

Deliberate Acts Of Kindness

An old and wise friend gave me some sage advice recently, "Be kind," he said, "everyone you meet is fighting a battle." Life is a battlefield, although for some of us including yours truly, it seems that fate has chosen marshmallows or water balloons instead of hand grenades and M-16s as the weapons of destruction. Still we all suffer. Coming into this world must have been no treat, going out most definitely won't be, and everything in between – well, the "eat, drink, and be merry" of Omar Khayyam is often overwhelmed by the pain of loss, personal debilitation, or simply the overwhelming deluge of circumstance. It's under these conditions, as my friendly advice-giver would agree, that kindness is the temporary salve that heals. My wife Sue is the kindest person I have ever known; not because of publicised acts of generosity of which there have been some, but because of everyday acts of kindness, of which there have been multitudes. There are hundreds and hundreds of people who would choose to be one of her best friends if the time were available – some on the A-list, but most of them category B's and C's – waiters, repairmen, average people with greater than average battles being fought behind sometimes cheerful facades. Sue brings music to their quiet desperation.

I have observed through her that being kind involves sacrificing the inward/ personal moment for an outward reaching smile. It includes a heartfelt, not conversationally correct, "how are you" with more listening than talking. And it can involve, given enough hours in the day, a follow-up good deed or a simple reminder of empathy and caring. Kindness comes in other forms

too. Jonas Salk was very kind, as are doctors, teachers, or any working person whose outward reach often exceeds personal gain. Lovingly raising a family is an act of kindness. People that write checks for Katrina or African relief are kind as well. I guess when you get down to it, kindness comes in many shapes, but the important thing is that it keeps coming. We're all fighting a battle whether it be in New Orleans, Darfur, or Newport Beach, California. I'm going to try to be more like Sue, smile more often, extend an ear even during my busy day, and set a goal to become an Empathy Prince in addition to a Bond King. (Talk about reach exceeding your grasp!) Join me if you're not already there.

Interest rate markets can be kind or unkind depending – as Shakespeare might have intoned – whether you "a borrower or a lender be." The last few years have been magnificent ones for many homeowners as yields came down from their turn of the century peaks and landed in a valley so low that the lure of assuming a mortgage became irresistible. Houses were then turned into ATM machines as refinancing, equity extraction, and a plethora of funny money mortgage innovations placed cash in the hands of consumers. The U.S. and global economic recovery over the past four years, as detailed in previous *Outlooks*, has thus been asset-based with housing leading the pack. Central banks worldwide, through both historically low real policy rates (Fed Funds) and the recycling of reserves into longer-dated U.S. Treasuries (Bretton Woods II) bear responsibility for much of the froth. Ordinary citizens with a capitalist bent – gettin' while the gettin' is good – must own up to

the remainder. Combined, they have produced a growing economy but one which is acutely dependent on housing continuing to go up, equity continuing to be extracted, and consumption continuing to be motivated by what seems to be an endless chain of paper prosperity.

Wiser and more experienced counsel know that such a foundation for wealth generation is really a castle built on sand instead of granite, and the only question is when the tide will rush in to wash it away. Last month Alan Greenspan finally rang the warning bell with his admonition about risk premiums as detailed in my September *Outlook*. More recently through the E-mail pipes have appeared two Federal Reserve studies that cast considerable light on when the housing bubble might pop, and when our specious prosperity might lose a touch of its lustre. Before I speak to them directly let me summarise my sequence for house bubble popping or froth skimming, and then blend in the Federal Reserve studies for illumination.

- 1) Housing prices will cool/stop going up very much/even go down in some cities, WHEN...
 - a. Interest rates rise to a high enough level to make the purchase of a new home a burden instead of a boon for first time buyers.
 - b. Mild regulatory pressure begins to reduce the amount of funny-money lending.
 - c. Speculators sniff the beginning of the end.
- 2) Home equitisation should retreat shortly thereafter.
- 3) Consumption/the U.S. economy will then weaken when the house ATM starts running out of fresh new \$25,000/\$50,000/\$100,000 home equity loan dollar bills.
- 4) The Fed will cut interest rates in order to start the game all over again.

Let me state categorically that the above sequence is barely questionable, almost inevitable, 99% unavoidable, and in modern parlance – “slam-dunk.” In so

saying, I hope I am not being unkind to those of you who think otherwise – I’m trying to do you a favour! What I can’t do is tell you how soon all of this unfolds which I admit is a critical variable. The following from the aforementioned Federal Reserve research could provide some clues however.

The Board of Governors of the Federal Reserve System have just released Discussion Paper #841 entitled “House prices and Monetary Policy: A Cross-Country Study,” a project covering 18 major country housing markets since 1970. The paper cites many influences for housing prices including demographics and financial deregulation (funny-money mortgages) but the title gives away the dominant culprit – interest rates. After chasing through the 68 pages of this paper, I will cut to it – the chase that is. Housing prices chase interest rates: when yields go down (short nominal rates, longer real rates) real housing prices go up. When yields go up, they go down. Could have told you that I guess without the study – common sense and all – but it helps to have the Fed’s imprimatur attached to an opinion – with no guarantees of course. They/I cite the following charts as confirmation, broken into two distinct time periods – pre and post 1985 – covering housing prices and policy rates (Fed Funds) for 18 countries.

While their written conclusions are not as definitive as my own which follow, I think it’s pretty clear that real housing prices have peaked on average four to six quarters after the central bank first raises interest rates and following what appears to be 200 basis points of short-term rate hikes. The tightening then continues (too much exuberance!) another two quarters thereafter for what looks like a total cyclical increase of 300 basis points or so. With the caveat that many countries in this study have housing markets with greater sensitivity to short rates than our own, I find it illuminating that our own Fed has raised policy rates for nearly five quarters now to the tune of 275 basis points, dead on the average point where real housing

prices have peaked over the past 35 years.

Additional studies have shown that the current level of short rates is beginning to eliminate many first time buyers from the market since they have increasingly used adjustable-rate mortgages to squeeze through the door. Affordability indices, primarily a function of mortgage rates, are hitting 15-year lows, and banks' willingness to lend – a function to some extent of regulatory pressure – is going down as well. Because upwards of 20% of new home purchases now are either for second homes or for condo flipping to a hoped for "bag holder," speculators cannot be sleeping easily these nights. Combined with the dominant influence of still rising short rates, condition #1 of my froth-skimming scenario cannot be far away.

Condition #2 referenced a retreat in home equitisation and it is here where a September 2005 study by Alan Greenspan himself (along with Fed staffer James Kennedy) comes in handy. That this is only the second study to which he has attached his name during his entire Chairmanship tells you something about the importance of this paper that focuses on equity extraction financed by home mortgages. Greenspan, in his typical style, draws no conclusions but simply lays out the evidence presented below in Chart III.

Greenspan states that homeowners borrowed \$600 billion last year against the growing equity in their homes made possible by the annual gains in housing prices of near double-digits in recent years. That \$600 billion amounts to nearly 7% of disposable personal income. While Greenspan again does not take the risky step of suggesting how much of that flows through to spending, private economists

and good old common sense suggest at least 50% and maybe more. People don't borrow money to deposit it in the bank. They borrow money to spend. If so, and using a conservative 50% figure, the chart points out that home equitisation has added ½ to 1% annually to the U.S. GDP growth rate in recent years. Should home prices stop going up at recent rates, equity extraction will become more difficult. Studies by Goldman Sachs on other home asset-based economies, such as Australia's, point to retail sales slowdowns of as much as 4% once equitisation rolls over. This week's consumer reports from the UK point to the same conclusion. Even Greenspan himself

Chart I

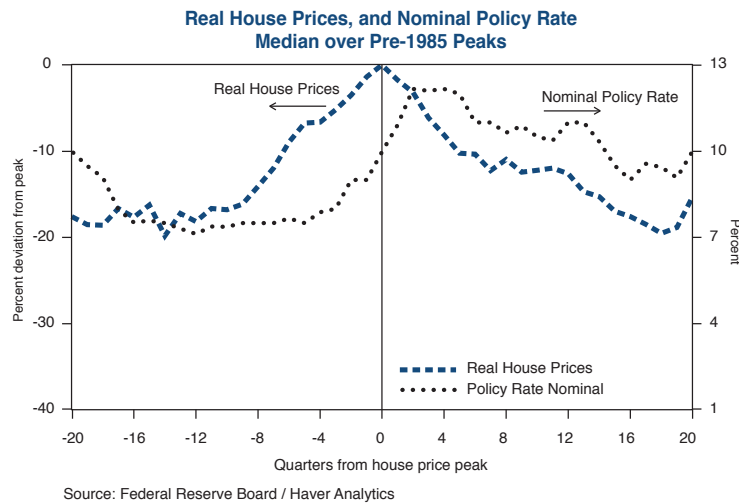
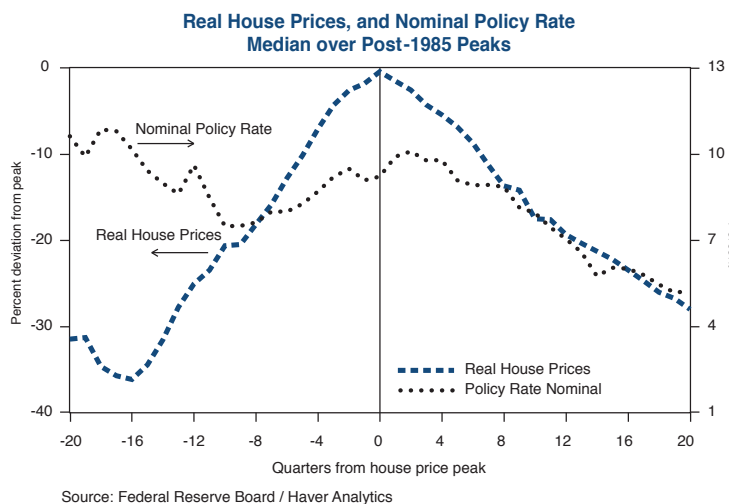


Chart II

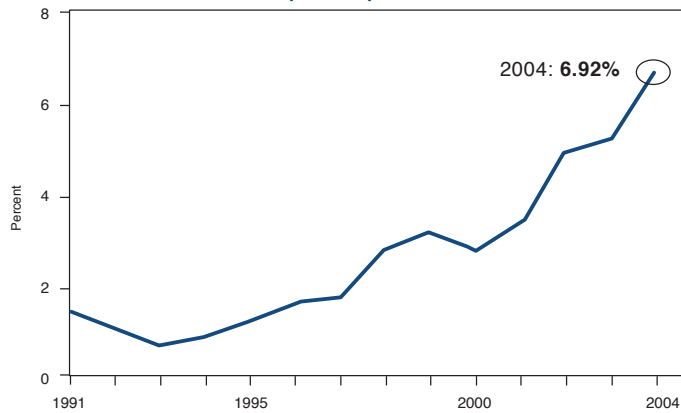


in a speech last week said that "should mortgage interest rates rise...mortgage refinancing cash-outs would decline as would equity extraction and presumably consumption expenditure growth." Conditions #2 and #3 in my housing timetable then, seem likely to unfold within perhaps the next three to six months.

How weak the U.S. economy gets will depend on numerous factors: oil/natural gas prices, China's continuing growth miracle, and of course the level of U.S. interest rates – themselves a function of the Fed and foreign willingness to buy our Treasury and corporate bonds. But make no mistake about it, the froth in the U.S. housing market is about to lose its effervescence; the bubble is about to become less bubbly. If real housing prices decline in the U.S. in 2006 or 2007, a recession is nearly inevitable. If higher yields simply slow the pace of appreciation to a more rational single digit number, then we could escape with a 1-2% GDP economy. In either case, however, our Fed with its new Chairman will likely be in the enviable position of lowering rates come mid-year 2006. Currently ogreish central bankers within twelve months time will thus be responsible for some rather deliberate acts of kindness: lowering yields to keep our

Chart III

Lending Spree
Borrowing against home equity as a share of disposable personal income



Source: Wall Street Journal, September 27, 2005
Alan Greenspan and James Kennedy, Federal Reserve

asset-based economy alive and kicking. Whether in the fullness of time that will be judged to be kind is another question, but it appears that this overwhelming deluge of circumstance will require lower yields at least one more time.

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