SAFEHAVEN

April 2014 - Castles in The Air

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The word "bubble" is suffering from overuse. Still, with money for nothing inflating markets around the world, we are seeing how prices inflate to enormous proportions where the prospect of pushing those prices even higher draws a crowd. When such artificial stimulants to bond, mortgage and tea-cup enthusiasm reaches a peak, the switch from green to red is often quick.

A reminder comes by way of "Run, Run, Run, Was the Financial Crisis Panic over Institution Runs Justified?" by Vern McKinley. Published on April 10, 2014, by the Cato Institute, McKinley writes: "Countrywide's [a premier sub-prime lender when the going was good - FJS] second-quarter 2007 financial results indicated no significant weaknesses and the major rating agencies assigned it strong ratings with a stable outlook. [Although, a *MarketWatch* headline on July 24, 2007: "U.S. Stocks Close Sharply Off on Credit Woes, Dow Slides 226 points; Countrywide Says Risks Extend Beyond Subprime." This is a reminder that "the market" quickly forgets what it does not want to know, as we see on May 1, 2014. - FJS]

"This calm changed dramatically on August 2, 2007, as Countrywide was unable to roll over its commercial paper or borrow in the repo market.... On August 14, Countrywide released its July operational results, reporting that foreclosures and delinquencies were up and that loan production had fallen by 14% during the preceding month.... On August 15... a Merrill Lynch analyst switched Countrywide from a "buy" to a "sell" rating.... [T]hat led to a *Los Angeles Times* article that [Angelo] Mozilo [CEO of Countrywide] blamed for causing the run that ensued.... One customer pulled $500,000 from a Countrywide Bank branch... 'It's because of the fear of bankruptcy.... I don't care if it's FDIC-insured - I want out.'"

Countrywide follows a pattern seen dozens of times over the past twenty years. The quality of loans had fallen off a cliff but the economists, the brokerage houses, and - of course - the Federal Reserve - were in the dark. The stock market played the schizophrenic, "Oh, No!" and "Good thing that's Over!" game. It peaked in October 2007. The catalyst for collapse was "loan production had fallen by 14%." Even the *carpe diem* frat boys on TV know the deteriorating quality of loans will not cause a ruckus as long as the *percentage* of missed payments and defaults does not rise. But, once Countrywide & friends could no longer feed the fast, rising *rate* of new loan production, the façade was near its end. The combination of more defaults and lower production is soon impossible to hide.

The FOMC (Federal Open Market Committee, where monetary policy is set) had talked about houses at its meeting on March 27-28, 2006. Federal Reserve Chairman Ben S. Bernanke reminded the anointed: "residential housing is, of course, only about 6 percent of GDP." We can read, actually see, inside the professor's mind, since it is so simple: He is looking at a pie chart of

the GDP, with slices of red, magenta, honeydew, and fern. The residential housing slice is a thin one, and, as his sort is programmed to regurgitate, isolated from the others. Any ambitious student at Princeton or the FOMC knows "6%" is the "A" response. Lights out.

At the December 2006 meeting, reclining even deeper into his barcalounger, the most prominent cheerleader for the Great Moderation was tranquil. He tossed manufacturing sectors, including furniture and appliances into his splendid-isolation view, since "this is about 15 percent of the economy compared with 85 percent of the economy." The 85 percent was another world.

Bernanke went on in this vein through 2007, not taking the time to bone up on inevitable cross currents that accelerate when recognition and margin calls lead the man at the bank to declare "I want out."

A sample of the commotion after Countrywide's August 15, 2007, hiccup follows; showing how quickly an accumulation of accepted beliefs vanish in a credit collapse:

Aug. 15, 2007 (Bloomberg) POOLE SAYS "REAL ECONOMY"UNHURT BY SUBPRIME COLLAPSE

Aug. 16 (Bloomberg) - "Investors are scooping up U.S. Treasury bills like few times in history as an expanding credit crunch makes it hard for companies to roll over short-term debt. The yield on the three-month Treasury bill fell 0.54 percentage point yesterday to 4.09 percent, the lowest since 2005. It was the biggest single-day decline since Oct. 13, 1989, when the Dow Jones Industrial Average tumbled 6.9 percent...."

Aug. 16 (Thomson Financial) PAULSON SEES MARKET TURMOIL STALLING U.S. GROWTH, BUT NO RECESSION - "U.S. Treasury Secretary Henry Paulson said... the financial system and economy are 'strong enough to absorb the losses.... **'[L]ooking over periods of stress that I've seen, this is the strongest global economy we've had,' he said."**

Aug. 17 (Boston Globe) "First Magnus Financial Corp., based in Tucson, which purchases mortgages from loan brokers and is one of the 10 largest mortgage wholesalers in New England, yesterday said it would no longer fund new loans...."

Aug. 21 (Reuters) - MARSH: MANY CLAIMS LOOM IN THE SUBPRIME CRISIS "Marsh Inc., the world's largest insurance broker and risk adviser, yesterday warned financial institutions they may face more claims as a result of the subprime mortgage crisis...."

Aug. 21 (Bloomberg) "COMERCIAL PAPER ROILS BORROWERS WITH $550 BILLION COMING DUE "Ottimo Funding LLC, whose name is Italian for 'excellent, has the highest possible credit rating and doesn't own subprime mortgage bonds. That made no difference to investors who refused to buy Ottimo's $3 billion of short-term debt this month as losses on home loans to risky borrowers infect the global credit markets. 'It's pretty much a straight contagion,' said George Marshman, chief investment officer of Stamford, Connecticut- based Aladdin Capital Management, which oversees about $20 billion, including Ottimo."

Aug. 21 (Fortune) CAPITAL ONE AND THE MORTGAGE DOMINO EFFECT "Capital One's shuttered GreenPoint Mortgage is the latest mortgage banking explosion to bump Wall Street's panic meter up a notch."

Aug 21 (Los Angeles Times) "THE NUMBER OF U.S. HOMES FACING FORECLOSURE SURGED 58 PERCENT IN THE FIRST SIX MONTHS OF THE YEAR...."

Aug. 22 - (Reuters) "TIGHTENING GLOBAL CREDIT MARKETS HAVE TAKEN A TOLL ON U.S. MORTGAGE-BACKED SECURITIES ISSUED BY FANNIE MAE AND FREDDIE Mac...."

Aug 22 - (AP) MONEY MARKET FUNDS FACE PRESSURE AMID BROADER UNEASE ABOUT CREDIT "The market turmoil of the past month spawned by growing credit market problems is spilling over to money market funds...."

Aug. 22 (Bloomberg) DEVELOPER'S BIG MANHATTAN MOVE FACES A CREDIT SQEEZE "Harry Macklowe, the New York developer, was flying high in February when he decided to buy a portfolio of prime Midtown Manhattan office towers for nearly $7 billion, using only $50 million of his own money.... Skip to next paragraphHis 2003 purchase of the General Motors Building on 59th Street and Fifth Avenue for $1.4 billion, though derided at the time as reckless, had been vindicated as the value of the building soared, enhancing Mr. Macklowe's reputation as a visionary tycoon.... But as the crisis over subprime residential mortgages spills over into other real estate sectors, causing a severe tightening of credit, there is widespread talk in the industry that Mr. Macklowe is in deep trouble, so much so that he could lose control not only of the newly acquired portfolio but also the G.M. Building and other properties that were used as collateral for short-term debt that must be repaid six months from now."

Aug. 22 (Bloomberg) - TOLL BROTHERS INC. THE LARGEST U.S. LUXURY HOMEBUILDER, SAID THIRD-QUARTER PROFITS FELL 85 PERCENT"

Aug. 22 (TheStreet.com) IS WAMU THE NEXT COUNRTRYWIDE?

Specifically stated in the travails of Harry Macklowe, but running through the other dislocations mentioned, is collateral. With Macklowe, it is collateral in the literal sense. Given the turmoil after August 15, 2007, lenders marked down the value of Macklowe's assets that stood behind his borrowings. As a hunch, his assets were additionally discounted because "he decided to buy a portfolio of prime Midtown Manhattan office towers for nearly $7 billion, using only $50 million of his own money." In other words, when the reliable but jury-rigged, "Greenspan/Bernanke put" becomes unhinged, the (downward) revaluation of collateral is not a cold, hard calculation, but, "I want out," on the lenders part.

The FOMC chatted about their magenta and honeydew economy deep into 2008. Federal Reserve Chairman Ben S. Bernanke told an audience of economists on June 9, 2008: "The risk that the economy has entered a substantial downturn appears to have diminished over the past month or so." The recently released 2008 FOMC transcripts show Ben & Co. were not putting on a brave face. They really believed this stuff.

A handful of district *presidents* operated with a full seabag, and could see the 6% of GDP was not separate from the professor's textbook, FOMC-Approved economy. ("Yes, Ben, 6%. Another "A".)

The lethargy is worse in 2014. Old hands on the Federal Reserve staff who dealt in markets have retired. The professors' minds are more constipated than ever. Federal Reserve Chairwoman Janet Yellen sounds like Alan Greenspan in 2005 - or 1995: The Fed is lifting the stock market, the housing market, and the consequent "channel" from those to consumer spending will fuel "escape velocity."

She could not be more wrong. Consumers are not in a position to increase credit. The Greenspan leveraging of America could only happen once. An *extraordinary* supplement of consumer spending and credit is needed to save the Holy GDP. Consumer credit debt rose from 105% to 117% during the first Reagan Administration (1980-1985) to 205% in 2007. Total credit (business, household, financial, and government) rose from 150% to 350% of GDP. This will not rise to 500%.

Yellen cannot think differently. Federal Reserve policy will "encourage consumers to spend and businesses to invest, to promote a recovery in the housing market, and to put more people to work." (Janet Yellen, March 31, 2014, National Interagency Community Reinvestment Conference, Chicago, Ill) In the same speech: "We are trying to help families afford things they need so that greater spending can drive job creation and even more spending, thereby strengthening the recovery." The Fed believes the "Wealth Effect" from rising asset prices is the "Channel" to GDP "Escape Velocity." (The first thing we do is kill their vocabulary.)

This channel has never worked as they claim. Michael Feroli, chief U.S. economist at J.P. Morgan, calculates the amount of acquired wealth spent by consumers was 3.8% from 1952 through 2009. That is 3.8 cents of every additional dollar in "wealth." (Another word economists have mangled.) Since 2009, Feroli calculates households have spent 1.9 cents of each incremental dollar, half the historical average. Feroli also found that withdrawal of home equity has been negative for the past five years.

Yellen toted her "wealth" channel to Congressman Frank Lucas on February 11, 2014: "I would agree that one of the channels by which monetary policy works is asset prices, and we have been trying to push down interest rates, particularly longer-term interest rates. Those rates do matter to the valuation of all assets, both [*Sic*] stocks, houses, and land prices. And so I think it is fair to say that our monetary policy has had an effect of boosting asset prices."

Yellen's theoretical world not only lacks a theory but is at odds with reality. Maybe the Fed can claim a partial victory: the U.S. Census median price for new homes sold in March 2014 rose 13.3% from a year earlier and reached a new record high of $290,000. As one might guess, sales have fallen.

Redfin, a real-estate brokerage firm, calculates house sales have collapsed in 2013's most effervescent Arizona and California housing markets. In Phoenix, inventories rose 42.7% from March 2013 but sales fell 17.4%. Redfin describes what eludes Yellen: "Someone who

purchased a $350,000 home in Riverside [CA] in March 2013 with a twenty percent down payment and a 30-year fixed mortgage rate of 3.4% would have a monthly mortgage payment of $1,241. But with prices up 19.6%, the same home would now cost $418,600. At the current mortgage rate of 4.33%, the monthly mortgage payment on that home is now $1,663, a 34% jump from a year ago."

California Association of Realtors Chief Economist Leslie Appleton-Young recently warned: "Housing affordability is really taking a bite out of the market. We haven't seen this issue since 2007." This is a remarkable comparison, given that, just seven years earlier, California housing was collapsing faster than London during the Blitz. In October 2007, California Association of Realtors Chief Economist Leslie Appleton-Young announced: "The impact of the credit crunch spread throughout all tiers of the market in September." California statewide median home prices had sunk $58,140 from September 2006 and statewide home sales fell 39% from the year before. The California Association of Realtors "Unsold Inventory Index" increased to 16.6 months, double the level in March 2007. It had been 6.4 months in September 2006. San Francisco Bay Area sales fell 46% over the past year; High Desert sales were 63% lower. (In December 2003, California Association of Realtors Chief Economist Leslie Appleton-Young told her audience the chronic shortage of homes for sale coupled with attractively low mortgage rates would keep the pressure on buyers: "The message is 'Boy, this is the time,' Young said. 'It doesn't look like the situation is going to change any time soon.'")

The rate of home ownership in the United States just fell to the lowest level since 1995: 64.8%. It is not a coincidence that then-Fed Chairman Alan Greenspan started confiscating our interest rates around that time, partly to goose the housing market. He had enjoined Fannie Mae and Freddie Mac to turn their mortgage regurgitations into assembly lines, to quicken the pace of credit flows since the economy was moving to China.

At the July 1995 FOMC meeting, Greenspan expounded on mortgage growth and the GDP: "[M]ortgage applications for purchasing new and existing homes have been moving up....The home builders data clearly indicate that things are moving. This is important not only because of the importance of the residential construction sector, but also because history suggests that motor vehicle sales and some parts of the residential building industry move together. If there is firmness in the home building area it has to exert, if history is any guide, some upward movement in the motor vehicle area, which would be very useful." Especially useful to a public servant whose annual review consists of the percentage increase to GDP.

The ownership rate of houses peaked at 69.2% in 2004. The mad rush into home mortgages was only possible through the Fed's perpetual perversion of interest rates. When interest rates are too low, the riffraff banned from Vegas hangs a "Loans" shingle in the pool hall.

It appears Chairman Yellen came close to admitting low rates had destroyed balance in the housing market in her February 2014 meeting with the Congressmen. This is gathered from the phrasing of a question by Representative Patrick Murphy:

MURPHY: "The collapse of the housing bubble and resulting financial crisis devastated the global economy and cost Americans $17 trillion worth of wealth. Many of us assign

responsibility for low interest rates and lax capital and leverage standards to the Federal Reserve and then Chairman Greenspan. While I do not believe the Fed caused the crisis, [Come on, Murph! Let it fly! - FJS] its policies certainly helped fuel the Bubble. In June 2009, you said that higher short-term interest rates might have slowed the unsustainable increase in housing prices. With the benefit of hindsight, would measures to slow the housing bubble have been appropriate?"

YELLEN: ".... [P]olicies to have addressed the factors that led to that Bubble would certainly have been desirable. I think a major failure there was in regulation and in supervision, and not just in monetary policy."

The bureaucrat's utopia. New and more regulation.

The housing market is not hitting a single cylinder. The Fed cut mortgage rates from 6.5% to 3.3% over five years. Around 80% of mortgage originations are refinancings, not money-purchase mortgages. And now, that has dried up, for the simple arithmetic Redfin described in the Riverside, California market.

The combination of higher payments (delinquencies rise) and lower volume is similar to when Countrywide's loan production sank in the summer of 2007. Mortgage originations from the four big banks (Wells Fargo, Bank of America, J.P.MorganChase, Citi) averaged $300 billion a quarter from 2010 through 2013 (average of $1.2 trillion each year, $300 billion a quarter). They fell to $67 billion in the first quarter of 2014. Total mortgage-backed security (MBS) issuance has fallen from $185 billion in June 2013 to $87.2 billion March 2014.

This is bad for collateral. When credit expands beyond its capacity to fund positive-return projects, asset quality deteriorates This is a dangerous moment: asset prices must not fall, and acceptable collateral must rise at a faster rate, not fall by $98 billion a month, as MBS securitization has since June 2013.

House sales affirm life is good at the top. The bottom is getting worse. The National Association of Realtors (NAR) existing home sales data for March 2014 calculates number of houses sold for below $100,000 fell 17% year over year. Those between $100,000 and $250,000, fell 10%. House sales for prices above $1 million rose 14.8% in February 2014 and 7.8% in March 2014. Vacation home sales rose 30% in 2013, from 553,000 in 2012 to 717,000 in 2013.

Spending at the top must not slacken. Hermès has stationed a baseball glove in its window - with a sales tag of $14,100. To the question, "Why so expensive?" *MarketWatch* was reminded the mitt is "absolutely top-grade." The Ritz-Carlton in Chicago offers a $100 grilled cheese sandwich, stuffed with 40-year-old aged Wisconsin cheddar that's been "infused with 24K gold flakes." New asset classes include old cars. Classic Auto Funds Limited (CAF) is "launching several investment partnerships using collectable cars as the hard asset." Fund CAF/1 is already up and running, or, at least, in storage: with a 1971 Ferrari Dino 246 GT and a 1964 Maserati Mistral 3.5. The investment partners (conjecture comes from how this ended in 2007) will turn this asset into (discounted) collateral. The investors will then use the borrowed money to buy Facebook shares (passé as that may be) or to bid against Chinese businessman Liu Yiqian, who

bought a fifteenth century porcelain cup at Southeby's in Hong Kong for $36 million. Also recalling 2007: how will this collateral look to the lender in a panic? The larger point here is that collateral's velocity cannot slow down, from fatigue or concern. The imaginary value behind assets must keep rising, or all will fall.

Federal Reserve Chairman Janet Yellen came to the job touted as a "great labor economist." She betrayed an untutored knowledge of labor data during a speech in Chicago on March 31, 2014: "Since the unemployment rate peaked at 10 percent in October 2009, the economy has added more than 7-1/2 million jobs and the unemployment rate has fallen more than 3 percentage points to 6.7 percent. That progress has been gradual but remarkably steady--February was the 41st consecutive month of payroll growth, one of the longest stretches ever."

What jobs have been created during those 41 months? Not the sort that can pay for a house. Before looking at the poor quality, the quantity is absent. Yellen is looking for a renaissance when there are fewer payroll (NFP: non-farm payroll) workers than in 2007.

In "The Born Again Jobs Scam: The Ugly Truth Behind 'Jobs Friday'," David Stockman writes on his ContraCorner website there were 138.4 million NFP jobs in December 2007. In March 2014, the total was 137.9 million. There are 500,000 fewer payroll workers today.

The span from December 2007 to March 2014 is 75 months. Seventy-five months after jobs peaked in 1990 (as we entered the 1900-1991 recession), there were 10 million *net* new jobs. Seventy-five months after the post-2000 job peak, there were five million *net* new jobs. In March 2014, we are still half-a-million jobs south of the zero bound.

Stockman makes the distinction of "breadwinner jobs." Breadwinner jobs produce annual pay of about $45,000. "The Born Again Jobs Scam," lists the breadwinner-job industries and income data as calculated by the Bureau of Labor Statistics.

It is assumed here that only those with breadwinner jobs can buy a house. Short of that, there are methods to finagle a house through student loan and the used-car loan markets, but that is limited.

The Greenspan NASDAQ Bubble peaked in 2000 and breadwinner jobs reached 72.7 million. After Greenspan and Bernanke artificially revved up the mortgage-finance economy through 2007, jobs topped out at 71.9 million in December 2007. By June 2009, the deflated mortgage bubble had cost five million jobs: there were 66.2 million NFP workers in June 2009. By March 2014, there were 68.3 million breadwinner jobs, 3.6 million fewer than in December 2007, a level achieved during the second Clinton Administration. The quality within the breadwinner industries has deteriorated significantly and the population has grown.

Ben Bernanke's "six percent" also failed because his approach was wholly abstract. Construction and its financing had lost its mind. Today, again, grandiosity is the rule.

Hudson Yards, on New York's West Side, is the largest such development in Manhattan since Rockefeller Center in the 1930s. Residential towers at 15 Hudson Yards and 35 Hudson Yards

will rise 910 feet, with 70 floors of "unobstructed views of the of the city and Hudson River.... 15 Hudson Yards will be the ideal place for New York's creative visionaries to live." A search for a perfect resident at 35 Hudson Yards was unavailing.

The 52-story South Tower will be the first to soar. That in itself is commonplace. It is when one reads "it is to become the home of the luxury handbag maker Coach," tentatively named "Coach Tower," that securitization of vintage cars looks relatively sane. The Masterplan, on Hudson Yards' promotion website, expects 17,440,000 square feet of office, residential, hotels, shops on 28 acres.

When Mayor Bloomberg launched the Hudson Yards initiative, he compared it to Canary Wharf's influence in London. This may not be the most encouraging comparison, at least for the builders, since Canary Wharf crushed the Reichmann Family (Olympia & York), and its creditors, with $20 billion of unpaid bills when it filed for bankruptcy.

As to London, the glass cube tower invasion rises as one of the most celebrated skyline additions in decades goes broke. On April 25, 2014, the Gherkin Building was placed in receivership. The following paragraph from *Realty Today* just about sums up the derangement of minds and finance in 2007: "VG Immobilien purchased the building in 2007 from architects Norman + Foster [Always a red flag for extravagance - FJS] for $1 billion. The Germany-based realty firm financed the deal through a loan, part of which was in Swiss Francs. The currency has gained about 63 percent on the dollar in the last seven years, which ballooned the debt price to a point that it breached levels of debt allowed to be held in the country, reports Bloomberg."

Another cautionary comparison lies partially built but wholly insolvent in Seoul, South Korea. "Dream Hub," a proposed 138-acre building project, midwifed by former Seoul Mayor Oh Se-Hoon (this was to be his ticket to the presidency), has entered bankruptcy. Sparing the details reported by the *Wall Street Journal* (which published "just the tip of the iceberg"), six years after groundbreaking, the anticipated 150-story, 2,181-foot-tall skyscraper is stillborn, and Oh Se-Hoon will not comment on his foregone objective to turn Seoul "into a center of global commerce."

Boston Properties has acquired the groundbreaking (on March 27, 2013) Salesforce Tower in San Francisco. The 1,070 foot, 61-floor tower (expected completion in 2017) will rise 200 feet above Transamerica Pyramid, currently the tallest building in San Francisco, and the west coast. It will "eventually be eclipsed in height by the 73-story Wilshire Grand in Los Angeles." Originally contracted on "spec," meaning the builder did not have a substantial tenant at the outset, Salesforce will rent 700,000 square feet in its namesake skyscraper. Mayor Lee of San Francisco commented: "It's not just about an expanding company. It's about a company that has faith in our city and is demonstrating that. And has faith in the kind of values we try to teach our kids about giving back."

These mayors. ("Boston Mayor Martin Walsh said [in late April] he wants to make his city the tech capital of the world.... And he's "not afraid to build a skyscraper for [high-tech] workforce housing.") What does that mean? A case might be made that Boston Properties is the model of faith and charity. Salesforce "had operating losses of $35 million, $111 million, and $286 million

the past 3 years? (Yes, the losses are increasing in size.) On top of that, CRM has net debt of over $1 billion on their balance sheet." (Thank you, Kevin Duffy at Bearing Asset Management) San Francisco as a whole is grossly overrun by social media operations at unsustainable rents that have a whiff of Webvan, the San Francisco Internet grocer that went public in 2000, broke in 2001, after placing a $1 billion order with Bechtel to build grocery warehouses.

Despite mounting evidence the house and skyscraper markets are long in the tooth, they continue to rise. Harry Macklowe, undeterred after losing the GM Building (and seven others following the 2007 credit crunch), received FAA approval to build "the tallest residential tower in the western hemisphere." If all goes as planned (it is under construction), the 95-story apartment house, at 432 Park Avenue, will glower down upon Central Park, with "[p]rices at the proposed 1,396-foot tall skyscraper start[ing] at $20 million for three-bedroom units with libraries. Full-floor penthouses with 360-degree views cost up to $95 million. A one-bedroom can be had for close to $7 million." Harry "Macklowe claims he has already sold one-third of the 123 units, but [CORE broker Jarrod Guy Randolph] worried about pricing."

Come on, Jarrod. Follow Harry. He didn't even graduate from college. Parents and students paying extortionist tuitions, take note.