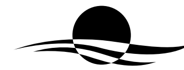
# Growth STRATEGIES

*Trend Analysis That Builds Business Decisions*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## 1 – ROGER'S POST ON THE PRESIDENTIAL ELECTION

My colleague Jorn Thulstrup, founder and president of the Institute for Business Cycle Analysis and publisher of the US Consumer Demand Indices, asked me to write a post for our subscribers on the coming Presidential election in light of the results from our most recent monthly survey. Here are my thoughts:

Our latest US Consumer Demand Indices (CDI) show a record high "Hesitation Index" (that is to say, 71% of American households have made NO decisions to buy ANY durable goods – from cars to toys – in the next three months). In August 2007, before the crisis, only 52% of households were in the same state of mind. So we are far from out of the woods.

Meanwhile, businesses are in a holding pattern, capital is on the sidelines, and the federal government faces a fiscal cliff at year's end.

We are at record levels of unemployment (both long-term structural and short-term cyclical), underemployment, disability claims, food stamp usage and debt (both governmental and household). We have the lowest workforce participation rate in 30 (or 60) years. Gasoline prices have soared, home values have dropped, and real estate and stock markets are being supported by extraordinary government intervention. It is hard to see how any President is reelected in this environment. On the other hand, consider:

We need pro-growth and business-friendly policies to put our economy back on the growth trend line; robust economic growth is the only way out of our employment, entitlement and fiscal nightmares. Do voters realize this, or do they accept that current conditions are the "new normal" – low economic growth, low employment growth, low income growth, high levels of dependence on government?

Even if they do realize that growth is desirable and necessary, do they know what policies will be conducive to growth, and which candidate or political party is more likely to implement them?

Maybe not. And maybe some parts of the President's and Democrat Party's coalition (minorities, youth, feminists, teachers, lawyers, university professors, the media, environmentalists, public sector employees, transfer payment recipients, etc.) do not care about growth, perhaps even find it distasteful. We shall see. But the election will turn on those questions, and the results will define our future.

## 2 – HOUSING FOLLIES

### REPORTING OR CHEERLEADING?

Media outlets act as cheerleaders when reporting on economic and housing market news, but this misreporting distorts reality and is deeply misleading. For example, *The Wall Street Journal* headlines, "Housing Market Displays New Vigor as Prices Rise," and writes:

> Home prices notched their strongest year-to-date gains since 2005, climbing 5.9% through July and signaling the housing market's steady trudge toward recovery. The rising prices in the Case-Shiller 20-city index could play a pivotal role in changing consumer sentiment toward housing and drawing in buyers from the sidelines. Another lure: Mortgage rates are falling to record lows after the Federal Reserve resumed buying mortgage-backed securities two weeks ago, helping to offset rising prices.

This reporting completely overlooks the fact that the housing market is an artificial, even fraudulent market, anything but a free market where inventory is allowed to clear and prices are allowed to find a clearing point. Obviously it is now public policy to keep home prices inflated (a welcomed gift for incumbent politicians, underwater mortgage holders, banks and the real-estate industry), but crushing to hopeful first-time home buyers. This policy includes record-low interest rates and controlled inventory (the shadow market of homes is immense, and is only slowly leaked out to market).

Even so, home prices nationally are only up 2.1% since last July. With headline inflation running 3.2% this means that inflation-adjusted housing prices are actually dropping.

Also, the Treasury Department recently announced it has changed the terms of its bailout agreement with Freddie Mac and Fannie Mae in a way that reduces the chance of receivership, which is where both belong. This ensures they will never become solvent or independent of the federal government.

What is now occurring is that the government pretty much dominates the entire mortgage market. Including FHA loans, the Government now guarantees about 90% of all mortgage loans (up from 30% in 2006). What was supposed to help increase responsible home ownership has had the opposite result.

As Dan Murphy writes on nationalreview.com:

> The FHA's increased market share has not been a good thing for taxpayers. One-sixth of all FHA loans were delinquent as of August 2012. This translates to over 1.2 million borrowers who have missed at least one payment. Even more ominously, 58% of the delinquent loans were "seriously delinquent," which means that almost 10% of all FHA borrowers had missed three consecutive months of payments or are now in foreclosure.
>
> These and other facts undermine reports that the housing market has finally turned a corner. Claims on defaulted single-family loans have been steadily rising over the past four quarters. What's more, the FHA's insurance fund paid $5.3 billion in claims in the third quarter of fiscal year 2012. As a result, the FHA's cash flow has turned negative. Remember, you, the taxpayers, are ultimately the FHA's insurance fund. You paid out $5.3 billion in claims this quarter, and you now have a negative cash flow. You and your housing fund are broke, and no one even bothered to tell you.

## FORGET ALL THE HOUSING COMEBACK TALK

Here's why the housing market is still a disaster, write Matthew Boesler and Mamta Badkar on bussinessinsider.com:

- Expectations for higher home prices have been declining in recent months.
- Revisions to housing starts have turned negative.
- The number of people applying for new mortgages has yet to climb.
- The shadow inventory is still at extremely elevated levels.
- In some markets, banks are selling less of their inventory of unoccupied houses. So it will take longer to clear out the shadow inventory.
- The amount of time it takes to process a foreclosure is rising, which is another sign that shadow supply is being held off the market.
- In some markets, like Illinois, foreclosures are on the rise.
- In New York, pre-foreclosure notices are surging.
- In California, mortgage delinquency rates are staggering.
- Price per square foot is down in almost every major market in the northeastern US.
- Delinquency rates are staggering in the 15 worst major metro housing markets.
- If loan modification programs don't pick up, subprime mortgages in foreclosure will continue to surge.

- Re-defaults on mortgages modified between 2008 and 2011 are rising.

## OUR FAVORITE HOUSING ANALYST

One of our favorite sources of housing market research and analysis is www.doctorhousingbubble.com. The blogger makes some excellent points in recent posts:

**Government policy favors the wealthy**

One of the biggest ironies of current housing policy is that its initial target was in helping middle class Americans when the actual results have helped upper middle class and wealthier American homeowners get sweeter deals on their home purchases. The fact of the matter is current low rates and government guarantees of massive mortgages have aided wealthier Americans to purchase more expensive homes. So what, you may say? Well, these loans are heavily subsidized on both ends. First, the interest rate is low courtesy of the Fed massively buying up mortgage-backed securities in the market. Next, many of these homeowners max out the interest tax deduction on the back-end. Homeowners with more modest abodes don't get that big of a bang for their buck once you factor in the typical standard deductions.

**Managing the shadow inventory**

At the peak in 2009 and 2010 we had roughly 6 million homes in the shadow inventory pipeline. The good news is that this has been slowly winding down. The "throw everything" at the wall approach has supported this wind down by:

1. Dropping mortgage rates to historically low levels (at the cost of the Fed increasing their balance sheet to nearly $3 trillion).
2. Constraining inventory (the slow leaking out of shadow inventory is possible courtesy of banks having the ability to re-write accounting rules, for example suspending mark-to-market and taking years to move on non-performing loans).
3. Drop in home prices (home values across the nation are looking better in relation to rising rents, especially with absurdly low interest rates).

The Fed is trying to use housing as the catalyst for another economic recovery. Yet with 30-year fixed-rate mortgages in the 3% range, and FHA insured loans requiring only a 3.5% down payment, you really can't get any more leverage unless you bring no-doc loans back. We would feel better if home price increases were occurring because of rising household incomes. But US households are facing more than a lost decade of household wage growth. Remember, we still have over 5 million Americans that are in distress on their mortgages.

**Young and living at home**

The trend for young Americans is unmistakable when it comes to housing. The US percentage of 25-to-34-year-olds living at parents' home has increased to 14% (compared to 10% in 2003 or 1983), while the homeownership rate of the same group declined to 38% (from 43% in 2003).

This is an important trend to recognize because it highlights that many of these people are not seeking rentals let alone homes to purchase.

**Fed targets employment via interest rates**

The Fed has some lofty goals in pushing the unemployment rate lower.

Their longer run goal is to get unemployment down to 5.2% but that seems like a very difficult task to accomplish merely by buying up mortgage-backed securities and guaranteeing the entire mortgage market. What will this really do? Well, first of all it will funnel more economic activity into housing but is that necessarily good? No, that's mal-investment.

Ultimately, the financial sector and government sector are one and the same. The Fed has stepped into deep uncharted waters. According to economist Lawrence Lindsey, with purchases of $40 billion a month in mortgage debt, the Fed is virtually funding the entire US deficit. If this becomes the new ordinary, it's hard to imagine the Fed's maneuvering room should another crisis hit.

Worse, the central bank's recently announced bid to stimulate the economy has also taken the pressure off politicians to deal with the US fiscal cliff, Lindsay argues, which could result in destabilizing tax hikes and spending cuts automatically taking effect early next year. The effect of QE3 on interest rates may also keep Congress from reining in borrowing. Why would any Congress not borrow and spend if they could borrow at 60 basis points?

## WHAT IF HOUSING DECLINES FOR A GENERATION?

A strong case can be made that the fundamental supports of the housing market – demographics, employment, creditworthiness and income – will not recover for a generation. It can even be argued that housing has lost its status as the foundation of middle class wealth, not for a generation, but for the long term.

So writes Charles Hugh Smith.

He begins by noting that despite the many tax breaks lavished on housing – the mortgage interest deduction, etc. – there is nothing magical about housing as an asset. That is, its price responds in an open, transparent market to supply and demand and the cost of money and risk. There are a number of quantifiable inputs that feed into supply and demand – new housing starts, mortgage rates and income, to name three – but there are other less quantifiable inputs as well, notably the belief (or faith) that housing will return to being a "good investment," i.e. rising in price roughly 1 percent above the rate of inflation.

If this faith erodes, then the other factors of demand face an insurmountable headwind, for the most fundamental support of housing is the belief that buying a house is the first step to securing middle class wealth.

Rising rates of home-ownership require five conditions, continues Smith:

1 Favorable demographics: A cohort of potential buyers that is larger than the cohort of potential sellers.
2 Rising household formation rates: An expanding population does not necessarily translate into rising rates of household formation. If the number of people per household goes up, then the number of households can plummet even as population expands.
3 A large cohort of creditworthy potential buyers: That means buyers with savings, buyers with sufficient income to pay the mortgage and buyers with low debt loads.
4 An economy that generates rising incomes to support home-ownership.
5 An unshakable belief that owning a house is a favorable and secure investment that will rise in value in the decades ahead.

If the first four conditions have eroded, then the belief in the permanence of a rising housing market will also erode. And they all have in fact eroded: the demographics are not favorable to housing on a number of fronts; household formation is in a long-term decline; labor's share of the national income has plummeted to historic lows; income has declined, especially for younger workers.

What few are willing to entertain, concludes Smith, is the possibility that housing is no longer the foundation of middle class wealth, and that its decline is structural, not cyclical.