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listeningin

It's Only Just Begun

David Levy Sees Unwinding Housing Boom As Extraordinarily Destructive

***David Levy**, Chairman of Mount Kisco's **Jerome Levy Forecasting Center LLC**, and third-generation proponent of pragmatic, profits-oriented economic and financial analysis, is not a brazen self-promoter. Anything but. Basically stopped talking, period, to the press back in '02. So when he dropped me an urgently worded missive about what's fast-becoming the housing mess a few weeks back, I couldn't help but give him a call. Listen in.*
KMW

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There seems to be an awful lot of confidence out there, at least if you look at the stock market, that problems in real estate aren't contagious –which bothers you so much you're willing to climb up on a soapbox?

To be frank, the public discussion is so far off-base that I have been having trouble containing myself. There have been a number of comments in the press in the last few weeks–including, most notably, from Alan Greenspan–suggesting that it's time to be looking for the bottom. I have a very different view based on our research here at the Levy Forecasting Center. This is a market that went way, *way* beyond what the fundamentals justified– because of two factors, which are well-known, although not necessarily broadly understood. One is the fact that speculators played a big role. In fact, even some pretty conservative places like Fannie Mae have estimated that the last year, if not year and a half or more, of the market's rise was entirely accounted for by speculator purchases. The other factor that is not fully appreciated is the extent to which exotic or non-traditional mortgage vehicles enabled people to buy much more house than they ever could have before, or at least at buy at much higher prices, if not buy more physical house–despite the fact interest rates were going up. We refer to that as *payment leverage*. Suppose somebody bought a house with a fixed-rate mortgage in 2003, say in the summer months, at those very low rates we had when Treasuries hit their peak and Treasury yields were at their lows, so their monthly payment was $1,000. If we compare that mortgage with the size of a loan that a person could have gotten with the same $1,000 payment in the middle of 2005, using an interest-only, three-year ARM, they actually could have paid 40% more for a

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John Darkow
Columbia Daily Tribune, MO
Page 1 Illustration

house in the more recent period.

Despite higher interest rates?

Yes. So we wonder what drove home prices up! It had nothing to do with a fixed-rate mortgage, or very little to do with it. It had to do with most home buyers freeing themselves from the traditional fetters of interest rate restrictions on what they could buy. So now that we have a number of factors gradually working to undermine the accessibility of those types of vehicles, the market is coming undone.

So it would seem. Yet when *Business Week* emblazons *"How Toxic Is Your Mortgage"* on its cover, the news *can't be all bad* for housing. Besides, the economic stats look awfully mixed. There even were dueling headlines in the *Wall Street Journal* recently, taking opposite sides of the debate over housing's impact on consumer spending. [See newsbite on w@w website.]

Yes. There are so many statistics on consumer spending that at any given moment one can find something that will support almost any view. We believe income is holding up and it has probably been underestimated a little for the past six months. We *know* there have been some upward revisions for periods prior to that, as the state employment offices have provided data to the federal government on wages and salaries. If that's the case, the saving rate, which had been plunging for a very long time and now has been flat (as much as we can trust the data) for about a year or so, may actually have started to move up. If we look at something like general merchandise stores, especially at high-end stores, they have been doing pretty well year-over-year. But if we throw the whole kit and caboodle into a spending measure, in terms of including not just the discounters, but also including auto sales, spending on housing, eating out at restaurants, vacations, travels, boats, furniture, it does appear that we're starting to see weakening in some big ticket items which had been buoyed by spending part of the home equity that had been extracted. So that suggests that the saving rate may be turning up.

Which is not an unalloyed blessing, you're implying, despite all the moaning about America's woeful lack of savings?

A rising saving rate *seems* benign as it begins, but if it is a trend that's going to accelerate–which we think it will, over the next year or so–it means that spending will not be as growing as fast as income. The wages and salaries that businesses are paying out will keep growing, but the money that comes back to them as revenues will be falling off relative to that.

There's been increasing attention paid lately to the yawning gap in this country between the rich and everybody else. Does that skew your consumer spending analysis?

There's no question that if we want to look at the distribution of the consumer spending dollar and of income, there are a lot of interesting and very important, and in some cases disturbing, patterns. But rather than get sidetracked into that, I'd rather make a point I believe is more powerful. The U.S. is at a critical point in what may well become its most infamous financial episode in the post-World-War-II era. Yet, there is little public or professional understanding of the forces at work or how they will interact.

"What's missing is recognition that the 'housing bubble' is *not* just about home prices, home building, and home-equity-financed consumption; it is also about *extraordinary financial conditions* that enabled a household sector *unable to adequately service its debt* to obtain massive amounts of new credit that have, for a time, masked its financial vulnerability."

How so?

What's missing is recognition that the "housing bubble" is *not* just about home prices, home building, and home-equity-financed consumption; it is also about *extraordinary financial conditions* that enabled a household sector that was *unable to adequately service its debt* to obtain massive amounts of new credit that have, for a time, masked its financial vulnerability. The Forecasting Center's financially oriented, macroeconomic-profit-centered approach highlights today's extraordinary underlying financial conditions–including balance sheet structure and the relationships of assets and liabilities to cash flow and income, attitudes toward debt and risk, lender and investor behavior, and lending standards and controls. These circumstances have *everything* to do with why the bubble occurred and *everything* to do with why its undoing will be *far more destructive* than almost anyone thinks. As it is, the household sector overall is not able to service the debt it now carries without *massive* infusions of new credit. [See box, page 4.] Over the last few years, we have seen many households borrowing repeatedly through home equity loans, cash-out mortgage refinancings, home equity lines of credit. We've seen their debt rise enormously fast. We've seen people–based at least on the official saving rate–saving *nothing.* Which means that many, many households are–

Teetering on the edge?

At best. You simply cannot take away homeowners' ability to do equity extractions without undermining the financial stability of *a lot* of households –which then sets in motion a whole set of changes in the lending environ-

ment. You have a *Catch 22* situation. There's an old saying that "When anyone can borrow, no one will default," and I think that's a pretty good description of what we've been through in the last few years.

I guess that's the flip side of a bank always being willing to give you a loan—unless you really need one.

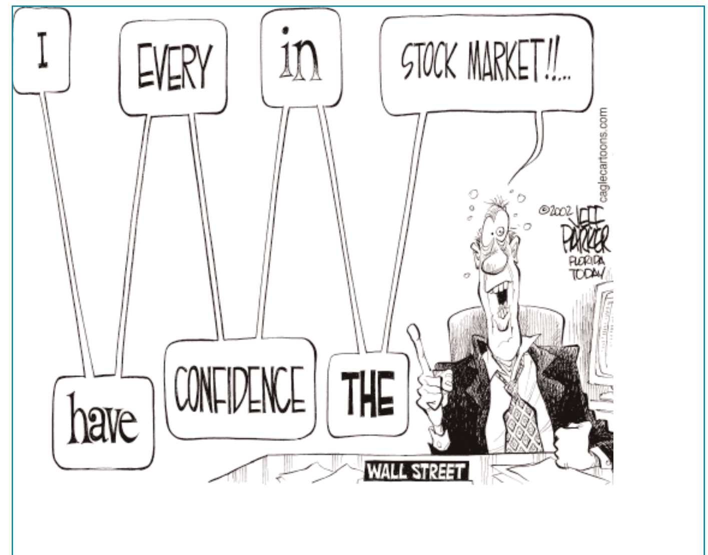
That's another old saying. My point is that when the last recession hit, household debt service ratios hit a record and people started having a lot of problems. We had very high foreclosure rates, very high charge-offs on both mortgage loans and consumer loans. But what happened then was *unlike* in any other cycle. In the past, what had always happened then was that consumers pared down their debt, or at least stopped borrowing so their debt would drop relative to income. Instead, during the last recession, borrowing *accelerated*. People basically borrowed their way out of credit problems, with much of that money coming through these wonderful windfalls that occurred when people could refinance a mortgage, lower their payments and still walk away with tens of thousands of dollars in extra cash. But we are now facing the opposite situation: Not only is it expensive to take cash out, but you can't refinance your mortgage without paying a higher rate on the new loan than on the old loan. As the debt service burden soars, the cost of extracting equity rises and the equity available for extraction drops. So mortgage and consumer debt woes will surface at an accelerating pace.

Okay, higher rates are cramping the style of folks who had grown accustomed to using their houses as ATMs. But isn't that really just a small slice of the market?

It's a narrow slice of the market, in the same way as that, in December, 1999, the slice of the corporate market, particularly of the tech sector, that was considered marginal in terms of its ability to service its debt was narrow. There were very few *evident* problems because everybody assumed they could sell additional equity if they needed to. They could raise cash readily because it was *assumed* their market value was an invincible form of collateral. In much the same way, residential real estate has become an invincible source of collateral in the eyes of many lenders. But once that changes, even some very healthy businesses that depend on lines of credit, and even some households that have steady jobs and steady incomes and look pretty good, may turn out to have extended themselves in ways that assumed that this magic ATM with a chimney and doors and windows would be available any time they needed it. The idea of a rainy-day fund really has become passé because people figure they will always have a rainy-day credit card or even, in this era, the ability to take cash out of their houses. But that could change suddenly if households' fundamental ability to service debts starts to deteriorate. And it wouldn't have to affect *most* home owners. I'm talking just about the percentage, though small, rising enough to make a significant hole in the earnings of lenders.

I could have sworn that the right to a cheap HELOC was added to the Constitution some time in the last decade!

Well, maybe there's a new version of the "Contract with America" that I'm not aware of. Look, each of these problems, looked at separately—falling new home construction, declining consumer spending (which we've only seen hints of at this point) and the financial problems of households, don't look so bad on an *a la carte* basis. But when you put them on the same plate they start to interact. The problem is that the more problems you have in housing, as collateral values drop, as some people find themselves with negative equity, the more access to funding deteriorates, the more the ability to spend deteriorates—and that weakens the economy and feeds back to more problems in the housing market. So it's a *vicious* cycle that we have to be concerned about. We've been living an amazing *virtuous* cycle of not just healthy lending conditions as far as credit availability is concerned, but of *extraordinarily lax lending conditions* and extraordinarily high rates of consumer spending and extraordinary valuations of houses, and extraordinary demand for housing. As those things undo, each will keep irritating the others and we will have a much bigger problem than you might expect if you just looked at one piece.



You're suggesting that a lot of the no-income-verification loans and such were made to people who haven't a prayer of repaying them?

Well, there was a study was done indicating that 90% of the people who took out no-income-verification loans exaggerated their income by at least 5%, and that 60% exaggerated their income by a much larger fraction, 25% or 50%. I can't remember which.

So they really are liar's loans?

Yes. Why else would anyone pay the extra basis points to use one of those? Now, in many cases, the liar may have been the mortgage broker –but one way or another, those loans were basically pure collateral bets. The lenders didn't care what the borrowers' incomes were because they felt they had the collateral. When you are in an environment where home prices are rising, first of all, the lender doesn't *need* collateral because if the borrower gets in enough trouble he can sell the house at a profit and pay off the loan. But when home prices start to drop, not only does that make it difficult or in many cases impossible for the home owner to get out, but it also means that the lender will end up with a house that will not make it whole at the end of a foreclosure process.

Yet there have been very few indications, so far, of mounting loan quality problems at the lenders.

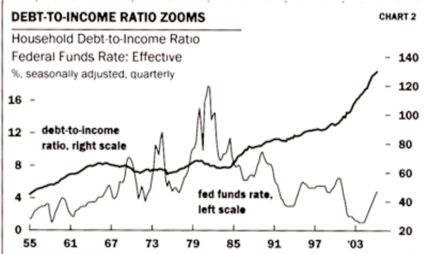
Just the very beginnings of it. There was an interesting story in the *Wall Street Journal* within the last week or so that pointed out that there has been an increase in buybacks by loan originators of loans that they had put into pools—because the loans defaulted so early that they were forced to make good on them. The absolute number of these buybacks is still very small, but it's the direction of the trend that is disturbing.

Really? I hear over and over around Wall Street about how the packaging and selling of so many mortgage derivatives has dispersed lending risk to the four winds.

There are two issues here. One is the fact that lenders have been working very aggressively to maintain good loan performance *statistics* by taking loans that begin to be troubled and doing *whatever* they have to,

The Ever More Incredible Household Debt

Since 2000, the household debt ratio has surged from 94% to 130%, an average of 6 points a year. It rose nearly 10 points in 2005 alone, providing households with $1.2 trillion in addition to their incomes for consumption and buying houses. However, rising interest rates have made this debt level unsustainable. It is likely that within two years this ratio will not only stop rising but decline, severely reducing profits.



Source: *The Levy Forecast*

to refinance borrowers who become delinquent–even borrowers in the midst of foreclosure proceedings–to keep them "current." But eventually, lenders will be forced to tighten standards, which will only intensify problems in the housing market, increase the drag on consumer spending and worsen household debt woes. That, I'm afraid, will amount to a vicious cycle leading to a recession and prolonged credit crunch. The other issue is the fact that the concept of distributing risk more broadly –the idea that financial innovation protects us from risk–is only partly true and in one sense is *exactly wrong*. It *is* true that derivatives increase the tolerance for problems, much in the same way that, when you link together several mountain climbers on the mountain, you reduce the risk that one will fall to his doom. However, the overall *risk increases because of this sense of security.* Eventually, you get the point where, in essence, the mountain climbers have climbed higher and higher onto more and more slippery slopes, so you have more than one or two fall together and drag the entire party down.

Then you foresee some systemic or catastrophic failure?
That's what, essentially, I think would describe the real estate problems we had at the end of the 1980s. As we came into the early 1990s, there was more risk diversification than we had had in years past, although not nearly as much as today–

It was miniscule, by comparison.
Right, today, not only mortgage-backed securities but the collateralized debt obligations derived from them are clearly huge parts of the market. And the eagerness of hedge funds, foreign investors and others to take on a lot of risk by buying very risky tranches of CDOs has not cooled at all. This all goes back to a fundamental fact about this economy that is an observation very seldom made–which is that balance sheets in the private economy have gotten much bigger relative to incomes over a period of many decades. In other words, assets-to-income ratios have gone up and debt-to-income ratios have gone up. Both of these trends have accelerated, in fact, in recent decades.

Which tells you?
This changes a lot of things about how the economy operates. It makes things like wealth effects and refinancings much more important–and it puts different pressures on lenders, on investors and on people managing money. Lenders in each cycle have had more difficulty finding sound loans that they can make in enough volume to generate the income they need. Investors find it increasingly difficult to find market returns that are in line with historical objectives. And fund managers today, because so many people have been chasing after *everything* that looks like it might give an above-market return, find it very difficult to generate above-market returns. The "missing alpha syndrome," the inability to get above-market returns, that is troubling a lot of hedge fund managers is actually a by-product of the kind of economy that these big balance sheets have created. As balance sheets have gotten bigger and bigger, they have driven interest rates lower and market valuations higher. So returns generally are more and more difficult to get. In this environment people will jump on *anything* that looks like it carries a big return, even if it entails a lot of risk, whether it's junk bonds, emerging market debt or things like CDOs that are reflecting very difficult to measure risk in the home mortgage market. One of the things about risk diversification and financial innovation that enables us to spread that risk to a wide number of holders is that it also obfuscates the original risk. It's not like the old days when the local bank knew their loan customer, knew what their income was and could make a reasonably sound judgment about whether they should make a loan.

We're about as far from those days as we could get–
There's a great deal of overconfidence today because people have been so impressed–as I have been–by the willingness of people to continue to buy up these very risky pieces of the mortgage market that it seems as if *nothing* will ever shake them. It *seems* we can consider that the economy is, in essence, *protected* against the risk that we'll see a pullback in funding from the mortgage market.

Isn't that akin to believing in a perpetual motion machine?
That's my point. That is how it *seems*, but it seems like that in much the way that it *seemed*, in early 2000, that the internet bubble would last forever. I well remember how people who were bears on the stock market back then and called it a bubble–and we certainly count ourselves in those numbers–were looked at as lunatics. The temptation was enormous to just shrug and say, "This thing has just got a mind of its own."

And throw in the towel–
Yes, but in fact there's a basic fundamental principle which is that unsustainable trends end–

As Herb Stein said, "If something can't go on forever, it will stop."
That sounds like a Herb-ism, one of the funniest guys I ever met, as well as a wonderful guy and a brilliant guy. The thing is, it's just human nature to believe more strongly in a trend the longer it continues. So what happens when an unsustainable trend continues is that people find more and more reasons to believe that it's *not* unsustainable. I don't know what's going to crack the credit markets, but there are a number of things on the horizon that could start to undermine lenders' sense of invincibility and the aura of a lack of risk in mortgage markets.

It's not just in mortgage markets. CFOs, according to a recent issue of *Institutional Investor*, have fallen in love with Wall Street confections *with maturities of up to 30 years* but repackaged as short-term paper, all for a yield advantage of 25-40 basis points.
That just shows, again, how difficult it is to operate in a big-balance-sheet economy. It's a tremendous problem for anyone who's got any cash or assets to figure out how to generate a return that meets objectives. I don't think this environment changes until people become more worried about *conserving their capital* than they are about earning return. So as long as the economy and financial stability are holding up reasonably well, money will chase just about anything. We see that happening in commercial real estate now, in various forms of high-risk debt; in money rushing into emerging markets. Why has the cocoa market been so volatile in the past year? Why has the copper market been so flooded with new participants that speculative demand has swamped fundamental demand at times? It's all because there's a lot of money that can't find a sound place to go and is taking risk to chase capital gains.

Exactly.

Again, it's a direct outcome of that fundamental change in balance sheets. We now have an economy that–because of its levels of debt–*needs* to have relatively low interest rates, or it breaks down. We are somewhere in the process of beginning a breakdowns now. In each cycle, we have more debt and it's even harder to support high interest rates. But if you have lower interest rates and higher asset valuations, that means that rates of returns are lower. So if you are looking for 1980s-type of returns and at targets of 8%- 9%, which were doable during the stock market boom, it's getting a lot trickier to find traditional ways to put money to work that will give anything near that.

The investor's lament. So now what?

Well, if one understands this environment, there are some great opportunities. And, after this mess corrects itself, we will have a much healthier and more appealing environment for long-term investment. But right now the most important thing is to understand the nature of this expansion–and *how heavily* it has depended on housing. That is what people don't fully appreciate.

Consumers whistled past the last recession with barely a blip. So why get all hot and bothered now?

In essence, because the problems in that recession were focused in the non-financial corporate sector–and because of that, those corporations actually have *finally* begun what I think will be an enduring process of moving toward lower overhead, reducing debt. Sure, there are cyclical and other exceptions. But overall, non-financial corporations have started the process of shrinking their balance sheets relative to income. On the other hand, the balance sheets of the household sector, which by and large didn't have to go through that recession, as you said, absolutely took off. The combination of having the most dramatic swing in fiscal policy since World War II, going from surplus to huge deficits for a while, which put just enormous stimulus into the economy, and of the the low interest rates that got the housing boom going, eventually coupled with the financial innovation that enabled the housing boom to take on a life of its own, even after financial conditions started to change, proved enormously stimulative to consumer balance sheets. The problem is that people don't recognize how important–and abnormal and unsustainable–these financial conditions were. But what is going to break the bubble is the deterioration of the housing market itself. Things that are starting to happen as home prices fall. First of all, in some of the more troubled markets, there already are major problems with home equity going negative. Because it is *very* difficult to refinance such property owners. I grant you that many banks *will* in fact overlook the loss of equity and try to refinance mortgages just to keep their reported problem loans down, but that becomes more and more difficult for them to accomplish when equity goes negative.

How can you measure that, if the banks are doing their darndest to avoid reporting problem loans?

If they can create a new loan and give someone some extra cash in the process, the lenders should be all right at least for the time being. But it also depends on the volume. If you get to the point where you have an epidemic of problem loans, like we've seen in the past, for instance at the Bank of New England, or in the savings & loan industry (which also had a whole set of other structural problems), there comes a time when the losses mount up to a point that they can't be discreetly dealt with. One of the other things that is interesting to watch is the regulatory response, which is a classic case of shutting the barn door after the horses have escaped. The Fed and other federal bank regulators, with what I would describe as "anti-publicity" very quietly issued a joint letter of guidance on nontraditional loans on Sept. 29, which basically says that you should not lend to someone with an interest-only loan or an option ARM, if they can only make the initial payments and are not able to pay off the whole loan based on normal sound credit evaluation standards. [Available at http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/attachment1.pdf.]

That doesn't exactly sound radical, I have to say.

Precisely. But the proposal to take this step was introduced in the summer–*of 2005*. The Comptroller of the Currency pushed for this the most, as best we can tell. But the process took a long time. They finally issued a study draft in December, then extended the study period, and only now have they issued issued their guidance, albeit with very little publicity. There was much more attention paid to the draft being issued the previous December.

Actually, I presumed it was pretty much a done deal when they issued that draft.

No, they were just asking for comment back then, and it's unclear how much jawboning has gone on in the interim. We *do know* that that there is still some very strong option ARM lending going on. Some institutions still have a heavy reliance on it. That's not to say that they couldn't lend this way under this guidance letter, or that there aren't sound uses for option ARM loans, but they are clearly being used by a much broader section of the population than really ought to be in them. We don't know to what extent the regulators' letter will lead to any tougher enforcement. Whether it will cause some reduction in the availability of these loans; whether it will be an abrupt change, a gradual change, or a minimal change. But it's yet one other element weighing on the market. Then we also have the cumulative effect of rising interest rates or at least higher interest rates, assuming they don't go any higher. Higher rates have a cumulative effect on household finances. As more resets occur or as people continue to pay higher rates of interest, which erode the cash they have available, we increase the pressures on the household sector and make it more and more difficult to maintain low rates of default and delinquency. At some point, these factors, plus the slowing of the economy, and possibly other things that we can't anticipate, such as something that might cause a change in attitude about buying the CDOs that ultimately are financing much of the mortgage boom, will create extreme pressures on this bubble. We just don't know exactly what or *when* that will be. But as time goes on, the pressures build.

Do the banks *have* to abide by the regulator's "guidance" letter? Or is there a lot of wiggle room?

It's not clear to me. What *is* clear is that there are some conflicting influences at work. First, putting it down on paper that one should not make certain kinds of loans all by itself has some impact. It's a little bit like driving on a road that used to have no speed limit posted. If someone puts up a 55 limit, even if you don't think there are any cops around, you may drive a little more slowly and carefully. In addition, there are at least some regulators, probably most notably the Comptroller of the Currency, who will be more aggressive in pushing this. How and when this then spreads to the state regulators of some of the mortgage banks–these are questions that have to do with human dynamics, politics, etc. I think there will be *some* effect, but I would hesitate to say this is going to be *the* killing blow for the bubble.

It's after-the-fact, as you noted. The bubble is already deflating.

That's right. The housing market bubble could not be sustained even *with* all these exotic mortgages. They *were* able to take the prices up to a certain level–but then we just simply could no longer supply enough buyers able to pay those prices. Maybe, if someone had gone to the next step and invented a 40-year, zero-payment, balloon mortgage–where

people would basically have had no debt until they either sold the property or lived there for another 40 years–the bubble could have gone farther. But nobody did. We finally seem to have hit some kind of a limit. As a result, the market has begun to loose some steam. And as it has been loosing steam, the psychology has changed. Buyers have learned to wait it out and sellers have become a little bit more anxious.

Still, as I said at the outset, there's a growing belief that housing has bottomed–

One myth about the housing market is that its recent troubles reflect the fact that we've been working through a wave of speculator selling. The evidence is that the speculators actually may have been doing *a little less buying,* but they're not doing a whole lot of selling. This is typically the case when small investors pile onto the last leg of a bubble. They're the last ones in and usually *not* the first ones out. One piece of evidence is the University of Michigan's Consumer Sentiment Survey, which asks people whether it's a good time to buy a house, and if so why. The percent saying that it is a good time–because it's a good investment –hit an all-time high in 2005 and has not come back down very much from that level. These people are still maintaining hopes and, anecdotally, if you talk to people who bought a condo in Florida or Las Vegas or one of these places, many of them are *holding and hoping*, rather than saying, "This is not going the way I expected. I'm dumping my position in this market right now." What *is* happening is that speculators–who probably signed contracts to buy a year ago, but now find that what they would be paying as the balance due to close the transaction would be more than the market value of the home–are walking away from those deals. But we are not seeing a whole wave of selling by people who already own these things. People in general are often paralyzed when they are not sure what to do in a market like this. So I don't expect real estate to fall off a cliff; it's more likely to become a relentlessly bad market over a long time. So eventually the cost of holding the property or–

Taxes, insurance, maintenance–

All those things will push them more and more to sell. But then many people will be constrained by what their debt is on a property and how much they put into it. All too many people, I suspect, will be stuck in a situation where they really cannot sell without having to fork over a lot more cash to pay off their mortgage. The main take-away from this is not to think we're merely working through a temporary problem in housing caused by speculators. What we're dealing with are fundamental problems with the valuations in the housing market, with its expectations about volume in terms of growth in home ownership and with a very painful correction that will take quite a period of time to work its way out. In other words, we see an extended hangover, similar to those in 1991-1993 and 2002-2003; one that will correct a significant part of the private sector's balance sheet bloat and move the economy closer to a new era with the potential for more stable financial conditions and a strong, healthy economic expansion and prosperity.

So where are the good opportunities that implies?

Let me be clear: I am wary about most asset classes today. But I do expect some exceptional opportunities to develop at or after the next business cycle trough. Until then, the No. 1 opportunity over the next couple of years is going to be in capitalizing on declining interest rates. As these financial problems we have been talking about come to a head and as the economy starts getting to serious trouble, as it falls into recession, the Fed has only one recourse. Chairman Bernanke has clearly written and reiterated in his statements that if there is a crisis he believes in acting aggressively–much as Greenspan did during the last recession (although not during the recession of the early 1990s). As a result, we will see a dramatic drop in interest rates–

Excuse me, but they're not exactly sky-high now.

Exactly. At that point, for the first time in a quarter century, it's not going to be possible to put rates *well below* where they've been; to take them where they've never been before, creating refinancing opportunities that no one has seen the likes of for a long time. Once you've been at 1%, you can go to a fraction of that, I suppose. But since the Fed Funds rate was at 1% only a few years ago, people who bought homes and took out mortgages then are not going to be in a position to refinance. Meanwhile, people who took out an option ARM or an interest-only may have a great deal of difficulty because they will not get the same instruments with narrow spreads and cheap rates, if they're able to get them at all. A refinancing bonanza will certainly be there for some, but it's going to be complicated by much less accommodating financing.

Okay, so a rate cut won't be enough to reflate the bubble. But certainly it could be able to ease things enough at the margin–

One problem that a rate cut won't cure is the fact that consumers have an enormous amount of debt and will have to *reduce* that debt, rather than increase it. And the process of reducing debt is a drag on the economy.

It's just a drag, period.

A *big* drag, in this case. We're talking about reversing the effects of the stimulus we had from having the saving rate drop as people first enjoyed wealth effects from the stock market in the 1990s and then added a lot of borrowing and then turned to a remarkable degree to equity extraction. We're talking about reversing stimulus that added hundreds of billions of dollars, over a period of 10 or 15 years, to consumer spending. Putting it in percentage terms, we're talking about the difference between consumers spending 92% or 93% of their incomes and spending 100% of their incomes. That process cannot continue under the kind of financial circumstances we see coming out of the problems in housing. The consumer is going to be forced into not only a recessionary pullback in spending, but what we think will be a *secular pullback* that is going to have implications for the construction of retail buildings, for business expansion, for businesses' attitudes about their prospects. I expect a difficult period as we work through this. The good news is it is a healing process. The U.S. economy, while it may have a rough time during the recession–and may have to struggle through a hangover period after it (as it has after the last two recessions, instead of bouncing back quickly), will offer some wonderful long-term opportunities when pessimism reigns. And there will also be international opportunities, once we get through some of these adjustments.

Tell me about some of that good news–

Well, for one thing, some of the trends that we're aware of now and that people are excited about will only become more compelling with time. I'm talking about the need to change to more efficient kinds of and uses of energy, using communications to substitute for transportation in more ways. We are only just beginning to see people use technology, for example, to avoid having to send service people into the field to check machinery, find problems, find parts, and get something fixed. We're starting to design machines with the ability to communicate directly to the manufacturer and provide the information needed to analyze problems, so they can be fixed without involving a lot of service calls and transportation. There will be all kinds of new business models. Manufacturing, not this year, not next year, maybe not even in five years, but over the next generation, we're going to see reviving in the U.S. as labor costs become much less important and logistics, proximity to markets, become dominant factors. There are all kinds of issues involving environmental concerns and limits to resources that should eventually prove to be investment opportunities and stimulants to the economy, not drags. It's when we invest in new technologies to get around obstacles that we create wealth and stimulate our economy. It's not so much when we don't have to make any changes because everything is wonderful and can stay as it is.

But for now, you're staying on the defense?

We've got a few years before those opportunities develop. I still think one's

main stance should be watching carefully and preparing to become defensive –if not to be defensive right now. Look, as long as the economy holds together even moderately, there are going to be areas that will continue to boom. Money is finally coming back in the stock market–whether it's just because people, having partly exhausted all other possibilities, are hoping maybe it's safe to finally go back into the water, doesn't really matter. But that money flow could dry up pretty quickly if earnings start to become a concern. I don't want to suggest that there aren't strong fundamentals in some markets. But even in an area where the fundamentals are strong, one has to be concerned about the high probability that we will have a painful correction as a result of the deflation of the housing bubble.

Couldn't the money flowing back into stocks now help to defuse that risk? That's a favorite theme of the Goldilocks crowd.

There is a rotating flow of funds from one asset class to another which kind of dovetails with the rotation of sectors. "Housing is weakening but that doesn't matter because nonresidential building is taking off and business investment is still strong and maybe our exports are strong." The problem is, if housing is slowing–residential investment peaked at over an $800 billion annual rate at the beginning of this year. By contrast, investment in nonresidential buildings, is about $300 billion at an annual rate.

I'd call that a sizeable gap.

There's a mismatch there. There is actually a higher level of overall nonresidential investment, but a big chunk of that is investment in oil rigs and oil exploration. And while that will stay strong, it had a *huge* rise following the Katrina disaster and the panic that ensued. So it's probably not going to grow quite as fast as it did earlier. The other thing that can make a huge difference is the personal saving rate. We've been in a long period in which it's only gone one way: down. But it has *finally* started to bottom out over the last year. Every time the personal savings rate drops by a percentage point, that means consumption will grow 1% faster than income. That represents, on the scale of today's economy, about $100 billion of extra consumption. A very big chunk of change.

So without that stimulus, you're implying–

What's particularly important when you analyze the flows of funds that account for a corporate profits (something that very few people know how to do, but what we've been doing for many decades) you realize that it directly influences business and then ultimately profits. It's the difference between what business pays out in wages and salaries and what comes back in as revenue that determines profitability. Profits depend on how many other sources of revenue there are, such as investment in new housing which is financed by banks or in other ways, but they also depend on how much consumers decide to hold onto and not bring back to business cash registers as revenue. In the typical recession, we *used to* see the saving rate rise by a couple of points. But we have not had one of those "typical" corrections since this long downward trend in the saving rate began during the 1980s. We have not had a really serious consumer pullback. This time, however, I think we're going to have at least a typical consumer pullback, if not a more pronounced one. That means that within the space of perhaps just a couple of quarters or maybe over a year, we could see hundreds of billions of dollars of consumer spending pull away. We could actually see consumer spending growth come to a halt, even with income growing. And that's bad news for profits, bad news for the economy.

That makes you pretty much of an outlier, among economic forecasters–who pretty much expect corporate profits, which have been great, to stay that way.

Well, corporate profits clearly had a great revival coming out of the mess of the 2001 recession and its aftermath. There's no question that, focusing on non-financial business, margins are the highest they've been in many years. There's a lot of legitimate strength there. However, the profits that are being reported–let's say that I think that companies have found ways to get around Sarbanes-Oxley. We are still seeing strong evidence that profits–operating profits in particular, are being significantly overstated. When a lot of bookkeeping magic is being performed to keep profits looking healthy, earnings shortfalls will tend to become more of a factor as the economy slows down, because true earnings haven't really been growing as fast as people think.

What evidence are you looking at?

If, for instance, we look at something like the S&P's measure of core earnings, which they designed to try to get a better sense of what they think *really* are ongoing operating expenses, that measure has actually flattened out quite a bit in the last two quarters. I'm not saying it is a *perfect* measure, but it's telling us something. Also, if we simply look at the way businesses behave, we don't *usually* see the kind of drop in executive sentiment that is reflected in the slowing rates of growth in capital spending and in employment that we've seen over the last couple of quarters when profit margins are hitting one new multi-year high after another. Business is usually euphoric in that environment. So I think that underlying business conditions are not quite as strong as they look. They were very good through 2005, but we're in a process where they've been plateauing and margins are starting to narrow and so we're overall headed to a less favorable trend.

Can you specify what accounting magic is being conjured?

I'll preface this by saying we did a fairly extensive bit of analysis on this in the late 1990s because we became aware, in the mid 1990s, that something was wrong between what companies were reporting and the way the economy seemed to be behaving. One of the things we discovered at that point was that operating earnings were running *way ahead* of net income–even though, according to IRS data, companies were reporting unusually high *net* gains on sales of assets, which suggested that across the broad sweep of the S&P 500, we should have seen net income even higher than operating earnings. That indicated people were finding ways to bury what should have been counted as regular operating expenses in one-time charge-offs, either prepaying with restructuring charges or finding other ways to make after-the-fact adjustments. I don't know that any part of Sarbanes-Oxley prevents someone from making an estimate of what their future expenses for restructuring will be that turns out to be inaccurate. There's just too much uncertainty. It's very easy, for example through restructuring charges, to prepay operating expenses. I can't say exactly what is being done, but the overall figures do not fit what's happening in the economy. We continue to see net income running *way* below operating earnings, which means that something is quite distorted.

You can't be more precise?

Well, one place I think we'll ultimately see a huge change is in financial profits, which have really been distorting the corporate profitability statistics. I was careful to talk earlier about profits in the *nonfinancial* corporate sector. But let's talk about our favorite subject, the mortgage market. In part because it's difficult to generate enough earnings through the old-fashioned process of making mortgage loans, holding them and earning interest on them, originators have taken to selling most of these loans, which has the advantage of enabling them to make an estimate of their expenses and future losses and book profits up front.

So their "profits" are only as good as those estimates turn out to be.

Exactly. So, if the housing slump becomes, as we expect, quite severe, losses will increase and many of those earnings that we've been seeing over the last few years will be restated. One of the questions we're asked most frequently by our clients is who is going to take the biggest hit when the mortgage market gets into trouble–

Good question. There are long tails almost everywhere you look.

It's a very complicated story. The tentacles run here, there. The process of spreading risk means you don't know where there's a Long-Term Capital Management or an Amaranth or a bank where the mortgage banker's accounting control system has completely broken down or was side-stepped. There are so many ways in which this thing could affect financials, it's very difficult to say. But it's fair to say that the effect will be broad, that those in the mortgage-lending business will at least have a much weaker market going forward. What balance sheet problems they experience will depend on how much of the remaining risks are either on their books or they're liable for in one way or another.

So how can an investor take advantage of all this—besides fading the mortgage brokers?

Clearly it is going to be a huge process to work out these problems. What we don't know is what role the federal government will play. But there likely will be considerable pressure on Congress to *do something*.

You think?

Inevitably. It's one thing to talk about problems in the corporate sector and shareholders losing money, even employees being laid off. But's it's definitely quite something else again if it comes to many people actually losing their homes and many, many more actually becoming afraid that they might lose their homes. In that situation, we'd probably see a "Homeowners Protection Act," or who knows what it would be called, which might provide some federal money or protection or some process for stabilizing the situation. Then again, if that does happen, a legislative solution will take time. So what intermediate steps the Fed and other regulators might take, how they might stabilize the situation, who knows. The only thing that is a sure bet is that at that crisis point, the Fed puts interest rates to the floor.

But not *before*?

No. They are stuck being on guard against inflation. They have to be very careful not to cut interest rates in a way that would give the economy more momentum and simply intensify or complicate the problem of slowing it down. So they only want to cut rates when they're quite sure that the economy really is at risk and that they are moderating a slowdown or easing the pain of a recession and not actually reaccelerating the economy to an inflationary pace. Ironically, if they actually see some inflation numbers or something that scares them, which is quite possible, and decide to make another tightening move, that might very well be a trigger that accelerates the demise of the big-balance sheet economy.

So the Fed could pull a Japan and zig when they should zag?

It's a complicated question whether the Bank of Japan did the wrong thing. Implicit in the assumptions of its critics is that there was some *nice way* for Japan's bubble to burst; to shrink its massively excessive balance sheets. I don't think so. It took a long time, but they didn't have a Great Depression; they held their society together; they allowed their businesses and banks to clean things up. Should it have been done faster? Sure. But by and large, they avoided a much more severe disaster. Now, I'm very bullish on Japan. Their biggest problem is that they're on the same planet with all the rest of us and so will be affected by problems here. But Japan's corporate balance sheets are now in great shape, and they're still world leaders in many technologies. Japan is one of the first economies likely to really prosper in what should be a happier period of more reasonably-sized balance sheets.

While the U.S. lags?

Keep in mind that the U.S. has the strongest economic and government institutions in the world. We may not believe in who's running the country at any given time, but Americans have a great deal of confidence that it will endure. Unlike the Japanese, we tend to take the bull by the horns a little bit more when we have financial problems. I'm sure there will be some foot-dragging and obfuscating and politicking and foolish things done, as happened during the savings & loan crisis. And it *was* inefficient in some ways, but the fact is, we got through it, we didn't have runs on banks. Our system isn't perfect, but it does take care of problems. I don't want to underestimate how difficult and long the adjustments may be, but the process will lead to a much better period.

But nearer term?

Unless there is some way found to prolong the financial shell games and the mortgage market can continue to grow for a very long time, we are just starting the process of transitioning from a boom to a recession. The tendency will be for the economy to weaken over the next 12 months, most likely in the first half of 2007, and once we're in recession, it will tend to last longer than average. We may actually, given time, get some modest deflation in this cycle. Generally speaking, we're expecting to see more surprises; things that are not like past cycles. Again, this is because people have been so motivated by financial pressures to find new ways of trying to make money, new forms of lending or new forms of investing, that the unwindings may create unfamiliar patterns. So one should *expect to be surprised* and expect that some of the things people are most confident in–particularly the stability and strength of corporate profits, the stability of household finances and the persistent strength of consumer spending–may change in surprising ways. After all, one of the things we've found lots of ways to do with all the derivatives, hedges and complexity that have been layered onto the mortgage market–along with diversification of risks and disintermediation –is magnify the systemic risk in the process of trying to magnify returns.

***Wonderful.* Thanks, David.**

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