



Washing Each Other's Underwear, Paper Shuffling, and McMansions.

By Joe Average.

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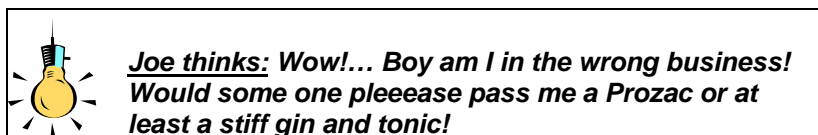
When the “mother of all stock market booms” came to an abrupt halt in March 2000, “see no bubbles” Alan Greenspan came charging to the rescue. As the NASDAQ crashed and burned, dropping 78% during the next nineteen months, the Federal Reserve Chairman morphed into “easy money Al” and orchestrated a massive flood of liquidity in order to avert a global recession.

Unfortunately, while central banks are able to crank up the printing presses (or more correctly, add zeroes to a computer money account... creating “money out of thin air”), they are not able to control where this money flows. Consequently, financial assets reflat, hedge funds exploded in number, banks and mortgage brokers scrambled to throw money at anyone with a pulse, and “**The worldwide rise in house prices**” gave rise to “**the biggest bubble in history**” (The Economist June 16th 2005... www.economist.com).

This time it really *is* different!

A global meltdown had been averted, thanks to Alan Greenspan and his sidekick “helicopter money-printing press” Bernanke. However, this time the “recovery” didn't follow the normal business cycle where money should have been pulled out of inefficient companies and malinvestment and then redirected back into more productive manufacturing industries and infrastructure. Instead, hot money chased quick and easy returns in stocks and financial instruments. Stockbrokers on Wall Street were back! Commissions soared once again as **paper shuffling brokers** churned stocks. Huge bonuses were back in vogue and the champagne corks were flying. Meanwhile, not to be outdone, the high flyers in real estate were also hitting home runs as the real estate boom went ballistic. Doug Noland in his Credit Bubble Bulletin of June 3, 2005 (www.prudentbear.com) describes how:

“Michael Neeley, a real estate broker... in less than two weeks...cleared nearly \$98,000... The real estate boom has been good to agents like Mr.Neeley... In addition to the Bentley, Mr.Neeley's blossoming wealth has allowed him to buy four Mercedes, two Jaguars and two Range Rovers. He spends lavishly on theater tickets, Tiffany jewelry, Louis Vuitton belts and shoes, and owns 28 pairs of Alain Mikli eyeglasses, which are color-coordinated with his wardrobe... In Manhattan, the best real estate agents cleared over \$2 million last year.”



Average Joe consumers in America, afraid of missing out on the party, madly began pulling the equity out of their rapidly appreciating homes and crowded into stores to buy huge plasma screens, expensive furniture and garden landscaping, S.U.V.s, and second and third homes on little or no money down. In fact, the American consumer was now the main pillar propping up the U.S. economy and was estimated to be contributing to some 60% of G.D.P.

However, amidst all this economic madness something strange and worrying was unfolding. Instead of U.S. manufacturing jobs increasing as would happen during a normal recovery, workers continued to be laid off as **American industries were gutted and jobs exported to cheap labor countries like China and India.** This “recovery” has been by far the most anaemic since World War II.

The following graph and quote are courtesy of Robert Prechter's Elliot Wave International (www.elliottwave.com):



“The rising sectors of the economy are (1) construction, which is a beneficiary of the housing mania, and (2) financial activities, which are lagging beneficiaries of the exhausted financial mania. *That’s it.* Retail trade, wholesale trade, transportation and utilities are all down moderately from 2000. The only reason the overall economy is expanding at all is the employment generated in the financial and construction sectors by Reflation Levitation. As the dream ends and the implosion accelerates, the aggregate economic numbers will go with them, and we will have no manufacturing base to support recovery.”

Stephen Roach, chief analyst for Morgan Stanley explains it thus: “**There’s good growth and bad growth. The former is well supported by internal income generation and saving. The latter is driven by asset bubbles and debt. The United States, in my opinion, has been on a bad-growth binge for nearly a decade, but especially over the past five years. In a US-centric global economy, that means the rest of the world has also become overly dependant on bad growth as the sustenance of a false prosperity. With a saving-short U.S. economy now hooked on an increasingly frothy property market, risks of the ultimate post-bubble shakeout are looming. That’s because, unlike the equity bubble of the late 1990’s, the housing bubble has been built on a mountain of debt.**”



Joe wonders: ... Why don't they give a guy of this calibre and savvy a job at the Federal Reserve?

Jim Puplava (Financial Sense) addresses this issue by differentiating between the *‘real economy’* and the *“financial economy”*. The “real economy” is where goods are manufactured, transported and traded, and where essential services (e.g....”where doctors heal people”) are provided. The “financial economy” is where “paper is traded and credit is created”. The extent to which these two economies have gotten out of kilter was highlighted in Jim’s radio interview with Dr. Marc Faber (The Gloom, Boom& Doom Report) where they mentioned an interesting fact.

“... whereas in the 1950’s and 1960’s corporate profits were still derived 50% from the manufacturing sector, and only about 10-15% from the financial sector, today, more than 50% of S&P earnings - if you add the financial subsidiaries of industrial companies such as GE Capital and GM Acceptance Corp, etc., – are derived from the financial sector, and only 10% from the manufacturing sector. So in the US we have a kind of very bizarre economy where the manufacturing sector has contracted as a percentage of the economy and we have what I call the asset sector of the economy that has been grossly inflated: the financial markets and the housing market”.

Dr. Marc Faber,
Interview June 18, 2005 www.financialsense.com

“Made in Japan” becomes “Made in China”

China, population 1.3 billion, has now moved to centre stage as manufacturer to the world. Its cheap labor force and ability to rapidly copy manufacturing processes has enabled its economy to catapult forward in a boom of its own as it eagerly expanded to supply insatiable American and global demand for cheaper products.

Americans continue to spend their way into debt only because China and Japan are currently financing U.S. current account deficit, which has hit 6.4 per cent of G.D.P. In other words, the United States is trading IOU’s for cheap Asian goods.

Fearing that a continuing devaluation of a weakening U.S. dollar will further erode their massive dollar holdings, the Chinese are now purposefully manoeuvring to use their surplus cash to instead acquire American companies and their resources, such as U.S. oil company Unocal (an American icon).

Lessons of Dot.com Bubble Bust

The dawn of the Internet and the “New Era” of Information Technology looked set to transform the world and especially U.S. economy. Just as the Industrial Revolution had allowed the Anglo-Saxon world to leap ahead of Central Asia and the Orient, the Information Revolution was supposed to cement U.S. domination of the world economy. **America wasn’t worried if the baton of industrial manufacture now passed to China and other less developed nations... let them have it! ... surely the U.S. would always stay several steps ahead by maintaining tight control of intellectual systems and property as evidenced by the domination of companies like Microsoft and Google.**

Problem is... the China and India are marching to the beat of a different drum! Instead of being held in check by the Information Revolution, they are using it brilliantly to their advantage. They are rapidly breaking down the technological barriers and rewriting the global investment script.

China seems unable (or unwilling?) to stamp out flagrant piracy of intellectual property while using computer technology to transfer and copy everything under the sun. Instead of being hamstrung by an antiquated banking system they have leap-frogged straight over check accounts to credit cards and the ATM. Instead of being slowed down by the lack of telephone landline infrastructure they have leap-frogged straight to mobile phones. **The pace of their development is simply breathtaking!**

India meanwhile is quietly undergoing its own revolution. This nation of some 1.1 billion is churning out armies of well-trained, English speaking computer programmers and IT personnel who will work for a fraction of their Western counterparts. India acts as magnet to corporations around the globe seeking to cut costs to the bone as globalisation increases competition. The transfer of information now possible allows Indian call centres to dial account holders in Britain, Australia and the United States... accounting and insurance firms to outsource back-office work overseas... Indian radiographers to read X-ray results to American hospitals over the Internet.

The Australian Financial Review, 12 July 2005.

Byte-sized rivals make US spit chips.

Welcome to the new information technology industry, where global supply and design chains are fast becoming the norm... The shift of programming work to low-cost regions in Asia and Eastern Europe, and the mass migration of industry to China, has sharply reduced the numbers employed in recent years in Silicon Valley in California, the traditional heart of the computer industry.

While diehard American IT executives insist they will remain the centre of the universe... The proportion working for Asian firms is increasing...

Mr Jordan (chairman and chief executive of Texas-based computing services firm EDS) believes a drift in jobs is inevitable but he also believes **the US “will always be the Mecca for innovation** due to its access to capital and its access to the largest and most sophisticated markets”.

Arjun Malhotra, chairman and CEO at IT consulting company Headstrong, **disagrees** in part, noting that **venture capital continues to pour into countries like India.**

“They don’t want that money to be spent on development in Silicon Valley or in the US,” he said.

Emma Connors and Mark Jones.

www.afr.com

So what does it all mean?

What it means is that **when** Greenspan’s credit and housing bubble bursts, the U.S. economy will be hit hard.

According to The Economist, **homebuyers in Los Angeles are relying on their homes to increase in value “by a whopping 22% a year over the next decade”.** This would push the median price per house up 800% to well over \$3 million, while at the current rate of increase the median family income would only rise to around \$54k.

Consumers are now relying on their homes to make up for static or falling incomes, and to provide them with a comfortable pension in their twilight years. These same consumers may soon be rudely awakened from their dream of ever increasing property prices and financial instruments. They may awake to a stark reality indeed. If so, how might they react?

Firstly, they will realise the need to **stop spending and start saving** (as former generations once did). For example, in tough times young people may choose to move back home to save rent (if their parents will have them back) rather than choke on a large mortgage.

Secondly, they will begin to par back or **eliminate spending on non-essential services** they can do themselves or do without, such as mowing their own lawn, doing their own housework and laundry, passing up on pampering facials, massages, manicures and so on.

Thirdly, loans will be paid back (or in many cases repudiated) as people **strive to get out of debt**. If house prices stop rising, or (Heaven forbid!) actually begin to drop, there will be Hell to pay... not to mention the possibility of rising unemployment, rising interest rates, rising oil prices, rising cost of living, etc, etc.

Fourthly, a severe slump in financial instruments will mean **fewer paper shufflers will be required** leading to an increase in lay-offs. Meanwhile, a downturn in the residential building industry will ultimately see builders and their trades-people chasing work with further lay-offs to follow. The past several years have been a bonanza for mortgage brokers, bankers, builders and retailers of household hard goods... but the fact remains that **historically low interest rates have brought forward future production resulting in massive overbuilding which may take a decade to work off**. The party was great, but the hangover is going to be a doozy with the prospect of many lean years to come!

As Eric Fry warns in Rude Awakening (www.dailyreckoning.com) ...”housing-related industries have produced a whopping 43% of the nation’s total net sector employment growth... any slackening of real estate activity would slow employment growth in the industry. Indeed, **this massive job-creator could become a job-destroyer.**” Some analysts even credit the housing asset bubble with adding as much as 2% to overall GDP. Clearly then, a collapse in house prices would severely impact upon economic growth.

CONCLUSION: If Robert Prechter's analysis is correct (and this Average Joe thinks he just might be) then the United States is destined to pay for its profligacy and the economic mismanagement. America may well curse the time it allowed its manufacturing sector to be decimated. At the end of the day, it's all very well to rely more heavily on the Information Technology, financial and service industries, but the nation should still have a dynamic manufacturing industry. One wit put it succinctly thus ... ***"as a nation we can't survive just by washing each other's underwear!"***



Cheers, Joe Average.

(aka Bill Swagell).

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