emerging equity markets also held up quite well, unlike the contagion that was experienced in 1997. The resilience in the emerging stock markets is partly due to improvement in the underlying financial strength of these countries.

Sources: Federal Reserve Flow of Funds, Bailard Research, Oak Associates, Bear Stearns, Bloomberg, Ned Davis Research

DISCLAIMER

This piece has been distributed for informational purposes only and is not a recommendation of, or an offer to sell or a solicitation of an offer to buy, any particular security, strategy or investment product. This piece does not take into account the particular investment objectives, financial situations or needs of individual clients. This piece contains the current opinions of the author and such opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Bailard cannot provide investment advice in any state or jurisdiction in which it is not registered or exempt from registration.

© 2006 BAILARD, INC. FOSTER CITY, CALIFORNIA

For more information, please call 800.BAILARD (800.224.5273) or visit www.bailard.com.

Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, California 94404

Bailard

INVESTING. **REDEFINED.** ®