

Too Much of a “Good” Thing: Proceed to the Exit – Part 3

by Doug Wakefield with Ben Hill

“‘In the year to June,’ observes Lombard Street Research in a July 25 bulletin, ‘the median price of existing homes rose by 0.9%. On a six-month annualized basis, it fell to 0.7%. This represents a sharp deceleration from double-digit house-price inflation as recently as January, when prices rose by 11.9% over a 12-month period. The June number was also the lowest annual rise in 11 years.’”¹

– Grant’s Interest Rate Observer, August 11, 2006

If we’re looking to validate the bursting of the real estate bubble, numbers like these are instructive. And yet these numbers should come as no surprise. Give it another year and almost everyone we meet will tell us they saw this coming. Still, as real estate prices deflate, many of these same individuals will lose money. If you’ve been reading this series of short essays, you already know that we’ve been living through the greatest real estate bubble in history. But if our former Fed Chairman couldn’t identify a bubble until after it had popped, who am I to think that I can? In January of 2004, Greenspan stated:

“It is far from obvious that bubbles, even if identified early, can be preempted at lower cost than a substantial economic contraction and possible financial destabilization – the very outcomes we would be seeking to avoid.”²

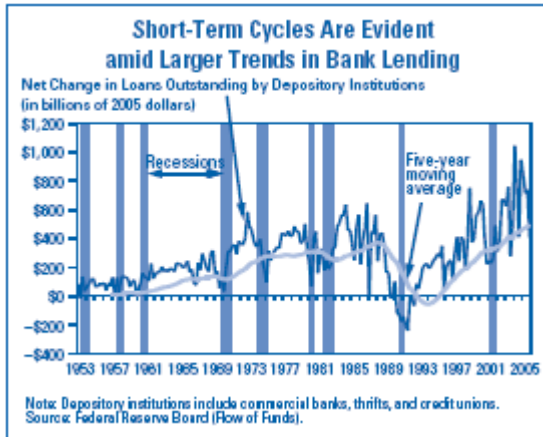
In their Summer 2006 Outlook, the FDIC seems to be better at identifying manias and crashes. They begin by looking at what the Greeks could have taught our former Fed Head about credit booms. The report states:

“Since ancient times, credit markets have undergone periodic booms and busts. In 594 BC, for example, the Greek state of Attica found itself under severe economic stress because of the massive debt incurred by many of its citizens. The ensuing civil disorder resulted in a handover of power to Solon, one of the ‘seven wise men’ of Greece. Solon took radical steps to restore balance to the economy, such as canceling debts, freeing those enslaved for failing to repay their loans, and devaluing the currency by 25 percent.”³

The report goes on to look at the credit cycle over the last 200 years. At some point in the future, when we hear, “No one could have foreseen the massive contraction of credit, and the concomitant, sharp decline in real estate prices, ahead of time,” we need only look at the numbers that government agencies have produced to know that this was not the case. For the record, I note two highly visible government sources that have written of this quandary ahead of its demise.

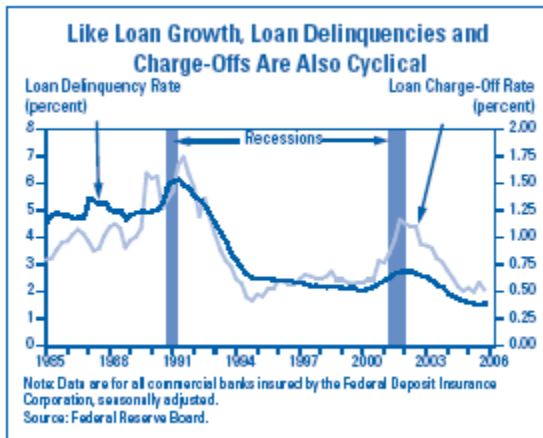
The FDIC Outlook continues:

“Like credit growth, the metrics of credit cycle quality tend to be fairly well coordinated with the overall business cycle. Because companies and consumers have more trouble paying their debts when the economy is stagnant or in a recession, loan performance tends to deteriorate during those periods.”⁴



The source of these two charts, from the FDIC report, is the Federal Reserve Board. As such, the data upon which these charts are built would have been readily available to the Fed at any time. We all make mistakes, so perhaps it was a simple oversight.

Still, based on the following comments, some of the guys at the Federal Reserve should have gone across the street and bought lunch for the guys at the FDIC.



“Commercial real estate (CRE) lending has come to be recognized as a highly cyclical business. Waves of construction and growth in credit often have been followed by gluts of commercial space, rising vacancies, and sometimes severe credit problems arising from the sector. During the last broad CRE credit cycle, collapsing property values in the southwestern United States and New England contributed to the many of more than 2,000 failures of institutions insured

by the Federal Deposit Insurance Corporation (FDIC) that occurred between 1980 and 1993. From this experience, one could make the case that CRE and construction and development (C&D) lending are among the riskiest of asset classes over the complete cycle.”⁵

Yet, when Greenspan was confronted with regulators’ concerns over the amount of easy credit extended to heavily leveraged, derivative-trading hedge funds, Greenspan was inclined toward removing all margin requirements. In late 1995, he stated:

“Removal of these financing constraints would promote the safety and soundness of broker-dealers by permitting more financing alternatives and hence more effective liquidity management.... In the case of broker-dealers, the Federal Reserve Board sees no public policy purpose in it being involved in overseeing their securities credit.”⁶

While liquidity was being expanded through the derivatives players, it was also made readily available through commercial mortgage-backed securities (CMBSs). The Resolution Trust Corporation, a government agency that took nonperforming assets from failed thrifts and repackaged them into tranches that matched the “risk tolerance” of investors, created this investment. Though the number of these loans continued to grow in the mid ‘90s, in 1998 liquidity (in this market) dried up. Every effect has its cause. The FDIC Outlook states:

“Then in 1998, the scenario was reversed after a series of financial crises caused liquidity in the CMBS market to vanish. CMBS were shunned when investors responded with a ‘flight to quality’ after the Asian currency crisis in 1997, the collapse of Long Term Capital Management, and Russia’s default on its foreign debt in 1998. Consequently, the liquidity in the U.S. public capital markets ‘dried up,’ and many CMBS originators were left holding millions of dollars of CRE loans with no buyers. Nomura Securities folded most of its U.S. CMBS operations in 1998 for some time after losing \$1 billion, and Criimi Mae, a provider and servicer of CMBS, filed for bankruptcy protection.”⁷

As for the fallout from a housing bubble, in their 2003 report titled “When Bubbles Burst,” the International Monetary Fund notes the following.

“Equity price busts on average occurred about once every 13 years, lasted about 2 ½ years, and involved price declines for about 45% (though the busts in the mid 1970s averaged about 60 percent). Housing busts on average occurred about once every 20 years, lasted about 4 years, and involved price declines of about 30 percent. While only about one-fourth of equity price booms were followed by busts, about 40 percent of housing price booms ended in busts. Both types of busts were highly synchronized across countries.”⁸

As for Greenspan, he maintained:

“The notion that a well-timed incremental tightening could have been calibrated to prevent the late 1990s bubble while preserving economic stability is almost surely an illusion.

Instead of trying to contain a putative bubble by drastic actions with largely unpredictable consequences, we chose, as we noted in our mid-1999 congressional testimony, to focus on policies ‘to mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion.’”⁹

We tend to agree more with Roger Lowenstein, who, in his book, When Genius Failed, states:

“A bit of liquidity greases the wheels of markets; what Greenspan overlooked is that with too much liquidity, the market is apt to skid off the tracks. Too much

trading encourages speculation, and no market, no matter how liquid, can accommodate all potential sellers when the day of reckoning comes.”¹⁰

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Sources:

1. Grant's Interest Rate Observer, August 11, 2006, James Grant, page 1
2. Alan Greenspan, "[Risk and Uncertainty in Monetary Policy](#)" speech to the American Economics Association, January 3, 2004
3. [FDIC Outlook](#), Summer 2006, page 3
4. Ibid
5. Ibid, page 14
6. Alan Greenspan, 1995 Testimony before Congress ([When Genius Failed](#), (2000), Roger Lowenstein, page 106
7. FDIC Outlook, Summer 2006, page 16 & 17
8. When Bubbles Burst, 2003 IMF Report, Thomas Helbling & Marco Terrones <http://www.bestmindsinc.com/documents/WhenBubblesBurst.chapter2IMFReport.2003.pdf.pdf>
9. Alan Greenspan, "[Risk and Uncertainty in Monetary Policy](#)" speech to the American Economics Association, January 3, 2004
10. When Genius Failed: The Rise and Fall of Long-Term Capital Management, (2000), Roger Lowenstein, page 106

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