Countering Euphoria
Mardjokic.com
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A copy of this article is available in PDF format here.

I am often pleasantly surprised by how eternally optimistic the human spirit can be. No matter how precarious a position we might find ourselves in, we tend to look for the good and ignore the bad. Over the last few months economist after investment manager after Wall Street analyst have pointed to a tide of marginally better economic data as signs of a recovery. Whilst the numbers are 'positive' there are still plenty of negatives in the economy. Perhaps most important: pound for pound the scale still tips in favor of the bears.

Much of the upward revision in GDP has been predicated on the tax stimulus that was recently passed. I don't doubt that a year from now we will be 3% wealthier but the growth is being subsidized with borrowed dollars which is preciously how we got into this situation in the first place. This time we are substituting the great mortgage machine for the Treasury press.

On either side of the political isle we have Democrats unwilling to cut spending and Republicans unwilling to raise taxes. What is our balance sheet going to look like at the end of 2011? Bond investors are already started voting with their feet. A recent treasury auction for 2Y notes went well but the 5Y auction didn't meet expectation. That tells me investors are comfortable with the credit worthiness of the US government for the next two years, but broaden that horizon to five years and their confidence wavers.

At its simplest we are transferring spending (and debt) from the consumer to the government. We are hoping to nurse the great American balance sheet back to health, but if the consumer doesn't get back on their feet soon we are going to have a second, much larger patient to take care of.

The other two 800lb, apparently translucent, guerrillas in the room are housing and employment. Neither of which seem to be doing too well. Yes, jobless claims are at the lowest levels since 2008 but this is a sign that the jobs market is just being to thaw.

On to housing: many economists see housing headed for a double dip all by itself. The Case Schiller index for October showed the third straight month of decline; in fact only 4 cities (out of 20) posted home prices that were higher today than they were a year ago. This is particularly troubling since nearly a third of America's net worth is tied up in home prices. Nearly $6T as of Q3'10. The other $12T is tied to equity/401K accounts. To further my argument: a Moody's economist estimated that for every dollar decline in home equity, owners will spend ~5 cents less over the coming 18 months. With home prices set to take another dip, I don't see how the American consumer will be ready to take the reins from the government and sooner or later the training wheels must come off.

With these sobering thoughts I leave you: Happy New Year!

APPENDIX 1

THE WALL STREET JOURNAL.
WSJ.com

REAL ESTATE | DECEMBER 29, 2010

Housing Recovery Stalls

Fresh Fall in Home Prices Is Headwind for Economy; Other Signs Still Strong

By S. MITRA KALITA
And SUDEEP REDDY

A new bout of declining home prices is threatening to hamper the U.S. recovery, just as consumers and the overall economy have been showing signs of healing.

WSJ's Mitra Kalita discusses October's U.S. housing price decline with Yale University economics professor Robert J. Shiller, who says the struggling housing market will likely continue to weigh on the overall economy.

Home prices across 20 major metropolitan areas fell 1.3% in October from September, the third straight month-over-month drop, according to the S&P/Case-Shiller home-price index released Tuesday. Many economists expect the declines to continue into at least next spring, erasing most of the gains made since prices bottomed out in early 2009.

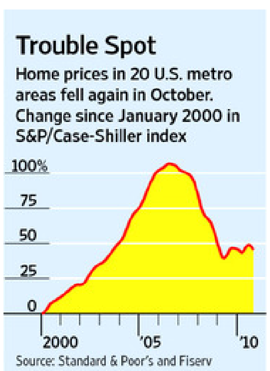
The housing market, which appeared poised for a recovery earlier in the year, now could be heading for a second downward drift.

"This looks like a double-dip [in housing] is pretty much on the way, if not already here," said David Blitzer, chairman of the Standard & Poor's index committee. "Somebody who thought last year that it's going to be straight up from here was wrong."

Other news in recent weeks, however, has offered hope the economy is on the cusp of strong, sustainable growth. Retail sales returned to levels seen just before the recession started in 2007. Manufacturing continues to expand. U.S. exports are back to where they were just before the financial crisis.

Optimism among heads of small businesses and large corporations is also near pre-recession levels. And tax legislation that includes a one-year payroll-tax cut for most workers has boosted prospects.

Yet the twin forces of jobs and housing remain trouble spots. The labor market has added a million jobs in the past year, but that pace is far too slow to offset an unemployment rate that climbed to 9.8% last month.



Job worries are hampering consumer confidence despite strength in holiday sales and a rising stock market. The Conference Board, a business research group, said Tuesday that its confidence index fell to 52.5 from 54.3 in November, as consumers' views about job availability worsened.

The index, after rising through May as the economy showed early signs of improvement, now has retreated to its level of a year ago. The percentage of people planning to buy a home is also back to where it was a year ago, erasing improvement seen in early 2010.

U.S. Consumer-Confidence Index Slips

In the Case-Shiller data, all 20 cities in the index posted month-over-month declines in October.

As for year-over-year data, only four areas—Los Angeles, San Diego, San Francisco and Washington, D.C.—showed prices higher than in October 2009. Six markets hit their lowest since prices started falling four years ago, dropping below their spring 2009 levels, when most regions saw prices bottom out. The six were Atlanta, Miami, Seattle, Tampa, Charlotte, N.C., and Portland, Ore.

Prices in several markets, including Las Vegas and Cleveland, are nearly down to 2000 levels.

View Full Image

Ariel Zambelich for The Wall Street Journal

Steve and Tasha McLaughlin said they plan to default

The housing index was driven down by factors including the expiration of a federal tax credit for buyers who signed contracts by April 30, which caused demand to fall off.

Prices also were weighed down by a huge inventory of foreclosed homes, which tend to sell at sharply discounted prices.

In recent months, according to the National Association of Realtors, foreclosure and other distressed sales have represented more than 30% of home sales—and more than half in some states, such as Nevada.

Wells Fargo & Co. projects prices will drop 8% more by mid-2011, given high supply. "Demand is still

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dead in the water," said Wells economist Sam Bullard.

Prices also face other hurdles: slightly rising mortgage rates, and homeowners who owe more on their houses than they're worth, and thus may walk away as values dip further.

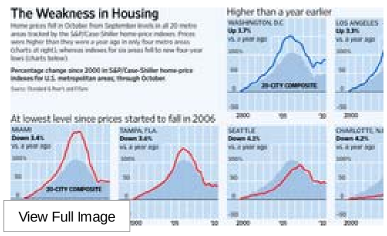
The owners under pressure include Tasha McLaughlin, a 33-year-old mother of two in Sacramento's South Natomas neighborhood. She and her husband, Steve, bought their two-bedroom house in 2004 for $256,000, intending to stay about five years. After 11 months of trying to sell it between 2006 and 2007, the family took it off the market.

"Everyone is saying we should foreclose or claim bankruptcy, but I have a moral issue with that," said Mrs. McLaughlin. "The more we try to pay the mortgage and pinch pennies, the more we get punished."

Now, with a similar home down the block listed for $80,000, the McLaughlins are accepting that they won't recoup their losses anytime soon. Their interest-only loan is set to increase their current $1,600 monthly payment to $2,200 in seven years. If they were to default on their mortgage and walk away, they calculate that in about the same time, seven years, their credit scores would be stable enough to allow them to buy again elsewhere.

"I am just going to swallow my pride and walk out. I have to," said Mrs. McLaughlin. "The market for homes is not going up."

Housing analysts agree that markets such as Sacramento, Las Vegas and parts of Arizona and Florida are at risk of more declines. "These places relied so heavily on mortgages and real estate for their economy that we're going to see a two-tiered recovery," said Chris Mayer, a professor of real estate at Columbia Business School. "Luxury spending is not going on across the country—it's happening among highly skilled consumers who live in the places that have seen some recovery."



More

A Look at Case-Shiller, by Metro Area

Homes remain a key part of Americans' wealth. Households held $6.4 trillion of home equity at the end of the third quarter, alongside $12.2 trillion in stocks and mutual-fund shares, according to Federal Reserve data.

For every dollar decline in housing wealth, consumers reduce spending by about a nickel in the subsequent 18 months, Moody's Economy.com chief economist Mark Zandi estimates. He cautioned that other factors, such as the stock market's strength and tax credits, could offset this effect.

"People feel poorer when their houses are going down in value," said Jack Fitzgerald, chief executive of Fitzgerald Auto Malls, which has a dozen locations along the East Coast. He is seeing many customers who could buy new cars choosing used cars instead, "spending as little as they can." While sales are improving, he expects them to grow only slowly, given all the consumer uncertainty.

Still, the overall economy's dependence on housing diminished greatly since the financial crisis, said Ivy Zelman, chief executive of Zelman & Associates, a housing-research firm. "Consumers have shown us they can still spend even if home prices go down," she said. But falling home values "put a lid on the recovery and the magnitude of it."

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APPENDIX 2

Bloomberg Businessweek
Thursday December 30, 2010

Bloomberg

Treasuries Extend Drop After $35 Billion Five-Year Note Auction

December 29, 2010, 4:22 PM EST

By Cordell Eddings

Dec. 28 (Bloomberg) -- Treasuries extended their decline after the U.S. sale of $35 billion in five-year notes was met with lower-than-average demand.

The notes drew a yield of 2.149 percent, compared with the average forecast of 2.133 percent in a Bloomberg News survey of 9 of the 18 primary dealers. The bid-to-cover ratio, which gauges demand by comparing total bids with the amount of securities offered, was 2.61, compared with an average of 2.77 for the past 10 sales.

"The market has backed up a lot and should provide value, but no one wants to catch the falling knife this week," said Scott Sherman, an interest-rate strategist at Credit Suisse Group AG in New York, before the auction. As a primary dealer, the firm is obligated to participate in U.S. debt sales.

The yield on the current five-year note climbed 10 basis points, or 0.10 percentage point, to 2.12 percent at 1:03 p.m. in New York, according to BGCantor Market Data. The yield on the benchmark 10-year note gained 11 basis points to 3.44 percent.

At today's auction of the December 2015 maturity, indirect bidders, an investor class that includes foreign central banks, purchased 35.6 percent of the notes, compared with 31.5 percent at the Nov. 23 sale and an average of 42.3 percent for the past 10 sales.

Direct bidders, non-primary dealer investors that place their bids directly with the Treasury, purchased 6.2 percent of the notes, compared with 15.6 percent last month and the 10-sale average of 12 percent.

Treasury Losses

U.S. notes and bonds have handed investors a 2.1 percent loss in December, paring the annual return to 5.7 percent, according to figures compiled by Bloomberg and the European Federation of Financial Analysts Societies. That's the worst monthly performance among 26 sovereign indexes.

Treasuries rallied yesterday after the U.S. government's $35 billion auction of two-year securities drew strong demand. Bidding amounted to 3.71 times the debt available, the highest since a reading of 3.78 on Sept. 27. The U.S. plans to sell $29 billion of seven-year debt tomorrow.

An index of global bonds was poised to fall for a fourth month, the longest decline in two years, on speculation quickening economic growth will lead stocks to outperform debt in 2011. The gauge has declined 2.2 percent since the end of August, according to Bank of America Merrill Lynch figures.

The Standard & Poor's 500 Index has returned 20 percent during the period, according to data compiled by Bloomberg. The index was little changed today.

Retail Sales

Retail sales, excluding autos, rose 5.5 percent from Nov. 5 through Dec. 24, said MasterCard Advisors' SpendingPulse, which measures retail sales by all payment forms. That compared with a 4.1 percent gain a year earlier. The numbers include sales made over the Internet.

"The economic recovery should continue into the new year, sending the unemployment rate down to 8.6 percent at the end of 2011," said Michael Pond, co-head of interest-rate strategy at Barclays Plc in New York, in an interview with Deirdre Bolton on Bloomberg Television's "InsideTrack" program.

Employers added fewer jobs than forecast in November, and the unemployment rate rose to 9.8 percent, the Labor Department reported Dec. 3.

The Conference Board's consumer confidence index unexpectedly decreased to 52.5 this month from a revised 54.3 in November, the New York-based research group reported today. The median forecast of 61 economists in a Bloomberg News survey was for an increase to 56.3 from a previously reported 54.1.

Property Values

The S&P/Case-Shiller index of property values fell 0.8 percent in October from a year earlier in the biggest year-over- year decline since December 2009. The decrease exceeded the 0.2 percent drop projected by the median forecast of economists surveyed by Bloomberg News.

The difference between rates on 10-year notes and Treasury Inflation Protected Securities, a gauge of trader expectations for consumer prices over the life of the securities, has widened to 2.29 percentage points from 2.11 percentage points on Nov. 30. The five-year average is 2.09 percentage points.

The Federal Reserve bought $6.78 billion of Treasuries maturing from July 2013 through November 2014 today as part of its effort to add $600 billion to the economy through June under the second round of quantitative easing.

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