

Economic Commentary



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Goodbye Six, Hello Seven

Some have nicknamed the late Harvard economist Hyman Minsky “Bubble Boy,” as his great contribution to economics has come from his cyclical theory of financial crisis. He was a somewhat difficult economist to pigeonhole as he had ties to the very conservative Chicago School, was a big admirer of John Maynard Keynes, and at the same time studied under the Austrian economist Joseph Schumpeter.

We would guess that his true allegiance was to Keynes, as he believed strongly that capitalism is inherently unstable, and therefore government intervention is necessary.

We, on the other hand, as you know from our previous commentaries, believe just the opposite: i.e. capitalism is self-correcting and it is government intervention that causes instability—a la the Federal Reserve.

In surfing the web, we found a blog located at www.askaboutmoney.com, which details the stages of Minsky’s financial crisis theory. We have taken the liberty of extracting this from the blog site. The blogger himself said he stole it from another undisclosed web site. If push comes to shove, at least we will have a cell mate in Leavenworth if convicted of plagiarism.

Please note that these seven stages have occurred time and time again in economic history. The most recent two, of course, have been the tech bust at the turn of the century, and now the housing bust.

As an aside, don’t you believe the Greenspan move to 1% short-term interest rates had something to do with the current financial bust? As a matter of fact, since Greenspan’s entrance on the stage in 1987, he became the champion bubble blower of all time. We will soon find out if Ber-

nanke is cut from the same cloth.

Stage One – Displacement

Every financial crisis starts with a disturbance. It might be the invention of a new technology, such as the internet. It could be a shift in economic policy. For example, interest rates might be reduced unexpectedly. Whatever it is, the world changes for one sector of the economy. People see the sector differently.

Stage Two – Prices start to increase

Following the displacement, prices in the displaced sector start to rise. Initially, the price increase is barely noticed. Usually, these higher prices reflect some underlying improvement in fundamentals. As the price increases gain momentum, people start to notice.

Stage three – Easy Credit

Increasing prices are not enough for a bubble. Every financial crisis needs rocket fuel and there is only one thing that this rocket burns -

cheap credit. Without it, there can be no speculation. Without it, the consequences of the displacement peter out and the sector returns to normal. When a bubble starts, the market is invaded by outsiders. Without cheap credit, the outsiders can't join in.

Cheap credit is the entrance ticket for outsiders. For example, gas prices have risen sharply in recent years. However, banks aren't giving out loans so that people can store gas in their garages in the hope that the price will double in three months. The banks, however, are prepared to give loans to people with poor credit to hold condos in the hope that they can be quickly flipped.

The rise in easy credit is also often associated with financial innovation. Often, a new type of financial instrument is developed that misprices [sic] risk. Indeed, easy credit and financial innovation is a dangerous cocktail. The South-Sea Bubble started life as new-fangled legal innovation called the limited liability joint stock company. In 1929, stock prices were propelled into the stratosphere with the help of margin. Housing prices today accelerated as interest-only mortgages

emerged as a viable means for financing overpriced real estate purchases.

Stage Four – Overtrading

As the effects of easy credit kicks in, the market starts to overtrade. Overtrading stimulates volumes and shortages emerge. Prices start to accelerate, and easy profits are made. More outsiders are attracted, and prices run out of control. Accelerating prices attract the foolish, greedy and the desperate to enter the market. As a fire needs more fuel, a bubble needs more outsiders.

Stage five – Euphoria

The bubble now enters its most tragic stage. Some wise voices will stand up and say that the bubble can no longer continue. They put together convincing arguments based upon long run fundamentals and sound economic logic. However, these arguments evaporate in the heat of the one overriding fact – the price is still rising. The wise are shouted down by charlatans, who justify insane prices by the euphoric claim that the world is different and this new world means higher prices.

Of course, the “new world” claim is true; the world is different every day, but that doesn't mean that prices run out of control. The charlatan wins the day and unjustified optimism takes over. At this point, the charlatans bolster their optimism with the cruelest of all lies; when prices finally reach their new long run level, there will be a “soft landing”. The idea of a gentle deceleration of prices calms the nerves. The outsiders are trapped in knowing denial. They know that prices can't keep rising forever, but they rarely act on that knowledge. Everything is safe so long as they quit one day before the bubble bursts. Those that did not enter the market are stuck in a terrible dilemma. They can not enter but neither can they stay out. They know that they have missed the beginning of the bubble. They are bombarded daily with stories of easy riches and friends making massive profits. The strong stay out and reconcile themselves to the missed opportunity. The weak enter the fire and are damned.

Stage Six - Insider profit taking

Everyone wants to believe in a new brighter future but a bubble takes that desire and turns it upside

down. A bubble demands that everyone believes in a brighter future, and so long as this euphoria continues, the bubble is sustained. However, as madness takes hold of the outsiders, the insiders remember the old world. They lose their faith and start to panic. They understand their market, and they know that it has all gone too far. Insiders start to cash out. Typically, the insiders try to sneak away unnoticed, and sometimes they get away with it. Other times, the outsiders see them as they leave. Whether the outsiders see them leave or not, insider profit taking signals the beginning of the end.

Stage seven - Revulsion

Sometimes, panic of the insiders infects the outsiders. Other times, it is the end of cheap credit or some unanticipated piece of news. But whatever may be, euphoria is replaced with revulsion. The building is on fire and everyone starts to run for the door. Outsiders start to sell, but there are no buyers. Panic sets in; prices start to tumble downwards, credit dries up, and losses start to accumulate.

Here is the paradox of all bubbles – everyone knows how the fatal combination

of easy credit, overtrading and euphoria will affect prices. Minsky didn't need to write down a thing about the madness of speculation. America's investors have a lifetime of experience. Within the space of five years, America moved from the tech stock bubble into the real estate bubble. Today's housing prices are grossly overvalued. Everyone knows that prices will collapse. It might be tomorrow, or it might be two years from now. One thing, however is certain, the longer it takes for the bubble to burst, the more painful it will be.

Doesn't the above sound familiar? Now let's bridge the gap between the tech bust and the housing bust. The following comes from the web site www.safehaven.com on March 30, 2001.

Since commercial paper is a major holding of money market funds (and since money market funds are a component of M3, adding CP back to M3 in calculating a measure of "money" or "liquidity" would be double-counting CP), the fact that money market fund assets continue their historic expansion in the face of stagnating CP issuance provides clear evidence of acceleration in the issuance

of other money market instruments. Money fund assets jumped an amazing \$40 billion last week to \$2.08 trillion, and have now exploded for an increase of \$210 billion over just that past 11 weeks (annualized growth rate of 53%). Money fund assets have surged \$414 billion, or at a rate of 34%, since mid-year 2000 (38 weeks). This stunning surge in money fund assets is clearly associated with the ballooning of GSE balance sheets. Not only are the GSEs borrowing in the money market to fund their mortgage purchases, it is quite likely that a significant increase in money market borrowings is being used by the financial sector to finance speculative positions in agency debt (and other) securities. The manufacturing sector may be, voluntarily and otherwise, tempering commercial paper borrowings, but the real estate finance superstructure continues to lend with absolute reckless abandon and this process is leaving footprints all over the monetary aggregates (and real estate prices, consumer spending, and system fragility).

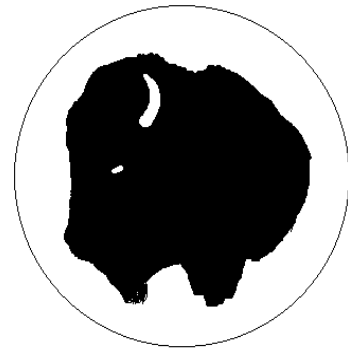
This week saw news of record home prices in the San Francisco Bay Area and strong sales and price gains in Florida. For the

first two months of the year, existing home sales are running at a rate of 5.2 million units, right at 1999's record pace. New homes have sold at a rate of 922,000 units through February, compared to 903,000 units sold last year. The crucial issue, however, is the financing of extracted equity. Yesterday from Business-Wire: "Standard & Poor's is projecting 20%-25% growth in home equity line of credit (HELOC) securitization volume in 2001—a dramatic increase from the relatively stable levels in 1999 and 2000, according to a new report titled 'The Changing Landscape of the HELOC Market.'" Wednesday the Mortgage Bankers Association reported a surge in refinance activity, with applications jumping to the highest level since the historic refinancing boom of October 1998. Refinancings are currently running at about 6 times year ago levels. And with 59% of mortgage applications associated with refinancings, total applications are more than double last year. Purchase applications have been running near last year's very strong pace.

Yesterday from Dow Jones News: "Angelo Mozilo, chief executive of Countrywide Credit Industries Inc., believes 2001 will be a record-setting year for the number of home refinancings. In a CNBC interview Thursday, Mozilo said loan application numbers are exceeding those of 1998, which set a record for home refinancings. While mortgage bankers have predicted 2001 will ring up \$1.5 trillion in refinancings, Mozilo believes the figure could reach \$1.6 trillion to \$1.7 trillion." With mortgage originations of about \$1 trillion last year, Countrywide's prediction of potentially a 70% increase should be an "eye-opener." And with 1998's "off the charts" record mortgage refinancings of \$1.5 trillion looking increasingly in jeopardy, the amount of extracted equity will almost certainly prove unprecedented. One cannot overstate the importance of this development. This refinancing boom is stimulating consumer spending, while also the main factor driving the surge in broad money supply and general financial system liquidity in the face of the historic NASDAQ de-

cline. Yes, the great technology bubble has burst but the even greater real estate finance bubble thrives, for now...

Right under our noses, a new bubble was being created at the same time that the tech bubble was deflating. Once again, rather than let the tech bubble burst work its way through the economy, and thus prevent the housing bubble from igniting, the Federal Reserve "came to the rescue." Gasoline was poured on the fire, and now, six years later, the bill may finally be paid. Or maybe not; we shall see. 1994 Mexico, 1997 Asia, 1998 long-term capital management, 2001 tech burst, and now the housing burst—what's next?



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