

Economic Commentary



Central Plains Advisors, Inc. • 800 E. 1st St. Ste. 220 Wichita, KS 67202-2767 • Economic Consulting & Investment Management

March 31, 2007

Step Number 3 At Hand

For the first time in many years it appears that consumers will need to liquidate some of their investments in order to replenish their liquidity, and spending ability. The reason for this is that the housing industry cash extraction, which has added so much to the consumer being able to maintain his consumption and investment—spending has come to a halt, or at least a severe slowdown. In 2005 and 2006, he drew down his savings due to lack of income; before that it was not necessary. This will continue in 2007 at an even greater drawdown, including liquidation of other investments. The consumer has had a 3-step heightened consumption enhancer, which was necessary since real income has been lacking. The desire to consume, however, has not been lacking. Estimates to date are that income is lagging by \$400B when compared to prior recoveries and expansions. To review, the three steps are as follows: 1) draw down savings, 2) extract equity from homes, and now 3) liquidate other in-

vestments, such as stocks and bonds. This is where the real trouble begins. As we have stated many times before—look out below!

With the above in mind, i.e. the potential shutdown of 70% of the GDP contributor, we would like to survey the big picture. To do so, we are calling upon two recent papers penned by those whom we respect for their economic and market interpretive abilities. We have only one caveat to their work. The entire mess in which we find ourselves has primarily to do with the historical misreading of the 1920's and '30's economy, as well as Japan's experience of the 1990's to date. History is a great teacher; however, to base public policy on the wrong historical model can have disastrous consequences.

Michael Shedlock (Mish), an Austrian-leaning financial analyst who authors the web site www.globaleconomicanalysis.blogspot.com, has it right. He believes, as do we, that the current economic condition is built on a founda-

tion of “sand debt”, while most of those on Wall Street ascribe to the “Goldilocks economy”. The name of his piece is *Counterfeiting Money—Crime or Good Economics?* The paper is much too long for us to include in our commentary. We urge you to study this in detail. In our opinion it proves the inflationists wrong. Deflation is the probable problem.

Stephen Roach of Morgan Stanley is another favorite of ours. We have followed him for decades. Although we have not agreed with every position he has taken, the following article is right on target.

The Great Unraveling

From bubble to bubble—it's a painfully familiar saga. First equities, now housing. First denial, then grudging acceptance. It's the pattern and its repetitive character that is so striking. For the second time in seven years, asset-dependent America has gone to excess. And once again, twin bubbles in a particular asset class and the real

economy are in the process of bursting—most likely with greater-than-expected consequences for the US economy, a US-centric global economy, and world financial markets.

Sub-prime is today's dot-com—the pin that pricks a much larger bubble. Seven years ago, the optimists argued that equities as a broad asset class were in reasonably good shape—that any excesses were concentrated in about 350 of the so-called Internet pure-plays that collectively accounted for only about 6% of the total capitalization of the US equity market at year-end 1999. That view turned out to be dead wrong. The dot-com bubble burst, and over the next two and a half years, the much broader S&P 500 index fell by 49% while the asset-dependent US economy slipped into a mild recession, pulling the rest of the world down with it. Fast-forward seven years, and the actors have changed but the plot is strikingly similar. This time, it's the US housing bubble that has burst, and the immediate repercussions have been concentrated in a relatively small segment of that market—sub-

prime mortgage debt, which makes up around 10% of total securitized home debt outstanding. As was the case seven years ago, I suspect that a powerful dynamic has now been set in motion by a small mis-priced portion of a major asset class that will have surprisingly broad macro consequences for the US economy as a whole.

Too much attention is being focused on the narrow story—the extent of any damage to housing and mortgage finance markets. There's a much bigger story. Yes, the US housing market is currently in a serious recession—even the optimists concede that point. To me, the real debate is about “spillovers”—whether the housing downturn will spread to the rest of the economy. In my view, the lessons of the dot-com shakeout are key in this instance. Seven years ago, the spillover effects played out with a vengeance in the corporate sector, where the dot-com mania had prompted an unsustainable binge in capital spending and hiring. The unwinding of that binge triggered the recession of 2000-01. Today, the spillover effects are likely to be concen-

trated in the much larger consumer sector. And the loss of that pillar of support is perfectly capable of triggering yet another post-bubble recession.

The spillover mechanism is hardly complex. *A s s e t - d e p e n d e n t* economies go to excess because they generate a burst of domestic demand that outstrips the underlying support of income generation. In the absence of rapid asset appreciation and the wealth effects they spawn, the demand overhang needs to be marked up to market. The spillover is a principal characteristic of such a post-bubble shakeout. Interestingly enough, in the current situation, spillovers have first become evident in business capital spending, as underscored by outright declines in shipments of non-defense capital goods in four of the past five months. The combination of the housing recession and a sharp slowdown in capex has pushed overall GDP growth down to a 2% annual rate over the past three quarters ending 1Q07—well below the 3.7% average gains over the previous three years. Yet this slowdown has occurred in

the face of ongoing resilience in consumer demand; real personal consumption growth is still averaging 3.2% over the three quarters ending 1Q07—only a modest downshift from the astonishing 3.7% growth trend of the past decade.

Therein lies the risk. To the extent the US economy is now flirting with “growth recession” territory—a sub-2% GDP trajectory—while consumer demand remains brisk, a pullback in personal consumption could well be the proverbial straw that breaks this camel’s back. The case for a consumer spillover is compelling, in my view. A chronic shortfall of labor income generation sets the stage—real private compensation remains over \$400 billion below the trajectory of the typical business cycle expansion. At the same time, reflecting the asset-dependent mindset of the American consumer, debt and debt service obligations have surged to all-time highs whereas the income-based saving rate has dipped into negative territory for two years in a row—the first such occurrence since the early 1930s. Equity extraction from rapidly rising residential prop-

erty values has squared this circle—more than tripling as a share of disposable personal income from 2.5% in 2002 to 8.5% at its peak in 2005. The bursting of the housing bubble has all but eliminated that important prop to US consumer demand. The equity-extraction effect is now going the other way—having already unwound one-third of the run-up of the past four years. In my view, that puts the income-short, saving-short, overly-indebted American consumer now very much at risk—bringing into play the biggest spillover of them all for an asset-dependent US economy. February’s surprisingly weak retail sales report—notwithstanding ever-present weather-related distortions—may well be a hint of what lies ahead.

It didn’t have to be this way. Were it not for a serious policy blunder by America’s central bank, I suspect the US economy could have been much more successful in avoiding the perils of a multi-bubble syndrome. Former Fed Chairman Alan Greenspan crossed the line, in my view, by encouraging reckless behavior in the midst of each of the last two asset bubbles.

In early 2000, while NASDAQ was cresting toward 5000, he was unabashed in his enthusiastic endorsement of a once-in-a-generation increase in productivity growth that he argued justified seemingly lofty valuations of equity markets. This was tantamount to a green light for market speculators and legions of individual investors at just the point when the equity bubble was nearing its end. And then only four years later, he did it again—this time directing his counsel at the players of the property bubble. In early 2004, he urged homeowners to shift from fixed to floating rate mortgages, and in early 2005, he extolled the virtues of sub-prime borrowing—the extension of credit to unworthy borrowers. Far from the heartless central banker that is supposed to “take the punchbowl away just when the party is getting good,” Alan Greenspan turned into an unabashed cheerleader for the excesses of an increasingly asset-dependent US economy. I fear history will not judge the Maestro’s legacy kindly. And now he’s reinventing himself as a forecaster. Figure that!

Greenspan or not, downside risks are building in the US economy. The sub-prime carnage is getting all the headlines these days, but in the end, I suspect it will be only a footnote in yet another post-bubble shakeout. America got into this mess by first succumbing to the siren song of the equity bubble (see my 25 April 2005 dispatch, "Original Sin"). Fearful of a Japan-like outcome, the Federal Reserve was quick to ease aggressively in order to contain the downside. The excess liquidity that was then injected into the system after the bursting of the equity bubble set the markets up for a series of other bubbles—especially residential property, emerging markets, high-yield corporate credit, and mortgages. Meanwhile, the yen carry trade added high-octane fuel to the levered play in risky assets, and the income-based saving shortfall of America's asset-dependent economy resulted in the mother of all current account deficits. No one in their right mind ever thought this mess was sustainable—barring, of course, the

fringe "new paradigmers" who always seem to show up at bubble time. It was just a question of when, and under what conditions, it would end.

Is the Great Unraveling finally at hand? It's hard to tell. As bubble begets bubble, the asset-dependent character of the US economy has become more deeply entrenched. A similar self-reinforcing mechanism is at work in driving a still US-centric global economy. Lacking in autonomous support from private consumption, the rest of the world would be lost without the asset-dependent American consumer. All this takes us to a rather disturbing bi-modal endgame—the bursting of the proverbial Big Bubble that brings the whole house of cards down or the inflation of yet another bubble to buy more time.

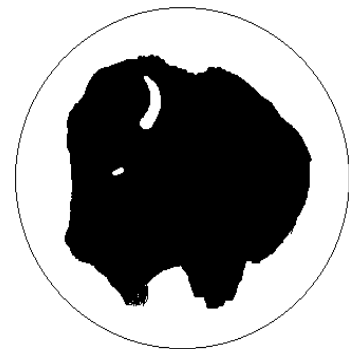
The exit strategy is painfully simple: Ultimately, it is up to Ben Bernanke—and whether he has both the wisdom and the courage to break the daisy chain of the "Greenspan put." If

he doesn't, I am convinced that this liquidity-driven era of excesses and imbalances will ultimately go down in history as the outgrowth of a huge failure for modern-day central banking. In the meantime, prepare for the downside-spillover risks are bound to intensify as yet another post-bubble shakeout unfolds.

Taken from www.morganstanley.com.

Summary

Timing is uncertain, but the facts are not. We consider the economy and the financial markets to be at great risk. There could be a short-term blip upward in long government rates. If so, a grand new buying opportunity would be at hand. We can only hope so.



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