A Reprint from *Tierra Grande*

PROCEED WITH CAUTION

By Gerald Klassen & Mark G. Dotzour

Chances are you may be feeling a little manic depressive if your outlook on the economy is driven by headlines from the popular news media. Real estate investors with lots of cash, investment managers and market pundits are trying to convince you that recovery is near and now is the time to jump in. Bankers, small business owners, the unemployed and real estate investors in need of financing paint a much different picture. Who should you believe?

For every piece of good news, there seems to be less publicized data that suggest the need for caution. The S&P/Case-Shiller Home Price Index came roaring back in 2009, but Robert Shiller thinks there is a greater than 50 percent chance it will decline in the future.

Existing home sales surged with the first-time homebuyer tax credit, but how many future sales were pulled into the current year? Mortgage rates were at near all-time lows during 2009, but the Federal Reserve and U.S. Treasury were the only buyers of mortgages, and they paid inflated prices. Christmas retail sales in 2009 showed slight growth over 2008, but 2008 activity had fallen disastrously from 2007.

Recovery from this recession will not be like those in past inventory-led recessions. The United States has not had a balance sheet recession with massively falling asset prices (deflation) since the Great Depression. In unprecedented actions, the Fed plugged the hole in business and personal balance sheets by using its own balance sheet to lend over $2 trillion to those in need of financing and to fund the federal deficit. They have been able to keep asset prices levitating. But because this has never happened before, no one knows how it will turn out.

In *The Great Depression: A Diary*, a young lawyer named Benjamin Roth recounts life and business during the Depression. The parallel of events and attitudes between then and now is astounding. Many of the actions taken by the Fed, government, businesses and individuals during this recession mirror those taken during the Great Depression. History is repeating itself.

At the conclusion of Roth's diary, he comments that "prominent bankers, businessmen, etc. were all wrong in most of their predictions. Use your own judgment and do your own thinking."

Business leaders, policy makers and private citizens are struggling to guess what lies ahead. Rather than predicting future economic conditions, this article identifies reasons for exercising caution in business decisions.

A risk of a second banking crisis remains. There were actually two banking crises during the Depression. The first was a crisis of liquidity between 1929 and 32, which corresponds to our 2008 financial crisis. During that period, continual bank runs caused many banks to fail because there was no deposit insurance. Banks could not

sell the mortgages and illiquid assets they owned to pay out depositor withdrawals.

President Herbert Hoover addressed this by creating the Reconstruction Finance Corporation to make loans to the banks, taking the frozen mortgages and illiquid assets as collateral. By late 1932, this put enough cash into the banks to ease the bank runs.

In 2008, there was a bank run of a different sort. Institutional investors withdrew the short-term financing (deposits) they had provided to brokers such as Bear Stearns and Lehman Brothers, structured investment vehicles and money market funds. These entities could not sell their illiquid real estate assets to pay back the financing.

This withdrawal of short-term financing forced the Fed to step in with its alphabet soup of lending programs that accepted the illiquid mortgage-backed securities (MBS) and other assets as collateral for the loans. Without the liquidity, many more banks and corporations would have failed, and the economy would be in much worse shape.

The second banking crisis of the Depression was a solvency crisis that came in 1933. In October 1932, Roth noted in his diary that banks "seem to have started a regular drive to foreclose real estate. This may be because there has been so much public talk about a moratorium on mortgages. Every day sees about 30 new cases started and many of our friends in fine homes on the north side [of Youngstown, OH] are included in the list of casualties."

In January 1933, Roth notices "bank closings are again coming to the front. . . . These banks are not closed by runs but by steady withdrawals of depositors caused by necessity and by inability to collect on frozen mortgage loans."

Losses from foreclosures and the inability to collect on mortgages eventually caused many banks to fail and resulted in FDR's 1933 Bank Holiday. During the Bank Holiday, weak banks were liquidated or merged into stronger banks.

The current actions of the Fed, FDIC and bank regulators are an effort to prevent a solvency crisis in this Great Recession. The worst-case scenario for unemployment is playing out and new defaults on mortgages are accelerating. The commercial real estate (CRE) problem will hit in full force in 2010. If the Fed cannot keep asset prices levitating, losses on collateral could cause a second banking crisis.

The debate rages on as to whether CRE will be the "next shoe to drop." Most will agree that CRE values have fallen somewhere in the 40 percent range depending on asset type and geography. The more important factor is the secondary impact this will have on the economy. Consider these statistics from the Small Business Administration:

- Small businesses (firms employing 500 workers or fewer) accounted for 64 percent of net new job creation over the past 15 years.
- Very small businesses (firms employing fewer than 50 workers), which employ almost one-third of working Americans, experienced 45 percent of the job losses this downturn.
- The main sources of credit for small businesses are credit cards, home equity loans and smaller regional banks. The first two are shrinking rapidly.
- Nearly 40 percent of outstanding small business loans are held by banks with the greatest exposure to commercial property risk.

The Federal Open Market Committee Minutes from December 15–16, 2009, provide a summary of the link between commercial real estate and the plight of small businesses:

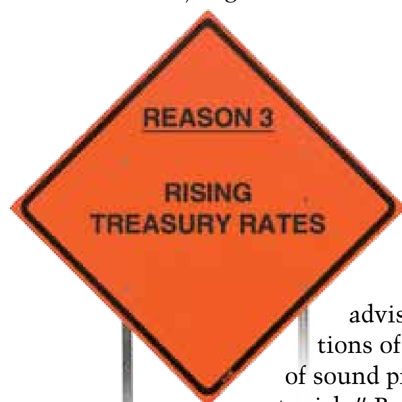
> Bank loans, however, continued to contract sharply in all categories, reflecting lack of demand, deterioration in potential borrowers' credit quality, uncertainty about the economic outlook, and banks' concerns about their own capital positions. With rising levels of nonperforming loans expected to be a continuing source of stress, and with many regional and small banks vulnerable to the deteriorating performance of CRE loans, bank lending terms and standards were seen as likely to remain tight. Participants again noted the contrast between large and small firms' access to financing. Large firms that can issue debt in the markets appeared to have relatively little difficulty obtaining credit. In contrast, smaller firms, which tend to be more dependent on commercial banks for financing, reportedly faced substantial constraints in gaining access to credit. While survey evidence suggested that small businesses considered weak demand to be a larger problem than access to credit, participants saw limited credit availability as a potential constraint on future investment and hiring by small businesses, which normally are a significant source of employment growth in recoveries.

"During the boom years it became popular to buy real estate at inflated prices on a shoestring. This was done by encumbering it with a 1st, 2nd and 3rd mtge. Second mortgage loan companies were formed to buy these 2nd mortgages at a discount of 10% to 25% per year. It has proven to be a bad investment because at each sheriff sale the 2nd mortgage is wiped out. Most of these companies have frozen assets and seem to be heading for bankruptcies. Good, conservative first mortgages have proven to be good investments altho' in many cases the mortgagee has been forced to take over the property."

—Benjamin Roth, June 1931

***THE MAIN SOURCES** of credit for small businesses are credit cards, home equity loans and smaller regional banks. The first two are shrinking rapidly.*

The U.S. Department of the Treasury is currently drafting a Troubled Asset Relief Program (TARP)-like plan to provide capital to small and mid-sized banks so they can continue lending to small businesses. However, the retroactive meddling of Congress and the public stigma attached to the original TARP will make it challenging to get small banks to accept the "assistance." It may be more likely that the banks will hunker down, reduce loan balances and try to ride out the CRE storm. This will retard job growth in 2010.



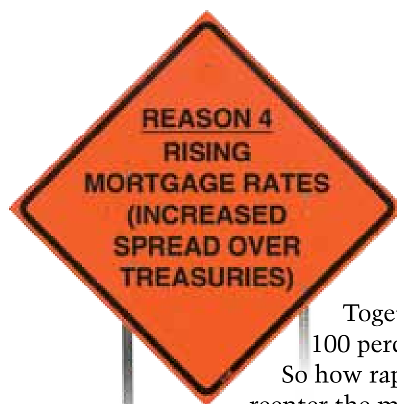
In January, the Fed and FDIC issued an interest rate risk advisory "reminding institutions of supervisory expectations of sound practices to manage interest rate risk." Banks were advised to stress-test portfolios with interest rates rising up to 400 basis points. This far exceeds the 50-to-150-basis-point rise that most market pundits are expecting.

Record fiscal deficits and a lack of appetite for long-dated Treasuries could put upward pressure on Treasury rates regardless of what the Fed does with short-term interest rates. Investors are crowding into shorter-term Treasury obligations and eschewing maturities over two years. This is a clear warning sign that investors expect the bubble in long-term Treasuries to deflate soon.

However, the outlook for higher rates is complicated by rising demand for fixed-income investments by U.S. investors. As long as investors continue to prefer fixed-income over equities, demand may be large enough to put downward pressure on rates.

The Japanese experience following their property crash in 1991 provides interesting insight. Ever since that time, Japanese investors have preferred government securities to equities. Given their high savings rate and investing preference, they have purchased so much government debt that Japan has been able to reach a national debt to GDP ratio of 200 percent while holding down rates on ten-year government bonds to around 1.5 percent.

The domestic source of demand has helped keep interest rates down and prevented a crash of the yen. The emerging problem now is that the Japanese population has reached an age at which it will be net sellers of government securities. This will cause rates to increase and could trigger a long-awaited fiscal crisis.



The Fed and Treasury are no longer purchasing MBS. Together they constituted nearly 100 percent of the market in 2009. So how rapidly will private investors reenter the market?

Fannie and Freddie have become wards of the state and are vulnerable to political influence. Will investors be willing to purchase MBS originated by Fannie and Freddie when there is a risk that Congress could use Fannie and Freddie to impose principal cramdowns? It seems likely that the risk premium on MBS will increase in the near term to reflect increased risks to investors while Congress works through the foreclosure mess.

On the other hand, the uncapping of support on Fannie and Freddie creates an interesting possibility for sustained low mortgage rates. If the administration feels rising mortgage rates will threaten economic recovery, it could use Fannie and Freddie to execute new MBS purchases in place of the Fed. Strong bid prices from the government-sponsored enterprises (GSEs)

could be used to maintain low mortgage rates like the Fed did in 2009.

This would provide continued support for real estate while preventing the Fed's balance sheet from ballooning further. However, it would leave taxpayers liable for any further problems occurring within the GSEs. But how is this any different from taxpayer exposure to problems with the Fed's balance sheet?

> *"I am getting weary of depression talk and patent remedies. You hear it on all sides. The favorite remedy is repeal of Prohibition and the bringing back of liquor in hope that a new industry will give employment and that real estate values will be stimulated."*
>
> —Benjamin Roth, September 9, 1931

While many market participants celebrated holiday sales that exceeded expectations, 2009 sales growth was modest compared with the disastrous 2008 holiday season. The International Council of Shopping Centers reported that same-store sales for December rose 2.8 percent over December 2008. The equity markets have risen on the back of higher corporate profits attributed to cost cutting, and now they are expecting top-line revenue growth to increase as the economy exits the recession.

Market pundits declared the recession over after the initial estimate of third-quarter 2009 GDP came in at 3.5 percent. After two subsequent revisions, we learned that third-quarter GDP was really only 2.2 percent.

David Rosenberg of Gluskin Sheff + Associates Inc. writes that after a recession ends it is normal for GDP to grow at a 7 percent annual rate in the first quarter of growth. The 2.2 percent annualized GDP growth is the worst in recorded history. Rosenberg is bearish on near-term growth in consumer demand because of the significant debt burden on consumers and shrinking demand for and supply of consumer credit.

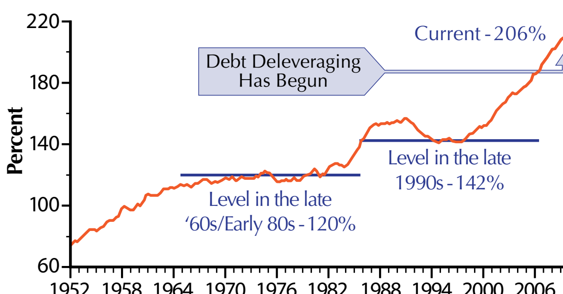
According to Rosenberg, the consumer deleveraging process is in its early stages. The current level of U.S. outstanding nonfederal debt is $27 trillion (compare this with 2008 U.S. GDP of $14.2 trillion) and is currently 206 percent of nonfederal GDP (Figure 1). This is another way of illustrating that private consumers and businesses have a historically high level of debt.

If debt returns to 1990s levels, approximately $8 trillion of nonfederal debt needs to be extinguished. To return to 1960s and 1970s debt levels, credit needs to be reduced by at least $11 trillion.

So far the credit decline is setting a record pace. Consumer credit dropped a record $17.5 billion in November as unemployment hovered at 10 percent and banks tightened lending standards (Figure 2). The ten-month streak in credit declines is the longest since record-keeping started in 1943. As long as unemployment remains high, demand for credit will be significantly lower. And as long as banks are under pressure from regulators, they will be tightening lending standards.

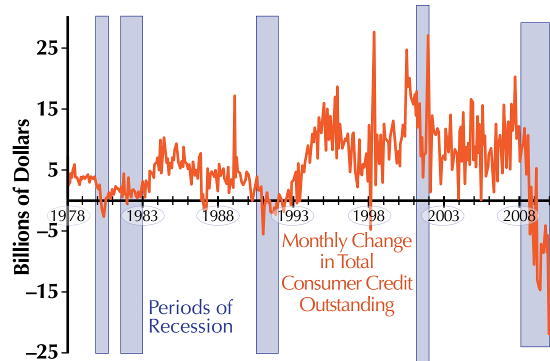
All of this adds up to a significant risk that consumer spending will not meet current growth expectations.

Figure 1. Total Nonfederal Debt to Nonfederal GDP Ratio



Sources: Federal Reserve Board, Bureau of Labor Statistics, Gluskin Sheff + Associates Inc. [Breakfast with Dave, December 14, 2009, www.gluskinsheff.com]

Figure 2. Historic Consumer Credit Collapse of The Great Recession



Source: Federal Reserve Board, G.19 Consumer Credit

Equity markets in the United States began their steep ascent in March 2009 when the $586 billion Chinese stimulus package showed success in stimulating the Chinese economy. The thought then was that China and other emerging economies could lead the United States out of recession through growth in their own economies. At the same time, Chinese banks flooded the economy with an estimated $1.1 trillion (one-fourth of annual GDP) in new lending in the first half of 2009. Bank loan balances surged more than 30 percent in 2009.

The problem with the Chinese stimulus is that it was not used to create a social safety net that would give consumers the confidence to reduce savings and spend more. Rather, it was used to build infrastructure and factories as well as purchase stocks, real estate and commodities. Residential real estate prices rose at record rates during 2009. It is noteworthy that for a stimulus equal to one-quarter of GDP the Chinese only achieved 2009 GDP growth of 8.7 percent.

"Pres. Hoover starts an 'anti-hoarding' campaign in which people with hidden money are asked to buy government bonds."

—Benjamin Roth, January 11, 1932

The events surrounding the current asset bubble in China are reminiscent of Japan in the late 1980s and early 1990s. The Japanese built their wealth through exports, which reached a peak of 10 percent of global exports in 1986. Japan used the new wealth from its economic success to invest overseas, including U.S. real estate.

In 2009, the Chinese share of global exports reached 10 percent. The Chinese have embarked on an expedition of global acquisitions and are beginning to show interest in U.S. real estate. The *Financial Times* reported that China Investment Corporate has retained Cohen & Steers, Angelo Gordon and Morgan Stanley to identify opportunities in commercial real estate. In January 2010, SL Green Realty Corp. announced that it had refinanced 1515 Broadway in Manhattan with a $475 million mortgage from a syndicate led by the Bank of China.

When the Japanese property bubble burst in 1991, Japanese investors were forced to sell overseas assets, including U.S. real estate, to raise cash to deal with the liquidity crunch at home. The Chinese bubble is still growing, but China is beginning to recognize the threat of this "emerging" phenomenon. The absurdity of the bubble is described well in a June 2009 article in the Far East Economic Review (http://www.feer.com/economics/2009/june53/Chinas-Real-Estate-Riddle). From 2004 to 2008, investors purchased 587 million square meters (6.3 billion square feet) of apartments only to leave them vacant. There is no real secondary market in China so current values are not known. And there are no property taxes on real estate held, so it is easier for individuals to use property as a store of value.

Now Chinese policy makers are attempting to restrict real estate lending. They have raised interest rates, instituted lending restrictions and are considering implementing a property tax. But they are hesitant to adopt significant curbs because doing so could slow GDP growth (remember Greenspan's fears from 2002–2005?). The Chinese property bubble probably has room to grow, and the Chinese are likely to use their U.S. currency reserves to purchase U.S. real estate assets in 2010 and 2011.

But if the bubble bursts, two things will happen. First, equity markets will fall when they realize that the Chinese are not able to lead global economic growth. Second, the Chinese will need to sell some foreign assets to raise cash to deal with domestic liquidity issues.

As a footnote to the Japanese experience, Japan's urban property prices are still down almost two-thirds below peak values.

Without another stimulus package to plug budget holes at the state and local levels, there will be a new round of layoffs in the government sector. If job growth does not increase soon, this will push the unemployment rate higher. According to Rosenberg, state and local tax revenues are down 10.7 percent year-over-year as of third quarter 2009.

According to the National Conference of State Legislatures, 43 states reported a total budget deficit of $183 billion in 2009. That group estimates that the total could rise to $200

billion for fiscal year 2010. The Center on Budget and Policy Priorities estimates that states will have budget shortfalls totaling $350 billion for the two-year period from 2010 to 2011.

The American Recovery and Reinvestment Act (the "original" $787 billion stimulus package) has helped lessen the impact of budget shortfalls so far, but the federal assistance will end before budget gaps have abated. The act designated $135 billion to $140 billion over roughly 2½ years to help states maintain their current levels of service. The stimulus money has reduced the amount of state cutbacks up to now, but without further stimulus or significant economic recovery, states will need to make sizable cutbacks in services or raise taxes and fees soon.

THE AMERICAN RECOVERY AND REINVESTMENT ACT *has helped lessen the impact of budget shortfalls so far, but the federal assistance will end before budget gaps have abated.*

The U.S. economy is in uncharted territory created by unprecedented actions of the Fed. The outcome is unknown. Parallels between the Great Depression and this Great Recession are abundant.

Roth wrote in his diary in 1931 that "immediately after the 1929 crash the speculators rushed in to buy 'bargains' but were badly mistaken because the market kept going down and down even tho industrial leaders kept on assuring the people that everything was fine and the worst was over."

Four years passed between the stock market crash and the Bank Holiday of 1933. In 1932 Roth wrote, "So far in the last 2 years the stock market has made 8 fake starts upward and then eventually came back to record lows. Commodities have also steadily declined and show no definite sign of upward turn."

Perhaps Roth's best advice is:

> O.P.M. (Other People's Money — or credit) are the three most powerful letters in business but must be wisely and moderately used. Most of the banks are now almost liquid and these vast resources will soon again be loaned out for business expansion. To use the funds for business expansion and yet with moderation is the height of good business management. To operate today without access to such credits is almost impossible in this day of big business.

Remember, think for yourself and proceed with caution.

Klassen (gklassen@tamu.edu) is a research analyst and Dr. Dotzour (dotzour@tamu.edu) is chief economist with the Real Estate Center at Texas A&M University.

THE TAKEAWAY

Media headlines are proclaiming that the recovery has arrived, and now is the best time to "get back into the market." But this recovery will be different than those following past recessions because the downturn was caused by too much debt. The Fed took unprecedented actions to save the banking system in 2008, but it is too early to know if the seven dangers that lie ahead can be avoided.

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

Director, Gary W. Maler; **Chief Economist,** Dr. Mark G. Dotzour; **Senior Editor,** David S. Jones; **Managing Editor,** Nancy McQuistion; **Associate Editor,** Bryan Pope; **Assistant Editor,** Kammy Baumann; **Art Director,** Robert P. Beals II; **Graphic Designer,** JP Beato III; **Circulation Manager,** Mark Baumann; **Typography,** Real Estate Center.

Advisory Committee

James Michael Boyd, Houston, chairman; Barbara A. Russell, Denton, vice chairman; Mona R. Bailey, North Richland Hills; Louis A. Cortes, China Grove; Jacquelyn K. Hawkins, Austin; Joe Bob McCartt, Amarillo; D. Marc McDougal, Lubbock; Kathleen McKenzie Owen, Pipe Creek; Ronald C. Wakefield, San Antonio; and John D. Eckstrum, Conroe, ex-officio representing the Texas Real Estate Commission.

Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: Robert Beals II, pp. 1, 3; Real Estate Center files, p. 6.