Economic Commentary

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Consumer: Out of Money and Nowhere to Go

As Paul Kasriel, Director of Economic Research at The Northern Trust Company, said recently, "Greenspan is a fascinating study. Some day I hope to write a book about him. Right now I am willing to say he is the luckiest Federal Reserve chairman in history." This comment was an answer to a question concerning his stewardship of the nation's central bank. When asked, "How so?" he answered, "He was fortunate in two big ways. First off, he was fortunate to preside over the economy at a time when productivity was soaring and the global supply of goods was expanding rapidly because China had entered the world trading arena. In that environment, the Fed could create large amounts of money and credit without causing inflation other than in asset prices."

A brief review of the last 25 years or so, we believe, will be beneficial to all who have an interest in the economy and more importantly the trend of future financial markets. As you know, it is our opinion that financial markets reflect the economic fundamentals in the long term. During shorter periods of time, the markets reflect day-to-day news as interpreted by the consensus of market participants. This consensus then has a huge dose of normal human behavioral traits which unfortunately has mostly been wrong, particularly at critical turning points. The 1980's had three important public policy events that influenced greatly today's conditions. First of all, Fed Chairman Paul Volker came in to replace a series of inept chairmen that followed Truman appointee Paul Martin. Volker absolutely brought inflation to a halt as measured by the various price indices. In so doing, the early 80's experienced a very severe recession which resulted in the oil patch and mortgage lenders going through the ringer. Various interest rates were in double digits, some in the low 20's. Next, a new tax law in 1986 led to the demise of the savings and loan industry along with many large real estate developers. By this time in 1990-91, Greenspan had come upon the scene and bailed out the remaining financial institutions that hadn't gone broke by that time. This was done by lowering the Federal Funds rate to 3%, drastically lowering the cost of funds to the banks, which allowed them to restore their depleted capital accounts, as their margins went from 1% to 3%. Remember, the difference between the above is not 2%, but 200%!

The 1990's began with a very mild recession which was followed by a quite weak recovery and expansion. It appeared as if a recession was about to commence again in 1995; however, this also coincided with the productivity explosion in high tech. All of these events made for benign use of monetary stimuli and low interest rates through most of the 1990's. Inflation remained under check in prices but not in asset values. The excesses of the Fed first went to the stock market and then later in the 2000's to housing and other real estate venues. If you recall in the early 2000's, the Fed took the federal funds rate to 1%, rates not seen since the Great Depression of the 1930's.

So here's the rub in our opinion. The banks today have 62% of their assets in real estate loans, primarily mortgage loans. It is the greatest housing bubble in the history of the world. The reason? For 15 years the Fed managed interest rates in order to make the banking industry strong, and once again aggressive as they were in the 1960's and 70's (this is at least one of the reasons). Their thinking (again in our opinion) was to keep the economy growing as China and India were, and still are, hollowing out our manufacturing industries as well as middle management employees of all kinds. The consequence of all these factors brings us to where we are today after their latest move to raise short-term rates. This is the cause for the abrupt halt to the housing bubble. We do believe that although their stated cause for this upward move was to stop goods and services inflation before it started, the real reason was their realization that the inflation in assets values were out of control. They knew full well that throughout history, <u>all</u> bubbles burst, and the aftermath can be severe, a la Japan in the 1990's and the U.S. in the 1930's.

Today the consumer is over-indebted in relation to his income. He by far is the weakest link of the economic sectors. The problem is government spending is notoriously inefficient and corporate spending amounts to primarily buying back their own stock. This creates no jobs and the consumer on an income basis is broke! His balance sheet looks good now, but it too will become weak if this housing break becomes as bad as we think likely.

The new player in the economic sectors now, of course, is the financial community. As you recall, earlier and historically the three sectors have been the consumer, corporate, and government sectors. The financial sector was always separate and functioned as a distributor of credit to what we have always called the real economy. That–for better or for worse–is no longer the case. The year 2006 will go down in history as the greatest merger and acquisitions period ever. It eclipses the year 2000. Maybe it's a part of the transition from a manufacturing economy to service that has necessitated the financial people becoming a big time participant in the "new" real economy. While all this change is taking place, we are to Asia what England was to us during the late 1800's through the 1920's. The problem, however, is we have heavily indebted the consumer to keep him spending and, through mergers and acquisitions, are in the process of increasing the debts of our corporate sector.

The government, as always, remains in debt. We have said it before but say it again–we do not understand why more investors are not concerned about debt. It's up to our collective necks now, and when it gets up to our eyeballs, it's all over.

History is fine, but where are we now and what do we see for the future? The consumer is the key. Liquidity has been in abundance for the consumer to continue to finance his purchases through using mortgage market "innovations". These so-called innovations allowed almost anyone who was still breathing to finance a new home and/or withdraw funds from an older one whose value had increased. It now appears that this is over. If it is, then the consumer is staring the proverbial wall in the face. Merger and acquisition activity, it appears, will be the only source of money, and it will go only to a select few stockholders which have been doing much better over the last few years than anyone else. The Wal-Mart consumer group is left out, and we are seeing that reflected in Wal-Mart's sales. Also, merger and acquisitions activity will cut the workforce even more as jobs are eliminated. Not a pretty picture for the average consumer.

The question then becomes, will further easing by the Fed, which we expect before too long, once again bail out the weakest sector link (this time the consumer)? If not, we are in a peck of trouble!

Being one that tends to beat a dead horse to death, Central Plains Advisors, Inc., through the eyes and hand of Piscataqua Research Inc.'s Stephen Church, returns again to the housing area for the critical input to the outlook for the economy. The following is the summary of his latest piece, "The Consumer Crunch: December 2006 Update."

Is the Party Over on New Year's?

Summary: American consumers are out of cash; up to their eyeballs in debt; and figuring out that they are being played for fools. Will New Year's resolutions to stop spending be the "line in the sand"? Since liquidity continues to drop to new lows, we see no other real choice.

Our September, 2006 update showed that we had reached Step 5 of our economic process. Based on current information, we have advanced to Step 6. Our housing bubble analysis shows that Step 6 will be a multi-year process of diminishing real residential investment.

The Federal Reserve appears to be finishing 2006 on a 5-month monetary stimulation binge. Stocks and bonds are responding to the stimulation in a classic manner. Unlike 2001 through 2003, consumer liquidity is still declining in spite of the stimulation.

We expect the Federal Reserve will be even more aggressive in 2007 as they try to reliquify households. We expect falling consumer liquidity will force much lower corporate profits. 2007 should be an economically interesting year. Our suggestion: take your gains on long Treasuries!

The only change we would make is his suggestion–we believe it should read, "Our suggestion: Take your gains on less than A rated long bonds, but most of all common stocks."

To better understand his analysis of the housing bubble and how it has worked through the economic chain of events to obliterate financially the consumer, please read carefully the following. Note that M-1 refers to primarily checking accounts, and M-2 refers to primarily checking and savings accounts. Again, we would change the final sentence to: "We could get deflation, recession, or both".

The Economic Process

In our paper, "Real Estate and Money Supply", we outlined the economic trajectory that the U.S. economy is likely to follow. This section describes that process and is integrated with our updated economic analysis.

Current information indicates that we have progressed to Step 6 of our economic process. The process follows:

Step 1: The Federal Reserve raises interest rates and begins effecting the willingness and ability of consumers to access their back-up liquidity: home equity loans. This piece began in summer of 2004.

Step 2: Consumers allow M-1 growth to stagnate instead of accessing home equity loans to maintain liquidity. M-1 growth reached 0% in November, 2004. Since November, 2004, M-1 is nearly unchanged.

Step 3: Liquidity becomes more dependent on mortgage refinancing. Consumers recognize that the best way to increase short-term liquidity is by controlling large purchases based upon their access to long-term financing. The sales fluctuations in the auto industry have shown this view to be correct.

Step 4: Existing home resales moderate as consumer liquidity remains under pressure. New home sales remain strong. Since home resales generate M-2 and new home sales deplete M-2, this step is the critical step. Home resales peaked in June through November, 2005.

Step 5: Existing home resales decline. Home resales are now clearly declining. October information shows home resales down 11.5% from 2005. Median home resale prices are now down 3.5% from 2005.

M-2 mortgage-related accounts have been near 0% growth on a year-over-year basis since the end of September. M-2, itself, has declined to under 5% growth on a year-over-year basis.

Step 6: New home sales and remodeling decline. This step is now happening. New permits and home starts have declined 28%. New homes under construction have declined 6%. New homes completed have only declined 1%. New home sale prices have been flat during most of 2006. Builders are in a race to complete and clear existing inventories as new home sales fell 25% nationally during October.

We have progressed to Step 6 of this consumer cash flow driven process. Now, we will learn whether a Step 6 slowdown leads to a recession or not.

In our paper, "Recipe for a Depression", we estimated the National Income and Product Accounts for the 1920's. We showed that residential construction declined significantly from 1928 to 1929. Non-residential construction lagged approximately a year behind falling residential construction.

It is possible that a similar economic process is already at work in 2006. If we had to benchmark the process, we would compare our current status to approximately June, 1929. We have three data points that seem comparable: falling residential investment, peaking non-residential investment, and rising auto inventories.

Our current economic guesstimates show that the 4th quarter of 2006 will be low but positive. Based on the aggressive inversion of the yield curve during the fourth quarter, new mortgage debt generation should be sufficient to maintain consumer spending into December.

In the best case for 2007, we barely avoid the recession that we are now approaching. In the worst case, the Federal Reserve fails to maintain debt flow to the consumer and 75% of the economy achieves a net negative growth rate. We could get inflation, recession, or both.

There you have it. We thought a year ago the consumer was "out of gas." We were wrong as the financial industries' various "give away" mortgage programs were just gearing up. Old fashioned bankers would never have done what these seemingly bright young computer literate ivy league MBAs introduced to the lending marketplace. Is it possible the world has passed us by in our belief that one should adhere to reasonable lending standards? Yes it is, but don't count on it.

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