Navigating A Few Continuing Bumps On The Road To Economic Recovery

by Patrick J. McKenna

According to many of the reports in the media, our economy is now expanding at an ever-growing pace. Unlike the last 'green shoots' illusion, many believe this "recovery" is real. The economy is getting back in gear. Everything is going to be okay.

Practically everyone believes that the economy is recovering . . . but there are a few continuing bumps that you need to take into account with your firm's strategic planning. I'm not trying to be pessimistic here, but the facts are the facts. Housing and jobs are the twin pillars of household wealth in America. The papers are full of stories about what happens to people when these pillars give way. High unemployment rates have lowered household income and forced people to take jobs at salaries far below their peaks. A record number, 40 million, of Americans now depend on food stamps. Children have been moving back in with their parents – even adult children. And tax receipts are falling. At the local and state level this is causing havoc. The feds can print money. But California, Illinois and New Jersey can't. And between the 50 states there is something like $2 trillion worth of unfunded pension obligations.

Let's take a closer look at some of the conditions that may very well make the road to recovery rather bumpy and protracted:

• Looking At Some Scary Consumer Statistics

Right now, in early 2011, one in five Americans is unemployed, underemployed or just plain out of work; and one in nine can't make the minimum payment on their credit cards.

That said, the officially reported employment numbers are out-of-whack. In 2010, for example, a total of about 1.1 million new jobs were created. That sounds nice, until you realize that the economy needs to add about 120,000 jobs per month - or 1.4 million - just to stay even with population growth.

Right now, there are 130 million people with jobs. According to the Feds, there are 15 million more who would like to have jobs but can't find work. That puts the total workforce at 145 million.

But wait; ten years ago the portion of the population that wanted to be employed was just over 50%. That would be about 160 million today. What happened? Do fewer people want to work today? Or are there actually fewer jobs, and more people unemployed, than the official figures tell us? Based on these numbers, the real tally of the jobless is probably about 30 million, or about 18.7%.

Meanwhile according to Arianna Huffington in her new book *Third World America*, companies with revenues in excess of $5 billion are expected to take over 350,000 jobs offshore in 2011 and 2012. Some are forecasting a total of 3.4 million service jobs moving offshore by 2015 in a range of fairly well paid while-collar occupations. Accenture now employs more people in India than in America. And a recent Harvard Business School

study found that 42% of US jobs – more than 50 million, are vulnerable to being sent offshore.

If that weren't bad enough, in 2006, there were 26.5 million people who received **food stamps**. In 2007, there were 26.2 million people in the program. So, the "normal" level of food stamp participation was around 26 million people. Things changed in 2008. The number of participants increased by 1.9 million. We were still in a recession during the first half of 2009. Food stamp participants increased by another 5.2 million people that year. There were then a total 33.4 million people receiving food stamps. The recession officially ended by July 2009, and one would expect the worsening to stop. But millions more who weren't officially "poor" in 2009 became poor in 2010. 6.8 million more joined the ranks of food stamp participants. These people aren't your "average" food stamp participants - these are hardworking Americans who have fallen on hard times. Now, there are more than 40 million people receiving food stamps, though to remove the stigma they don't call it the "food stamp program" anymore. Now, they use debit cards to distribute the handouts and they call it the Supplemental Nutrition Assistance Program (SNAP). Oh Snap!

Meanwhile, U.S. consumers have withdrawn a total of $311 billion from their savings and investment accounts during 2009 and 2010. Americans have reached deeper into their savings than at any point in the past six decades. And to make matters even worse, consumer debt has been on the rise again over the past few months. As of this writing, it is now at an annual rate of $2.4 trillion. That's just below the all time high point of $2.58 trillion reached in July 2008. Or put slightly differently, the average family's debt-to-income ratio is 150%, meaning that for every $1000 in after-tax income they make, American families owe $1500.

• Looking At What's Really Going On In Residential Real Estate

The bleakest year in US foreclosures has just begun. Lenders are poised to take back more homes in 2011 than in any other year since the meltdown began. And, the peak in foreclosures is not expected until March of 2012 – five years after the crisis began.

Fourteen percent of America's 56 million mortgages are already delinquent or in foreclosure. So if you multiply 56 million by 14%, that means that 7.8 million people right now are not paying their mortgages. 7.8 million homeowners have been delinquent for 30, 60 or 90 days . . . or are in foreclosure already.

And the real story is even worse. Because of loan modification programs, the banks have been slowing down the foreclosure pipeline and not taking properties onto their books. That means that the rate of NON-foreclosure on delinquent borrowers is climbing sharply. 24% of the people who have not made a mortgage payment during the last two years have still not been foreclosed on. That's how clogged the foreclosure pipeline is.

So what's going on? Well, there are a lot of modifications going on, but they don't really work. It turns out that even when you cut someone's mortgage payment by 50% or more, half of them still default within 12 months. Why is that? Because the real driver is people being under water, people who have no 'skin in the game.' So, when the value of the property falls below their debt, they're walking away. As it turns out, the unemployment rate isn't really much of a driver of default rates. Instead, it's all about home equity . . . or the lack thereof.

What does the future hold? Today about 17.2% of homeowners are underwater. But if home prices drop 10% from here, 27% of homeowners would go underwater. In other

words, a 10% drop in home prices would cause a 56% increase in the number of people underwater . . . which would almost certainly lead to another surge in defaults.

One big problem in all of this is second liens. You have $842 billion in second liens outstanding and the majority of them are owned by the Big 4 banks. And you have this bizarre situation where American consumers are not making the $1,200 monthly payment on their first lien, but maybe just to prevent harassing phone calls from debt lenders, they are paying the $150 second lien. That means that the banks are looking at this and they're holding all of these second liens at par, even if the first lien has already gone bad.

This situation makes the banks very reluctant to approve a short sale, since that would completely wipe out the second lien - because if you write down the first lien, the second lien is a zero. Of course, banks just don't want to do that because it's a huge amount of money that would wipe out the equity of these Big 4 banks, if they were to mark these second liens to zero. This is a big problem.

Net-net, there's more pain to come in the real estate market.

[A portion of this was excerpted from a presentation delivered by Whitney Tilson, the Managing Partner of T2 Partners.]

• Delaying and Praying Over Commercial Real Estate

Then there's commercial real estate. With the majority of commercial real estate loans that are coming due, nothing is happening on them. They don't get refinanced, but they don't get foreclosed on either. It's "extend and pretend" or "delay and pray."

Banks have avoided writing down billions of dollars in soured commercial loans by extending their maturity dates. There are now $1.5 trillion of commercial real estate loans coming due over the next four years – half with mortgages in excess of current property values. The 100 largest banks, by assets, have an average of one-quarter of their loan portfolios tied up in commercial real estate and that percentage is even more concentrated for the smaller community banks. Banks are not making as many new loans because they have all these old bad loans on their books. These bad loans are likely to be the trigger behind a flurry of coming M&A activity in the financial sector throughout 2011.

• Looking At Bank Failures In Slow Motion

Every Friday evening a few more banks are closed - seized by the various state banking regulators and handed over to the Federal Deposit Insurance Corporation (FDIC) for liquidation. This all happens rather quietly, barely making the news. We're told these bank failures are no big deal. The names of the banks change over the weekend and many customers don't notice the difference. We've only had 294 failures as of this writing. Adjusted to current dollars, the Depression banking crisis was $100 billion, the S&L crisis was $923 billion, and the current crisis . . . is nearly $8 *trillion!*

So while an FDIC spokesperson, Sheila Bair, said the current crisis would be "nothing compared with previous cycles, such as the savings-and-loan days," it's actually much bigger, because the financial sector had grown to be nearly half the economy by 2006 - as measured by the earnings of the S&P 500. But the question is; why haven't there been more bank failures? In 2008, there were 25 failures, in 2009 there were 140, and in 2010 about 129 have been seized on Friday nights. The greatest real-estate bubble in history popped - first residential and then commercial - and we only have 294 failures?

It takes easy credit to make a real-estate bubble and it was America's commercial banks that provided most of it. It's estimated that "half the community banks in America remain overleveraged to commercial real estate, and the possible losses that remain are about $1.5 trillion," according to bank-stock analyst Richard Suttmeier.

Almost 3,000 of the 7,830 banks in the United States are loaded with real-estate loans where the collateral value has fallen over 40 percent, and yet less than 300 banks have failed?

We all know what's happened to the residential-property market, but to illustrate how bad the situation is for the commercial market, over 8 percent of commercial mortgages that have been packaged into bonds are delinquent; more than $51.5 billion of such loans are at least 60 days late on payments compared with $22 billion a year ago.

If anything the commercial property market would seem to be getting worse. Losses on loans packaged into US commercial-mortgage-backed securities totaled $501 million in August 2010 - more than double the $245 million in April 2010, and over 10 times the $41 million in losses of 2009. Past-due loans and leases at the nation's banks and S&Ls increased 16.2 percent from second quarter 2009 to the second quarter of 2010. Restructured loans and leases increased nearly 54 percent.

The delinquency numbers are bad anyway you look at it. So, they must be reflected in bank's profit numbers, right? Well, no. Second-quarter 2010 earnings by the nation's banks were the highest in 3 years - nearly $22 billion. Based on these numbers, FDIC chair Sheila Bair claims, "The banking sector is gaining strength. Earnings have grown, and most asset quality indicators are moving in the right direction, putting banks in a stronger position to lend."

By the way, of the $21.6 billion in second-quarter 2010 profits, $19.9 billion was earned by the 105 largest banks in the country. The other $1.7 billion in profits was spread between the other 7,725 banks.

Interestingly, in 2010, Elizabeth Warren and her Congressional Oversight Panel did a report that indicated 2,988 banks were in trouble because of real-estate concentration in their loan portfolios. Ms. Warren noted that office vacancies had increased 25 percent since 2006-2007, apartment vacancy was up 35 percent, industrial was up 45 percent, and retail vacancy had increased 70 percent since 2006-2007.

[A portion of this was excerpted from a presentation given by Douglas French to an Economic Summit in October 2010.]

• Looking At State and Municipal Debt

Though vast and complicated, the root of American municipalities is like any business or household: money goes in, money goes out. Done right, a municipality takes in more money than it pays out. Money comes in mostly from taxes and revenue streams such as utilities and tolls. Money goes out to finance municipal government payrolls and public works programs. Cities and states sell bonds when they can't pay upfront for such needs. No big deal . . . at least, it wasn't a big deal until recently.

In this era of high unemployment and shrinking economies, state and municipal revenues are hurting. Tax revenue tends to be lower with millions of Americans out of work. Just

the same, they use less power, drive through fewer tolls. Pay that parking ticket? I don't think so . . . not this year.
Since the recession began states have seen an unprecedented collapse in revenues. At least 44 states and the District of Columbia are projecting budget shortfalls totaling $125 billion for fiscal 2012 (which begins on July 1, 2011 for most states) according to a survey from the Center on Budget and Policy Priorities. With the exception of Vermont, every U.S. state has laws guaranteeing that they must pass balanced budgets.

States have struggled during the past few years, but 2012 may be the most difficult year yet. Easy cuts have already been made. The federal stimulus has given states nearly $200 billion over the past two years – and by the end of this fiscal year, aid will all but dry up. And many states are already tapped out on their rainy-day reserves.

Governments are desperate to cut spending. But their biggest expense of all is untouchable - pension plans. California offers a telling example. A recent Stanford study concluded that the state pension fund program is under-funded by roughly $500 billion. The researchers urged the Governor to inject $360 billion into its public benefit systems - right now - to have an 80% chance of meeting 80% of obligations over the next 16 years. But, facing a $20 billion state budget gap, what could he possibly do?

It's precisely this pickle that undid Vallejo. That San Francisco suburb declared bankruptcy in 2008. Tax revenue had collapsed, a major shipyard closed and all of a sudden the city found itself paying 90% of its annual budget to retired public employee pensions. 90%!

How deep in the hole are the state and local governments? Truth is, nobody knows. The states report their liabilities in strange ways, often ignoring accounting conventions. California faces a $19 billion shortfall. New Jersey's public pension system is $100 billion in the hole. New York's system may lack almost twice that much. Illinois spends twice as much as it gets in taxes.

So municipalities kick the can down the road. New employees buy into the funds. Fund managers maintain their projections of endless 8% annual returns. Retirees keep taking out the funds they were promised . . . and no one pays the tab. Orin Cramer, chairman of New Jersey's pension program, estimates a national funding gap around $2 trillion. The municipal bond market is roughly $2.7 trillion. If Cramer is on target, that's a total liability about the size of France and Britain's annual GDP - combined.

Therefore, in yet another sub-prime redux, Wall Street has found a way to make the muni bond problem even worse. Like the mortgage market, the municipal bond market has morphed into its own new era of highflying finance, adjustable-rate loans and complex securities. Meredith Whitney, the "genius" that called the banking crash of 2008, went on *60 Minutes* a few months back, claiming that the muni-market will see more defaults than anyone can imagine. She called for "hundreds of billions" in losses.

• Looking At a U.S. Debt That's Tough To Even Calculate

Boston University economist Laurence Kotlikoff says U.S. government debt is not $13.5-trillion (US), which is 60 per cent of current gross domestic product, as global investors and American taxpayers think, but rather 14-fold higher: $200-trillion - 840 per cent of current GDP. "Let's get real," Professor Kotlikoff says. "The U.S. is bankrupt." Professor Kotlikoff is a noted economist, a research associate at the US National Bureau of Economic

Research and a former senior economist with then-president Ronald Reagan's Council of Economic Advisers.

Writing in the September 2010 issue of *Finance and Development*, a journal of the International Monetary Fund, Professor Kotlikoff says the IMF itself has quietly confirmed that the US is in terrible fiscal trouble - far worse than the Washington-based lender of last resort has previously acknowledged. "The U.S. fiscal gap is huge," the IMF asserted in a June 2010 report. "Closing the fiscal gap requires a permanent annual fiscal adjustment equal to about 14 per cent of U.S. GDP."

Professor Kotlikoff says: "The IMF is saying that, to close this fiscal gap [by taxation], would require an immediate and permanent **doubling** of our personal income taxes, our corporate taxes and all other federal taxes.

One way or another, the fiscal gap must be closed. If not, the country's spending will forever exceed its revenue growth, and no one's real debt can increase faster than his real income forever. Professor Kotlikoff uses "fiscal gap," not the accumulation of deficits, to define public debt. The fiscal gap is the difference between a government's projected revenue (expressed in today's dollar value) and its projected spending (also expressed in today's dollar value). By this measure, the United States is in worse shape than Greece.

• Looking At 'The Great Correction'

In August 2008, I authored an article entitled, *Managing Through A Prolonged Downturn* in which I asserted "*that for the next five years, every time you think it's safe to get up and dust yourself off from this downturn, every time you feel like you've endured the worst of it, another piece of news is going to come along to freshly bludgeon you. This time the economic slowdown is going to be a lot different and, in many ways, a hell of a lot tougher."* An economist friend of mine calls this the 'Great Correction.' He tells me that his Great Correction is very different from an economic slowdown or recession. It is not a pause in an otherwise healthy economy. Instead, it is a change of direction . . . an adjustment to new circumstances.

To give you one small indication of the kind of adjustment that is taking place, he points to some good news. U.S. manufacturing is finally picking up. For the first time in 10 years, more people are now joining the manufacturing labor force than leaving it. Of course, this is just what you'd expect. Labor costs are going down. At the margin, America's competitive position is improving.

But, he tells me, this is not, as the media has advertised, "proof" the economy is recovering. Far from it. It is proof that the economy is going in a different direction . . . and responding to a different set of circumstances. Much of the last 10 years was spent in bubble territory. During that time the economy was losing manufacturing jobs, not gaining them. The economy is not now "recovering" to the bubble conditions of 2005-2006. It is moving on.

And it's a good thing. Would we want to go back to an economy that destroyed real jobs in manufacturing while creating only jobs in finance and housing? Now the economy is simply doing what it should do: it's adjusting to new conditions. Unfortunately, it will take time. You don't shift the world's largest economy overnight. So, the rate of joblessness and uncertainty is likely to remain high for some years as this transition takes place.

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