The Kiplinger Letter

FORECASTS FOR MANAGEMENT DECISIONMAKING

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Dear Client: Washington, June 22, 2007

Get used to living with less water. Severe droughts are here to stay. Worst off: The South and West. But other areas also must learn to cope with less rainfall.

The shortage is not yet a crisis, and with planning, it won't ever become one. But it still means lots of big changes.

ECONOMIC FORECASTS

GDP
2% for the year

Interest rates
Prime ending '07 at 8.25%

Inflation
About 2.5% for the year

Employment
1.5 million more jobs

Trade deficit
Narrowing to $761 billion, 5.6% of GDP

Crude oil
Averaging $60 a barrel

Housing sales NEW FORECAST
Down 9.6% in '07, up 1.7% in '08

Retail sales
Slowing to 3% growth

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WATER

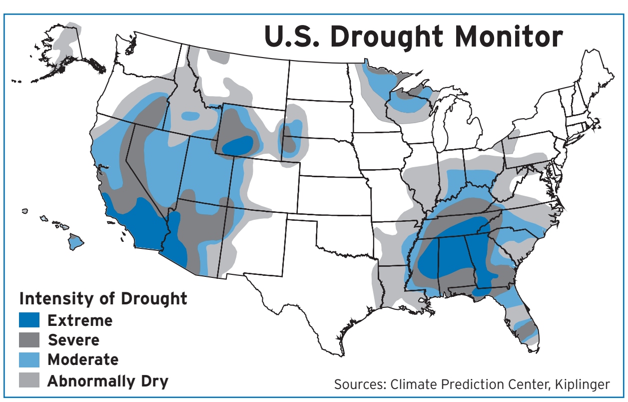
Conservation will be the new norm. Higher prices will help make it happen. Consumers, both business and residential, will pay more...in some places, a lot more, with rates that'll escalate as use increases.

Limits on use. Some will be mandatory, as is the case in a few Calif. counties now. But most communities will rely on pleading, cajoling or tax incentives to cut water use.

More ways to save. Some businesses will add roofs that can catch rainwater, get rid of fountains, replace thirsty lawns with less-demanding plants or install faucets that shut off automatically after a set time. Purchases of appliances that use less water... better washing machines, air conditioners, toilets, etc...will spike.

Recycling. Las Vegas leans heavily on a capture, collect, treat and redistribute system, offering incentives to consumers and companies. Firms can earn rebates...up to a lifetime limit of $150,000 per property. It's a success story that other cities can learn from: In five years, water use in Las Vegas fell by 18 billion gallons as population surged.

Stocking up. To help smooth out dips in supply, Fla. communities plan to skim millions of gallons from rivers, such as the St. Johns. The water will be pumped, cleaned and stored. Other communities are adding reservoir capacity and putting up new water towers to prepare for future droughts.



Desalination. San Diego, for one, is pinning hopes on a new plant. The catch: It's a drain on power.

Bucks from Congress will help, but the main burden will fall on local leaders, individuals and firms. (More on page 2.)

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WATER WINNERS

For those involved in water technology, there's money to be made. Demand for water recycling plants will grow sharply. Sales of equipment for filtration, ultraviolet oxidation and vapor compression will rise 15% annually for five years from today's $1.8-billion level.

Among the leading manufacturers: CH2M Hill, Separation Dynamics, Mi-T-M Corp., Siemens, Arbortech Corp. and EZ Environmental Solutions.

Also: Sun Frost, Applied Energy Recovery Systems, SETS Systems and other makers of water efficient appliances, for both consumer and industrial applications, as the water conservation market grows.

Other winners: Firms that dredge reservoirs or make water towers.

HOUSING

Higher mortgage rates are yet another drag on starts and sales. The increase in rates...30-year fixed mortgages now average 6.7%, up from 6.1% a month ago...will crimp demand in already weakened markets.

Starts are now likely to total only 1.35 million this year, 100,000 fewer than estimated before rates jumped. Expect a modest rise to 1.5 million next year, still well below the 2005 peak of 2.07 million.

Inventories of unsold homes are lofty and will go even higher. Nationally, the new-home backlog now equals about 6.5 months of sales. Surveys show that builder sentiment is the most pessimistic since 1991, when the housing market last found itself in a deep national slump.

Look for new-home sales to come in at 920,000 this year, with existing-home sales, the bulk of the market, totaling 5.9 million. Next year...a modest improvement to 940,000 and 6 million, respectively.

Higher rates will also accelerate the pace of foreclosures. Defaults, the first stage of the process, will hit about 1.25 million this year and next, up from 900,000 last year and 800,000 in 2005.

But foreclosures will be highly concentrated in a few areas. One hard-hit patch will be the northern auto belt in Mich., Ohio and Ind. Others are the once-hot targets of quick-flip investors: Ariz., Calif., Fla. and Nev. Many homeowners also are weighed down by property taxes inflated by the boom era. It'll take a while to readjust taxes lower.

No matter what Congress eventually passes on immigration...
New arrivals will fuel housing demand over the long term. Even if lawmakers sharply curtail the flow of immigrants in the future, those already here and their children will buy thousands of starter homes over the next 10 years, creating a firm foundation for housing sales.

Their impact will also have a much wider geographic reach, spanning out from Calif., Fla., N.J. and N.Y. to Ark., Conn., Ga., Ky., N.C., R.I. and the Md. and Va. suburbs of Washington, D.C.

There won't be many winners in the subprime mortgage meltdown.
But two do come to mind: Fannie Mae and Freddie Mac, the mortgage giants backed by the government. Accounting scandals at both a few years ago led Congress to think about reining them in. Not anymore.

Fannie and Freddie will escape the much tighter supervision sought by some because they're needed to help stabilize housing markets. The two big companies provide liquidity by buying mortgages from lenders, which then have the capital to offer new mortgages. So the last thing that lawmakers want to do at this precarious moment is clip their wings.

That's not to say Fannie and Freddie haven't taken some lumps. They had to accept temporary limits on how they invest their portfolios, and their stock fell sharply...both on Wall Street and on Capitol Hill.

ELECTION 2008

Don't be surprised if Fred Thompson shoots right to the top next month when the former senator from Tennessee announces that he'll seek the Republican presidential nomination in 2008.

But don't assume he'll stay there. GOP conservatives are eager for him to run. They're not thrilled with other Republican contenders and see the actor as Reagan-like, able to stir the GOP base. But...

Thompson is no Ronald Reagan. He's not a conservative ideologue but a pragmatist, and his record shows he has crossed conservatives on abortion, campaign finance and the Clinton impeachment effort.

And he's not an outsider, though he'll cast himself as one. He'll dust off the red pickup truck he used in his Senate campaigns and don his cowboy boots to play the part of a modest country lawyer running to shake up Washington. But it will be hard for the TV star to gloss over more than a dozen years as a high-priced lobbyist.

Thompson also needs to quickly articulate a policy agenda that's more specific than anything he has said so far on such issues as Iraq and health care. And he'll have to raise lots of cash fast.

Plus the other Republican candidates won't just fade away. Most have more than enough money to stay in the race until February, when a raft of early primaries and caucuses may decide the winner.

CREDIT SCORES

A crackdown on a credit scam will have unintended consequences.

The problem: Matchmaker firms pair people with bad credit ratings or no credit history with safe borrowers. Both names go on the account, although the risky one can't use it and may not even have a card. The firms, including InstantCreditBuilders and Seasoned Trade Lines, charge a finder's fee, and the person lending his or her good name receives part. The bad risk can quickly earn a better credit rating. It's one of the practices contributing to the subprime mortgage crisis.

The solution: Fair Isaac Corp., which sets FICO credit scores, which are widely used by lenders of all types, is changing its formula to weed out the free-riders and produce more-accurate credit scores.

The unintended effect: The change will hurt younger people and others who frequently use the system to build up a credit rating. Card owners can still help by granting full credit-charging privileges, but that carries a risk that the co-owner will run up big monthly bills.

HEALTH CARE

As wellness programs grow, more states are getting into the act.

They're offering tax incentives to employers that help workers quit smoking, lose weight, join a health club or manage chronic diseases. Calif., Fla., Ind., N.J. and N.Y. are considering wellness tax credits, now that there's plenty of evidence that such plans really do cut costs.

Some states, though, are putting limits on what employers can do. Mass. lawmakers are mulling whether to add weight as a protected class under antidiscrimination laws. Lawmakers in Wash. wonder whether smokers need protection from bias. They may make it illegal for firms to require that workers quit smoking, or even to ask employees about tobacco use.

Good news for employers that provide retiree medical coverage:

They're close to gaining approval to reduce benefits for retirees who are eligible for Medicare. An appeals court upheld proposed rules likely to be finalized soon by the Equal Employment Opportunity Comm.

TAXES

Employers beware: The IRS wants you to help close the tax gap. The IRS push to get more of the revenue Uncle Sam is entitled to will include targeting payroll tax dodges fancied by some businesses.

The top employer issue: Misclassifying workers as contractors when they're really employees. Expect the agency to take a tougher line if firms have too much control over workers to justify contractor status. The agency will use leads from workers, who...beginning next year... can file special forms if they think that they have been misclassified.

Congress will weigh in, too, upping fines for any violations.

Other targets: Payroll tax fraud, excess worker reimbursements for expenses and S firm owners taking dividends to avoid payroll taxes.

Congress, meanwhile, is eyeing the tax returns of bigger fish.

Lawmakers are likely to hike taxes on a few private equity giants that go public. They'll do it by closing a loophole that allows firms to use a 15% tax rate on profits instead of the usual 35% corporate rate.

So far, only two firms fit the criteria: The Blackstone Group, which just went public, and the Fortress Investment Group, a hedge fund.

Investment firms object, arguing that it will discourage others from going public and make it harder for the U.S. to compete worldwide.

But many on Wall Street see the bill as the lesser of two evils. They're hoping that if lawmakers pass this bill, they won't press so hard for a much broader measure that would apply to most private partnerships. That would hit hedge funds, venture capitalists, real estate partnerships and many oil and gas companies, raising up to $6 billion a year.

PERSONAL FINANCE

Want to get out of a car lease? Look for an Internet matchmaker. Online companies are helping firms and consumers find others trying to sublease their cars, allowing lessees to avoid paying big fees as well as most debt obligations. Three such companies: LeaseTrade.com, LeaseTrader.com and Swapalease.com. Fees for both buyers and sellers are about $75...plus the seller pays $200-$250 to transfer the title.

Lease swapping has really taken off in recent months... a result of higher car prices. Some 17 million will lease cars this year.

PASSPORT MESS

Does the passport fiasco signal deeper long-term problems? The State Dept. says it just goofed, underestimating the demand generated by new travel rules, which triggered a 12-week backlog.

But the mess comes at a particularly bad time for the nation.

Americans increasingly believe the government is incompetent... unable to handle their basic needs, whether it's issuing passports, tracking illegal aliens, protecting personal data, providing health care for wounded soldiers or dealing effectively with natural disasters.

The repercussions may be severe. Just when they're needed most, fewer qualified people than ever seem to be attracted to public service.

Yours very truly,

Knight Kiplinger

June 22, 2007 THE KIPLINGER WASHINGTON EDITORS

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