The Bubble Blues

By The Mogambo Guru

05/09/05 Bubbles – in just about anything you can imagine, from debt to real estate – have taken the country by storm. What will happen when they burst? The Mogambo Guru predicts that the average American's sense of blissful ignorance will be replaced by misery and heartache…

The fact that mortgage applications keep increasing is not surprising. It would have been surprising to learn they had NOT been increasing. The reason is that so much money has been made in buying and selling real estate since the stock market stopped being profitable in 2000, and since people are so desperate to make some money (now that they have sunk into so much debt), that they are willing to take a desperate gamble and plow a few bucks, and a little time, into the housing market, hoping for that big windfall payday (BWP) that will save their financial butts.

Plus, it involves something they understand (houses) as they all live in one, although I am not such an expert, as I live under a bridge and scream at the cars that go by to shut off that damn radio and think about how the Federal Reserve is destroying our money, and then maybe they will spend a little more time at home, thinking and whimpering and hatching plots of revenge against Alan Greenspan, instead of driving up and down the damn roads, up and down, down and up, back and forth, forth and back, night and day, day and night, until I can't stand it any more because it is making me crazy with the driving, driving, driving!

Housing Bubbles: Violating the Principle of Supply and Demand

But plowing into real estate they are, as sales of new homes climbed to a record in March. The Commerce Department reported, "Sales unexpectedly increased 12.2 percent to 1.431 million houses at an annual rate." But before you interpret this to mean that house prices are going up in response to this increased activity, the Commerce Department also reported, "The median price fell to $212,300 in March from $234,100 a month earlier." Wow! A ten percent plunge in prices in one lousy month!

Beyond that, another "wow!" is in order when you consider that this means that demand is going up, but prices are coming down, violating the whole principle of the theory of supply and demand!

Kurt Richebächer, everybody's favorite Austrian school of economics deep-thinker, doesn't even live in the United States, but in Europe. But even from way over there across the Atlantic ocean he can easily see that there is a housing bubble in the United States, and he writes, "The growth of home mortgages exploded from an annual rate of $368.3 billion in 2000 to an annual rate of $884.9 billion in 2004, compared with a simultaneous increase in residential building from $446.9 billion to $662.3 billion. Altogether, the United States experienced a credit expansion of close to $10 trillion during these four years. This equates with simultaneous nominal GDP growth of $1.9 trillion. America's financial system is really one gigantic credit-and-debt bubble."

For a moment, the revelation is so startling that it makes time stand still. My brain gasps and reels as it tried to comprehend the concept of ten MORE trillion dollars in debt (which is almost as much as the total value of ALL the goods and services produced in the whole freaking country in a whole year!) in four lousy years!! Note the use of two exclamation points to indicate that my eyes are bugging out in freaking disbelief!! Look! There they are again!

The Financial Times newspapers quote Paul Kasriel, chief economist at Northern Trust, as remarking that, on a nationwide basis, the market value of real estate is now close to 200% of disposable income. The previous high in that ratio was in the late ’80s, when it climbed close to 160%. They note that he thinks, "A ratio close to 200% cannot last more than a few months. It is the equivalent of NASDAQ trading over 5000."

Housing Bubbles: Three Standard Deviations From the Mean

Speaking of houses, Jeremy Grantham, chairman of GMO, in his letter to his investors, notes that prices of houses are going crazy all over the place. He notes that in the United Kingdom, house prices are selling for six times average earnings of the guys buying the houses, a mortgage so huge that it is more than three standard deviations above the earnings norm (3.6 times annual earnings) established during the previous zillion years.

If you can remember what a standard deviation is, then you are not drinking enough beer. For the rest of us, I put on my Mogambo Educator Mortarboard (MEM), and explain that it is a measure of the variability from the average (also called the "mean"). In this case, three standard deviations from the mean, which is a long, long way from the average, means that the chances are about 1-in-10 zillion that the mortgage application is going to be submitted to a loan officer who is so drunk or incompetent that he will loan somebody enough money to buy a house that is 3.6 times as much as the guy makes in a whole year. From a financial standpoint, the reason that mortgage people don’t loan that kind of money to people is that the guy is almost sure to default on the loan, and the mortgage people hate that. Well, I assume that they hate it, as I surmise from the way the guy at the bank goes ballistic when I tell him that I can’t make this month’s mortgage payment again, which is a long, LONG way from actual default. In my case, about three more months, I figure.

But it is not just in the United Kingdom, but also in Sydney, Australia, where mortgages are routinely made at "about 4.8 times annual earnings." Here in the United States, he notes, "In Boston, a whopping 6.5 times annual earnings (over 2 standard deviations), and for the United States as a whole, about 4.3 times annual income, versus an historical average of 3.4 times income, and is three standard deviations above the mean."

Housing Bubbles: Bubbles Break

Germany remains about the only place where people did not go crazy with this silly house-buying crap, and so they will be rewarded in the end.

I have lost the author of "What do we really know?" and if you are the person who wrote it, I apologize, but if you send me a few bucks maybe I will be more careful next time, but probably not. But whoever it is has also looked at things from this standard deviation thing, although they refer to a standard deviation as a "sigma."

They have looked specifically at economic/financial indices that are, or were, at the 2-sigma level, which are pretty rare occurrences. I can see you are on the edge of your seat, and you want to know, "What happened?"

They say that ALL bubbles (which they define as anything where the average prices are in the range of 2-sigma events) broke and ended badly. So how many bubbles did they find? They found 28 bubbles around the world, including stock markets, currencies, and commodities, and including our stock market bubble here, although they did not, as far as I can tell, include our bond bubble and our housing bubbles in their analysis. And all of them broke, which they characterize as "all the identified bubbles did indeed move all the way back to (or below) the trend that existed prior to those bubbles forming." What they did NOT mention was that the reversion back down to the mean left bankruptcy, heartache and misery strewn all over everything.

And they perfectly sum up The Mogambo's stupid opinion that there is nothing that can be done with bubbles except try and prevent them from forming, and, failing that, suffer from them. They write, "Bad monetarist policy may have caused the Great Depression, and good policy may have let us down gently after 2000 (we shall see), but both were clear asset bubbles and both broke. The monetary environment was different for all 28 bubbles, but all of them broke."

Regards,

The Mogambo Guru
for The Daily Reckoning

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P.S. The Mogambo Sez: The Federal Reserve and the government, in cahoots with their cronies on Wall Street, are going to pull every trick in the book to keep the markets up. How else to explain that the stock market ended up after the Fed raised interest rates today, for the eighth time in a row?