June, 2007

Monthly Review 216

Sub-prime mortgage fiasco – the start of something big

Summary. In this review Brian Reading opens with a short essay on how the Eurasian savings glut – of its nature deflationary, since it can be redefined as weak domestic demand – has nonetheless provoked a global boom through its spectacular stimulus to liquidity. The epicentre of this borrowing spree has of course been the US housing market, the subject of the main article (and title piece) in this review, by Leigh Skene. This article details the dismal narrative itself, and why the housing-market woes highlighted by the sub-prime mortgage fiasco are likely to knock on into a broader US domestic demand crunch. Liquidity flowing downhill can get round mountainous blocks – at least this is one view. But with the exhaustion of US household borrowers – and soon of their counterparts in Britain and Spain – the glut of investible funds may increasingly be "pushing on a piece of string": the basically deflationary impact of inadequate Eurasian spending may come to the fore.

Main Points

- Households spending 109% of their income (on housing and consumption) has been financed by equity drawdown to 53% of housing market values, compared with two thirds some 20 years ago. Onto this balance sheet vulnerability is layered falling income – by 3.8% for real median incomes over the past five years. Ageing of the population is reducing incomes and raising medical costs, so that savings rates have been negative for two years, despite the impending retirement of baby-boomers.
- Sub-prime mortgages were 14% delinquent by end-2006, but interest rate resets and the end of introductory "teaser" rates will raise the cost of almost $1 trillion of mortgages in 2007 and 2008. The sub-prime and Alt A (also not prime) mortgages are 25% of the total and 40% of those originated in 2006.
- As well as the "Ninja" (no income, no job or assets) excesses of the likes of New Century, soon to fan out into a network of law suits, of the $6 trillion of mortgages syndicated as mortgage backed securities, commercial banks own some $¾ trillion, generally in the weaker credit *tranches*, though this is less than their capital.
- Higher mortgage costs will be exacerbated as market spreads widen while Treasuries are weak. Added to weak real incomes and worsening balance sheets as house prices decline (against the US belief system) this will sap household spending. The current housing slump has lasted half as long as previous ones: it is probably less than half over. (Summary: Charles Dumas)

Leigh Skene (main article), Brian Reading (introductory essay)

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Did the Eurasian savings glut cause a global boom?

Savings glut spawned a world liquidity glut

Excess savings caused a boom …

It is counter-intuitive to suggest that excess savings can cause a boom. But look at how financial markets have developed and ask where all the money has come from? Hedge funds have raise $1.6trn and multiplied it with leverage. If it's five times, that's $8trn compared with US $13trn GDP. We know where the money goes, but where do such colossal sums come from? Portfolio shifts and regulatory arbitrage are changing the financial system as we have known it.

…by spawning a world liquidity glut …

My colleague Charles Dumas was the first to explain the Eurasian savings glut's role in global finance. Ben Bernanke got the public credit for it a year later. The other side of the coin is the global liquidity glut. Instead of the savings glut causing a world recession it initially caused a world boom. That was the result of the liquidity glut. Mind-boggling sums are paid in private equity buy-outs. Even a bid for Citigroup is rumoured with a price tag of $200bn plus. Hedge funds gamble on a colossal scale on derivative markets. Credit default swaps can be multiples of the value at risk in the underlying companies. Deutsche Bank shorted the sub-prime mortgage market and made a fortune from other gamblers' losses. Carry trades wreck havoc in victim economies from Iceland to New Zealand. Central banks lose control as interest rate movements produce perverse results – in some cases raising rates attracts liquidity and boosts asset prices and demand (not to mention sending exchange rates such as the NZ dollar to absurd levels).

… because US consumers borrowed and spent excess Eurasian savings

The savings glut has spawned a tsunami of liquidity that is engulfing markets and economies. The US was first on the receiving end – because of American consumers' willingness to borrow and spend. But as the American appetite for debt is satiated, the wave that crossed the Pacific is now washing the shores of Europe. Meanwhile in China savings glut money imprisoned at home has temporarily been offered mouthwatering returns – in the Shanghai stock market. There has been nothing like this since the South Seas bubble and Tulip-mania – or at least 1999-2000!

Unprecedented financial imbalances resulted

The story starts with the Eurasian savings glut. This has translated into unprecedented financial imbalances within and between countries. Current account balances are the transmission mechanism, simply because they equal net capital flows between economies. Capital inflows cause current account deficits through their impact in raising exchange rates – until the deficits become unsustainable. Then causation reverses and deficits cause currencies to collapse. Purchasing (spending) power parity has been replaced by lending power parity – the total return on assets in different countries. The savings glut is Eurasian but becoming concentrated in China and Japan. The "new dollar area" or "Bretton Woods mark 2", fixed or managed currencies, has meant that that net capital flows are via official currency reserves, mostly into dollars. China now has $1.2trn and Japan $0.9trn. These reserves go predominantly into low yielding government bonds. (That explains why the US as a debtor country has been paid to borrow. Until recently the return on its foreign

assets so exceeded the payments on its liabilities that it had a positive net investment income on current account.) If so much foreign money is poured into a national pool it inevitably overflows as domestic liquidity.

Lower returns forced institutional investors into alternative assets

The effect of capital inflows is to raise asset prices – meanwhile lowering yields. Total returns are increased. But the big institutional investors such as pension funds and insurance companies are subject to rules that make the fall in yields a disaster. The lower actuaries assume interest rates to be, the larger they calculate the present value of future liabilities. Deficits emerge almost regardless of total returns. It is not greed that is driving markets today, but need – the need for higher returns because of the perceived deficits. A result is a portfolio shift to alternative investments, where higher rewards can be obtained, albeit at higher risk. Old Mutual Corporate Bond Fund is mandated to put up to 20% of its assets into junk or unrated bonds! Institutional funds are enormous – pension funds, life insurance, academic foundations and charitable trusts. Even when they put a small proportion into alternative investments (hedge funds, private equity) it is a huge addition to liquidity – a portfolio shift. Hitherto staid mutual fund money managers are forced to follow suit. This is how the Eurasian savings glut, by lowering returns, causes the liquidity glut. The foreign money that goes US Treasuries crowds out domestic funds.

Divorcing credit from money growth …

It could be said that arbitrary regulations (actuarial estimates of the present value of future liabilities) create the need for higher yields. Regulations also divorce money growth from credit growth. Money is defined as what you can get your hands on easily and spend – bank balances, building society deposits (S&L in the US) and in some measures money market mutual funds. But non-monetary financial institutions such as pension funds and insurance companies also lend although their liabilities do not count as money. Monetary financial institutions' loans create deposits. They could therefore lend without limit unless constrained. The original constraint was liquidity ratios because of the danger of runs on banks. But as markets became bigger and more liquid so that more assets could be turned rapidly into cash, and central banks accepted the role of lenders of last resort, liquidity became no constraint. Its place was taken by solvency – capital adequacy ratios as set out by Basel 1. Then came the law of unintended consequences.

… and changing the way the monetary system works

The financial revolution of the past two decades has changed the operations of the monetary system. Banks package loans and syndicate them as asset-backed debt, removing them from their books. If a loan creates a deposit, the sale of a loan destroys one. It reduces risk-weighted assets while enhancing capital (management fees and selling income and repayment streams for present value). This means banks can originate more loans in their place. Money supply grows with banks' enhanced capital. But credit – to the consumer and home buyer – grows even faster. Pension funds and insurance companies were in the wholesale lending business, through bond markets, to companies and government. The development of asset-backed markets made them suppliers of consumer, student and mortgage credit. But as brokers, originators and even final lenders could obtain rewards while unloading risk through syndication and credit default swaps, lending quality was bound to erode: ending with "Ninja" loans to people with no income, no jobs or assets.

The boom needs borrowers and spenders, lax lending standards supplied them

The liquidity glut can only cause the global boom as long as there are borrowers and spenders. When lending standards become lax the key is asset price inflation. A 100% Ninja loan with no interest payments and amortization – i.e., the loan goes up with the accumulated interest – works as long as property prices rise more than interest rates. The moment property prices falter or fall, the loan may default. This is part of the sub-prime mortgage market story that Leigh Skene tells here.

Buy-outs explain equity market buoyancy as the US cools

The private equity buy-out story is different. It largely explains the buoyancy of equity markets when growth and profit prospects are weakening. As during a flood a river can change course, creating new channels, so can financial flows. Institutional investors put money into private equity vehicles instead of into markets as shareholders. Private equity turns public companies private. But the reduction in the supply of equity is largely matched by the reduction in institutional direct demand. Why should this raise prices? Buy-outs offer a premium price and rumours of buy-outs push up other share prices. As far as this is a re-routing of institutional money into the market it should not raise average prices. But it is backed by bank-financed leverage which is supplying liquidity (demand) while reducing supply.

It is improbable that the sub-prime problem can be contained

From a global perspective, the liquidity-driven world boom is now causing rising inflation and hence rising policy interest rates. US growth has already slowed markedly, partly the result of the sub-prime debacle. Many of the lowered lending standards in that market – no or low documentation, inadequate assessed valuations and excessive loan to value ratios – applied as much to Alt-A mortgages and even to some "prime" ones. It is improbable that the sub-prime problem can be contained. The US landing is thus likely to become harder. By borrowing and spending less, the US 'adds' to the savings glut – or more accurately forces liquidity to go elsewhere. This portfolio shift could well be exacerbated as and when China and Japan actively manage a part of their official currency reserves.

The wall of money is shifting to Euroland, but will Europeans now borrow and spend?

The contention here is that the Eurasian savings glut actually caused the US boom that has now run out of steam. The torrent of liquidity has already shifted towards Europe as demonstrated by euro strength and dollar weakness. Can this cause European consumers to borrow and spend, so that Europe takes over America's locomotive role? It is too early to abandon the view that a US hard landing will cause a serious global slowdown (via China and Japan). My colleague Gabriel Stein believes it unlikely that Europeans will stop saving in the way that Americans did. But one must wonder what happens to liquidity if the savings glut persists.

Brian Reading

The Sub-prime Mortgage Fiasco – The Start of Something Big

Housing has trashed household solvency

Fewer household reserves to meet mortgage problems

The 1985-90 housing correction caused only a small rise in the US mortgage default rate. The personal savings rate was about the same ratio of personal disposable income as household interest payments throughout the correction and mortgage rates fell by about 1½ percentage points. The high savings rate plus falling interest rates provided an effective buffer against defaults. Conditions are different today. The personal savings rate has been negative every month since April 2005, so few consumers that run into difficulty will be able to divert savings into paying interest. Rising interest rates, especially from low 'teaser' rates are raising delinquencies, which are widening spreads from Treasuries to mortgages. Also, securitization has greatly complicated adjusting the terms of delinquent mortgages to meet the needs of the borrowers, so mortgage delinquencies will pose much bigger problems than in the past.

Three separate housing excesses in 2001-05

The explosion of household debt from 2001 to 2005 shown in chart 1 funded a huge housing boom that was fed by three extreme deviations from prudent practices. First, the Fed held interest rates far too low for far too long. Second, the pressure of excess liquidity pushed lending standards down so far that 100%, negative-amortization mortgages with little or no verified documentation of borrowers' jobs, incomes or assets constituted a big part of the mortgages approved in 2006. Third, lenders securitized and sold most of these 'liars' (many unconfirmed declarations of income, assets and property values proved to be grossly exaggerated) or 'Ninja' (no income, no job or assets) mortgages. The lenders had good reason to lend as much as possible and disregard the quality of the loans. They retained the fees for servicing them, but rid themselves of the credit risk after the first few months had elapsed.

Household liquidity now stretched

This loosening of lending standards occurred after household liquidity had dropped drastically. Avoiding big losses in hard times requires an adequate supply of liquid assets. Household liquidity (all assets excluding real estate, equities and private business ownership) exceeded 250% of household liabilities in 1952. The ratio fell to 150% in 1984, but that was enough liquidity to prevent a big rise in mortgage delinquencies in the housing correction that began the next year. The household liquidity ratio fell under 100% for the first time in 1997 and to 75% in the third quarter of 2006. This low level of liquidity raises the probability of big losses in the current correction, probably through repossessions.

Homeowners' equity lowest ever

The annual household financial balance after investment in housing was normally positive up to 1995. It deteriorated continuously thereafter to a deficit of over 9% of personal disposable income in 2006, causing the steep rise in the household debt shown in chart 1. Falling interest rates offset much of the rise in debt up to 2004, but the subsequent rise in interest rates pushed up annual household interest costs to near the level that had initiated the previous housing correction. The high personal sensitivity to interest rates due to the big fall in household liquidity burst the housing bubble and mortgage delinquencies are soaring as a result.

Debt growth is unlimited: it is the ability to pay interest that is limited

Interest rates rose at an accelerating rate from the 1950s to the credit crunch in the early 1980s. Total interest paid as a proportion of GDP rose eight times faster than debt outstanding from 1962 to 1982. Falling interest rates due to the easing of the Fed induced credit crunch of the early 1980s has more than offset the rise in debt since then. From 1982 to 1989 debt outstanding rose more than five times faster than interest paid. From 1989 to 2003, both falling interest rates and financial engineering reduced the annual interest paid as a proportion of GDP by an average of 3.8% a year while debt outstanding as a proportion of GDP rose by 2.2% a year.

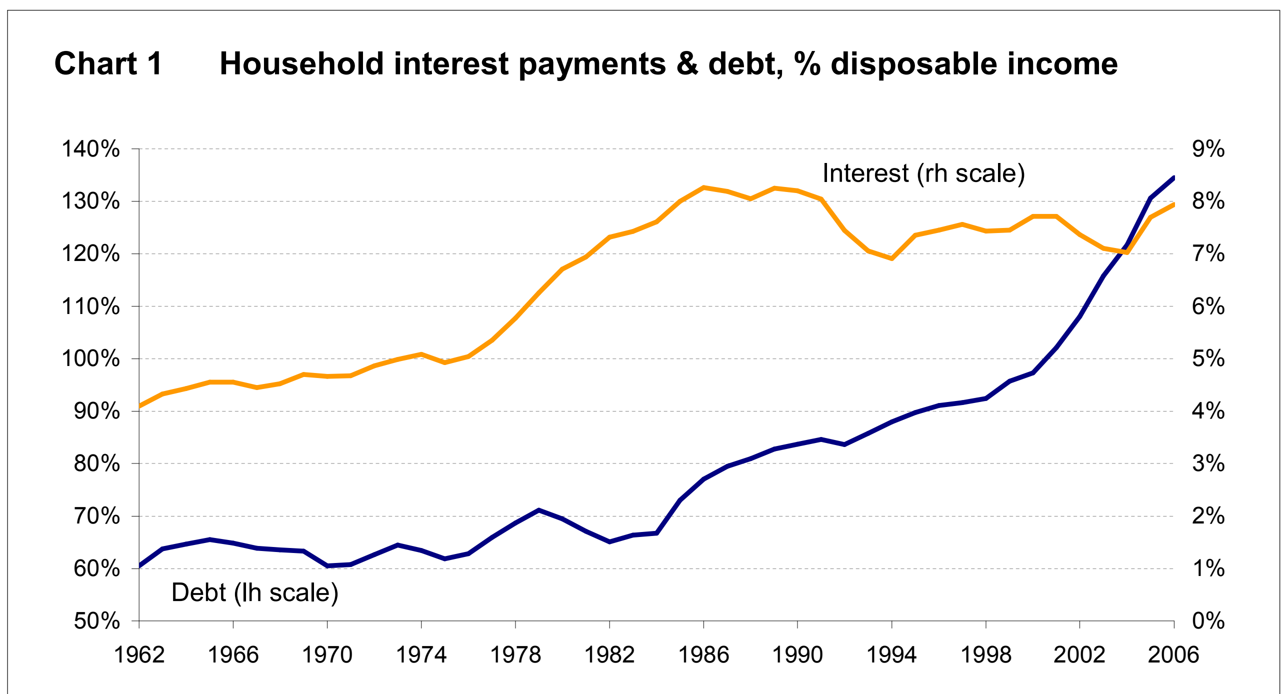
Clearly, both rising debt outstanding and falling annual interest rate payments were not sustainable in perpetuity. The interest rate burden has been rising more than three times faster than debt outstanding since 2003. Households currently are the most vulnerable borrowers and interest payments as a proportion of disposable personal income are now close to the peak in the mid 1980s that began a five year correction in the housing market (see chart 1). The high current level of interest paid relative to income has begun another correction.

The dollar amount of household debt grew more than the dollar value of houses in the biggest bull market in real estate in US history, so owners' equity in their homes fell to 53% of market value, the lowest figure ever.

Real median incomes down, spending up

Home owners' balance sheets have become more vulnerable at a time when real personal disposable incomes were growing slowly and the call on disposable income for items other than housing were rising. The Census Bureau reported that median household income adjusted for inflation has fallen by 3.8% over the past five years – yet consumption, which had varied between 66% and 68% of GDP from 1982 to1999, rose to almost 71% in 2001 and is now almost 72%. Aging population means retirement is reducing incomes for more people while their medical costs are rising. As a result, the personal savings rate has been negative for the last 24 months – the worst performance since the Great Depression.

Chart 1 Household interest payments & debt, % disposable income



"Borrow-and-spend" at end of its tether

How could this happen, especially with the baby boom generation wanting to retire soon? The answer is rising house prices and falling interest rates let home owners increase the amount of their mortgages with little or no increase in their monthly payments. They gladly accepted this source of apparently free cash and spent much of it on consumption. Thus, most American consumers have been living beyond their diminishing real incomes by turning assets, mainly their homes, into sources of cash. Asset-based consumption is coming to an end. House prices are no longer rising, interest rates are no longer falling and lending standards are being tightened. The first and most direct effect of these changes is soaring mortgage delinquencies.

Mortgage delinquencies will prolong the housing correction

Sub-prime just the start of the rot …

Credit corrections always start in the most vulnerable place, in this case sub-prime mortgage loans. More than 14% of them were delinquent at the end of 2006 and delinquencies are rising in the other mortgage categories too, especially Alt-A, a class between sub-prime and prime also often with relatively little formal documentation. Mortgages in default hit an all time high of 2.87% in the first quarter of 2007 and 149,150 foreclosures were filed in March, up 7% from February and 47% from March 2006. This level default isn't particularly serious. The problem is that it's rising rapidly and will keep doing so for some time.

… no job losses yet to create income problems

Mortgage delinquencies usually result from job and/or income losses, but Freddie Mac says such delinquencies have fallen while those due to excessive debt are rising sharply. The unintended consequences of trashing household solvency have created a big problem for many home owners. Delinquencies will worsen before improving, as interest rates on almost $1 trillion of adjustable rate mortgages (mainly negative amortization) will be reset significantly higher in 2007 and 2008. Few of these resets have yet occurred, yet delinquencies in 2006 vintage mortgages are running three to four times higher than in 2003 and 2004 vintages. Foreclosures in January and February ran at a rate projecting to a 33% increase in 2007. Resets should send the actual rate much higher. The pressure will be greatest in the sub-prime and Alt-A categories, now a big part of the market accounting for $2½ trillion of the $10 trillion outstanding and 40% of the originations in 2006.

Lenders vulnerable from excessive leverage

Losses from mortgage delinquencies have already forced 74 lenders out of business – a total that will rise further. Excessive leverage and booking profits far in excess of cash flows account for the high rate of failure. For example, the debt to equity ratio in the New Century Financial Corp. quarterly report for Sept. 30, 2006 was 11.5:1, relatively high for a sub-prime lender that securitized and sold mortgages with the proviso it replace defaulted mortgages with good ones in the first few months. Worse, the leverage on the mortgages New Century retained for 'investment' was 82:1. A delinquency rate much in excess of 1.2% would threaten its viability. The actual rate of around 14% proved a disaster.

MBS ructions aggravate lender pressures

Also, lenders booked the market interest rate, not the low teaser rates, as their income from negative amortization mortgages. This puffed up their stated incomes – but their cash flows proved inadequate to cope with the

rising number of early delinquencies, causing the flood of bankruptcies. Investment bankers retailed bonds issued by many of these lenders very shortly before their failures, albeit at very high interest rates. Investors stuck with such bonds are suing their investment bankers for selling them securities of companies they knew were about to fail.

Court involvement spiralling

The U.S. Attorney's Office for the Central District of California is conducting a federal criminal inquiry into trading in New Century Financial securities as well as accounting errors. Three class action claims have been filed in three states alleging NovaStar Financial issued "materially false and misleading" statements regarding the company's business, which led the company's stock to trade at an "artificially inflated" level. Incredibly lax lending standards have led some end buyers of mortgages, especially mortgage backed securities (MBS), to sue the original lenders and investment bankers for misrepresentation – even fraud. Courts will be very busy for many years sorting out the myriads of claims relating to housing and mortgages.

MBS market showing losses

About $6 trillion of the $10 trillion mortgages outstanding have been packaged into MBS. Reworking the terms of loans that have been securitized is almost impossible and sub-prime and Alt-A mortgages have been included in a wide variety of MBS securitizations, so the rise in delinquencies has sent the prices of even investment grade tranches of MBS tumbling. The sub-prime crash on February 23 erased five years of income in one day. The ABX index of BBB rated credit default swaps for sub-prime loans has lost almost one quarter of its value and the index of BBB- rated swaps has lost about one third this year.

Yield spreads widening in MBS market

We don't know where all the MBS bonds have been sold, but much of the demand, especially for the lower grade tranches, seems to have come from offshore. Much of the offshore demand may actually be from hedge funds registered in tax havens, but the losses have been widely spread. Commercial banks own only about $750 billion of MBS, less than their equity of about $850 billion, so even a relatively high loan loss ratio shouldn't, by itself, cause systemic risk. Belief Fed easing will contain mortgage delinquencies seems widespread, yet the spread from Treasuries to prime mortgages has more than doubled in the last three years. Even so, it remains far below the peak spread in the last housing correction. However, the rising mortgage delinquency rate will keep upward pressure on the spread from Treasuries to mortgages, so . . .

. . . mortgage problems will affect the economy significantly

New mortgages constrained by much tighter terms …

Falling interest rates, lower lending standards and increasing securitization of mortgages provided the ever increasing flow of first time buyers needed to sustain the housing bubble. Rising interest rates and falling median real incomes burst the bubble. The resulting rise in mortgage delinquencies created a rush to tighten lending standards. Freddie Mac will limit its purchase of sub-prime loans to properly documented loans that qualify borrowers at the fully indexed and amortized interest rate. This will virtually eliminate the notorious 2/28 loans, which accounted for nearly 80% of sub-prime mortgages in 2006. They featured a low fixed teaser rate for the first two years and an

adjustable rate tracking an index plus a big premium for the following 28 years. A wide variety of indices and premiums have been used to reset, with many resulting in rises of around 30% in the monthly payment.

… as interest resets worsen delinquency prospects

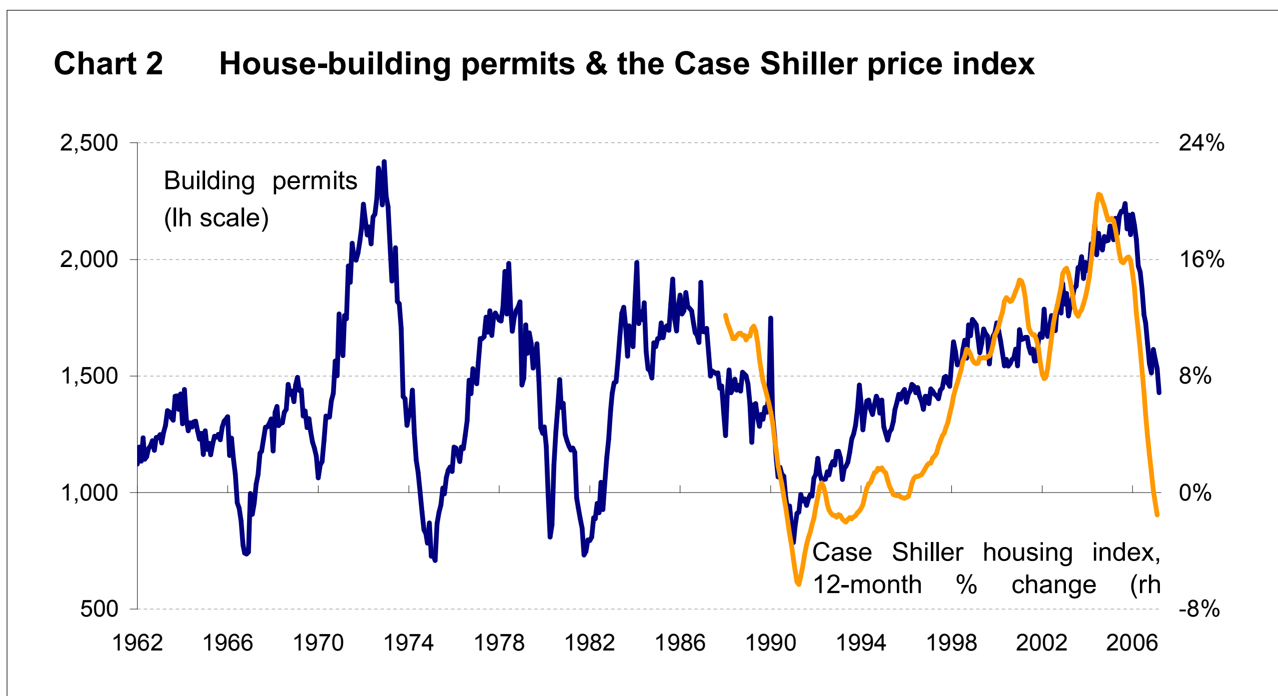
The big jumps in payments on negative amortization mortgages and gross exaggerations of borrowers' incomes and assets on low documentation loans have led to both federal and state legislators introducing tighter anti "predatory lending" laws and to requiring more disclosure on mortgage applications. Also, the last Fed survey of senior loan officers showed the highest ever proportion of banks tightening mortgage lending standards. History indicates mortgage lending standards will keep tightening until the delinquency rate starts falling once again. This won't occur until interest rate resets recede, which is about two years away because the tighter lending standards are preventing negative amortization mortgagors from refinancing.

But households still whistling 'Dixie' …

A recent survey showed only one in seven Americans believe house prices will go down, yet consumer plans to buy homes have fallen to a ten year low because stricter lending standards and poor affordability are restricting the flow of first time buyers into the housing market. The housing affordability index dipped below 100 (the median family income didn't qualify for a mortgage on a median priced single family home) in July 2006 for the first time in 20 years.

… while house prices decline

Although affordability has improved a bit with the slight fall in house prices and mortgage rates, it's still hovering around 15 year lows. The Case Shiller housing index is widely used as measuring a consistent product through time, but it's available back only to 1986 (see chart 2). Building permits are a good proxy for housing demand, so even the short history on chart 2 shows house prices respond quickly to changes in demand. Thus, tightening lending standards and falling house prices will keep reducing plans to buy – even if affordability keeps improving.



First-time buyer strike hits whole market

Fewer first time buyers not only lower the number of new homes that can be sold, but also restrict the ability of current home owners to upgrade, so the whole housing market slows down. Chart 2 shows building permits fell to the 700,000 to 800,000 range in the previous housing corrections and the same should happen in this one. Housing starts follow permits quite closely with a one month lag and completions follow the same pattern with an eight month lag.

House-building still has a long way to fall …

Building permits peaked in September 2005 and completions duly peaked in June 2006. Interruptions to the falling trends of housing statistics – such as has occurred over the last few months – are frequent and not a sign of an impending bottom. Permits and starts are probably about half way through their correction, under construction figures are far less than half way through theirs and completions are down only 5% from last year. Housing construction will fall a long way from here.

… probably for another 2 years

The current decline in housing statistics looks like the 2½ year fall from 1972 to 1975, short and fast. The first signs of recovery would appear in the spring of 2008 if the parallel were to continue. However, previous corrections were not bedevilled by soaring mortgage defaults, the resulting rise and fall of sub-prime and Alt-A mortgages and the complications arising from securitizing a big part of the mortgages outstanding. Negative amortization resets should keep foreclosures high through 2008, and it usually takes about a year from delivering the notice of foreclosure to bring a home onto the market. Thus, foreclosures have added little to the supply of housing for sale so far, but will add greatly to it through 2009. The housing correction should continue for at least another couple of years, and it will affect the entire economy.

But housing wealth effect is the most important

Housing may seem small at about 5% of GDP, but it is a very important sector of the economy for several reasons. First, it is very volatile, often rising 30% or more and contracting 20% or more on a year over year basis. It can change GDP growth by 2½ percentage points in a year. Also, it changes demand for both goods such as furniture and appliances and the services of real estate agents, mortgage lenders, etc. in the same direction, adding to the direct change. Lastly, the biggest asset most families have is their home, so higher house prices make them feel richer and they spend more. Estimates of the increase in spending caused by rising house prices vary from 4% to 9%, so the period 1994-2005 added from $500 to $1,200 to each home owner's annual consumption.

Sliding consumer debt growth only half done

Mortgage equity withdrawal (MEW) compounded this wealth effect up to 2006. Fed studies indicate mortgage equity withdrawal rose from $626.9 billion in 2001 to $1.43 trillion in 2005, boosting GDP by about 1½ percentage points in 2001, rising to about 3½ percentage points in 2005. MEW peaked in late 2005 and has been falling ever since, causing the growth rates of consumer debt and retail sales to fall for five consecutive quarters for the first time in over 15 years (see chart 3). The fall in consumer debt growth, like housing, may be about half over.

Falling house prices will slow consumption

House price declines should reverse the wealth effect of housing as more people realize they are occurring, slowing consumption even more. Recessions have occurred at about the same time as the previous five

lows for housing. (The 1967 recession was later revised out of existence.) Similarly, housing recoveries have all started after the economic slowdown had turned to recovery. There is no reason to believe that this housing correction and recovery will differ. A combination of the Fed's preferred measure of the yield curve being inverted and a fall in the real monetary base has signalled the last eight recessions correctly with no false positives. It is signalling recession once again (see chart 4).

Psychological changes the most important

Households in denial about foreclosures

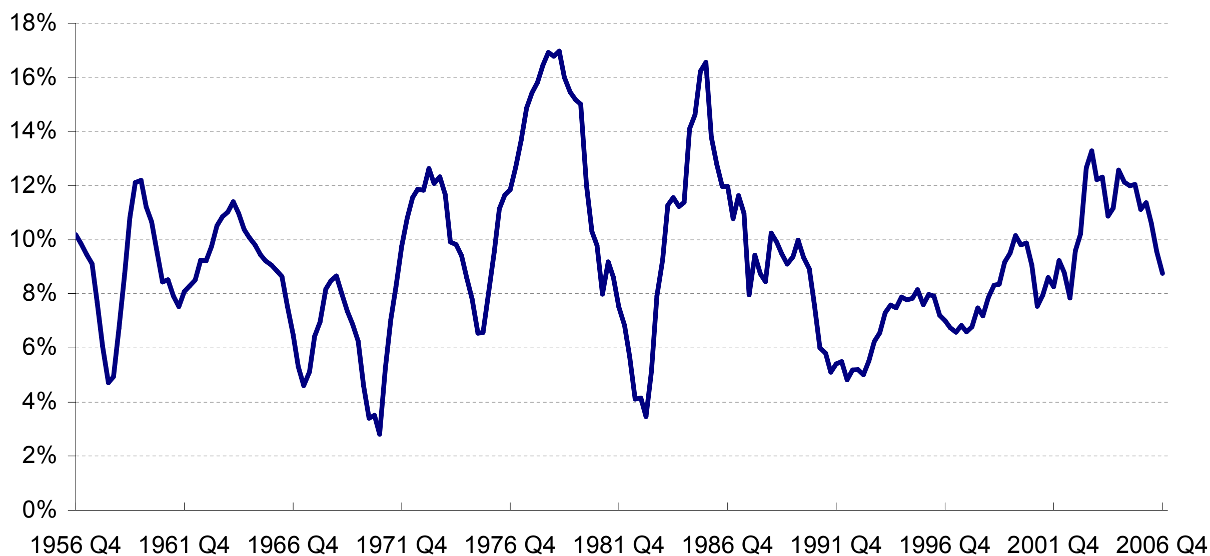
That six in seven Americans believe housing prices won't fall (even though they are already falling) shows they are in denial, afraid to face the current negative conditions. House prices will continue to fall for the next couple of years at least because foreclosures will keep rising and they depress prices for surrounding homes in two ways. First, foreclosure sales have averaged 15% under then current market prices. Second, foreclosed homes are usually left vacant for a year or so until they're sold, and so become both run down and a target for vandals.

Dis-saving is a problem with falling house prices

A recent survey showed one in five landlords is accidental because they had bought another property and couldn't get the price they wanted for the one they were trying to sell. But vacancy rates are rising, so renting is no panacea for trapped home owners. Their vacancy rate has been rising much faster than the rental vacancy rate in the last five quarters, (see chart 5) and that has put enough pressure on rents to reverse their rise in some areas. We saw above many home owners have big net financial liabilities, negative saving and falling real incomes – no problem when house prices were rising, but suddenly a big problem now house prices are falling.

Fear factor yet to come

Negative equity from falling house prices, rising foreclosures, inability to cover carrying costs with rents and weak income growth will turn the denial (suppressed fear) of falling house prices into overt fear. Not only



will this lower consumption but it will also change psychology in financial markets from the current risk seeking to risk aversion.

Risk aversion to replace risk appetite …

Falling interest rates due to the credit crunch turned the risk averse financial markets of the 1970s and early 1980s into risk seeking markets. Risk aversion occurred briefly in both recessions in the last quarter century, but hasn't yet appeared in the recent slowdown – even though this recovery has been by far the weakest in the post war period. It barely returned output to trend whereas all the others had raised output 3% or more over trend.

… that is still very high

Low interest rates and rapidly rising corporate profits created ebullient financial markets in spite of the weak recovery. After-tax profits have almost doubled from their 1997 peak and are at record levels relative to GDP. However, their growth slowed to 7% over the last three quarters

Chart 4 Yield curve & real monetary base growth

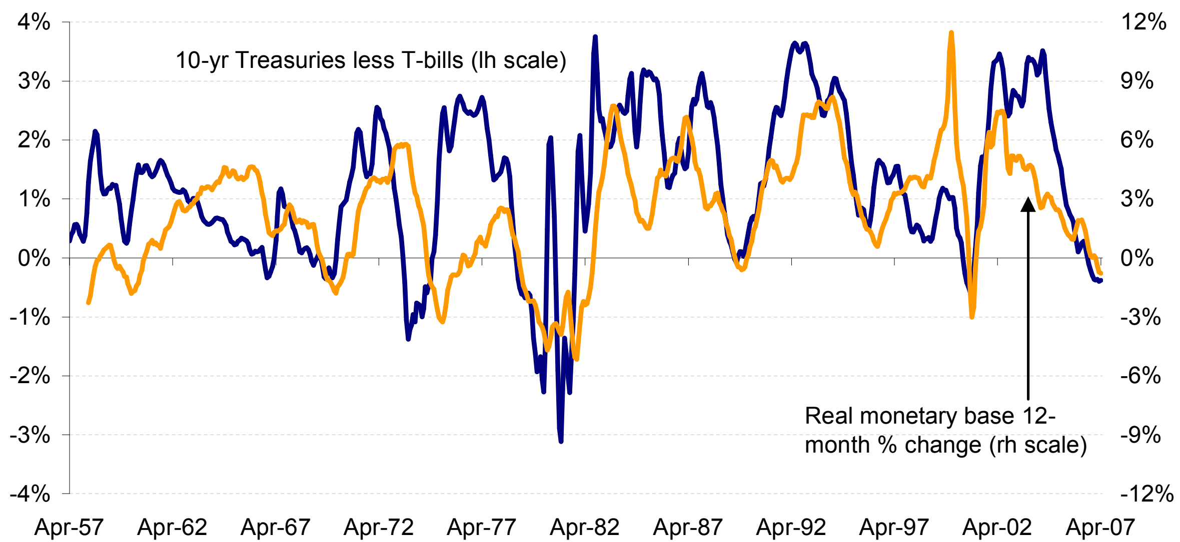
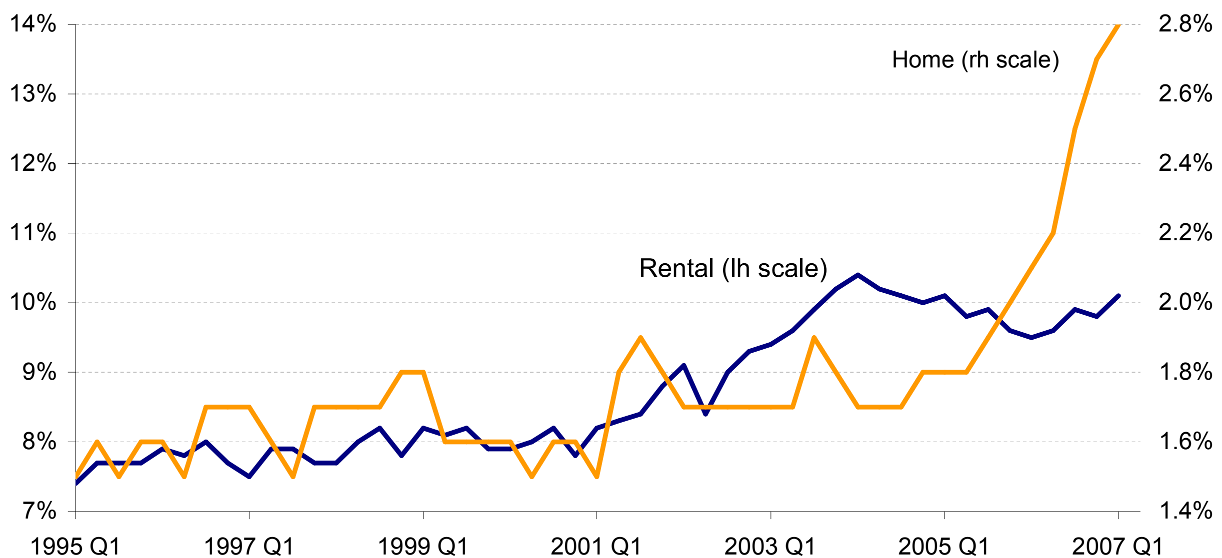


Chart 5 Housing vacancy rates by sector, %



from 23% in the preceding three and the continuing slowdown in output should soon cause profits to fall. Even so, equity market valuation ratios still range from average to overstretched and credit spreads range from narrow to very narrow. Denial in the housing market appears to have infected financial markets too.

Politics of falling incomes to reinforce downswing

In the current recovery, the ratio of labour to national income fell by about the same amount as the ratio of corporate profits rose, invoking a flurry of socialistic legislation, such as raising the minimum wage and, worse, the threat of protectionism. Congress is making a case for trade sanctions on China by focusing on the big bilateral trade deficit with China and ignoring the domestic saving shortfall (caused by excessively low interest rates) that is the real cause of the trade deficit. Trade sanctions would act like a tax hike on US consumers and businesses, leading to higher inflation and long term interest rates, which would push the slowing economy into recession. Also, China bashing invites Chinese retaliation, which would drive a broader wedge between the US and Asia and reduce the benefits of globalization.

Stock markets yet to confront economic downswing

Financial markets are not discounting the costs of the socialist measures or China bashing because excessive liquidity has lowered interest rates and funded a spate of mergers and acquisitions, stock buy backs and private equity buyouts that have reduced net equity outstanding by record amounts. This has kept stock markets rising, but won't do so for long. Covenant light leveraged loans are financing most of the equity reduction, just as sub-prime mortgages funded much of the late stages of the housing bubble, so corporate credit ratings are falling. The unexpected recession should turn risk seeking into risk aversion as lower profits and rising corporate bankruptcies blindside financial markets that are assuming the sub-prime mortgage problem has been contained.

Liquidity not in central bank control – could plunge

Recently, central banks seem to have lost control of financial aggregates as world money and credit have been growing at double digit rates even though all the major central banks are in tightening mode. The most likely cause is borrowing dollars from non US banks – as the dollar has been weak and the growth in foreign exchange reserves in some nations, especially China, have greatly exceeded the total of their trade surpluses plus foreign direct investment. These conditions resemble the 1970s when European banks lent vast sums of dollars to Latin America and the 1990s when Asian nations borrowed even bigger amounts of dollars from Asian banks. The previous episodes ended in a rapid drop in world liquidity and a sharp rise in the dollar. The greater imbalances that have to be rectified this time threaten a bigger drop in world liquidity, but the rise in the dollar may be muted.

Conclusion

Sub-prime to knock on to broader housing based downswing

The implosion of mortgage lenders has slowed and MBS and CDS markets have stabilized. Claims the sub-prime mortgage fiasco has been contained would be justified if it was an isolated event. It wasn't. It was the first of a sequence of events that will rebalance the massive global imbalances caused by what LSR calls the Eurasian savings glut. The sub-

prime mortgage problem caused the tightening of lending standards and fall in housing prices that are keeping enough first time buyers out of the housing market to ensure its correction will persist for some time. The housing correction and financial relationships indicate at least a domestic demand recession soon that will probably be aggravated by socialistic legislation, especially protectionism.

Consumer spending already falling

Consumption has been driving the US economy in this century, as it has accounted for 91% of the increase in GDP. Consumer debt, funded indirectly by the Eurasian savings glut, financed much of the rise in consumption and, as LSR has forecast, US consumers are running out of borrowing capacity before the Eurasian desire to save has begun to fall. US consumer credit rose at an annual rate of almost 7% in March, more than double the nominal personal consumption rise of only 3%. The more expensive revolving credit part of consumer credit rose over 9% showing many consumers are limited to their costlier credit lines. Then retail sales were unexpectedly poor in April. That was blamed on a shift in the Easter calendar – but if that were correct, why were the estimates so far off? A more realistic view is American consumers are tapped out.

Household debt overload means downswing prolonged

Falling house prices are limiting the borrowing options of ever more consumers, leaving the economy without a driving force. Also, looming recession threatens the viability of covenant light leveraged loans, but this isn't all bad news. US imports are highly levered to economic growth. The recent slowdown has already begun to lower the US trade deficit (see chart 6) and some Eurasian surpluses. While the recent reversal in oil prices has undone some of the improvement, the coming recession will lower the trade deficit much more. The falling trade deficit is starting to cut Asian export income. Will they respond by spending even less, or with policies to boost domestic spending? The answer to this question holds the key to the world economy in the next few years.

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