The Absolute Return Letter
June 2009

Green Shoots or Smoking Weed?

Can bubbles be managed?

Asset bubbles are strange animals. Ideally, you would like to punch the air out of them early before they become a real danger but, in practice, it is not quite so simple. Ben Bernanke and Alan Greenspan have actually both argued that asset bubbles cannot be detected and monetary policy should therefore not in any way be used to offset suspected bubbles[1].

I am not sure I agree with the two gentlemen, but that is less relevant for now. What is important to understand is what happens once the asset bubble bursts. In my experience, almost all post-bursting bubbles share two characteristics:

1) At the very least, asset prices revert to the mean, although many actually overshoot on the downside.

2) A long (and often painful) period ensues, where asset prices gradually claw back lost value. History suggests that this period is measured in years and sometimes in decades; *never* have asset prices recovered from a deflated bubble in just a matter of months.

The recent collapse of residential property prices – at this point still more advanced in the US than in Europe - is a classic asset bubble which is now deflating. The reason I have decided to write about it this month is because the 'green shoot' campaigners are missing a *hugely* important point about the effect that falling US property prices are going to have - not just on the US but also on the global economy[2].

Recovery will prove temporary

Make no mistake. I always expected and continue to expect an economic revival later this year, which unfortunately will prove temporary. There are many good reasons to expect such a short-term recovery, as I discussed in detail in the April issue of this letter. However, it is what happens afterwards that I worry about. The economic uplift is likely to last no more than one or two quarters after which we will have to face more gloom and doom.

There are at least two reasons property prices are so important to the overall economy. The first reason has to do with leverage. There has been a lot of talk about de-leveraging in recent months, and the consensus seems to be that most of it is now behind us. Perhaps, in the narrowest possible sense, that is correct. But leverage is not confined to hedge funds and banks. Many private households run heavily levered balance sheets as a result of their home ownership and it is this

[1] *See for example http://www.federalreserve.gov/boarddocs/speeches/2002/20021015/default.htm*

[2] *I have chosen to ignore the fact that property prices are now falling quite rapidly in many other countries as well. That only strengthens my case.*

leverage that is rapidly growing at the moment. Why is that? Because leverage is a function of both the numerator and the denominator and, as American home owners are about to find out for the first time, falling property prices can have a devastating effect on your balance sheet.

Secondly, property wealth has become an important part of many people's lives. In both the US and the UK (and in numerous other countries as well) many people have directed their savings towards property in recent years, and no small part of the profits have been recycled into the economy through equity withdrawal schemes. This has created a level of consumption which cannot be sustained if property prices do not continue to rise.

Property prices are down 32%

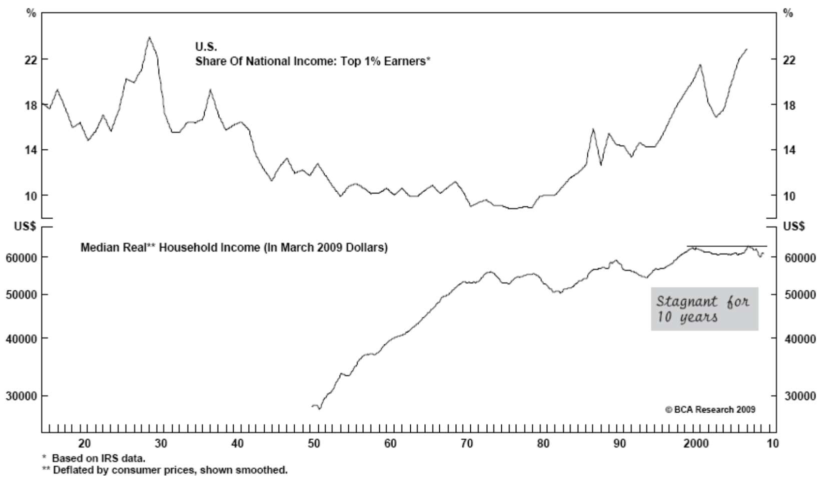
So let's take a closer look at US residential property prices which have been falling steadily for almost two years now. One of the better measures of that market is the Case-Shiller index. The index peaked in July 2006 and has since dropped by 32%. Now, in order to revert to the mean, US property prices must fall by about 40% or so in total. Therefore, with a bit of luck, those long suffering US home owners are about 75% of the way through the bear market.

But that is not the point I want to make. In December 2006, only a few months after the peak of the housing bull market, the total value of US residential property stood at \$21.9 trillion. Prices have dropped by 31% since the end of 2006, so the estimated value today is about \$15 trillion; however, the mortgage debt remains more or less unchanged and stands at \$10.6 trillion. In other words, whereas debt-to-equity in the US housing market was 48% as recently as in December 2006, it is now 70% and will rise to 80% once house prices have mean-reverted.

Wealth is extremely skewed

Although painful, a rise in debt-to-equity of that magnitude would actually be manageable if it weren't for the fact that income and wealth in the US is extremely skewed. The top 1% of income earners in the US account for a whopping 23% of national income while the median household has seen no improvement in income for the past ten years (see chart 1). Wealth is even more unevenly distributed. Almost 34% of all wealth in the US is held by the wealthiest 1% of the US population.

Chart 1: US Income Distribution



Source: BCA Research

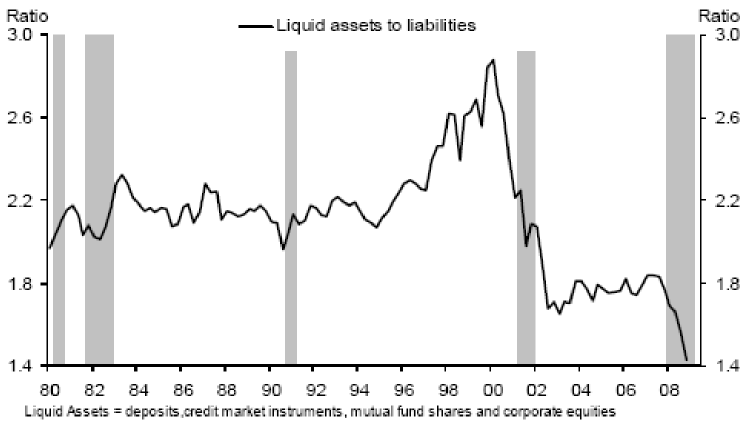
The same picture emerges when you look at home ownership. Almost one-third of all US households have no mortgage. If you adjust for that, the 70-80% debt-to-equity ratio suddenly becomes a major challenge because it means that the two-thirds who do have a mortgage already face a debt-to-equity ratio in excess of 100%. Even worse, once the mean reversion has run its course, two-thirds of US households will be facing a debt-to-equity ratio of 120-125% on average.

US consumers are broke

That is a shocking number and it blows a huge hole through the heart of the green shoots campaign so valiantly promoted by most of the mainstream media in recent weeks. The poorest two-thirds of US households are effectively broke, whether they realise it or not.

Obviously, households have assets and liabilities other than property and mortgages. Deutsche Bank has created a measure of liquid assets to liabilities which is illustrated in chart 2 below. As you can see, there has been significant damage done to household balance sheets in recent years. The first wave (2000-03) was mostly a function of the collapse of the dot com bubble. The second wave (2007-) has come about as a result of the more recent collapse in property and share prices. It is probably fair to say that US households are more financially stressed than at any time since the Great Depression.

Chart 2: US Households' Balance Sheets



Source: Deutsche Bank Global Markets Research

As DB points out in its report, households' ability to spend is a function of three factors - cash flow (which again is driven mainly by income, mortgage rates and tax), credit (bank lending) and homeowner equity (property prices). Now, with negative equity against their main asset, with even more pressure on income as a result of the recession and with virtually no savings to cushion the pain, the majority of US households have no choice but to cut back drastically on their consumption. And with the US consumer being forced to pull back, the global recovery story turns very pale indeed.

Tax hikes on the agenda

The wealthiest one third of US households may be in for a bit of a shock as well. The tax cuts implemented by President Bush are due to expire in 2010 and neither President Obama nor the Congress have shown any desire to extend the current scheme. In fact, tax hikes are already being discussed, and those Americans who think of European tax regimes as evil creatures should prepare for the beast to show up on their own door step. You only have to go back to the 1950s and early 1960s to find marginal tax rates of 90% in the US (President

Roosevelt's so-called 'New Deal'). My guess is that before Obama's first term is over the US will endure marginal tax rates of at least 60%.

So how is it possible for an economy to recover if two-thirds of its people are bankrupt and the remaining one-third will be taxed to death? *It isn't!!!*

Mortgage rates under pressure

Having said that, mortgage rates will be crucial in keeping the US consumer from suffocating completely, and there can be no doubt that the Fed will do everything in its power to keep a lid on them. But, lo and behold, interest rates are playing further havoc. Contrary to what most investors expected, long-dated government bond yields have actually crept up in recent weeks to the point where they may start to inflict some real damage on mortgage rates.

The situation is quite serious but, as far as I can tell, the average US house owner hasn't really woken up to the fact yet. At the very least, this will slow down the US (and hence the global) recovery to a trickle. At worst, Americans in their millions will walk away from their homes and post the keys to the mortgage provider as many US states allow, further undermining an already fragile financial sector. The US government, desperately trying to avoid nationalisation of large parts of the banking sector, may have no choice in the end.

Over the years I have learned never to underestimate the determination of the US consumer. He has always been prepared to spend his last dollar. Even when the tank was empty, he re-mortgaged his house so that the spending spree could continue a little longer. 70% of the US economy is accounted for by the consumer. That is more than 10% higher than the EU average (see table 1). Within the EU, only the UK comes close. But options are running out. There can be no doubt that the party is well and truly over.

Table 1: Private Consumption/GDP

Country	Weight
United States	69.9%
United Kingdom	64.6%
Italy	59.4%
Japan	58.6%
EU (27 countries)	57.8%
Switzerland	57.7%
France	57.7%
Germany	56.9%
Spain	56.7%

Source: Eurostat. All data from 4Q08.

We need the US consumer!

There is plenty of schadenfreude to detect here in Europe. Yet most of those people who argue that the American consumer has dug his own grave by acting so "irresponsibly" fail to understand that it is *precisely* the over-consumption in America which has driven the global economy to the lofty levels we have all come to like and enjoy. Without Americans being prepared to spend their last dime, there would have been no BRIC fairy tale and there would have been no German export boom, masking the fact that the domestic German economy has been on life support for a number of years now.

It is therefore an inescapable fact that with two of the largest consumer-driven economies in the world heading for a protracted slowdown, the global economy will take much longer to recover than most people realise, *unless* other countries such as Germany wake up and realise that their high savings ratio is as much part of the problem as the American and British *über-spending*. However, to persuade Mr. and Mrs. Schmidt to adopt Anglo-Saxon spending habits is a tall order - in particular when the problem is not recognised by supposedly intelligent people such as Angela Merkel, the German Chancellor. I could hardly believe my eyes and ears when, during the recent G20 summit in London, she declared that the German growth model would continue to be based on exports. To whom may I ask?

Niels C. Jensen

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The ARP Structural Alpha Portfolio
as at 30th April, 2009: