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The Daily Reckoning PRESENTS: The Good Doctor is back - and still wondering why our friends at the Fed seem to think that the U.S. economy is "sound" - even though all the signs seem to be saying otherwise. Read on...

CORPORATE AMERICA TO THE RESCUE?

by Dr. Kurt Richebächer

With some consternation, we have been reading that Fed officials think the U.S. economy is a lot sounder today than it was at the end of 2000 and in early 2001, when the Fed abruptly reversed course and began a string of rapid interest rate cuts. One can only wonder about its reasoning. What we see is a doubling of the U.S. trade deficit, the complete collapse of personal and national saving and an unprecedented borrowing deluge that created the most anemic GDP growth in the whole postwar period.

During the five years 1995-2000, nonfinancial debt growth by 32.4% went together with 22.2% real GDP growth. In the following five years 2000-05, nonfinancial debt grew by 47.3% and real GDP by 13.4%. There has been an atrocious deterioration in the relationship between debt growth and economic growth.

In his speech on the Economic Outlook on Nov. 28, Chairman Ben S. Bernanke said:

"A reasonable projection is that economic growth will be modestly below trend in the near term but that, over the course of the coming year, it will return to a rate that is roughly in line with the growth rate of the economy's underlying productive capacity.

"This scenario envisions that consumer spending - supported by rising incomes and the recent decline in energy prices - will continue to grow near its trend rate, and that the drag on the economy from the motor vehicle and housing sectors will gradually diminish."

To everybody's surprise, Mr. Bernanke indicated he was more afraid of inflation than of an economic slowdown. What, actually, would happen if he expressed some fears about an economic slowdown? He would unleash an undesirable torrent of speculation anticipating the coming rate cuts. It is one of the many bad ideas of Mr. Greenspan that central banks should foreshadow to the public their next policy moves. It only plays into the hands of speculators.

While admitting that "the correction in the housing market could turn out to be more severe and widespread than seems most likely at present," Mr. Bernanke added:

"Economic growth could rebound more vigorously than now expected. The solid rate of job growth, the decline in the unemployment rate and the healthy pace of capital investment could be signals that underlying fundamentals are stronger than generally recognized. Moreover, to date, there is little evidence that the weakness in housing markets is spilling over more broadly to consumer spending or aggregate employment. If these trends continue, growth in real activity might return to a pace that could intensify upward pressures on resource allocation."

Pondering the U.S. economy's performance in 2007 ultimately boils down to two main questions: first, whether the housing downturn will seriously hurt consumer spending; and second, whether capital spending by Corporate America will promptly come to the rescue when consumer spending slows.

In our view, the first eventuality is highly probable, and the second is highly improbable. The first of the two assumptions is simply commanded by the recognition that the housing bubble over the last few years has been the economy's main driving motor, against pronounced weakness in business capital investment. Sharply rising house prices provided the collateral, which enabled private households to embark on their greatest borrowing-and-spending binge of all time.

Those "wealth effects" from house price inflation, manifestly, played the key role in fueling the soaring home equity withdrawals. But the thing to see now is that to stop this easy credit source, it is enough for house prices to flatten. In fact, the curb to this borrowing-and-spending binge has started with a vengeance.

The fact is that private households have drastically curbed their mortgage borrowing. It amounted to \$672.7 billion in the third quarter 2006, sharply down from \$1,223.6 billion in the same quarter of last year. That is, consumer borrowing almost halved. It amazes us how little attention this fact finds.

It means that the most important credit source for spending in the economy is rapidly drying up, even though money and credit remain, in general, as loose as ever. It is drying up because the decisive lever of this borrowing binge, rising house prices, has broken down; most importantly, this lever is not under the control of the Federal Reserve.

A sharp decline or even cessation of such borrowing essentially indicates an impending sharp retrenchment in consumer spending. Mortgage equity withdrawal peaked at an annual rate of about \$730 billion, or 8.1% of GDP, in the third quarter 2005. One year later, in the third quarter 2006, it was sharply down to \$214 billion.

This, too, represents a pretty steep decline. Yet it seems to have had little effect on consumer spending, which rose 3.9% in 2004, 3.5% in 2005 and 2.9% in the third quarter of 2006. For the bullish consensus, this is instant proof of its prior assumption that the downturn in the housing market will not spill over more broadly to consumer spending or aggregate employment. The truth is that consumer spending has been squarely hit.

But to realize this, it is necessary to look at total spending by the consumer on consumption and residential investment. The latter was down 11.1% in the second quarter and 18% in the third quarter 2006, both at annual rate. Combined, the two components of consumer spending in the third quarter had slowed to an annual rate of 2%, the slowest growth rate since the past recession, against a 3.8% increase in 2005.

In 2005, real GDP rose \$345.1 billion, or 3.2%. Private households increased their total spending by \$312.2 billion, of which \$264.1 billion was on consumption and \$48.1 billion was on residential building. Together, the two components accounted for 91.8% of GDP growth. This spending boom compared with current income growth by just \$93.8 billion, or 1.2%. Thus, less than one-third of the rise in consumer spending was funded by current income growth and more than two-thirds was derived from additional borrowing. To us, this seems an unsustainable pattern.

Considering the dramatic reversal in the housing bubble, a virtual collapse of consumer borrowing is definitely in the cards for the United States. Compensating for this big loss in spending power will require a sharp surge in employment and income growth. Some recent employment numbers have been somewhat better than expected. But they are not nearly as good as would be necessary to offset the impending further sharp decline in consumer borrowing. Importantly, there is no acceleration in comparison with last year.

The median price of a new single-family home fell 9.7% year over year in September - the largest percentage decline since December 1970. The median price of an existing single-family home fell 2.5% year over year - the largest decline in the history of the series.

How likely is it that this housing downturn will be milder than average, as the consensus assumes? A rule of thumb says that the fierceness of a

downturn tends to be rather proportionate to that of the prior upturn. By any measure, this was America's wildest housing boom. We owe the following chart to Paul Kasriel of Northern Trust. It measures the dollar volume of single-family home sales to GDP. In 2005, it reached a record high of 16.3%, almost double the median percentage of the entire series dating back to 1968.

For us, the most obvious, and also most simple, measure of spending excess is associated increases in credit and debt. Between 2000 and third quarter 2006, the mortgage debt of U.S. private households soared from \$4,801.7 billion to \$9,497.4 billion. In barely six years, it has, thus, almost doubled.

We have been reading with utter amazement that stronger employment and income growth will offset the negative effects of the downturn in homebuilding. By available official numbers, the housing bubble - including directly related businesses such as furniture, mortgage finance and real estate - has created about 850,000 new jobs, about 30% of total job growth. Most of these jobs are sure to disappear.

Regards,

Dr. Kurt Richebacher
for The Daily Reckoning

Editor's Note: Dr. Richebacher has found the best investments to protect your portfolio, no matter what lies ahead for us in 2007. See his full report here:

Wealth Insurance

<http://www.isecureonline.com/Reports/RCH/ERCHG805>

Dr. Kurt Richebacher is the editor of The Richebacher Letter. Former Fed Chairman Paul Volcker once said: "Sometimes I think that the job of central bankers is to prove Kurt Richebacher wrong." A regular contributor to The Wall Street Journal, Strategic Investment and several other respected financial publications, Dr. Richebacher's insightful analysis stems from the Austrian School of economics. France's Le Figaro magazine has done a feature story on him as "the man who predicted the Asian crisis."

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