

Looking Back To Predict the Future

The text for our sermon today comes from a pugnacious Irish American woman. She said, “Look for the mosquito.” The author of that bit of wisdom was Mother Mary Jones, a winsome little old lady whose career “raising hell” as a union organizer spanned a fifty year period. Beloved by mine workers, she was jailed several times, and risked her life repeatedly during violent confrontations between workers and mine owners. On several occasions, her speeches challenging workers to show their manhood by standing up for their rights caused whole company towns to walk off their jobs and face starvation and eviction with their children living in tents in the middle of winter.

To understand the current woes of the real estate markets and the capital markets and the general economy, and where we are headed, we can learn a lot by going back to Mother Jones’ 19th century, a period of great financial instability in the pre-regulation American economy. Essentially, the deregulation and tax cutting policies of the Bush Administration attempted with considerable success to take us back to how things were before the New Deal of the 1930s. Lower taxes on the rich. Less regulation, especially of financial markets. Less government redistribution of wealth and income from rich to poor. Since redistribution mainly means government spending on education and health care, less redistribution means a less educated, less healthy, less productive workforce. Bush policies rely on the “invisible hand” of the market and “laissez faire” policies recommended by 19th century economic theorists. I didn’t make up the idea that we are now back to pre-New Deal government, I read it in a Paul Krugman op ed column in the New York Times. Krugman just won the Nobel Prize so maybe he knows something.

Having returned to something close to the regime in place in 1929, we seem to be having roughly the same outcome—a major collapse of market values, employment and output following a period where the rich got richer on paper and the poor had children. One view of the current crisis is that it is 1930. In fact, that is the view implicitly behind Democratic and Republican efforts to restart the economy. We should all hope that point of view isn’t right because it would mean we are probably just at the start of a very long depression.

When the housing price bubble burst, it took the Bush Administration about five minutes to conclude that socialism is a great idea after all when it comes to rescuing Wall Street. What Mother Jones and the socialists could not accomplish in a hundred years of agitating, the Bush Administration began with your tax dollars (well, by borrowing another trillion, so our kids tax dollars actually), nationalizing banks and major industries.

Government Bailouts -- Economic and Other

In my opinion, we should be highly skeptical of the Bush bailouts. Go have a look at New Orleans. How effective were they there in fixing a major problem? “Heckuva job, Henry & Ben?” If the credit default swaps and subprime loans are essentially an overleveraged Ponzi scheme, does putting more money in to keep the game going solve the problem? I don’t think so. Government should go back to spending on education, alleviating poverty and fixing potholes.

In 1936, John Maynard Keynes published his General Theory explaining how government can pull economies out of Great Depressions by means of macroeconomic management tools aimed at stimulating demand through government deficit spending and expansionist monetary policies. The U.S. government—Bush, Greenspan, Bernanke, Paulson, Congress, the incoming Obama team—all have learned the lessons of the 1930s by heart. So we are supposed to resist imposing tariffs or other controls that would reduce international trade, cut interest rates to zero to expand investment, and put the government into deep deficit to stimulate demand in general and consumption in particular. But are they fighting the last war with weapons that are obsolete? And what about the long run?

Keynes’ recommendations were a short term fix. He famously dismissed the long run by remarking that “in the long run we are all dead.” But I think this is already the long run and the long run, by definition, lasts much longer than the short run. It’s not as if the U.S. government has been running a big surplus during the good times (well, except for a brief dot.com bubble apparent Clinton surplus before the Bush tax cuts). Ignoring long run issues like the trade deficit, increasing inequality of incomes and wealth, declining infrastructure, climate change, etc. could put us into much worse long runs.

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The medium term worry should be that excessive U.S. government debt—increased by deficit fiscal policies to cure a short run problem—could result in a banana republic or Argentine scenario. Default on our debt, a run on the dollar, huge interest rates and runaway inflation, even higher unemployment. Do the rules the IMF imposed on little countries not apply to big countries? I guess we are going to find out. Hint: Maybe your U.S. bonds and T-bills are not really a risk free asset.

Many people, including “the markets” judging by how a speech by Paulson can push the S&P 500 down a couple of percent, remain skeptical. A deflationary, deleveraging feedback process is underway whereby investors troubled by margin calls and weak cash flows in falling markets sell assets to raise cash, thereby pushing asset prices down further. Weak consumer demand remains a problem, and results in layoffs as scared consumers, loaded with debt, slow down spending.

The Experts Say . . .

On December 22 C-Span covered an interesting session where a panel of Harvard University professors offered advice to incoming newly elected Congresspersons about how to repair the economy. The more conservative economists, like Greg Mankiw, warned about the possibility that in re-regulating financial markets, Congress might impede the wonderful engines of free enterprise, but they all unanimously recommended expansionary monetary and fiscal policy. Suddenly everybody is a Keynesian.

The most impassioned and interesting analysis and recommendations, in my opinion, came from a Bankruptcy Law specialist, Professor Elizabeth Warren. She pointed out that the full time, inflation adjusted pay of American males is \$800 dollars less than it was in the 1970s. She didn't explain why, but I think it has a lot to do with the fact that we now have global labor markets, so wages and salaries in the U.S. are under competitive downwards pressure from wages and salaries in China and India. 800,000 jobs left for overseas in the last year alone. They didn't tell us that when globalization's benefits were being touted. Anyway, she continued, families reacted by women entering the labor force, so that most families now have two wage earners. But “core” costs for health care, college educations, housing, energy and taxes went up.

Families coped with the squeeze of rising expenses versus falling incomes by taking on more debt. The consumer price index does not include interest; it assumes purchases are made for cash. But the average family now pays something like \$1600 per year in non-mortgage interest expenses, a further drag on demand for other goods and services. College graduates start life with heavy debts. Professor Warren pointed out that the current economic crisis began when easy credit led to increasing house prices financed with loans many households cannot afford to repay. Either house values have to fall to affordable levels or incomes have to rise so people can afford to pay mortgages. If house values fall, that means somebody has to take huge losses on all those too big mortgages made when house prices were higher. That seems more likely than wages in China rising enough to push up U.S. wages. And, thanks to bond risk being abolished by the geniuses who invented credit default swaps, you can multiply the mortgage losses by ten, the ratio of swaps to underlying mortgage backed securities.

So far, the somebody taking the losses has been you and me—U.S. taxpayers. Professor Warren contradicted her economist colleagues by saying “they are still doing it”, meaning subprime loans and credit default swaps are still being done, and that re-regulation of financial markets should be the first thing Congress does. I'm with her on that one.

What Mosquito?

In the 1860s Mother Jones' husband and four small children all died in a yellow fever epidemic. But during her lifetime, Pasteur discovered the germ theory of disease and Walter Reed discovered that yellow fever germs are spread by mosquitoes. When Mother Jones family got yellow fever, people thought it had something to do with bad air, and treatments were completely ineffective. Once it was understood that mosquitoes spread yellow fever, the disease disappeared from the U.S.A. When she said “Look for the mosquito” she meant look for the real cause of economic crashes.

It seems to me that the fundamentals are quite different now than they were in the 1930s. That leads me to suspect that both the laissez faire free markets theory and the Keynesian “government can fix it” theories are not correct and not sufficient to deal with this problem. This time we actually need to think about the long run. We need to reduce consumption and debt and live within our means and manage for environmental sustainability. The trade deficit, running at around 6-7% of total output in recent years, cannot continue so it will eventually stop. Oil, gas and coal, the energy sources that run the current economy, are running out and getting more expensive.

The fundamental causes of this downturn have to do with things like:

- a. Increasing disparities between rich and poor—maldistribution of wealth and incomes makes for too much investment (hence bubbles) and too little consumption (so investments' top line cash flows falter) since the rich invest and the poor consume.
- b. We are running out of stuff and encountering limits to growth—especially energy—on a little planet with a fragile environment. A carbon tax would be a sign Americans are starting to face reality. Don't hold your breath.
- c. There are a lot of poor people out there in other countries and in a global economy; American wages compete in world labor markets. The "law of one price" says "why would you buy it here when you can get it cheaper someplace else?"
- d. Complex modern economies absolutely need regulation of financial markets and insurance, a lesson proven by crash after crash before the 1930s. In a deregulated environment, financial rocket scientists invent products and frauds guaranteed to destroy the banking system. Market competition dynamics guarantee that the worst ideas gain market share, ballooning credit bubbles to unsustainable levels. Regulation can help create a level playing field so irresponsible lending can be constrained.

Everybody seems to agree that the "just let the markets handle it" theory is a dead letter, disproved by events. I'm not completely sure about that being true. Markets did eventually correct 19th century crashes—after a lot of pain and loss, of course—and smarter investors survived to pick up the pieces. I doubt the 1930s Keynesian solutions will prove to be correct this time around—I don't think they've found the mosquito yet.

The practical implications are that we've still got a rough ride ahead. I wouldn't bet on the U.S. dollar, but in a globally interdependent economy, it looks hard to find another safe haven. Maybe, since we decided (by electing Bush twice) go back to a before 1930 regulatory regime (that is, little or no regulation) and thereby create a crash, we just have to let the losses happen. Sorry about hits to our retirement savings (in fact I'm heartbroken, now that half my hard earned dough went away), but I think it might be worse if the government goes broke due to endless bailouts and we end up with worthless money. Losing half beats a bigger wipe out.

The Implications for Real Estate

I haven't talked much here about real estate implications. That's partly because real estate markets aren't really the problem. They are being driven, at the moment, by the macroeconomic meltdown. Lack of liquidity and credit will be huge problems for real estate. And unemployment and business failures will create cash flow issues.

On the bright side, if there is one, those with cash will find the best buying opportunities since—uh, actually since the 1930s, the last time asset values deflated to bargain basement levels. As always, the beauty of real estate is that by careful analysis we sometimes can pick winners in these markets where characteristics of individual properties matter.

Another cheerful caveat—I could be wrong about all this doom and gloom. The economy in some ways is far stronger than the 1920s economy and governments do know more about managing economies—at least we can hope that maybe they've found the right mosquito. I wouldn't be astonished if next year we are back headed upwards towards full employment and kicking ourselves for not buying at the bottom.

We probably can't forecast well enough to know for sure which scenario will actually happen. A lot will depend on whether Obama's team restores confidence and deals with real problems. If I had to bet, which I do, I'd stick with my insight that if you go back to pre-New Deal regulation you are doomed to have a pre-New Deal depression and there isn't much government can do, once the hole has been dug. Somebody has to take the losses on the credit default swaps and the subprimes, credit card debt, cmts, etc. The bottom line is the borrowers won't pay.

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Somebody joked that in the current environment the optimum portfolio allocation would be half cash and half canned goods.

Maybe real estate suitable for growing vegetables should be added to that list. Seriously, real estate, as a tangible asset, has always had some of the same appeal as gold or other tangible commodities. Financial assets may evaporate in a crash, real estate will still be there. Not worth much maybe, producing negative cash flows in some cases, but at least still there, waiting for better times. Notice also that with the financial system wrecked, they will be building a lot less competitive real estate product in the next few years.

Keep in mind: I'm way too pessimistic (it has something to do with my liver and having to give up beer). Things are darkest before the dawn. Warren Buffet says buy when everybody else is too scared to buy. In the wonderful world of real estate, there are always opportunities. And risks. Trying to avoid all risks—as with credit default swaps—turns out to be really risky. Now if we can just figure out how to swat that damn mosquito.

~Max Kummerow, Ph.D.