VOLUME V No. 43 W E D N E S D A Y March 5, 2003

WHEN THE U.S. REAL-ESTATE BUBBLE BURSTS, WHAT THEN ?

As with all bubbles, in the fullness of time, they burst.

Stock-market bubbles come and go, as do housing bubbles, commodity bubbles, etc, etc, etc.

The US is, presently, experiencing a housing bubble and, when it bursts, the aftershocks are likely to have far-reaching effects, throughout the country – and could, very well, cascade to Europe and Asia.

Disregarding the Iraqi situation, completely, a bursting bubble in the real-estate market of the US affects not only home-owners, whose net worth shrinks, of course, but the entire economy is drawn into the violent and turbulent situation, a maelstrom, if you will.

Real-estate deflation is not a term that is, entirely, common these days although the Hongkong Special Administrative Region (HKSAR) of the People's Republic of China (PRC) is well versed as to the effects of economic deflation, which it is, now, experiencing, as one shop after another has to close its doors for good due to it, being unable to turn a reasonable profit.

As disposable income in the HKSAR continues to wane, so purveyors of goods and services have to cut their cloth to fit the figure of the times.

There is a close correlation between what is known as The Wealth Effect (the volume of private assets) and private consumption. That goes without saying.

When the US equity markets started to fall out of bed, starting about 3 years ago, trillions of US dollars were wiped off the values of investors' portfolios, with the immediate, resultant effect of consumer spending, drying up.

Vastly increased personal and corporate bankruptcies followed in the path of the collapse of the equity markets.

And they continue to climb.

According to the US Bankruptcy Courts, the number of personal bankruptcies, logged in the fourth quarter of 2002, numbered 385,629 filings.

While this statistic, prima facie, was down on the previous quarter by about 6,244 filings, equivalent to about 1.59 percent, compared with the fourth quarter of 2001, it represented an increase of about 30,721 filings, equivalent to an increase of about 8.66 percent.

In fact, the number of personal bankruptcy filings in 2002 –1,537,730 filings – was a new record for the US for any one year.

That statistic was an increase of about 6 percent, Year-on-Year.

It is clear that high-debt burdens and a continuing weak labour market are having a dramatic impact on US consumers' ability to pay their bills as they fall due.

The situation is unlikely to be ameliorated in the near future, by the current looks of things.

The record levels of personal bankruptcies and corporate failures were a statistic that, no doubt, the Government of President George W. Bush could have done without, very nicely.

As for business bankruptcy filings (Chapter 11, only), in the fourth quarter of 2002, they rose from the third quarter figure of about 2,472 filings to 2,548 filings.

Compared with the fourth quarter of 2001, they were down by nearly 14 percent, however.

But the lower levels of corporate bankruptcies could be likened to being merely optical illusions, by and large, because of the economic shakeout of the past few years, which saw many companies vanish from the scene as successive negative quarters ushered in recession.

From a very low level of profit, of course, brought about by companies, making hefty Provisions for anything and everything in sight, over the past years or so, today, it does appear that things are on the mend in corporate America.

But are they, really, on the mend?

TARGET maintains that the worst may just be round the corner.

To begin with, disregarding the effects that the bursting of the US real-estate bubble is bound to have on the economy, TARGET notes that personal debt problems appear to be centred on lower-income households.

These households were the targets for aggressive lending policies of banks and finance houses, during 2001 and 2002.

In addition, property developers led these households to believe that they could afford their own home because mortgage rates stood at 40-year lows.

But, today, the job market in the US is not buoyant, any more, and layoffs are continuing to fill the headlines of newspapers, from New York to California.

For the week of February 22, 2003, the US Department of Labour announced that initial claims for unemployment insurance touched 417,000 claims.

This was an increase of about 11,000 claims, or about 2.71 percent, compared with the 406,000 claims, filed in the previous week.

However, the number of claims for the week, ended February 22, was at the highest level since the middle of December 2002.

What is very clear is that things are not improving in the US with regard to industry expanding, thereby creating jobs.

According to the US Government, about one million Americans exhausted their unemployment benefits, last year, and another one million Americans will exhaust their benefits, this year.

And those who used up their benefits are, still, without jobs or the prospects of landing jobs.

In order for this situation to clear up, there will have to be created about 150,000 jobs per month, according to the latest US Government's estimates.

It is unlikely that most areas of US industry – in many cases, flat on its face – will be able to achieve such a target … or anywhere near it.

While initial and continuing claims for unemployment insurance are likely to fall, later on in the year, it will partially be due to the fact that there are somewhere in the region of 2 million people who are, no longer, entitled to make claims against the US Government for such benefits.

Statistics can prove anything or nothing, as the logical fallacy states.

<u>The Bubble-Burster</u>

Whenever there is an unexplained and unusually strong price increase in respect of an industry, or a segment of an economy, one that is not verifiable by fundamental data, then, one can safely say that a bubble is at hand.

In the US, the average price of a house in 2002 rose by about 8.50 percent, Year-on-Year.

Even during the mild recession of 2001, house prices continued to rise by about 5 percent per annum.

There was some justification for the rise, all things considered.

However, things are now vastly different in the US, compared with just a few short years ago.

Since household income is the main determinant in setting the price of a house, as household incomes fall – as is the case, today – so the champagne taste is replaced with a beer pocket.

Over the past few years, US mortgage rates have eased by about 2 percent, on average.

For many US households, the lowering of interest rates has had the effect of leaving them with more disposable income.

For many households, that meant a trip down to the local departmental store to buy, not only consumables, but, also, some luxury items: It appeared that they could afford to reward themselves.

Also, motor-car companies in the US enticed these households to select a new motor-car of their choice – with no down payment and interest-free loans for the Big Three Motor manufacturers.

However, with the spate of companies, sacking tens of thousands of staff members, due to one reason or another, many households are stretched to the limits of their financial resources, today.

Regional values of houses in many parts of the US are, just, not sustainable.

Examples are in New York and San Diego, California, where house prices have been rising by about 20 percent per annum.

These price anomalies cannot continue and one may look to see a softening in house prices in most parts of Continental US, at the tail end of this year, culminating in much further and deeper cuts in the coming few years.

For places, such as New York and San Diego, there are likely to be relatively larger reductions in house prices as property speculators seek to rid themselves of their property holdings.

This will result in a domino effect, rippling through many states, depending on the severity of the cuts in house prices.

But the cuts will come, without question, and they will send quite a number of home-owners to the bankruptcy courts, around the country.

This situation will be exacerbated when interest rates start to rise, again.

This is likely to come before the end of the year because the US Federal Reserve Board will seek to contain the first sign of inflation.

US consumers are watching their pennies because there is no guarantee that they will have a job in the coming year.

Foreign-made goods, being much more price competitive than their US counterparts, in many cases, will be snapped up by thrifty US consumers, causing even further economic problems in The Land of The Free and The Home of The Brave.

What one has to remember is that, in the US, where equities play a material part in retail investment portfolios, real-estate holdings by households are known to be about 4 times higher than equity holdings.

For this reason, alone, consumer expenditure will be tailored, accordingly, and any reaction to a downward trend in house prices will cascade down the line much more strongly.

Equity markets will be hit because households, which have both equity holdings and real-estate holdings, will seek to try to keep their home, at the expense of equities.

It is clear that disposable income in the US, generally, will not increase very much over the next few years – if at all.

Without upward adjustments to disposable income, or if disposable income holds pat, it will mean that house prices cannot rise … and so they must fall, further.

Developers cannot keep extensive stocks of homes for any prolonged period of time out of the sheer necessity to maintain adequate and healthy cash flows: Time will mean a distinct loss of equity interest in the bricks and mortar in the stocks of property that developers have on their books because there is a shortage of qualified buyers.

As for the equity markets of the US, they must, by necessity, react to future trends in advance of the actuality of situations.

Those institutions that financed developers and home-owners may well be in trouble, themselves, if they are unable to recoup their money.

One must always remember that most houses are debt-financed: The level of associated debt service is absolutely critical.

Higher interest rates will impact on home-owners, depending on the severity of the increases in interest rates.

As it is, indications are that the real-estate market in many parts of the US is showing signs of softening.

Over the next few months, it is imperative that one watches for the next batch of economic statistics, released by the US Government in order to determine future trends.

The (US) National Association of Home Builders reported, on February 3, that its Housing Market Index (HMI, as it is known) fell by about 2 points to 62 points in February, compared with the January figure of 64 points.

Perhaps, more telling is the fact that the February 3 figure of 62 points is the lowest level of the past 7 months when the HMI stood at 55 points.

The February figures mark the third consecutive month of falls in the HMI.

Although the present level of the HMI remains, what could be described as sturdy, homebuilders must, now, be feeling the heat since it is clear that real-estate markets, throughout the US, are softening, in some cases, quite considerably.

Continuing low mortgage rates in the US will sustain the present levels, no doubt, but, come the end of the year when, as TARGET suggests, interest rates could start to rise, then, there could be a dramatic fall in house prices and, in places, such as New York, as already mentioned, the falls could well be dramatic.

As mortgage rates rise, household incomes will fall – the knock-on effect – resulting in the cascading effect, already covered.

The Impact on Asia

The US is, still, the largest market for Asia so that, when the US catches a slight chill, it is as though Asia had contracted pneumonia.

For many of the countries of Asia, with the exclusion the PRC, proper, they are facing difficult economic times.

While hotels may make claims that they are enjoying occupancy levels of 80-plus percent, one has to ask the key question: But at what rates, being demanded?

For the HKSAR, which is, already, suffering one of the largest economic retreats for many a decade, if the US market for its goods – which are produced, by and large, in the PRC, proper – is reduced, further, it could well result in an exaggerated downturn in business, which is on its proverbial knees, in any event.

Credit-card defaulters are, today, many a lender's nightmare, with an industry average of about 15 percent – which is an historic high, according to bankers with which **TARGET** has spoken.

Property repossessions are old hat in the HKSAR as many a bank is forced to hold onto huge portfolios of properties, taken back from customers, who could not meet their commitments to creditor banks.

When push comes to shove in the US, as it, inevitably, will come, there is likely to be, what the Americans like to call, a double whammy: Equity markets will retreat at a fast pace while the level of corporate and personal bankruptcies will rise to new record levels.

The HKSAR is solely dependent on her exports of goods, no matter where they are produced.

If there is no market for HKSAR-produced goods, it is goodnight, sweet prince.

The HKSAR looks to tourism for much of its bread and butter, but if North Americans and Europeans are cash-tight, it is likely that tourism, too, will wane because of the necessity of Americans and Europeans to conserve the dwindling levels of disposable income available.

So, in addition to HKSAR, home-grown problems, these 416 square miles, a pimple on the bottom of the PRC, will have to suffer the effects of a US economy, which has even greater problems.

What help Beijing can offer is unknown, of course, and a change of the Chief Executive in the HKSAR will cut little ice with investors of the territory.

One should not blame Chief Executive Tung Chee Hwa for the present economic crisis because, after all, he has only been a politician for about 66 months and, prior to taking up this post, he was not, exactly, a ball of fire in private enterprise.

As with any storm, one will just have to ride it out and wait for the weak to be swallowed by the strong.

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