February 2008 Local Market & Economics Report

The Wall Report

an economic commentary by Terrence R. Wall

Note: I wrote this report over the weekend, finishing it on Monday prior to the Producer Price Index being reported on Tuesday morning, February 26 which showed the PPI was up 1% in January. This is the highest it's been in 26 years. The PPI is running at an annualized rate of 12%. This is a lot higher than I had anticipated despite my warnings about excess inflation.

THE END OF AN ERA

I've been struggling to understand what is happening and how certain factors are converging and what that means for our economic future when I heard a guy named James Pethokoukis on CNBC say it's "the end of an era". He's the only one I have heard articulate what I have been saying, which is that certain events are occurring that will cause a convergence of negative economic consequences over the next few years. What Pethokoukis is referring to is the Reagan initiated era of lowering regulation, lowering taxes, and more economic freedom that kicked off 25 years of unprecedented economic prosperity (that even Clinton continued with his capital gains tax cut, NAFTA, and mostly hands-off approach to the economy and business in general). I would add to this during that same time a period of declining interest rates. (Short-term rates stood at 22% in 1982 and were still at 12% in 1991 when I started in business.)

What I am referring to is the coming increase in tax rates (because the Bush tax cuts were not renewed), the coming increase in trade barriers (because Congress didn't renew the Fast Track trade approval process), and a coming era of increased interest rates. The combination of these policy changes will result in less economic freedom and more economic volatility over the next four years, which is in stark contrast to the relative economic prosperity we have experienced since 1982 (with a couple minor and short exceptions). Think about it – my generation and the generations that follow have never, ever experienced a major economic downturn of the kind experienced by my father's generation or the Baby Boom generation (stagflation of the 1970's and the 22% interest rates of 1979-1982).

But enough on that for now; let's start our discussion with a quick review of the past six months and how all this is leading up to my comments about what the next four years hold.

David Hackworthy of Robert W. Baird told me, "you really nailed the whole subprime thing." Hey, when the coffee shop clerk tells me she can't afford even a $50 a month rise in her monthly mortgage payments and she's on an ARM, it's a clue to something bigger.

Admittedly, after having exited the stock market during the summer, I reinvested when the market was down in August. But then realizing that there were a record number of borrowers with ARMs and interest rates were rising, it wasn't difficult to do the math. In addition, when the whole mess hits the fan, the usual paradigm was not going to change, that paradigm being that the CEO firings at the financial houses was

going to lead to the new CEOs trying to clear out all the deadwood (bad subprime investments) by taking huge write-offs at year end so that the new CEOs could start the new year (their first year) with a clean slate. This action would naturally result in a down market, so I exited the market again during the high in October and have stayed out until the market started bottoming out just recently.

As a result I avoided a 54% drop in the NASDAQ and a 12.4% drop in the Dow. This was based upon not an analysis of the market, but rather an analysis of human behavior.

The one puzzling thing I couldn't understand about last year is why the GDP jumped up so suddenly and briefly during the third quarter of 2007 (4.9%), until the data finally became available that showed that the Fed pumped liquidity into the financial system. Although GDP did drop to an anemic 0.6% increase in the 4th quarter; I stated in the third quarter that there would be a slow down or "recession lite" as I called it (not withstanding other changes).

However, the ups and downs of GDP have far more to do with the Fed providing more or less money supply than anything else, which is why I now expect GDP to increase somewhat on paper even though we may feel like we've entered a recession or slowdown. The Fed has held a couple auctions of money (how much will you pay?!) which should result in pumping up the GDP figure.

Unfortunately, (I was also the first one to say that) the Fed priming the banks with additional liquidity was like trying to cure a drug addict's addiction by giving him more of his favorite drug so he won't suffer the signs of withdrawal. What Bernanke seems to have missed is that by temporarily avoiding the suffering associated with the withdraw; he has only prolonged the inevitable greater suffering that will have to occur to wean the addict off the drug. As I said last summer, the world is awash in liquidity and liquidity was not the issue; credit was. So why does the Fed try to cure the 'problem' with liquidity? All Bernanke did was give the bankers an excuse to not take the hit in 2007.

So now that Bernanke has given the New York financial houses another shot in the arm, many of them chose not to take their pain at year end, thinking instead that Bernanke would bail them out in 2008. The problem with that, as we have recently seen, is that many of the financial houses then took their write-offs in January (with more to come in 2008) instead of getting it over with at year end. All Bernanke did was push the problem into 2008 as well as stoke the flames of inflation for 2008 and 2009.

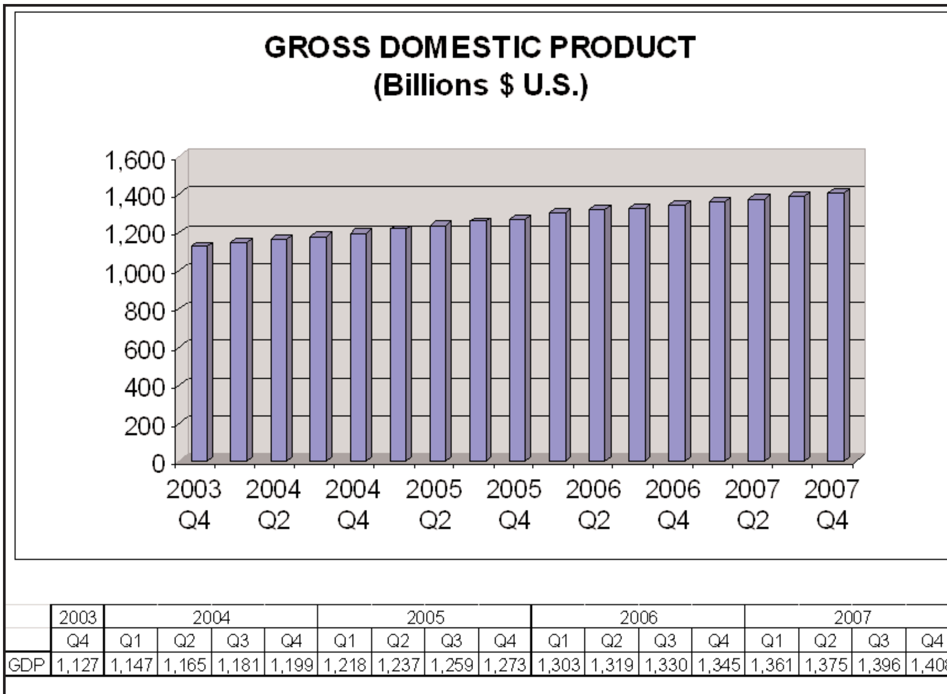
Chair of the Federal Reserve Ben Bernanke.

I don't think Bernanke understands that inflation (like high oil and gold prices) is the result of his own policies of extending more liquidity and a greater money supply combined with the Bush Administration's long-time policy of weakening the dollar. (You'll recall that for three years now I have been saying that Bush's policy of weakening the dollar, if successful, would create significant negative impacts and is no different than a third-world nation's dictator debasing his own currency for short-term political gain.) Bush finally got what he wanted, a U.S. dollar 14% weaker on the Euro and a good deal weaker on the Chinese Yuan, and weaker to the point of some countries not even wanting to accept the U.S. dollar as payment by tourists. (When has that ever happened?!)

The result of the weaker dollar and the additional liquidity that Bernanke infused into the system is higher oil prices, higher gold and other commodity prices (like steel, copper, etc.) and now inflation at more than double the Fed's target. (Of course, if you're in real estate, inflation benefits you by inflating the value of your real assets; and I recently instructed that our leases be changed to include language that protects us against inflation by raising rents according to the higher of a pre-set escalator or CPI.) You can

protect yourself against inflation by investing in real estate or the new Treasuries that are tied to inflation or by investing in other assets that benefit from inflation, that is, until the Fed is forced to clamp down.)

If Bernanke lowers interest rates even more this spring, the economy is probably headed towards a perfect storm a few years from now even though this year will look good – the combination of excess liquidity (in spite of tighter credit), the resulting inflation combined with the Bush tax cuts not being renewed (= automatic tax increase), and decreased international trade (resulting from Congress refusing to extend Bush's fast-track authority to automatically approve foreign trade agreements) will have consequences in future years. The result may be that the economy may experience a blip up in GDP this year (in spite of there being a downturn on Wall Street that has now bled over to Main Street) but a downturn in 2009 or later. And while the GDP may be positive on a technical data standpoint, we'll continue to feel like we're in a recession, (especially since the mass media continues to hammer home the negatives during the election year).



	2003	2004				2005				2006				2007			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	1,127	1,147	1,165	1,181	1,199	1,218	1,237	1,259	1,273	1,303	1,319	1,330	1,345	1,361	1,375	1,396	1,408

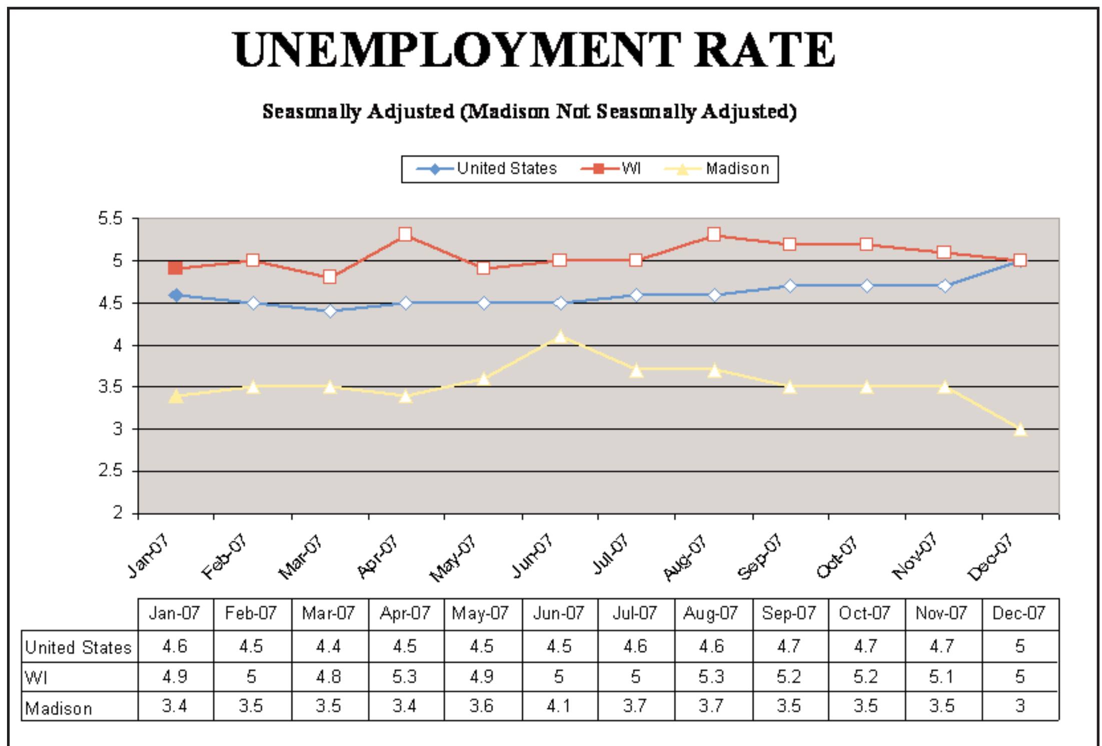
Likewise, while GDP may have dipped slightly into negative territory during the first quarter 2008, with the emergency rate-cut that the Fed instituted recently and the unexpected Bush rebates, the economy may uptick this summer. (Of course, there's nothing like the government taking probably $1200 out of our pockets so that it can rebate back $600; the difference being that there is a cost to issue those rebate checks – which is not a very efficient way to give us a tax cut.) In the end, statistical analysis of past rebates proves that the rebate checks may not be spent on consumer goods, but rather may be put towards debt reduction, thereby not having the positive impact on the economy that Bush and Congress envision. Making the Bush tax cuts permanent would have done much more.

The bottom line may be that inflation increases going into 2009, forcing the Fed to then clamp down on interest rates and liquidity once the Fed perceives that the banking and subprime crisis is over. For a period of time then, we may have a unique combination of inflation, tighter credit, less liquidity, increased taxes and lower international trade as the Democratic controlled Congress fails to approve new trade agreements (and maybe even tries to undo a few that Clinton and Bush signed into law).

So what will all this mean? We should be fine for 2008 enjoying lower interest rates, higher liquidity and no credit problems for those businesses with good credit. However, watch out for 2009 and 2010 given the convergence of all these factors and a new President and a new Congress whose actions no one can predict. If the President is a Republican, the best we can hope for is a stalemate with a Democratically controlled Congress (which is not likely to change since there is a record number of Republicans retiring). The worst could be a Democratically controlled Congress and a Democrat in the White House. (Just look what happened when the Republicans controlled Congress and the White House – a free-for-all in spending!) (I witnessed Obama's chief economist say on CNBC that Obama will raise taxes.) Therefore, my comments are not politically motivated – rather I am simply taking what the candidates do and say as true – increased spending, increased taxes, and increased trade barriers, all of which mean a slowing economy and money is withdrawn from the economy by the government.

And sooner or later, investors are going to wake up to the fact that in 2010 the capital gains rate is going to automatically jump up by 33% to 20% (from 15%). I would speculate that we would see a sell-off in the market by for-profit investors (not the not-for-profit pension funds) before then, maybe in 2009. (Or will they sell off in late 2008 after they see who won the White House and who won Congress – fearing a new tax increase in 2009 that would be retroactive to January 1, 2009?)

So are these circumstances closer to the Great Depression or the stagflation of the 1970's? Let's take a look in order to see where the economy may be headed.



	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07
United States	4.6	4.5	4.4	4.5	4.5	4.5	4.6	4.6	4.7	4.7	4.7	5
WI	4.9	5	4.8	5.3	4.9	5	5	5.3	5.2	5.2	5.1	5
Madison	3.4	3.5	3.5	3.4	3.6	4.1	3.7	3.7	3.5	3.5	3.5	3

The Great Depression was caused initially by the Smoot-Hawley tariff bill that imposed huge tariffs on imports, thereby shutting down free trade and restricting the flow of goods and capital, lessening the velocity of money. The Fed at the time then restricted the money supply thinking that was the cure. Roosevelt then came into office and imposed large tax increases (thereby removing even more capital from the economy and lowering the velocity of money even further) deepening the recession into a long depression. (Tax rates went as high as 90% back then.) The crash of the stock market was a symptom of the economy, not the cause of the Great Depression.

The 1970's stagflation was caused by a combination of events, all government imposed. Nixon took the U.S. dollar off the gold standard, lessening its value and causing inflation, while in the early part of the 1970's the Vietnam War caused large Federal budget deficits (which caused higher interest rates because the Fed had to offer higher rates to attract the capital to buy the bonds). OPEC was also organized at that time and imposed tighter production controls, which with a weaker dollar caused higher oil prices. (A race to the gas pump didn't help either.) Demographically the economy was also experiencing a seismic shift with the baby boomers "coming on-line(graduating and looking for jobs), driving up the unemployment rate. (Nixon bringing home the troops also drove up the unemployment rate as those soldiers looked for new jobs in the private sector.)

So while you read and see a lot about the "return of stagflation" in the mass media, I wouldn't place a bet on it. While we will see inflation, we won't see the other half, which is high unemployment. Demographically the country is not suffering from an over abundance of workers as compared to the number of jobs offered; in fact, the opposite is true. (Tells you how much the mass media understands about economics.) The country is currently experiencing an excess of jobs over workers, even though some workers are unemployed due to shifts within industries. (While we always hear about the job losses in the manufacturing sector in Michigan and Wisconsin, we never hear the media report about the job gains provided by new Toyota and Honda plants down south.)

Unlike the Great Depression, however, the world is

awash in capital presently, and each of us has the ability to shift gears and take advantage of that situation rather than sit on the sidelines. And even if the Fed tries to curtail inflation, Bernanke may find it quite difficult to be effective when commodity inflation is being caused by the growing demands of China and India and other growing economies over which the Fed has no control. (Don't forget that China would like very much to make the Yuan a reserve currency, which if it happens, would definitely devalue the power of the Fed.)

Right now we have a weaker dollar (like the 1970's), a loose Fed monetary policy (most unlike the Great Depression, but very much like the 1970's), but also tighter foreign trade controls (that won't come into play for a couple of years, but very much like during the Great Depression). Around the second half of 2011, however, we may have even tighter trade controls, higher taxes, and a Fed that feels it has to wring inflation out of the economy, very much like during the Great Depression. Why?

Let's look at the years between now and then. As long as Bernanke continues to cave in to Wall Street's demands for bailing investors out of every bad investment they make, we're going to see a surplus monetary policy. (Recall that I predicted that Bernanke was reactionary – being an academic his natural inclination is to study things for awhile versus taking immediate action, but then over react after the fact in order to try to make up for the delay. This is exactly how he has behaved since becoming Fed Chair.)

Fall's election will have impact on economic changes in the years to come.

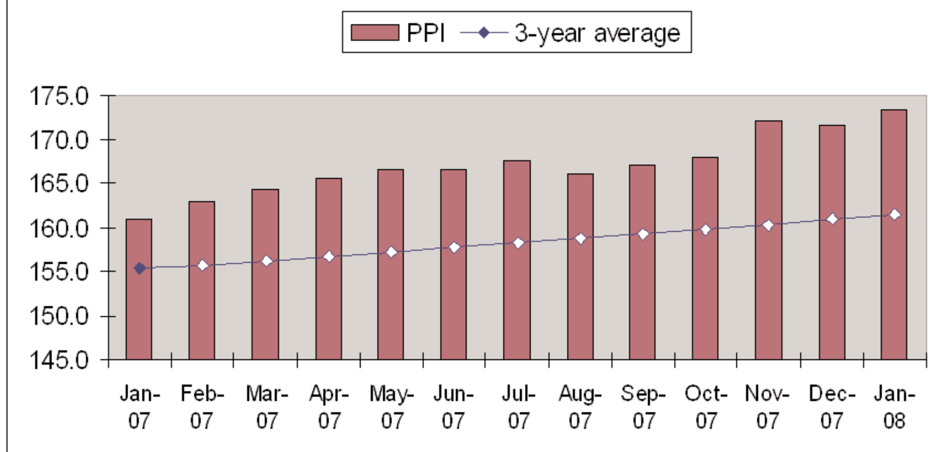
With a new Congress and a new President, we will then see higher taxes (because we're not going to see the Bush tax cuts reinstalled, leading to automatic tax increases.) We will also see tighter trade barriers and tariffs due to the Fast Track policy being ended. The resulting 2008-August 2011 period may look a lot like the Carter years, which is not good news. (And we'll have a spend-and-tax Democratic Congress with either a spend-and-tax President Obama or a go-along-get-along President McCain. Remember that a new administration can't just suddenly end the military spending necessary to support our troops in Iraq, so any additional domestic spending will be added to the present increase in defense spending.)

So why do I say 2008 to 2011? Because in the summer of 2011 we'll see a new Fed Chair appointed and the Fed by that time will realize the mistakes it has made and will institute a tighter monetary policy. (Let me be the first to predict that Bernanke will not be reappointed.) We could see a period of higher interest rates like the period of Fed Chairman Paul Volcker in 1980; maybe not to the extent of 22%, but that will depend on how bad inflation gets out of control.

Now, you all probably think I'm nuts, but then there are certain factors that are 'locked in' that appear not to change. For example, the high number of Republican Congressional retirements, the Fast Track policy terminated, the Bush tax cuts not renewed and therefore higher tax rates are certain. We already see the start of higher inflation, stoked by a locked-in looser monetary policy in the short term to address the subprime crisis. And that's why I believe these factors will combine to create certain results over the next three years.

In the short-term, what would have been a downturn in the economy (as I predicted before the Fed rushed in with quite a few cuts), may now turn into – who knows what! With the Fed's significant rate cuts, the Fed should have headed off the downturn for now; an increase in GDP always follows these kinds of significant rate cuts, but the tighter credit standards may limit the impact more than in the past.

Either way, we may not feel an upturn from the interest rate cuts or the downturn that would have happened if it weren't for those cuts. The economy may just hum along at its present pace and course for



	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08
PPI	160.9	162.9	164.4	165.5	166.5	166.6	167.5	166.1	167.0	167.9	172.2	171.6	173.3
3-yr. ave.	155.3	155.7	156.2	156.7	157.2	157.7	158.3	158.8	159.3	159.7	160.3	160.9	161.5

the year until the next major change in policy occurs, i.e. the election is over and we know what kind of fiscal policy we will see along with knowing how the Fed is going to react this spring and summer as the subprime crisis is finally dealt with. With Bernanke, it's hard to tell.

And in the real estate industry, inflation is a good thing, just as long as we are prepared for the rise in interest rates sometime in 2009 thru 2011, but not any later than 2011. And given the volatility in the markets and the economy, T. Wall Properties continues to lock in or swap out its loans so that we are protected, even if that means giving up some benefits from a temporary downturn in rates. I'd rather be locked and loaded and not suffer from a sudden upturn in rates, than to be focused on capturing each little downturn. The volatility is too great as compared to the last six years, so predicting the overall direction of rates and the economy is a lot more difficult and locking in your loan rates makes sense to reduce risk.

So that's it for this Wall Report, which was focused more on the overall economy and Fed behavior and the direction of the big picture over the next few years than past reports, which were focused on economic statistics. One reason for that is that overall the economic statistics are very mixed, with some stats being up, some down, and some not making any sense at all.

This mixed bag of stats indicates we may be in for a shift in direction; the question is - is it up or down? With the Fed rushing to the rescue again and again, I would say, unlike my prior prediction before the Fed intervened, that the economy can't very well head down in 2008 given the drop in interest rates. However, some sectors like the financial industry will continue to suffer until the subprime and housing crises are resolved and the losses put on the balance sheet. And resolving that large of a problem usually takes three years; the third year being the year that the data shows a return to normalcy. In the meantime, there are some great opportunities to take advantage of during the downturn in these industries, because they won't stay down forever.

However, as we approach 2009 thru 2011 we are in for a roller coaster ride, with increased trade barriers (= higher prices and more inflation), increased taxes, increased regulation from a Democratic controlled Congress, and higher interest rates. This Perfect Storm economy will eat away at our economic freedom. Domestic investment will suffer as a result as businesses and investors channel their capital to foreign opportunities. I am truly afraid of what might lie ahead during this period, and as a result, I will be taking steps to protect myself and T. Wall Properties. (Hey, I didn't just take on $100 million in institutional capital for fun – seeing what was coming I felt it was necessary to our survival and future prosperity.)

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