Buckle Up –
It's Going to be a Bumpy Ride
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By Claude Gruen

It is going to take a little bit of luck and some very adroit broken field running from policy makers in the central banks of United States and European money centers to keep the current economic contraction from dropping into a deep and relatively long recession. But given this knowledge, I believe the odds are with the runners.

The luck I refer to is the expanding search for oil, and the relative price stability that should follow. But even if oil prices settle downward and policy makers succeed in curing and calming the dysfunctional financial institutions in western capital markets, more needs to be done.

Consumers are now holding tight to their wallets, and it will take more enticing products to ease their cash flow once again. Just as retailers will have to adapt to this change, real estate providers, too, will have to think strategically.

This is a new market, and if the business cycle is to turn around, real estate professionals will need to earn returns by being market-sensitive responders rather than financial engineers.

Like the deep recession of 1873, the recent deceleration in the growth of the U.S. economy, and the contraction that may well be underway as this is written, began when defaults in credit instruments revealed that the value of those instruments had been pumped up much higher than could be sustained by the earnings of those obligated to make the payments called for in these instruments.

In 1873, the entities who could not meet their stock and bond payment obligations were railroad-building, stock and bond watering tycoons. In 2007, they were homeowners who didn't earn enough to meet the payments on teaser rate mortgages that should never have been issued. The depression of the 1870s wiped out the savings of many, and did not end until some time after all the water had been wrung out of railroad securities.

As someone who has recently sold a house, I can tell you housing prices have started to fall. In some regions, they may already have fallen far enough to allow the market of unsold houses to clear. But even in regions where this is the case, many would-by buyers are holding off purchases in the belief or hope that prices may drop further, or they may be having trouble securing lending. Mortgage providers have gone virtually catatonic after recognizing massive mortgage lending write-offs.

Further, the supply constraints that stifled competition and drove up housing prices in economically vigorous regions are still in place to serve as a floor that will keep new housing prices from falling to where they could profitably serve a larger consumer base.

The imprudent loans that sustained the effective demand for housing, when prices had risen beyond what buyers could afford, would not have been funded without the international securitization of mortgage loans and associated derivatives, and other newly popular financial products. While the scale of the resulting financial losses was originally estimated at approximately $350 billion, it now appears likely to be twice that amount.

As John Maynard Keynes explained in the 1930s, once such a credit shock occurs, consumers and those lenders left standing develop a preference for liquidity. Lenders become overly conservative in issuing credit and tend to over-price the loans they are willing to insure. Consumers seek to increase their savings. One might say that both were recently affected by the greed factor – they believe the economic contractions they see are harbingers of worse times to come.

In the first quarter of 2008, the economy lost just about 230,000 jobs. Even though more than 145 million Americans were still working, the loss of jobs added to fears caused by falling housing prices and rising costs for energy, food and other necessities.

In April, the highly respected and frequently prescient Reuters/University of Michigan consumer sentiment survey fell to a 26-year low of 62.6, from 69.5 in March. For the first time in decades, American consumers are following the advice of the prudent, who have told them to save more and spend less.

Franklin Delano Roosevelt understood the importance of the fear factor as he tried to jawbone his way out of the Great Depression of the 1930s. After his election in 1932, he famously said, "We have nothing to fear but fear itself." Unfortunately, his speech and other efforts didn't work to put the economy back on the path of growth. It took the defense effort of World War II to fuel an economic turnaround.

We are nowhere near the depth of the contraction that faced Roosevelt when he was elected in 1932. But the recently proven dysfunctionality of American financial institutions has infected the banking centers of Europe, causing the European economies to slow in the first quarter of this year. Thus, unless the central banks can thaw the overly cautious freeze up of capital markets, the investments needed to produce the upgraded new consumer products and business tools that can stimulate the needed demand will be stalled.

The bankers of central Europe and our own Federal Reserve System understand this full well. They have all read Keynes and understand that this is not the time to allow lenders to ride the brakes. Whether they have read Joseph Schumpeter or not, consumers and businesses are teaching producers the lesson he taught -- the key to getting consumers back in the store is to innovate so as to sell them something better than what they have; and the key to selling capital goods is to offer tools businesses need to stay competitive and profitable.

The economy can be pulled out of its current nosedive and start climbing back up in 2009, but we'll all have to be smart, lucky and willing to sustain some strong gravity pulls.

Claude Gruen is a Principal with Gruen Gruen + Associates, a research and consulting firm with offices in San Francisco and the Midwest.