

Perspectives

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History Inevitably Repeats Itself

"Thus, over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money. That is, over-indebtedness may lend importance to over-investment or over-speculation. The same is true as to over-confidence. I fancy that overconfidence seldom does any great harm except when, as, and if, it beguiles its victims into debt" (Irving Fisher, 1934).

A CLASSIC BOOM/BUST CYCLE

What is unfolding in the U.S. is a classic credit-driven boom/bust cycle that has been repeated many times before. Each cycle has its own unique aspects, but the big-picture stylized facts are the same. The roots of the boom phase are often found in deregulation and cheap money, which spark an uptrend in real estate prices. As prices rise and home equity grows, investors and homeowners are enticed to lever up, buy more and often times, more than their incomes can sustain. Banks and other lenders gain a false sense of security and loosen their lending standards well beyond what is prudent. Inevitably, the bubble bursts and the fall in real estate prices interacts negatively with balance sheets as deleveraging hits lenders and borrowers alike. Forced selling, falling collateral values and heightened risk aversion spread the pain to other parts of the economy and to financial markets. Bank capital becomes impaired, generating a substantial tightening in lending standards. A credit crunch intensifies the economic downturn. Ultimately, a very aggressive policy response is needed to end the financial crisis, often involving nationalization of some parts of the financial markets or real estate market.

The decline in residential real estate prices was substantial in all cases. Equity prices dropped. Financial stocks were hit even harder. The impact on the economy was painful, often involving a lengthy and/or deep recession. Nonetheless, a

swing in the availability of credit turbocharged the boom and bust in real estate and the economy. The implication for the U.S. today is that deleveraging will not prevent a recovery, but could be a headwind to growth for many years. This is a hopeful sign that we do not necessarily have to wait for U.S. house prices to stop falling before we get some relief in credit markets. Nonetheless, ending the financial crises in the past required massive policy intervention, typically including a partial nationalization of the banking. Once nationalization began, financial markets took off shortly thereafter.

The implication is that past crises required more than just easier monetary policy and some general fiscal stimulus. They usually involved a massive injection of central bank or taxpayer funds to relieve the financial system of the bad debts. Skittish investors needed some sense that a majority of the problem had been dealt with, and that the real estate meltdown no longer posed a systemic financial sector risk. The U.S. authorities have been aggressive in responding to the current crisis.

The Bear Stearns bailout has given some momentum to the Barney Frank/Chris Dodd proposals currently working their way through Congress to provide relief to struggling homeowners. Under the Barney Frank version, lenders would first mark down the value of the loan, creating positive equity for the homeowner (a loan-to-value ratio of 90%). The loan would

then be refinanced through the FHA. With \$15 billion in extra funding, the FHA would be able to provide up to \$300 billion in new loan insurance covering 1-2 million mortgage loans. Such a plan would diminish marginally the ultimate peak in the foreclosure rate, but would not end the housing market pain anytime soon.

The U.S. has entered a major deleveraging phase, both in terms of financial market leverage and household balance sheets. History shows that the unwinding of a credit-fueled asset price bubble can be long and painful. Fortunately, the U.S. authorities have learned from Japan's mistakes and are working hard to slow down the pace. It thus seems unlikely that the U.S. is headed for a Japan-style slump that lasts for a decade or more. Nonetheless, even aggressive policy action cannot stop the inevitable unwinding of the previous excesses. The U.S. economy is likely to suffer at least a mild recession, followed by a lackluster recovery period. The risks are to the downside. On a positive note, a sustained period of sub-par growth will kill off any lingering inflationary pressures, despite extremely low interest rates and a weaker dollar. Long-term investors who can accept liquidity risk can begin accumulating positions. The recession is only just getting underway. Nonetheless, the near term is likely to be rocky for anything besides very high-quality securities which is consistent with the components of our managed model portfolios. Historically, it has not paid to buy junk bonds.

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