

Recovery
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Recovery, Part I: The Economy

This is a four part commentary dealing with how and when we will get out of the current mess. This first part deals with the economy since it is the easiest of the four. Others will deal with real estate, finance and the unraveling of all the stimulus when the economy does recover.

The overriding reality of this recession is that it is not the second coming of the Great Flood—or even the Great Depression. It is a severe economic downturn that will rival the recession of 1982 in terms of both unemployment and GDP shrinkage. But we survived that one, and we will this one, as well. This one feels worse for two reasons. First, many people, because of the financial meltdown, have lost their savings. So not only does the recession attack income, financial problems attack wealth. The second reason is that we live in a world of unending micro-scrutiny thanks to all the fresh young faces in the media. In other words, we have too much information.

So how do we get out of recession? Let me propose the following scenario. First, the stimulus bill will work. You can't throw that much money at the economy and not have it respond. The stimulus will begin to take hold in the second quarter as rebate checks get to households and states begin to spend money on infrastructure and create jobs (except for South Carolina and Louisiana whose governors will evidently turn this money down—the ghost of Herbert Hoover lives!) At that point, firms will have worked through their layoffs and the jobs news will be less bad and may even be good. All this, plus the new media spotlight on good news stories—contrarianism sells—will begin to turn consumer psychology around. As this grows, the economy will stop shrinking and begin to grow late in the third quarter, with growth beginning to pick up momentum in the fourth quarter and into 2010.

The Recovery, Part II: The Financial Sector

This is the really tough one for now. The various mistakes and crimes that have infected finance have shattered all trust in the system, and without trust, it won't work. So, consumers will not commit to investments (and this includes real estate), and banks will not lend to each other or the public, despite the money being thrown at them by the Fed and the Congress. Unless the system unfreezes, there will be a long, slow, protracted economic recovery if there is one at all.

The financial meltdown is the product of bad decisions (and fraud) by virtually all actors in the system. In fact, if one were to invent a blame detection device for

this crisis, it would look very much like a mirror. From households who overreached for homes they could not afford all the way to investors in derivatives and mortgage backed securities who failed to exercise due diligence (because insurance companies who didn't have the means "guaranteed" their investment), everyone was drunk on the idea that the upward spiral would never end. The result has been the bleeding off of wealth which only intensified the sting of the economic downturn.

There are two problems here and they require different solutions. The first, and harder to tackle is the human problem. Bernie Madoff may be the worst case, but there have been other, less criminal, breaches of ethical behavior. We need to find some way to turn incentives in the financial system away from short term profit and toward longer term goals and considerations. The second issue is systemic. Many of the instruments and markets that got us into this mess lie outside the scope of any kind of oversight. If the President's speech to Congress was any indication, we shall see a new regulatory structure that will cover the mortgage market and the "shadow" banking activities represented by derivatives.

Right now, we are trying to shore up the system in the short run by recapitalizing potentially sound institutions and removing the nonperforming assets from their balance sheets. We have gone farther in the former than the latter, largely because identifying the assets is very difficult. But now that the banks have more capital, the task is to get them to use this to stimulate the economic. That has not happened to date. It will take stronger governmental action to get this done. Until it is done, the economic recovery will be hampered.

The Recovery, Part III: Real Estate

The real estate boom that began in 1995 lasted about ten years, twice the average length for an expansion. As the boom continued, more and more consumers, greedy to cash in or afraid that they would miss the train, got into the housing market. Getting in was easy since the mortgage industry had invented many new products that lowered (at least temporarily) monthly payments, and the Greenspan Fed was nice enough to keep lowering interest rates. Mortgage rates bottomed out in the summer of 2003, and 5-1 ARMs, interest only mortgages and other exotica intensified the declining cost of homeownership.

In this rush to own real property, the usual market controls were scrapped. Documentation of income and assets became optional, as were down payments and credit scores were largely ignored. In many cases, real estate agents and mortgage brokers, enticed by the promise of high commissions, qualified households who could not afford to carry the mortgage to which they committed. Even those who tried to uphold the old standards were overwhelmed by the thousands of new, untrained and largely clueless new members of the industry.

Speculators and builders added to the chaos. Seeing the prospect of realizing a profit without ever having to take possession of a property, speculators played the “flip” game. Builders, seeing this demand and looking for rosy earnings forecasts to please Wall Street, put more sticks in the ground than could ever be absorbed by normal demand.

When interest rates began adjusting upward and prices spiraled out of reach, the house of cards collapsed. Foreclosures and excess new home construction wound up as unsold inventory that created a drag on the market. Buyers took a hike, prices fell, and more foreclosures occurred. The result was the conversion of the boom (starting in late 2005) into a downturn in sales and prices of equal dimension.

But this didn't happen in every housing market. Where prices had risen only a little, and mass production builders were no where to be seen, the decline has been relatively mild. Conversely, the “rocket” markets in Florida, Arizona, Nevada and California, fell dramatically. Right now, ninety percent of the real estate markets in the United States have worked off their excess inventories and lack only a growing economy to return to normal.

What about the others? There are two keys to unlocking the inventory vise that is gripping some markets. The first of these is being addressed in both the private and the public sector. In both cases, efforts are being made to allow consumers to stay in their houses by loan renegotiation and foreclosure moratoria. This will stem the flood of foreclosures and stabilize housing markets. The second key is coming more slowly, but there has been progress. This is the willingness of financial institutions to allow short sales of real estate to which they hold the mortgage. Up to now, banks have been unwilling or unable to accommodate short sales, but the efforts of real estate professionals are bearing some fruit. Short sales are being made in increasing numbers.

When will the market turn? I think it turns with the economy. In other words, we'll see consistently good news in the late third quarter of this year. After that, 2010 looks like a good year. For real estate professionals, follow the three phases of market recovery. First, the number of new listings goes down (sellers are withholding their product from the market), then the number of days on the market goes down (buyers are back), and finally the ratio of sales price to listing price rises (buyers are really back).

The Recovery, Part IV: The Great Unraveling

When all this ends (wow, doesn't that sound great!), when the recession is over, and the financial mess is straightened out and real estate once more becomes “normal”, there is yet another set of problems that need to be addressed—and these are as difficult as the ones we're enduring now. The Federal budget deficit for this year will be \$1.75 trillion with similar numbers in the ensuing years. More

importantly, the Fed has pumped over a trillion dollars of liquidity into the economy through the banking system. Unless the budget is balanced and that liquidity neutralized, we are looking at significant inflation and perhaps a return to the Seventies when stagflation plagued the economy.

We cannot extricate ourselves from the economic and financial problems we are experiencing without a hefty dose of stimulus from the public sector. So for now budget deficits and monetary expansion are entirely appropriate. We don't know yet if we're doing the right things in the right amount, but the aggressiveness is exactly what's needed. You can be sure that there's more to come if needed. But economic policy—whether monetary or fiscal—works with a long lag. Thus, the spending that will be done in the second quarter will only begin to show up in the fourth, and the liquidity now being pumped into the banking system will affect the economy only later this year.

The analogy here is to the thermostat in your home. If you want the house hotter or cooler, you adjust the thermostat. But if you're unable to wait and keep adjusting it, you'll overshoot and find the temperature more extreme than you want. In the case of the economy, we cannot wait for the effects of the stimulus to be felt before we begin to ratchet back on it. If we do, it's too late.

Here's the really tough part. Since we don't know if we've done enough and since we don't know when what we've done will take effect, we don't know when it's time to pull back. Too soon and the recovery will sputter; too late and the economy will slip into high inflation. The administration and the Fed will have to walk a very fine line between these alternatives to get it right.

How will this happen? On the monetary side, the Fed will gradually raise interest rates (did I say this would be a free lunch?) as the economy recovers, and sell government securities to soak up excess bank reserves. On the fiscal side, some of the stimulus will be self-extinguishing like the one-time grants to localities for infrastructure improvement. Other parts, like the tax cuts, extended unemployment benefits and payments to households, will have to be repealed by the Congress. These actions will reduce the stimulative impact of the Federal budget and begin to close the deficit gap.