

# Fear not?

Art Ernst

A few weeks ago, the article I had planned for this space did not include a question mark.

President Obama was newly installed in a worldwide aura of goodwill and hope. Soon after the inauguration, most of us expected to hear speeches and statements focused on propping up the economy — perhaps even evoking FDR’s immortal claim we had “nothing to fear but fear itself.”

Back in 1932, there was much to fear. John Maynard Keynes had not yet written his most influential treatises showing how fiscal expansion can help the entire economy grow. Milton Friedman, who later demonstrated how monetary stimulus could foster a similar effect, was still a college student. And Arthur Laffer, whose supply-side theories revealed how changes in tax rates and other incentives could cause powerfully positive effects, was still a gleam in his father’s eye.

Roosevelt and the new Congress were shooting blind as they put into place the various pieces of The New Deal. Horror aficionados appreciate that monsters are scarier when their form is unknown. Fear was justified. But at present we can see quite clearly. We know the problems at hand as well as the actions that can fix them.

It follows, therefore, that we need not fear the unknown. Yet, there is much trepidation. In congressional testimony a few weeks back, Fed Chairman Ben Bernanke said he saw light at the end of the tunnel. Yet, many do not. What do the facts indicate?

## Housing

In sheer magnitude, the major catalyst for the current downturn was the bursting of the housing bubble. From 1975 through 1999, median home prices rose on average about 5.4 percent each year. From 2000 through the first quarter of 2006, they rose at an annual rate of more than 13

percent. After adjusting for inflation, home prices crept up by about a percent annually through 1999 but then rocketed at nearly a 10 percent annual pace for the next six years!

Since the peak, there has been a catastrophic loss of real estate value. I don’t need to repeat the numbers. You’ve seen them. You’ve experienced them.

Not widely discussed is the fact housing prices are currently approaching the long-term trend line. There will be continued price declines in places, perhaps many places. But we are now seeing the bottom of what has heretofore seemed an abyss.

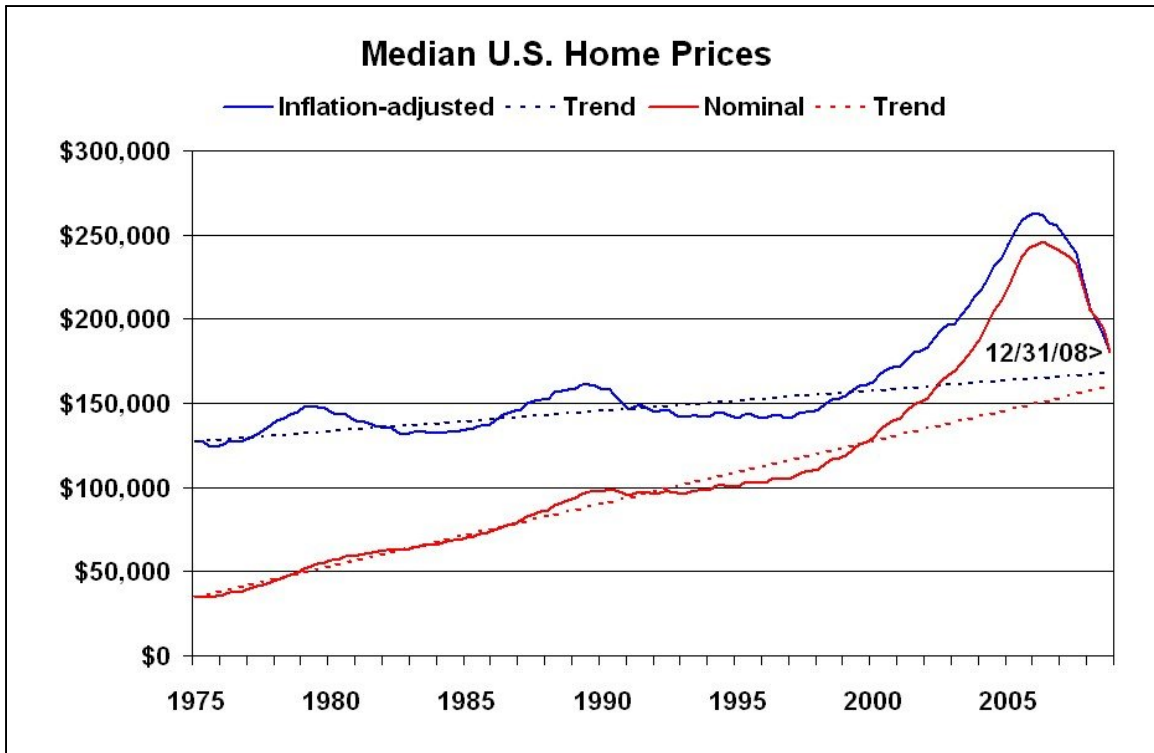
## Mortgages

The single biggest factor driving up home prices this decade was easy money. But while the price of a house can go up or down, amounts borrowed are contractually payable to the penny. While 92 percent of mortgagors are fulfilling their obligations, the eight percent who can’t present a major problem. As the ranks of the jobless grow, this latter percentage will climb as well.

In isolation, the numbers forebode a calamity in which we could see millions of families on the streets.

But we are not in isolation. The federal government recently codified and funded a program already begun by forward-looking banks through which payments and balances are reduced to affordable amounts.

There is much resentment among those who did not overextend as there’s a massive bailout of people who overspent and lived beyond their means. But which is worse: Forgiving past irresponsibility to help people stay in their homes and keep the economy going? Or a moralistic, Pyrrhic victory in which we all go down — just “them” more quickly than “us”?



Fact is, the bailout passed, and millions of fiscally destructive holes are being filled.

#### Other debt

One reason some feel disaster is unavoidable is because they see our total level of debt — government, corporate and individual — as unprecedented.

Actually, though, it is not.

The federal deficit has passed a trillion dollars and will be in the neighborhood of 12 percent of GDP this year. During World War II, the deficit hit 28 percent of GDP.

Corporate and personal debt are indeed at levels yet unseen. There will be much dislocation in the business world. But reinvigorated by the bailout, some tax cuts and government spending, consumers will get a respite in what is owed and a shot in the arm for what can be bought.

Some “experts” claim a day of reckoning will come when we eventually have to pay off all our debt. It’s not true, it never has been. We only have to meet the terms of any given loan. Refinancing is fine. Optimum and maximum debt levels as a portion of income and worth vary country by country, and family by family.

Besides, for the growing percentage of investors who want bonds as a significant portion of a portfolio for income and stability, more must be borrowed.

#### Scandals

From Madoff to Stanford to the bonus-sucking executives at UBS, Merrill Lynch and elsewhere who knowingly stole money from investors, clients and shareholders through fraud and deceit, there is reason for anger and a sense much worth has been forever stripped from the system. Each deserves separate articles, and perhaps the readership of this particular magazine could play a major role in recouping assets from the guilty parties.

But as a proportion of the trillions of dollars moving through the economy, the monies involved in all these scandals combined is not macro-economically significant.

#### Government action

History and the work of great economists have provided paths to cure a variety of economic ills. Regardless of one’s doctrinal leanings, a number of programs are now in place that could help extract us from the current downward spiral.

If you are a Keynesian, the stimulus package will pump \$787 billion into the economy. Despite complaints that some of the spending is not stimulative — funds for animal research, education and bridges to nowhere — the last I checked, scientists, teachers and construction workers shop, drive, pay for homes and even watch movies. Just as massive defense spending increases lifted the domestic economy in the 1980s, both good and bad government spending will, in subsequent rounds, filter through the free market to appropriate companies.

Meanwhile, if you are a supply-sider, the lower interest rates on mortgages, middle class tax cuts and Federal Reserve activism in the money markets should also boost spending.

And if you are a monetarist, the TARP fund, other separately approved rescues and whatever portion of deficit spending is not matched by Treasury bond issuance will provide growth to the money supply. In turn, this can engender real economic growth. It also will cause inflation but let's address that after the downturn is halted.

### **Caution**

While the housing bust was enough to cause an economic debacle, there have been so many troubling side stories, such as AIG's utter ignorance of the risk its portfolio contained or the colossal mistake the Feds made in letting Lehman Brothers fail, there seems to be systemic fear and doubt embedded in our psyche.

President Obama did not help when he talked down the economy as a tactic to get legislation passed. Congress failed to provide a package that would stimulate from the start, relying too much

on secondary rounds of spending after a rather wasteful first round. And now, with the economy still in decline, the administration has announced plans to raise taxes. These new taxes would be on the wealthy. Of course, it is the wealthy that hire the not-so-wealthy.

We know what to do to avert further disaster and we know what can worsen things. We need not fear the unknown. We should increasingly gain confidence in the positive effects of all that is done right, and seek change when we notice actions that are wrong.



Art Ernst is a strategist and adviser with Byrne Asset Management. During more than 25 years in the investment industry, he has served as an economist, analyst and institutional portfolio manager. He won the 1981 Eugene E. Agger Memorial Award as the top graduating economics major at Rutgers College and later earned his M.B.A. at the Wharton Graduate School of Business. Ernst manages stock, bond and balanced portfolios for individual and institutional clients. Reach him at [arternst@byrneasset.com](mailto:arternst@byrneasset.com); 609.497.1776.