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Wishes and Beliefs-- How They Influence Economic and Financial Forecasts

More than twenty years ago, I read an article in *Natural History Magazine* entitled, "The History of Rainmaking." This article dealt with the influence of wishes and how they establish beliefs which in turn determine behavior. It profoundly changed how I look at many of life's supposed truths: from political policies and economic forecasts to the oft-quoted bromides dispersed by well meaning relatives and friends.

That article outlined its thesis as follows. It asserted that, as man transitioned from the role of hunter to that of farmer, it dawned on him that if he could control the rain, the crops would not wither and die. The wish to control the rain led to a belief that it could be done.

Once the belief took hold, thousands of people came out of the woodwork claiming they could make it rain. (Hence, the origin of the word "rainmaker.") The belief in these rainmakers was faith-based, but empirically lacking. In other words, the rainmakers did sometimes seem to bring forth the rain, but this was never anything more than sheer coincidence. However, the *wish* for rain was strong enough that it made these random occurrences appear to justify the erroneous *belief* in the rainmakers.

According to the author of this article, this was another instance of a scenario that has been replayed throughout the centuries and on every continent. As human beings, we have an astounding propensity to allow our wishes to determine our beliefs. And, with these beliefs established, the ground has been and will always be fertile for "rainmakers" who choose to prey upon the believers.

Even in today's investment landscape, this age-old interplay of wishes, beliefs and behaviors is still at work. Specifically, a wish for the continuation of a robust housing market has led to several incorrect beliefs about the housing market's impending decline. Those who choose to let their wishes guide their beliefs say that housing prices may fall, but the landing will be soft. Similarly, they believe that the bursting of the housing bubble will occur in isolated, localized sectors, and not in the national economy as a whole. In our view, these beliefs are as foolish and ill-informed as thinking that a human being can control the rain.

To show why this is the case, let's discuss the realities of our current economic outlook.

First of all, 2007 may very well be a year of recession. In an earlier paper, "What the Market Has Not Discounted," we described the accelerants of economic and profit growth over the past four years. These accelerants included consumer spending that exceeded personal income, an explosion in government spending relative to tax receipts, and surging investment in residential structures and related materials (i.e. housing). We have now reached a point where these three accelerants have ceased to exert as positive an influence on the economy. And one of them – housing – may very well lead this country into a recession.[1]

Those whose wishes have led to misguided beliefs in the ongoing strength in the housing market may challenge this prediction of an upcoming national recession. "But housing has never had a national decline," they may say. True, but the majority of our country's housing has never been financed by the unsustainably intricate "house of cards" that is in place today.

These dangerously complex financing structures are largely the fault of Alan Greenspan, the former chairman of the Fed. A serial bubble blower, his policies first created a bubble in the equity markets which was then transitioned to the housing market. The bursting of the equity bubble at the beginning of this century had extremely negative consequences for the health of our nation's economy, but it is nothing compared to the financial fall-out that will occur when the housing bubble is punctured.

Bubbles are caused by the widespread acceptance of irresponsible financing strategies, and the housing bubble began when Greenspan provided negative real rates of interest as a method of offsetting deflation. Fearing a Japan-like period of deflation, this policy was adopted by our central bank to prevent just such a period. In fact, it led to the creation of the biggest housing bubble in centuries. Because of the Fed's insistence on exceptionally low interest rates, we have gone from "my house is my castle" to "my house is my ATM machine." There is no other way to explain how, over the past several years, the American consumer has consistently spent more than he has made.

Let us further examine the phenomenon of creative financing that was instigated by Greenspan's persistently low interest rates. The following facts are courtesy of Lon Witter of Witter & Westlake Investments in Louisville, Kentucky:

1. Nearly one third of new mortgages and home equity loans in 2005 were interest-only, compared to 0.6% in 2000. For California, 60% of all loans were interest-only or payment option ARMs in 2005.

2. 43% of first time home buyers in 2005 put no money down, and the median down payment was 2%.

3. More than 15% of 2005 home buyers owe at least 10% more than their homes are worth.

[1] See Paul Krugman's op-ed attached.

4. 10% of all home owners with mortgages have no equity in their home.

5. More than $2.7 trillion in mortgage loans will adjust to higher rates in 2006 and 2007.

We can use the fifth and final statistic to get a sense of the real impact of these creative financing strategies on the average home owner.[2] As Witter did, let's assume that the homeowner has a $250,000 three year adjustable-rate mortgage with an annual 2% rate hike cap. If the monthly payment is $1,123 today, the monthly payment will jump to $1,419 with the first adjustment and to $1,748 with the second adjustment. That is a $7,500 per year rise in mortgage costs to maintain the same mortgage. This comes at a time when median incomes in the U.S. are stagnant or rising little.

Historical precedent tells us that financing schemes such as the one outlined above come with dire consequences. For proof, we can look back to the junk bond situation in the late 1980s. If you were the acquirer, the concept was to use the target's balance sheet as collateral for whatever debt you incurred to enable the takeover offer in the first place. As many of us remember, that game ended in 1989 with the mini market crash started by the collapse of the United Airlines LBO deal.

Recently, however, this same scheme has allowed millions of prospective home buyers to buy homes with little or no money down, with the homes to be acquired as collateral. But what happens if the value of the homes falls, as is happening now? At some point, the home owner walks, leaving the mortgage lender with the house. So far, the mortgage lenders' response to this has been simple: they have floated the loan.

But the mortgage lenders' response is what has made the bursting of the housing bubble an event of national concern. The mortgage lenders have securitized these unpaid housing loans. Through the process of securitization, they have taken local risks, aggregated them, and turned them into national, systemic risks. Witter makes this important point in his Barron's editorial by citing the example of Washington Mutual.

At the end of 2003, only one percent of Washington Mutual's option ARMs were in negative amortization. [3] However, just one year later, 21% of WaMu's option ARMs were in negative amortization and, another year later, the percentage had ballooned to 47%. In terms of the overall value of loans outstanding, the percentage in negative amortization was 55%. With the endorsement of GAAP, in the first quarter of 2005

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[2] Analysis provided by Lon Witter in *Barron's*, August 21, 2006.

[3] Negative amortization is a cockamamie accounting procedure that allows the lender to book interest owed from the mortgage, but not yet received in cash, as income with the same amount added to the principal mortgage owed to the bank. The accounting entry is a debit to loan receivable and credit to mortgage income, and yet no cash has actually changed hands!

WaMu booked $25 million of negative amortization as earnings and, in the first quarter of 2006, that number had increased eight-fold to $203 million.[4]

Like junk bonds in the 80s, this structure will collapse when collateral values fall below asset values and stay there for a while. The mortgage institution has granted the homeowner a "put"; the ability to walk from the loan obligation when the gap between realized value and the mortgage payable becomes large enough to warrant such an action. When this happens, the housing problem goes national and the equity markets will decline.

The uncomfortable truth is that our current dilemma is based on a classic wish/belief misalignment. For the past decade, many of those who allowed their wishes to guide their beliefs took out no money down, interest-only, adjustable rate mortgages at the peak of the housing market. What's more, our country's financial institutions were happy to facilitate these perilous loans. In fact, the situation is now so serious that banks, according to Witter, now hold a record 43% of total assets in direct mortgage loans. (No wonder WaMu is looking for capital.)

Meanwhile, prices of homes have been dropping sequentially since early this year. Eventually, housing prices will be down year-over-year in every sector of the country. New home inventories are at a record high, and existing home inventories are 40% higher than one year ago. Traditional measures tell us that housing prices are more than 25% too high.

Three elements of the "wishes and beliefs" structure have brought us to this financial precipice: 1) central banks enforced low interest rates such that real rates became negative, 2) the economic history of the post-war period suggested (incorrectly) that housing never declines in unison but is a regional affair reflecting local economics, 3) the emergence of creative financing that has undermined the health and the sustainability of the national economy.

Simply put, the desire for a "soft landing" in housing prices and the desire for a housing decline that will occur only in certain, restricted geographies are equally unfortunate delusions. These beliefs are really wishes that refuse to recognize what a nation-wide "hard landing" could imply. It is the easy way out; it is also wrong.

As far as our investment recommendations are concerned, the post-Labor Day period is likely to be rough sailing for investors, particularly those who own shares of financial institutions engaged in the mortgage market. The lack of financial transparency within many of these organizations is something we have often written about in the past. Today, the "finance sector" is the largest sector within the S&P 500 and accounts for 22% of the

[4] As stated in the Financial Times, September 2, 2006, WaMu has become the first Non-European bank to issue debt ($25 billion) in the European covered bond market. "Covered bonds" are secured against pools of mortgages but are considered less risky than other mortgage backed securities because investors have recourse to the issuer's balance sheet. But book value protection is not the same as hard assets coverage. Caveat Emptor!

S&P 500, up 50% from its level 20 years ago. The magnitude of this sector and its fundamental instability have led us to advise our clients to seriously underweight this sector in their portfolios.

At Epoch, our insight and experience tell us that simply wishing for a robust economy will not result in one. If, however, you are an investor who lets your wishes guide your beliefs, if you have found yourself trusting in rainmakers, there has never been a better time to recognize this behavior and, most importantly, to change it. As the housing market declines, only investors with a realistic outlook will be able to protect and grow capital.

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With McMansion bubble going bust, is recession far behind?

PAUL KRUGMAN
THE NEW YORK TIMES

Bubble, bubble, Toll's in trouble. This week, Toll Brothers, the nation's premier builder of McMansions, announced that sales were way off, profits were down, and the company was walking away from already-purchased options on land for future development.

Toll's announcement was one of many indications that the long-feared housing bust has arrived. Home sales are down sharply; home prices, which rose 57 percent over the past five years (and much more than that along the coasts), are now falling in much of the country. The inventory of unsold existing homes is at a 13-year high; builders' confidence is at a 15-year low.

A year ago, Robert Toll, who runs Toll Brothers, was euphoric about the housing boom, declaring: "We've got the supply, and the market has got the demand. So it's a match made in heaven." In a *New York Times* profile of his company published last October, he dismissed worries about a possible bust. "Why can't real estate just have a boom like every other industry?" he asked. "Why do we have to have a bubble and then a pop?"

The current downturn, Toll now says, is unlike anything he's seen: Sales are slumping despite the absence of any "macroeconomic nasty condition" taking housing down along with the rest of the economy. He suggests that unease about the direction of the country and the war in Iraq is undermining confidence. All I have to say is: pop!

Now what? Until recently most business economists were predicting a "soft landing" for housing. Even now, the majority opinion seems to be that we're looking at a cooling market, not a bust. But this complacency looks increasingly like denial, as hard data – which tend, for technical reasons, to lag what's actually going on in the market – start to confirm anecdotal evidence that it is, indeed, a bust.

Why the sudden crackup? When prices were rising rapidly, some people bought houses purely as investments, betting that prices would keep going up. Other people rushed to buy houses, or stretched themselves to buy houses they couldn't really afford, because they feared that prices would rise out of reach if they waited. And all this speculative demand pushed prices even higher. In other words, there was a market bubble.

But eventually prices reached a level beyond what even optimistic potential buyers were willing to pay, especially after interest rates rose a bit. (They're still low by historical standards.) As demand fell short of supply, double-digit price increases declined into the low single digits, then went negative everywhere except in the South.

And with prices falling in many areas, the speculative demand for houses has gone into reverse, as people try to get out with a profit while they still can. There's now a rapidly growing glut of unsold houses. This is a recipe for a major bust, not a soft landing.

Moreover, it could be both a deep and a prolonged bust. Since 2000, much of the nation has experienced a rise in home prices comparable to the boom in Southern California during the late 1980s. After that bubble popped, Los Angeles house prices began a slow, grinding deflation, eventually falling 20 percent (34 percent after adjusting for inflation). Prices didn't begin a sustained recovery until 1996, more than six years after the downturn began.

Now imagine the same thing happening across a large part of the United States. It's an ugly picture, and not just for people and companies in the construction business. Many homeowners – especially those who bought their houses with interest-only loans or with minimal down payments – will find themselves in financial distress. And the economy as a whole will take a hit.

As far as I know, Nouriel Roubini of Roubini Global Economics is the only well-known economist flatly predicting a housing-led recession in the coming year. Most forecasters consider his call alarmist, and many Federal Reserve officials remain optimistic. Last week, Richard Fisher, the president of the Federal Reserve Bank of Dallas, dismissed "Eeyores in the analytical community" who worry about a possible recession.

Call me Eeyore. While I don't share Roubini's certainty, I see his point: Housing has been the main engine of U.S. economic growth over the past three years, and with that engine now going into reverse, it's hard to see how we can avoid a serious slowdown.