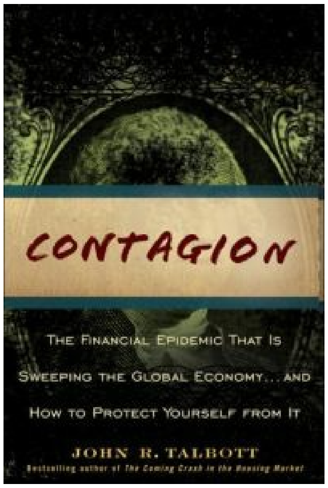

Book Contagion

The Financial Epidemic That Is Sweeping the Global Economy... and How to Protect Yourself from It

John R. Talbott
Wiley, 2008

Recommendation

John R. Talbott is a prescient, provocative financial writer. In this book, he points the finger at those he sees as the real culprits behind the global financial collapse. He relates the U.S. real estate market slump to the broader economic deterioration in American fundamentals. He forecasts a long, hard road to recovery, one that is so difficult, he says, that the U.S. may choose not to take it. That, of course, would be a disastrous decision, but he pessimistically posits that it would be in keeping with the self-centered baby boom generation. In addition to diagnosing a nearly terminal disease of corruption in the American system, Talbott makes some recommendations for investment strategies that *BooksInShort* finds may help individuals cope with challenging times.

Take-Aways

- Capitalism depends on trust, and the erosion of trust in recent years endangers the entire economic system.
- The U.S. government has severely mismanaged its finances.
- The U.S. government and the nation's businesses are corrupt, in part because of the power of corporate lobbyists.
- The proximate cause of the financial crisis was poor lending practices by banks.
- Depressed housing prices will last for the long term, so housing is no longer a great investment.
- Since Americans cannot rely on gains in housing or in the stock market – which has also become a poor investment – they will have to return to saving.
- Real estate price declines will occur in European countries that have seen dramatic increases during the bubble years.
- Slowdowns in the U.S. and Europe will spread the real estate slump to China.
- Unregulated, secretive hedge funds are well positioned to manipulate markets to their advantage. Their credit default swap investments pose a major future danger.
- The solution to the crisis depends on ethics, as well as politics and economics.

Summary

Fooled and Snookered

The current economic crisis is the product of greed, materialism and selfishness ¬– disease-like syndromes that spread on contact. People have lost their moral compass, with lawyers advertising to drum up malpractice suits and medical practitioners focused on profits instead of on healing. Wall Street is a nest of corruption and meretricious deception, but it is not at fault alone. The American government is also corrupt, lying, driven by money and run by hirelings paid by influential lobbyists and corporations. Campaign contributions buy influence – that's why companies and trade associations make them. Democrats and Republicans are alike. Financial institutions poured money into political campaigns to buy deregulation, but effective free markets need regulation – the rule of law is an important foundation in the way strong markets function.

> "The real cause of the housing boom and subsequent crash was...an entire system that had grown corrupt over the past 30 years."

The recession ending the first decade of the 21st century will be global and long-lived. By the close of 2008, America was only halfway into it. U.S. home prices are in for a permanent decline because banks will never again lend outrageous sums on the terms they extended in the past. The baby boomers' retirement will hamper economic output, so this important demographic trend will resonate like an echo chamber, magnifying the shockwaves of recession.

Why the U.S. Real Estate Bubble Collapsed

From 1955 to 2005, nominal prices of U.S. homes rose nationwide. On average, they doubled in real terms, but they quintupled in some cities. The rule of thumb for determining a reasonable housing price is a home's replacement value. In 2006, California existing home prices were triple or quintuple the price of building the home from scratch. At the same time, wages were flat. How could U.S. home prices grow as wages stalled?

> "Rather than America exporting our model of good government to the world, it appears that America has imported some of the government corruption endemic to the Third World."

Many often-cited causes are not really to blame. Interest rates were not the cause. In real terms, they have not fallen since Ronald Reagan's presidency. A change in inflationary expectations justified lower nominal interest rates, but real rates remained the same. Immigration was not the reason, nor scarce land, nor rising construction costs, nor regulation of housing construction, nor the law requiring banks to lend in poor, mostly minority neighborhoods. Fannie Mae and Freddie Mac, often blamed, were indeed poorly managed and overleveraged, but regulators had begun to control them long before the bubble popped. So what caused the collapse in American real estate?

> "The failure of banks and mortgage lenders to properly constrain homebuyers [borrowing] for overpriced homes was the primary cause of the housing bubble and eventual crash."

A corrupt regulatory and financial system led to excessive, unregulated lending for real estate. Banks lent money to homeowners without down payments despite their low incomes and questionable creditworthiness simply because the banks could make money doing so – and did not have to face the consequences of default. Banks competed to offer imprudent loans because they could sell them in the securitization market and, thereby, wash their hands of them. Financial industry deregulation made it easy. Moreover, the investment bankers and financial engineers who structured and sold these securities used outdated foreclosure data based on historical patterns set back when banks were more cautious. Homeowners also deserve some share of the blame. They borrowed without really thinking about their ability to repay, focusing instead on the profits they would garner when home prices rose. Why did they think prices were going to keep rising? Real estate agents told them so, in collusion with home appraisers.

> "Free markets are not well structured to deal with such long-lived asset industries."

What happened to the rating agencies (Standard & Poor's, Moody's, Fitch) that put their seals of approval on mortgage-backed securities whose base was so full of holes? They were pocketing fees from the investment banks that assembled the bond issues. Where were the government regulators who should have forestalled the developing crisis? The same lobbyists whose deep pockets put senators, representatives and presidents in office had captured the regulators as well.

Spreading Contagion

Subprime mortgages constitute only a tiny fraction – less than a tenth – of outstanding U.S. mortgages. However, plenty of other questionable mortgage categories flourished above the subprime level, such as NINJAs ("no income, no job, no application"), adjustable rate mortgages and exotic mortgages. The U.S. Treasury has taken over Fannie Mae and Freddie Mac, agencies that guarantee about \$5.3 trillion of U.S. mortgages. They will lose more than \$200 billion, possibly up to \$1 trillion. The banking system has already written off \$500 billion in losses related to the U.S. real estate collapse, but that's just the beginning. American homeowners are enormously overleveraged. The total losses suffered by investment and financial institutions worldwide could near or even exceed \$2 trillion.

Sinking Home Prices

American home prices have fallen steeply, but they have a lot farther to drop before they hit bottom. Even after the declines that have occurred, housing prices in the hottest markets have only retreated to 2004 levels. Were those prices justified? The imprudent lending that brought about the collapse had been underway since 1997. Though banks may never again lend on 2004 terms, even then housing prices depended on easy money from banks. This implies that home prices must fall below their 2004 levels. Given that home prices should not exceed replacement cost, American homes are still overvalued.

> "This housing price decline is different...because it started without a recession...upfront."

Consider, too, that people are no longer likely to look at residential real estate as a safe, secure investment. In fact, homes are consumption expenditures. The risk of default has become greatest in America's wealthiest neighborhoods, but most of those homeowners have not yet defaulted. They tend to be financially sophisticated, and to have safety cushions of savings and investments. Fiscally savvy people who owe more on their mortgages than their homes are worth may well recognize that defaulting is in their interest. To estimate your home's true worth, find its 1997 valuation and mark it up 30% to account for inflation; that's the real, fundamental value.

A Weak Economy

The U.S. has bounced back from economic reversals in the past, but it may not bounce back from this one. It is in bad financial shape. The government has been borrowing and spending excessively for some time. Social Security and Medicare are, for now, in cash-surplus positions, but only because baby boomers have not yet begun to retire. The total gross domestic product is \$14 trillion; the debt is \$11 trillion, not counting Fannie Mae and Freddie Mac's liabilities. Social Security adds \$38 trillion in liabilities, though future taxes will cover all but \$6.5 trillion of that.

> "I would recommend not holding any common equities."

Government borrowing did not go into fixing the nation's infrastructure or making other prudent investments that would pay off in the long term. Instead, it went into privatization and other policies that poured cash into the pockets of major corporations and their shareholders. The U.S. government and its people have been on a borrowing and spending spree. The bottom line: an $8-trillion fall in residential real estate, a $2-trillion drop in commercial real estate, and a $6-trillion lapse in the stock market that will cause severe, long-term problems for the American economy.

Prolonged Slump

The slump will endure in part because of banks' losses. Banks are thinly capitalized, and even small losses can threaten their capital base, causing them to pull back from lending. Indeed, American banks are cutting their lending in many areas unrelated to real estate. This pattern is familiar from 1982 to 1983, when banks lost considerable sums lending to U.S. and Third World farmers. At that time, their retrenchment precipitated a recession, as it did in 1990–1991 in the face of losses from junk bonds and commercial real estate.

> "A great deal of work has to be done in Washington to reinstitute meaningful and effective legislation and regulation on Wall Street and the financial markets."

The most serious, long-term harm to the American economy, however, will come from how much damage these recent years of excess have done to the public trust. Capitalism depends on trust and when trust disappears, so does economic activity.

Infecting the Global Economy

The contagion is rapidly spreading from the U.S. to Europe and Asia. Although the U.S. and Europe are home to only 12% of the world's people, they consume enough goods and services to have spurred the development of the export-driven BRIC economies (Brazil, Russia, India and China). Contagion is spreading both because foreign banks hold U.S. mortgage-backed securities and because the same forces that spurred irrationally high U.S. housing prices also led to increased home prices in Ireland, Spain, the United Kingdom and some other countries. The U.S. slowdown will reduce consumption and demand for exports from developing countries. A weak U.S. dollar will also be very costly both for banks and for countries that hold dollar reserves.

The Derivatives Threat

The $400-trillion to $600-trillion derivatives market is complicated and subtle, linking financial institutions in a network of obligations no one really understands. One of its most dangerous instruments is the credit default swap, essentially an insurance policy against a company being downgraded or going bankrupt. These instruments have a legitimate function in that they allow companies to do business without taking on excessive credit exposure. Unlike insurance, however, credit default swaps remain totally unregulated, though they grew from a $140-million market in the late 1990s to a $65-trillion market a decade later. They were largely responsible for AIG's difficulties, but the insurance giant is not the biggest player in this area. The major issuers are secretive, unregulated hedge funds. Their lofty returns are not attributable to brilliant investing, but rather to taking greater and greater risks. This has created large, unmeasured, unregulated pockets of risk that could endanger the global financial system, requiring governments to rescue it with taxpayers' money.

Local Government and Main Street

Local governments are big losers in the real estate crash. They invested heavily in so-called "auction rate securities," instruments often backed – at least in part – by mortgage bonds, which investment banks represented as being as solid as money market instruments. To induce investors to buy these securities, investment banks guaranteed them, but they reneged on these guarantees during the financial crisis. As a result, some local governments have been unable to get to their cash. The damage to local governments will worsen as property values and tax appraisals spiral down. Most school system budgets depend on property taxes. Local governments also face increasingly high expenses for retiree benefits, but will have little opportunity to raise taxes. Bankruptcy may be their only available exit strategy.

> "Washington itself needs reform."

Meanwhile, banks' lending cutbacks will make it harder to buy houses, finance college educations or run businesses. As unemployment rises, like in the troubled auto industry, economic activity will slow, spinning a vicious circle. Retirement plans with stock investments will suffer.

Investing for Safety

Conventional wisdom about investing no longer holds true. No defensive stocks remain. Consumers will cut back, even on healthcare and food. Investors should avoid equities altogether, although alcohol and tobacco may do better than other sectors. Bonds will be risky, especially municipals, where the risk of default is considerable. Longer-term corporate or government debt exposes investors to the risk of inflation. Short-term corporate debt offers low yields and, in this environment, the risk that a company may go bankrupt overnight. Avoid venture capital and hedge funds. Given all that, the best investments are: Treasury Inflation-Protected Securities (TIPS); rental housing, if you buy only when the market bottoms; commodities, especially gold; and long-term investments in China.

> "Maybe this crisis will be the clarion call needed to make people rethink how they wish to live their lives, to decide what is truly important in life, and what ultimately they hope to accomplish with their short time here on the planet."

The initial government response to the financial crisis, outlined by [then-]Treasury Secretary Henry Paulson, misdiagnosed the causes of the crisis and exposed taxpayers to the risk of steep losses. Only thorough reform of the broken, corrupt political and regulatory system – especially reform that addresses the influence of money in politics – can put the U.S. economy on a sound footing. However, the selfish, self-indulgent baby boomer generation may not tolerate the kind of reform required. Boomers will have to learn, with everyone else, that markets do not work well without regulatory structures – but even more importantly, they must have integrity and trust.

About the Author

John R. Talbott is a best-selling author, a former investment banker for Goldman Sachs and a former visiting scholar at UCLA's Anderson School of Management.