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Naples, London, and Home for June

By John Mauldin

In fantasy novels the intrepid heroes come across a sign saying "This Way Be Dragons." Of course, they venture on, facing calamity and death, but such is the nature of fantasy novels. We live in a very real world, and if we don't turn around there will be some very nasty dragons in our future. This week we look at three possible paths we can lead the world down. We then review a number of charts and data on the housing market.

If you just read the headlines on this week's data, you could be forgiven for assuming the worst is over – not. And then finally we look at some rather stark comparative data on the health-care systems of the US, Canada, and Great Britain. Everyone knows the US pays way more in terms of GDP than the latter two countries. Are we getting our money's worth? There is a lot to cover, and I hope to finish this on a flight to Naples, so let's jump right in.

This Way Be Dragons

More and more we read about the growing concern over $1-trillion-dollar deficits. Stanford professor John Taylor (creator of the famous Taylor Rule) jumped into the debate with a rather alarming op-ed in the *Financial Times* this week, echoing much of what I wrote last week, but with some real insights into what trillion-dollar deficits mean. Quoting:

"I believe the risk posed by this debt is systemic and could do more damage to the economy than the recent financial crisis. To understand the size of the risk, take a look at the numbers that Standard and Poor's considers. The deficit in 2019 is expected by the CBO [congressional Budget Office] to be $1,200bn (€859bn, £754bn). Income tax revenues are expected to be about $2,000bn that year, so a permanent 60 per cent across-the-board tax increase would be required to balance the budget. Clearly this will not and should not happen. So how else can debt service payments be brought down as a share of GDP?

"Inflation will do it. But how much? To bring the debt-to-GDP ratio down to the same level as at the end of 2008 would take a doubling of prices. That 100 per cent increase would make nominal GDP twice as high and thus cut the debt-to-GDP ratio in half, back to 41 from 82 per cent. A 100 per cent increase in the price level means about 10 per cent inflation for 10 years. But it would not be that smooth – probably more like the great inflation of the late 1960s and 1970s with boom followed by bust and recession every three or four years, and a successively higher inflation rate after each recession."

You can read the rest at (http://www.ft.com/cms/s/0/71520770-4a2c-11de-8e7e-00144feabdc0.html?nclick_check=1)

While Obama gives lip service to cutting the deficit in half, his actual budget increases it over the next 10 years. As I have been writing for some time, this is a very dangerous path. And it is one that the bond market seems to be concerned about, as interest rates are rising, even on mortgages that the Federal Reserve is buying in massive quantities in its effort to hold down rates and stimulate the housing market.

"The good news," Taylor concludes, "is that it is not too late. There is time to wake up, to make a mid-course correction, to get back on track. Many blame the rating agencies for not telling us about systemic risks in the private sector that lead to this crisis. Let us not ignore them when they try to tell us about the risks in the government sector that will lead to the next one."

Taylor is right that the massive tax increases necessary to fund these deficits and programs should not happen. But it is not clear to me that they won't. A Democratic Congress is talking of adopting John McCain's plan to tax health-care benefits. While this would be a tax on the middle class (on everyone) that Obama said he would not do, he is clearly willing to sign a bill that has such a tax.

The administration is starting to float trial balloons about a new VAT, or value-added tax. Many of my non-US readers will be familiar with VAT taxes, especially in Europe. A combination of a VAT and taxing health-care benefits would raise enough to get us to a deficit of "only" a few hundred billion. Take away the Iraq war and you get even closer. You can make an economic case that a VAT tax would be preferable to an income tax.

However, the administration is not talking about a substitute but an additional tax. There is momentum in the heavily Democrat-controlled Congress for large new health-care programs. While there is resistance to large deficits on the part of a few moderate Democrats, there is a chance they could be brought on board with a tax or a series of new taxes that would offer the potential to pay for the new programs. (Even though everyone knows that the cost overruns on new health-care benefits will be much larger than estimated.)

As much as it grieves me to say it, a tax on health-care benefits or a VAT tax large enough to hold the proposed deficits to something under 3% of GDP would be preferable to running decade-long trillion-dollar deficits, which would destroy the US economy and the dollar and do severe damage to the world economy. (For the record, I am assuming the Bush tax cuts are history.)

But while a large tax increase would keep the economy from crisis and collapse, it is not without very serious consequences. It will put a serious crimp in economic growth. It will lock in European growth rates and European-like unemployment rates. And we will be using those tax increases to fund new spending and will still not have solved the future problems with Social Security and Medicare, which are going to require massive increases in spending in another 5-7 years. Which of course means that either a cut in benefits or another round of growth-crippling tax hikes is down the pike.

A third path would be to simply go ahead and raise taxes on the rich, say no to increased spending on programs until we can afford them, hold the line on any new spending, and see if we can reintroduce the gradual budget control that was the result of the stand-off (and to some extent cooperation) between Gingrich and Clinton.

I put about a 5% probability on the third scenario happening. Better than the chances of a snowball in hell, but not much. The first disaster scenario is about a 35% probability, which is quite scary. If we do choose such a path, then short the dollar, buy gold, and invest abroad. It will be a very tricky and difficult environment.

I assign a 60% probability to the middle path. Maybe it's my basically optimistic nature and I am simply being naive, but I am hopeful that cooler heads will prevail and we will not run continual massive deficits larger than the growth of GDP. While that means rather large tax increases, since the current leadership wants to create massive new health-care entitlements and will do so, I would rather have to simply overcome higher taxes in my business rather than deal with a collapse of the dollar, high unemployment, high interest rates, and an extremely sluggish economy.

Each scenario will create a different investment environment. Ironically, the middle scenario could be good for the dollar over the long term. But it will be hell on corporate profits from US sources. Given the above, it seems like a 95% chance that we should start looking at investing a significant percentage outside of the US and Europe. Think Canada, Australia, Asia (not Japan), Brazil, South Africa, etc.

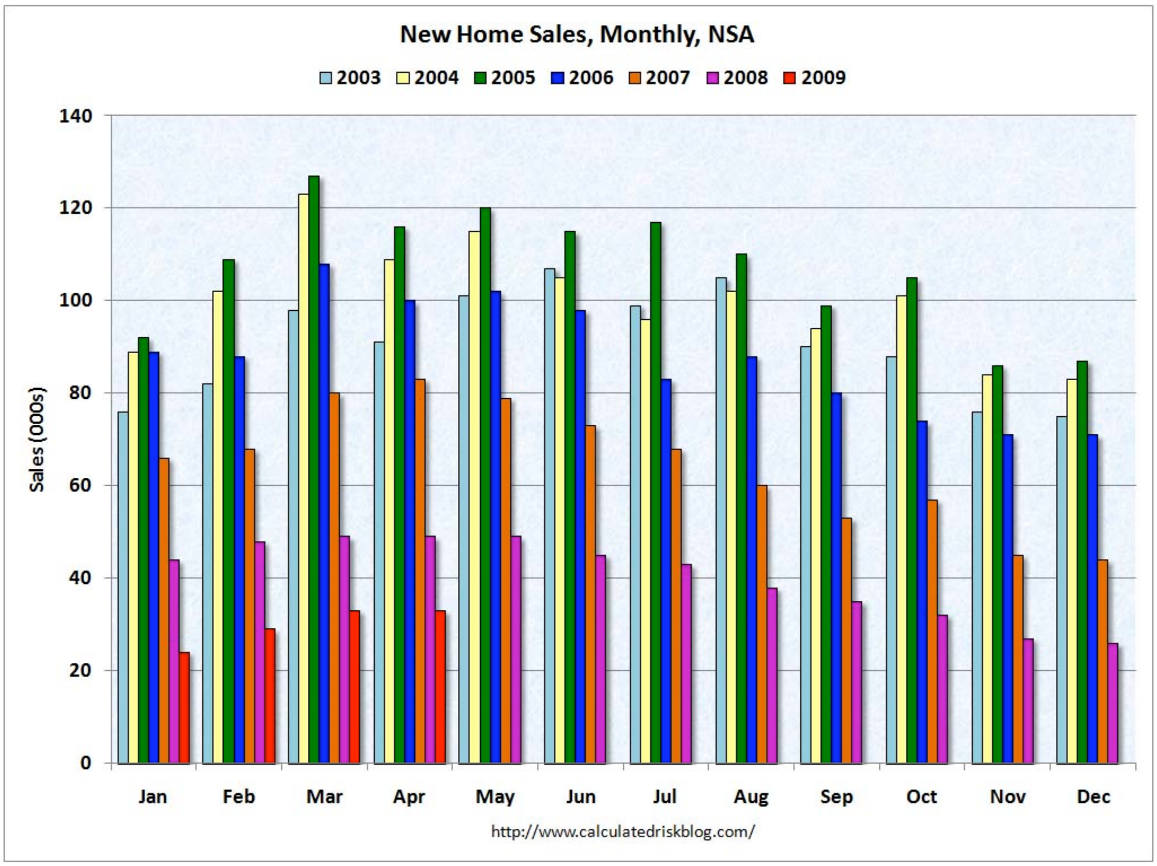
Normally, politics does not have all that much of an impact on the stock market. As an example, both Democrats and Republicans can take credit for the '90s, but it was really the dynamic of the free market that worked in spite of government. Same for the Bush years. While the tax cuts did help, it was the free market and increasing leverage that were the dominating factors.

This time it will be different. The choices we make as to how to fund, or not fund, the increases in spending that are our clear and sad destiny, will have a major impact on not just the US but the world economy. As US consumers have been a major part of the growth of the developing world, and especially Asia (China), a slowing of consumption in the US will mean a very slow recovery for the rest of the world. It will happen, but the choices made by politicians this year will have many unintended consequences. Just as deciding we would take a major part of the corn crop and turn it into expensive ethanol raised the price of tortillas in Mexico, raising taxes in the US will mean lower global consumer spending and trade. It is a very tangled web we weave.

A Housing Update

If you read the headlines the last few days you would think that the housing market has turned. Mostly they read something like “Home Sales Rise 0.3%,” and of course the reflexive bulls started talking about green shoots and a bottom in housing. And while someday we will actually have a bottom in housing, it will not be this month. It has been awhile since we have looked at the housing market, and it is time to review.

First. Of course home sales rose. It is April. Look at the graph below. It is the time of the year when home sales rise. And 0.3%? Really? The margin of error is close to plus or –minus 10% or so, so 0.3% is a meaningless number. It will be revised. Who knows which way? I don’t. (I am on the plane so I cannot access the exact margin of error, but 10% is not that far off.)



My main thesis since 2006 has been that the housing market was in a bubble that would burst. We built something like an extra 3 million homes over trend growth, and those homes are going to have to be absorbed in the normal way, through growth of population and the economy. We “need” about 1 million new homes a year to take care of population growth and demand. Further, we have cut off home availability to buyers who are in the subprime category, whereas during the boom you simply had to have a pulse, even a lying pulse, to get a home for which you did not have a chance of actually paying the mortgage.

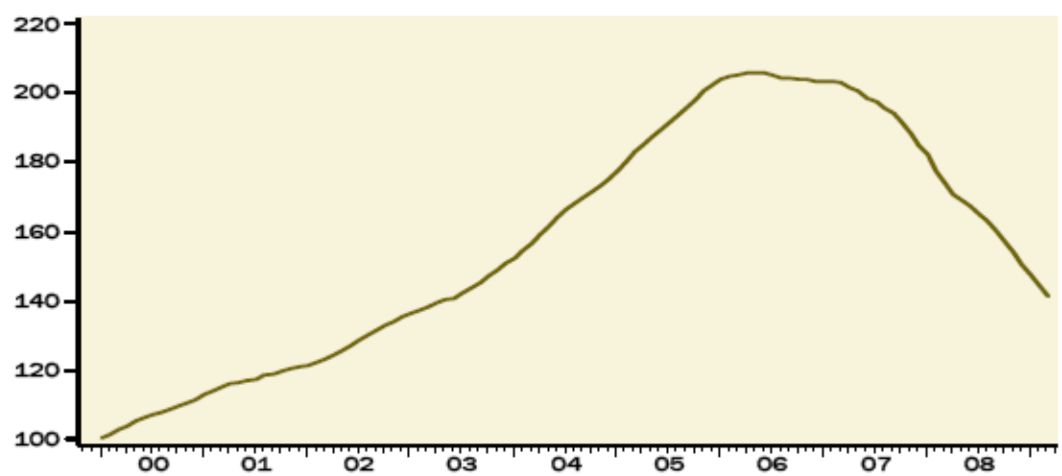
The earliest we see a real bottom to housing is late 2010 or 2011. By real bottom I am talking about housing values in general being to rise (assuming we do not visit scenario one and have significant inflation.) There is nothing that can be done about that. We have to work through the excess capacity. (More later on that below.)

We had the Case-Shiller home price data come out this week. Home prices are still in free fall. They are down almost 19% year over year and 32% from their 2006 highs (see chart below). If we get back to the long-term price growth trend, we would see another average 10% drop; and as prices tend to overshoot on the upside and the downside, in some markets they could fall even further.

Chart 1: HOME PRICES — STILL DEFLATING AFTER ALL THESE YEARS

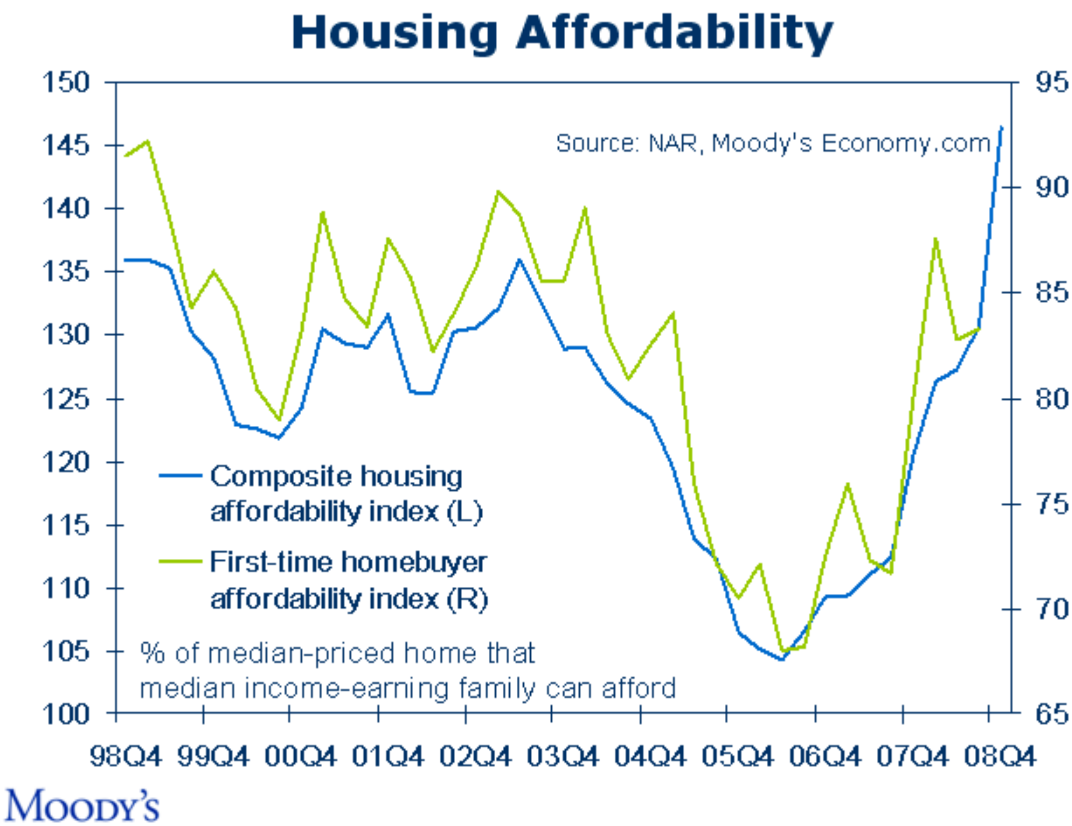
United States

S&P/Case-Shiller Home Price Index: Composite 20
(Jan 2000 = 100, seasonally adjusted)

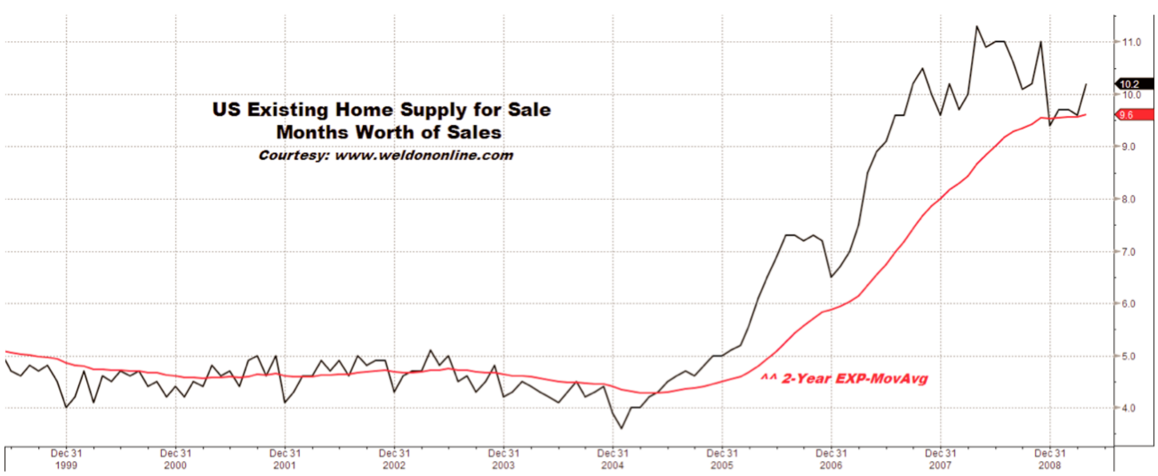


Source: Haver Analytics, Gluskin Sheff

Yet there is hope that we will not see a fall below trend. Housing in many areas is starting to once again become affordable (see chart from Moody's below) to more and more Americans and even first-time home buyers. The cure for the housing crisis is actually lower prices, as that brings more and more potential home buyers into the market. While housing sales are still quite depressed, what are selling are homes in foreclosure, as buyers perceive that there are bargains. And they are right.



On the negative side, the supply of homes available for sale is again rising, as more and more foreclosures come onto the market. And as we will see, this foreclosure trend is going to slow down soon. (Thanks to Greg Weldon at www.weldononline.com for the chart.)



Notice in the above chart that the supply of homes for sale is over ten months. But that average can be misleading. If you are in Florida, I read recently that in many areas it is over 40 months. And that is for homes that can be financed with governmentsponsored "conforming loans," typically up to $719,000. But what if your home cost more than that? National Association of Realtors chief economist Lawrence Yun said that the supply of existing homes for sale over $750,000 has reached a forty-month supply.

Diana Olick, the very on-top-of-it CNBC real estate reporter, had the following to say (emphasis mine).

"That's going to mean a new phase of the current housing recession. So far we've seen the 'correction' of a boom market that was driven by faulty, exotic loan products, investors looking to make a quick buck, and average Americans using their homes as ATMs. Now the losses are being driven by traditional economic factors and by sweeping price drops across the nation.

"**Yesterday Fitch ratings estimated that up to 75 percent of the modifications now being done through the administration's** Making Home Affordable **program will re-default in six months to a year.** I'm not talking about the old modifications, which were largely repayment plans that could actually raise monthly payments. I'm talking about the new mods, which lower monthly payments to 31 percent of a person's income. I couldn't understand Fitch's reasoning, so I called them.

"Diane Pendley, managing director at Fitch, said the problem is not on that "front-end" ratio, but on the back end, which is all of the borrowers other debt (credit cards, car loans, student loans, etc.). She said that in talking with servicers, she's hearing other debt is so high that most of today's troubled borrowers cannot afford any loan payment at all, even at a very modest debt-to-income ratio. *'Just getting the house payment done doesn't mean their lifestyle is sustainable,'* she said.

"Another problem is that with home prices continuing to fall, more and more borrowers, who are essentially just renting their mortgages now because they will never see any home equity, are walking away. Even if the mortgage payment is low, the property taxes and home maintenance costs are padding that payment, and without an upside to the investment, there's simply no reason to pay. Suffice it to say, the foreclosure crisis, on the high and low ends, is not getting any better."

And it gets worse.

More Prime Foreclosures In Our Future

The Mortgage Bankers Association noted that a record 12%, or 1 in 8 homeowners, in the US are now behind on their payments or in foreclosure. 10.6% of the mortgages in Florida are now somewhere in the process of actual foreclosure. (My seatmate here on the flight says the prices on the condos where he lives are now back to 1998 levels. It would be scary, he said, if you had to sell. There are new developments that only have 10% actual occupancy, as the bulk of the condos were bought for speculation. Now those 10% of buyers are having to shoulder all the fees for upkeep.

Nobody will buy, because the upkeep costs can be more than the mortgage. It is a vicious cycle.)

In Nevada foreclosures are 7.8%, Arizona 5.6%, and California 5.2%. 25% of subprime loans are now in foreclosure, 14% of FHA (government, taxpayer-guaranteed) loans and a growing 6% of all prime loans are now in foreclosure. (Note: the seasonal adjustments may overstate the actual numbers, as we are in new territory in terms of actual foreclosures.) Quoting from the MBA press release:

"In looking at these numbers, it is important to focus on what has changed as well what continue to be the key drivers of foreclosures. What has changed is the shifting of the problem somewhat away from the subprime and option ARM/Alt-A loans to the prime fixed-rate loans. **The foreclosure rate on prime fixed-rate loans has doubled in the last year, and, for the first time since the rapid growth of subprime lending, prime fixed-rate loans now represent the largest share of new foreclosures.** In addition, almost half of the overall increase in foreclosure starts we saw in the first quarter was due to the increase in prime fixed-rate loans." (emphasis mine)

How could so many prime loans be in foreclosure? These were people with good credit and jobs. The answer is the very deep and lengthy recession, coupled with high and rising unemployment. The number of foreclosures will not abate until unemployment starts to fall. And even optimistic forecasts assume unemployment will keep rising into 2010. As I have written for a long time, I think it is quite likely that we will see unemployment rise to over 10%. When I first wrote that a few years ago, many called me just another doom and gloom guy. Now, many think I am Pollyanna. Such is the life of those who believe in Muddle Through.

For those who think the end of the recession will be like all past recessions, the problems in the housing market should make for serious concern. As we will see on Monday in my *Outside the Box,* the average homeowner with a mortgage has very little, if any, equity. There is little room for home equity withdrawals – if banks were lending. And recent data shows a very serious and un-American-like drop in credit card borrowing. US consumers are retrenching, and global trade figures echo that.

We are in for a slow, Muddle Through recovery, with the real potential to slip back into recession when the tax increases hit. Stay tuned.

Are We Paying Too Much for Health Care?

I want to pass on this quick note from Dennis Gartman's eponymous letter. It should give all of those who favor a nationalized healthcare system pause, before they jump right in. Quoting Dennis:

"Canada is a wonderful place to have a nasty gash on one's forehead stitched, or to break one's nose in a game of pick-up baseball; but have cancer, or need eye surgery, or want an MRI, and the business of medicine in Canada and/or the UK breaks down badly in favour of medical care here in the US. For example… and we wish to thank *The Investor's Business Daily* for the data noted here this morning…

"… here in the US men and women survived cancer at an average of just a bit better than 65%. In England only 46% survive. In the US, 93% of those diagnosed with diabetes receive treatment within six months; in Canada only 43% do, and in the UK only 15% do! For those seniors needing a hip replacement and getting one within six months, 15% get it done in the UK; 43% get it done in Canada … and in the US 90% do! For those waiting to see a medical specialist, 23% of those in the US get in within four weeks, while 57% in Canada have not yet done so, and in the UK 60% are still waiting after four weeks.

"When it comes to proper medical equipment, in the US there are 71 MRI or CT scanners available per million people. In Canada there are but 18, and in the UK there are only 14! Ah, but the best figure of all is this: 11.7% of those 'seniors' in the US with 'low incomes' say they are in excellent health, which in and of itself sounds rather low … rather disconcerting … and an indictment of the system itself, doesn't it? But in Canada only 5.8% do!

"Yessiree bob, ya' jus' gotta' luv that collectivized, socialized medical care! Let's all go break a collective arm and enjoy the benefits of socialized medicine in the Commonwealth! (Canada) ... but heaven help you if you've got something really, really wrong. If that's the case, you'll be running south to the border faster than you can reach a specialist anywhere in Canada; of that we are certain."

Do we pay too much for health care here in the US? Everyone says yes. And there is a lot of waste (and waist) in the system. But if you are the person who needs treatment, maybe the answer is "not really." If you can't get the medical help you need when you need it, maybe the fact that it is theoretically free doesn't mean anything.

As an aside, I have two friends who have had immediate family members diagnosed with Lou Gehrig's Disease. For all practical purposes, it is a death sentence. Yet one family was told (at a top-five cancer hospital) there could be a cure within a few years, or at least clinical trials. But just not now. Unfortunately, the prognosis is less than a year.

I can guarantee you, if that was me or my family, I would like to be able to make the decision whether to try a radical treatment. What's my downside if I die a little earlier? Shouldn't that be my choice?

And if I don't want some nameless bureaucrat dictating who gets to live or die in the name of his scientific system, why in God's name would I want a bureaucrat deciding to ration my access to health care? But that is what the majority in Congress are planning for our future. And bluntly, I find that far harder to swallow than my taxes going up.

Naples, London, and East Europe

I am literally in the taxi in Naples as I finish this letter (even for me, this is a first). I am supposed to go right into meetings when I arrive. Ground zero for the housing crisis. But it is still a pretty city. Hopefully I can get out and do a little power walking on the beach tomorrow. I am looking forward to being with good friend and fellow writer Gary Scott and business partner Steve Blumenthal, as well as my friends from Jyske Bank.

The schedule says I am home all of June. Then I am off to London in the middle of July for my partner Niels Jensen's 50^{th} birthday, and then a vacation to far Eastern Europe. Thanks to everyone who wrote with suggestions and offers to help.

School is just about over for youngest son Trey, and we have been spending a lot of time reviewing material for his finals (with some success!) But then you get a call from the vice principal. Seems there was a little trash talk and the other (bigger) kid hit first, and then … "Really, Dad, it wasn't my fault. This is just so stupid." Well, you know how that goes. (Trey is fine.) After seven kids, I should get used to the regular surprises. Well, there is always next year to teach him how to avoid bullies. (Which of course Dad was soooo good at.)

It is time to hit the send button. We are pulling up to the resort. I have a good feeling about this summer. It will be busy (what else is new?), but I think it will be fun. Have a great first week of summer!

Your real life just keeps on coming at you analyst,

John Mauldin