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By William W. Priest, CEO

Bleak House, Bleak Times?

A novel written during the Victorian Age in England by Charles Dickens, Bleak House is one of Dickens' longest and most complex novels. According to critics, "it contains many different and divergent story lines that intertwine as characters meet by chance or fate. In that sense it is difficult to summarize, though key themes run through it: the foremost of these being the legal proceedings that seem to have no purpose but to line the pockets of lawyers" and middlemen.

As we look at 2008, the story of Bleak House seems an apt metaphor for what is about to befall the U.S. economy. This year will almost certainly usher in our first recession since 1991.[1] This recession will be led by a fall-off in consumer spending: a phenomenon that has already manifested itself in declining auto sales, retail sales, and restaurant revenues. It comes as no surprise, therefore, that consumer sentiment, as reflected by the University of Michigan survey, is at its lowest point since 1992, with the exception of a brief post-Katrina dip in 2005. The situation looks equally bad on the corporate front. For the first time in five years, corporate earnings declined year-over-year in the third quarter of 2007, a situation that will likely recur in the fourth quarter of 2007 and in the first half of 2008. The earnings recession suggested by David Rosenberg, a prominent Merrill Lynch strategist, is upon us.

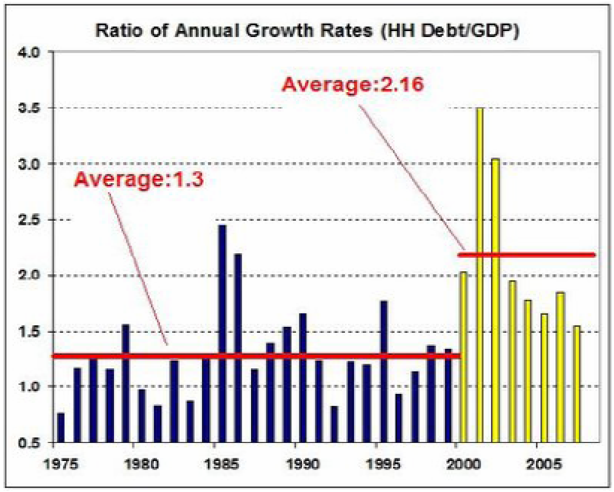
How did this happen and how bad will it get? Like the storyline in Bleak House, our current conundrum owes itself to a combination of separate events that came together, by both chance and fate, to set into motion a series of destabilizing situations. When attempting to identify each of these events and situations, the housing crisis may come immediately to the fore. But indebtedness – the housing crisis' underlying cause – is a trend of even greater importance and more widespread potential ramifications. Our discussion of today's economic "bleak house" will therefore begin on this subject.

Warren Buffet once said the U.S. is becoming a nation of sharecroppers. That is, we are selling the land around the homestead in order to maintain our standard of living, and now we're in danger of ultimately losing the homestead to creditors if we do not halt our profligate ways. As is so often the case, Buffet's statement was a prescient one. Since

[1] See Morgan Stanley Global Research, 12/10/07.

2000, the U.S. consumer has spent more money than he has earned, reflecting a genuine national addiction to debt. Figure 1 shows the seriousness of this addiction.

Figure 1



Source: Hellasious. "Household Debt and GDP Growth." Online posting. 1 October 2007. http://suddendeath.blogspot.com/2007/10/household-debt-and-gdp-growth.html

Today, the growth rate for household debt is double the rate of GDP growth, which stands in great contrast to the period between 1975 and 2000, when household debt grew at a rate of 1.3 times GDP growth. What happened in 2000 to change this 25-year trend?

It was, not surprisingly, a combination of things: a substantial stock market decline in 2000-2002; an exercise of the "Greenspan put" whereby the Fed lowered real interest rates to one percent (perhaps fearing a Japanese-like economic outcome without action from the central bank); and a national policy designed to encourage home ownership. Taken together, these monetary and fiscal policy actions created fertile ground for robust incremental consumer demand. "Go for it!" became the cry to the populace. What little savings rate existed at the beginning of the century quickly dissipated as our national savings rate fell into negative territory.

This trend dramatically manifested itself in the housing sector, in which a speculative bubble of massive proportions quickly formed. Today's housing bubble would have had far fewer consequences were it not for the role of securitization. In separating the originator of the security (the mortgage) from the ultimate owner (hedge funds, insurance company portfolios, pension funds both domestic and foreign bank SIVs, mutual funds and so on), securitization both created and revealed a major flaw in the system. Since the originator of the mortgage was no longer the owner of the mortgage it created, there was no longer any incentive to verify the mortgage's investment-worthiness, and due diligence soon became nothing more than a distant memory.[2]

[2] See paper, "A Roller Coaster Called Credit," by William W. Priest, www.eipny.com

Financial innovation eagerly filled this gap, as Wall Street devised a plethora of unregulated financial products known as CDOs, CLOs, SIVs, CDOs-squared. This derivative explosion would not have been possible without the blessing of the rating agencies, principally Moody's and S&P, which introduced the "mark to model" pricing techniques: strategies that were used when market pricing was either unavailable or, arguably, unacceptable. Largely as a result of these questionable innovations, the popularity of these mortgage-backed derivatives skyrocketed.

The supply of and demand for these products also grew as a result of the fee structure embedded in hedge funds. Hedge funds now control billions of dollars of assets, all of which is subject to asymmetric fee structures that are unfavorable for the client but irresistible to the fund managers. This fee structure includes a standard two percent fee on invested capital, a charge of 20% of the profits, plus no exposure to losses. Needless to say, this provides an incredible incentive for managers to speculate with their clients' money: a situation that has encouraged ill-considered investments in risky sectors, including mortgage-backed securities.

But back to the big picture. If we are to summarize how we got here, how the necessary conditions for a crisis appeared in the value of credit instruments, and how the real economy became so exposed to recession, consider the following, some of which we have just discussed:

1. The actions of the Central Bank, which, in reaction to the stock market decline of 1999-2001 and driven by a fear repeating Japan's mistakes, established extremely easy monetary conditions.
2. The birth and rapid growth of new financial products with strange acronyms, poor transparency of structure, and an absence of regulation.
3. The rapid rise of "mark to model" pricing and the hand-in-hand relationship between the rating agencies and the investment banks, resulting in these new financial products being falsely deemed "safe".[3]
4. The existence of very large pools of hedge fund capital, which was managed under the pressure of large and built-in incentives to speculate with other people's money.[4]
5. The ability and incentive to deploy massive use of leverage across a global financial system, resulting in financial security values (bonds and stocks but not derivatives) over three times the value of global GDP.

These five reasons tell us how we got here. And now the rest of the plot is rapidly unfolding. Today, the crisis in the financial economy is beginning to affect the real economy: US consumer spending comprises 72% of our GDP and 20% of global GDP, and there are stiff headwinds against continued spending of this magnitude. Rising fuel and food prices, mortgage interest rate resets on nearly 20% of existing house mortgages,

[3] How the rating agencies aided and abetted the investment banks in the sub prime crises.
[4] See paper, "Hedge Fund Math: Why Fees Matter," by William W. Priest and Michael Welhoelter, www.eipny.com

and clear evidence of a slowing economy and declining corporate profits are indications that recession is a likelihood, if not a certainty.

Housing, needless to say, will continue to decline. The S&P/Case-Shiller National Home Price Index reported a fall in American house prices of 4.5% in the third quarter compared with a year earlier: the biggest drop in the index's 20 year history. Home inventories continue to rise and mortgage lending criteria continue to stiffen. Affordability measures, as reflected in Hanley Woods[5] data, are improving but prices remain too high for both new home and existing home offerings, signaling further price declines and a need for inventory liquidation.

The CEO of Freddie Mac, Richard Syron, recently said: "We would expect that our total future credit losses on our current book of business would total approximately between $10 and $12 billion." His gloomy outlook on housing indicates that the worst still lies ahead, with losses reaching at least 10%. He also stated that, because 2008 is an election year, the distressing public face of massive foreclosures will become increasingly apparent, and that could impact the entire economy. "Household wealth in housing is about $21 trillion," he said. "It does not take a big shift in consumer confidence for it to have an effect in the economy."

With consumer spending likely to slow substantially and residential investment on a continued decline, the only real drivers of the U.S. economy in 2008 will be business investment spending, government spending net of tax receipts, and exports net of imports. For these drivers to pick up the slack in the face of an otherwise stagnant economic environment is a tall order; but it is possible so long as employment expands and wages per employee rise, but current signs indicate slowing employment growth, particularly in the private sector. So the table is set for 2008: a continued fall in housing prices, further contraction of credit, falling corporate earnings, and rising inflation spell recession, even stagflation.

Will this "bleak house" mean bleak times? The answer, as outlined above, is a complex one. For now, perhaps we are best served by focusing on something slightly simpler: the best strategy with which to weather this coming storm. In this regard, the fundamentals are clear and straightforward: by focusing on companies that intelligently deploy their free cash flow, our clients should experience relative, if not absolute, profitability and will be better positioned for the next stage, inevitable stage of global economic growth.

[5] Hanley Woods is a leading independent real estate research firm providing residential construction information and analysis for builders and developers.