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The Silverlining and a Big Dark Cloud

Looked at from a distance, the world is working surprisingly well. Almost all nations are experiencing real growth and interest rates are remarkably low. Indeed, rates are lower than almost anyone postulated a few months ago. Few things matter in finance more than interest rates. It is this rate that becomes the discount rate in one form or another for virtually all investments and provides the key metric when valuing public securities. It is the denominator in the present value mechanism that discounts future streams of benefits to the holders of these securities. To the extent these expectations remain constant, falling rates result in higher present values. In the case of the stock market, levels would rise with rates constant and earnings increasing in line with GDP growth.

On the other hand, looked at more closely, the world is not without problems, one of which is directly the result of low interest rates. The most visible one is that of housing where, according to almost any periodical one reads, a bubble exists in this market. According to *The Economist*, the "worldwide rise in house prices is the biggest bubble in history". "Prepare for the economic pain when it pops".

Their argument runs as follows. "The total value of residential property in developed economies rose by more than $30 trillion over the past five years to over $75 trillion, an increase equivalent to 100% of these countries' comprised GDP's". Compared to stock market bubbles of the past, the current state of the housing market is the biggest bubble in history.

According to the *The Economist*, a study by the International Monetary Fund found that output losses after house price busts in rich countries have, on average, been twice as large as those following crashes in stock markets and more often than not, crashes in the housing market are followed by recession. The link is employment in addition to wealth destruction. Since 2001, forty percent of jobs created in America have been in housing related sectors such as construction, real estate lending, and brokering. As an example, in California, there is a registered broker for every house sold last year! Dare we say, day-trader?

Two forces and one economic principle have driven this bubble. The former reflected the incentive for homeowners to borrow because of low rates, and to consider property as an attractive option for households seeking investment alternatives after losing faith in equities. In addition to these two forces, an economic principle at work was that of diversification as reflected in the process of securitization. Through securitizing heretofore illiquid assets – a single family mortgage for example – specific risk is spread over a large pool of liquid assets thereby reducing the lenders' economic cost in the event of a mortgage default. While mitigating loss from specific risk, there is a gradual increase in systemic risk. Diversification softens the importance of any single loss to the portfolio as a whole but leaves the portfolio exposed to the drivers of economic return for the entire asset class. This is where housing is today.

The most compelling evidence that home prices are over valued is the diverging relationships between housing prices and rents. The ratios of housing prices to rents can be thought of as a P/E ratio of sorts for the housing market. This number has never been higher than it is today. In America, for example, our ratio of housing prices to rents is 35% higher than the average level for the last quarter century during the period 1975-2000. This ratio is even worse in Britain, Australia and Spain.

At the heart of any bubble is systemic risk not specific risk. For developed countries, capital markets are liquid and deep enough to handle almost any specific risk. It is only when an entire asset class is at risk that the system is placed in harms way.

According to the National Association of Realtors, in 2004 nearly one quarter of all houses purchased were for investment purposes, not owner occupation. Another 11% were bought as second houses. Riskier forms of mortgage finance allowed these buyers to borrow more and more. Over 40% of all first time buyers and 25% of all buyers made no down payment on their home mortgage last year. ARM's (adjustable rate mortgage) have risen to 50% of all mortgages in those states with the biggest housing price increases. In today's world, little or no documentation of borrower's assets, employment, and income is required for a loan. As a colleague of mine has said, "It is here where you will observe the new 'perp walks'"

It is unlikely that the housing boom will end with a "bang". Rather, a whisper is likely but its repercussions can last a long time. What are the economic consequences? Much of the GDP growth has been financed by "cash-out" mortgages. Housing equity withdrawals have been massive but are now slowing sharply. For example, in Britain and Australia, household spending has slowed considerably as a consequence. In Australia, retail sales growth has slowed from an 8% rate to 1.8% over the past year and GDP growth has fallen to half of its original level – from 4% to 1.9%.

For the U.S., this trend is particularly significant. Goldman Sachs estimates that total housing related equity withdrawals accounted for 7.4% of personal disposable income in 2004. This is a really big deal, and independent of any other world issues (China, Iraq, and the fiscal and trade deficits) a decrease in housing equity would appear to be a proximate cause for slowing economic growth and ultimately corporate profits.

Many pundits cite the history of the American market and its resiliency to housing busts to downplay this concern for the housing market. The U.S. was the only country to avoid a boom and bust during the 1970-2001 period studied by the International Monetary

Fund. In its study, this organization looked at 14 countries and identified 20 “busts”. A bust occurred when real prices, not nominal prices, fell. All but one of these housing busts led to a recession with GDP falling after three years to an average of 8% below its previous growth trend. In Japan, prices dropped 14 years in a row, a 40% decrease from peak to trough. It is unlikely that the U.S. can remain exempt from this trend again.

With the outlook for consumer spending under a dark cloud should housing prices begin to erode, reduction in corporate profit forecasts cannot be far behind. With China likely to slow as well, due in part to the slowdown in the U.S. as well as the anticipated decline in the marginal efficiency of capital deployed in China. Taken together the investment outlook must be one of caution.

Investments, based on free cash flow levels purchased at reasonable prices, will remain attractive with yield playing an increasingly important role as a driver of equity returns. To us, yield is a combination of cash, share buybacks, and debt pay downs. All three elements are essential to enhanced shareholder value and equity prices. Such investments are the cornerstones of our portfolios.

The big, ominous cloud of a housing bubble cannot be ignored but recognizing its potential for changing the economic landscape allows us to focus on companies and sectors that should continue to attract capital and perform well. The silver lining of lower interest rates than expected should be with us for sometime providing valuation support for our portfolio of securities.