Newsletter July 2011




Welcome

Dear readers,

It sometimes seems that nothing changes except for the seasons and the weather but we are at a crucial crossroad economically and there are certainly things worthy to write about and pay attention to.
I will focus on the status of the deficit and the debt ceiling in general but also on the future of the housing and rental market in particular.
Another topic of interest is of course the financial turmoil in Europe and the Greek dilemma in particular and what this may mean for the Eurozone.

Happy reading,

Nick Doms

Content

The Housing and Rental Market

The latest news coming out of the housing market is less than encouraging and that may be an understatement.

A further decline in housing values of 5%, 1.5 million homes in shadow inventory, 2 million mortgages that are underwater and a decline in sales are not exactly signs of a stabilized market, let alone a recovery.
Some may think that the above is a pessimistic view of the current circumstances, but I call it pure realism since I have said many times that I do not believe in nor subscribe to sentimental optimism.

Robert Schiller, the prominent Yale economics professor and co-inventor of the Case-Schiller housing index, recently pointed out in an interview that Americans have been led to believe that by buying real estate that such would become their nest egg for the future because of the equity generated over time.
Mr. Schiller further pointed out that Americans have put all their eggs in one basket and if the basket breaks then all the eggs are gone or broken.
That is the case today and I will add from my perspective that many Americans are merely looking at a simple omelet that will not gain its value again over the next 10 to 15 years.

The above is based on the assumption and calculation that if the housing market were to stabilize in 2012, that an annual increase in value that equals the prevailing inflation rate would amount to 3% or 4% at current levels.
One can easily calculate how long it will take for home values to reach the outstanding mortgage obligations for 2 million Americans and if such is the case then there is still no profit or equity to talk about, it is just playing even at the end.
That certainly was not a good basket for most home owners.

So why are the low mortgage rates not capable of reviving or even stabilizing the housing markets then?

Low mortgage rates have only a minimal impact on buyers' sentiment when placed in a continuous declining market. The risk of declining values far outweighs the benefit of low mortgage costs.

Secondly, sellers are not inclined to upgrade to a bigger or better home in this uncertain environment and other homeowners are praying that they will be able to make the next payments and stay put if they can.

The turmoil in the housing market certainly has a trickle down effect on another important market: the rental market.

As many owners cannot or do not want to sell their homes in this depleted market, they turn to the rental market instead, at least temporarily.
While this may have a negative effect on the vacancy rates, it also provides opportunities for smart landlords that know how to create value and incentives for their residents while slowly increasing their rental income.

A warning sign has to be given about this though. Should the rental market become overvalued as the housing market was in 2007 without proper justification, added value to the property and the right incentive for potential residents, then we risk a collapse of the rental market in the next few years as the housing market slowly attracts new and careful buyers.

In essence, this is a game of chess and patience that will or may ultimately reap benefits for both parties involved as well as property managers but only with the right strategy and the correct focus.
Quality of service, maintenance and renovations of rental properties that adhere to the demand and wishes of potential residents will be key to the success of our existing rental market.
That in turn will attract new investors to the market and may reduce some pressure off the housing market, at least for homes or properties that are suitable for renting.

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The US Economy

The latest speech of Mr. Ben Bernanke, Chairman of the Federal Reserve, had a slightly different tone than the last one two months ago.
It was less optimistic, more subdued and more careful than before and there are good reasons for that.

Monetary policy can only do so much to revive an economy and when the fiscal policy does not cooperate or even contradicts the monetary policy, then there are no more bullets left to fire to try to win the war.

We are now sure that QEII will be reinvested endlessly and we may as well call that a mini QEIII. The zero interest monetary policy is here to stay for an extended period and that is where the real danger lurks among other things.

The US economy is growing but at a much slower pace than expected or predicted this far into the financial crisis. Here are some of the data to take into consideration.

-GDP growth stands at 1.8%
-Unemployment officially stands at 9.1% but in reality it is as high as 17.5%
-Corporate margins are dwindling, primarily in the small business sector
-Private equity is nowhere to be found because of uncertainty about future tax rates
-The budget deficit remains persistent with no solution in sight
-The debt/GDP ratio keeps climbing and the debt ceiling will have to be raised to at least $17 trillion for the government to meet its obligations through 2012-2013
-Manufacturing and production remain low
-Investments in infrastructure are absent

This may be the dose of reality we really need in order to start turning things around.

Monetary policy has done its job as best as it could but if the fiscal policy does not start catching up and doing its fair share, then the US economy will be lagging for a long time to come.
This means we will be falling further behind within the global economy and that is not good news for the average American.

The other bad news is that while the CPI/PPI may seem under control, food prices are under pressure because of rising commodities costs which in turn will put an extra burden on disposable income, hence less consumer spending, hence less economic recovery.

We are finding ourselves in a vicious circle after 4 years of recession or financial crisis, depending on who you ask, but the question should not be whether we are at risk of a double dip recession.
The reality is that independent of whether someone declared the recession to be over mid 2009, we are still all living and breathing it, so it is a continuation of the same.

The second quarter of 2011 will not bring a change and we can expect to quietly close the year on the same snail's pace with slow growth, moderate exports and high trade deficits.

That brings us to an outlook for 2012.

Unless the housing market improves dramatically, and my prediction is that it will not given the number of negative mortgages, and unemployment improves combined with serious austerity packages and investments in much needed infrastructure, that 2012 will be a year of stabilization but not necessarily a recovery.

The second point I would like to make is that inflationary pressures will continue to rise throughout the year and well into 2012 which will demand higher interest rates from the Federal Reserve in which case Capitol Hill will have to get their house in order to absorb the higher cost of borrowing.

Overall, happy days are not coming yet but then again we can always watch reruns on cable TV and pretend we travelled back in time when we were driving a Cadillac to the diner or the drive-in movie theater.

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Greece is the new European Troy

Those of you familiar with the Iliad know the story about Helen, Troy and the Trojan horse from classical readings.
Today we may have a new Troy story that may be written about, only the names are slightly different.
Papandreou, Greek Prime Minister, plays the lead role and he is building a financial Trojan horse that may very well undermine the entire Eurozone.

For the second time in a row, Greece needs another 110 billion euro bailout package in order to avoid default and that is on top of the next scheduled tranche (27 billion euros) of the first bailout that was secured by the ECB/IMF early last year.

I know that Greek olive oil is considered to be the best in the world, but I never knew it would become so expensive.

The Greek problem is dual in nature. There is obviously a debt/GDP problem that has to be resolved with severe austerity packages and serious budget cuts.
There is also a very serious underlying economical problem which remains unaddressed at this point in time.

This is where the shoe no longer fits the foot and I don't consider Greece to be the new European Cinderella either.

The Greeks do not want to give up their social benefits and spend more time protesting in the streets of Athens while in essence they should be working and become productive to revamp their economy.

The EU approves a new bailout package with strings attached before the Greek Parliament even votes on the required implementation of further austerity measures. That is not only a contradictio in terminis but that is really the new Trojan horse.

In essence this is the child asking for money and mom or dad write a blank check demanding the child starts saving but with the child making that decision after receiving the check and all remains to be seen whether the child delivers on the promise but the check has been cleared in the meantime.

Greece can be very happy to have such giving and wealthy parents but it will ultimately have a negative effect on the entire Eurozone and specifically the PIIGS countries.

We know that not all is very kosher in the European house but Ireland will recover from its mistakes and Portugal is too small economically to really have a negative impact.

But, if this continued risk of default spills over to Italy and/or Spain then we are talking about a very different picture going forward. Both countries are the 3rd and 4th largest European economies respectively and the consequences may become dire.

The other thing to take into consideration is that the EMU was built on pure political power, not on economics and certainly not on a joint monetary policy. Add to this as a favorite topping that the euro is not one of the preferred reserve currencies in the world and one can easily start to understand the risk Europe is taking with constantly funding lavish Greek spending with no end in sight.

The second Greek bailout will prove to be another band aid on the wound but it will not be the cure that is needed to make the patient survive. In my opinion, Greece will again look at a sovereign debt default within three years, which means another bailout without proper restructuring and without austerity being implemented.

What would happen to Greece if they were to leave the Eurozone or even if they were forced to leave?

The answer to this question is simple and dual in nature.
Greece would immediately default on all of its outstanding debt and secondly, the Greek legacy currency would devalue itself by at least 40%.

That is the reason Papandreou is playing nice with the EU Finance Ministers even before he has convinced his own Parliament to ensure a vote on meeting the mandatory austerity measures.

But there is a little adder under the grass that may be important to watch: China and their interest in Europe. The future will tell.

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Money makes the world go around

If Liza Minnelli would only have known, she would probably have received the Nobel price for Economics by now.

The same can be said about Alexander Hamilton, the first secretary of the US Treasury and inventor of our national debt, because I don't think he was counting on trillions back then.

The size of our national debt in conjunction with our budget deficit are two fiscal impediments that cloud our economic recovery no matter what the monetary policy may or may not be.

Our debt/GDP ratio stood at 97% in 2010 and is expected to exceed 100% in 2011 which will continue to rise unless fiscal solutions are being put in place. That ratio puts the US very close to the likes of the PIIGS countries.

Should the rating agencies take such figures into consideration, then our US Treasury notes and bonds would certainly not be rated AAA but would deserve an A+ or even a BB rating at best. That would make borrowing more complicated and certainly much more expensive, and we can't afford either one.

Congress will soon raise the debt ceiling from $14.3 trillion to maybe $16 or even $17 trillion just so we can meet our outstanding obligations for the next year or beyond but that is just a band aid not a solution.

All of this would not be too worrisome if the money we borrowed would be used to build new infrastructure that would ultimately generate revenue, but such is not the case.
We borrow to either refinance, pay our interest due or to simply pay for all the social programs we have implemented, none of which is a revenue generator.

This the equivalent of an individual asking his/her bank to raise the limit on a credit card to spend more on trivial purchases without the prospect of ever paying anything back.
I don't think that would work but on Capitol Hill, anything goes for pork hidden in bills.

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