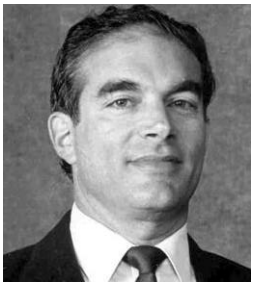

FOCUS ON THE ECONOMY

"BUBE"—Is the Market A Bull Or A Bear?

BY DR. MARK LEE LEVINE, CRE AND DR. LIBBI ROSE LEVINE SEGEV

I. THE GAME

"THE TERM "BUBE" IS A YIDDISH TERM for grandmother.* It is pronounced "buh-bee."

A Jewish grandmother can be stern, strong and directed. But, more often, the grandmother, Bube, is often sweet, kind and understanding. The question is to know the mood of Bube.

By a metaphor, one could ask: "Is a Bube stock market a Bear or a Bull?" That is, is Bube a "bear" (stern, strong)? Or, is this the day of the Bube "Bull Market" (sweet, kind and understanding)?

The term "Bube" often gives mixed messages to grandchildren, as to grandmother's mood. There can also be "confusion" as to the mood of the market. It is not always clear which factors actually influence Bube—or the Market—and the degree of such influence.

A. PROJECTIONS

Inconsistent signals are being given by the market. Are increasing interest rates good or bad? Is inflation good or bad? Is the interest rate (prime) moving up too quickly? What are the impacts of war, terrorism, the election, deficits, employment and other signals or signs of consumer confidence on the economy?

There is confusion as to whether the market is a bull or a bear market. What is Bube's mood—and how long will it last? Since economists cannot answer the questions—without many hedges, maybe we should ask Bube—depending on her mood!

* It is no small coincidence that Bube may be an acronym of Bu=Bull and Be=Bear!!

We have all heard, read, and seen multiple projections and suggestions from various entities that shed "light" on the path of the U.S. economy in the next 6 to 12 months.

The general format of the chosen game seems to be "Monopoly" during the past several decades when considering "playing" in the real estate market as well as the U.S. economy. The new game is to guesstimate the behavior of many variables and how they will affect the economy. Those variables might be such factors as economic growth, including Gross Domestic Product (GDP), Gross National Product (GNP), and many other indices which, allegedly, give us "insight" as to how the economy is actually performing and, implicitly, how it will perform.

In an article addressing how the U.S. economy is performing and how it will perform, by James R. DeLisle, Ph.D., there is a continuing attempt to prognosticate. [DeLisle, James R., "Real Estate and the Economy: The Train Has Left the Station," *The Appraisal Journal* 5 (Winter, 2004)].

According to the DeLisle article, some factors to consider as key indices in the analyses include GDP, GNP, whether employment is increasing or decreasing, inflation, interest rates, the stock market, consumer confidence, real estate markets and aspects within those markets, including capital funds.

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Many factors influence the U.S. economy. Despite uncertainty about where those factors may move, given the interplay of many facets of the economy, there is general reliability as to GDP, GNP, and related numbers in the U.S. economy.

However, when attempting to compare the U.S. position with foreign markets, there may be differences because of a lack of reliability in the reported data from some other countries. Such indicators as to the performance of markets, including the Gross Domestic Product (GDP), are noted in *The Economist* on a regular basis. (The concern is often focused on the issue of reliability of the data.)

When looking to the factors indicated by Dr. DeLisle (or by others who report the same type of information), recent indicators, if accurate, seem to be fairly positive. For example, the United States shows a GDP growth position for the year 2004 of somewhere in the range of 4.1% to 4.5%.

Employment growth has been improving in recent months. General concerns voiced by some economists on the current economic position is that the U.S. unemployment rate will continue to fall, reaching close to 5% in 2004.

As another example of favorable trends in the market, [reported in the Meyers Group "Housing Market Key Indicator Alert" (May 10, 2004)], existing home sales are still very strong. The amount of inventory is sufficiently low to indicate a favorable position within the residential real estate market.

However, affordability to purchase housing is dropping, which is, in part, a function of the recent increase in interest rates. The 30-year fixed long-term mortgage interest rates have been climbing back and are now near 6% . Although, on a relative basis, this is still a favorable interest rate, continued rise in the interest rate impacts the public from an economic and psychological standpoint. Most buyers recognize they "could have" received a lower interest rate, had they purchased or refinanced last year, as opposed to this year. (And, the implicit question exists: Will interest rates be higher next year?)

There is a negative economic impact of affordability as to rising interest rates, as opposed to only the psychological impact. Buyers generally recognize that they now qualify for a lesser purchase price or refinance amount toward a home, since interest rates have risen. They also face a higher monthly mortgage payment. Therefore, the affordability, of purchasing a home, or refinancing an existing home, has decreased.

B. OTHER FACTORS: MIXED MESSAGES

Inflation is an additional factor with regard to the U.S. economy. On the positive side, inflation remains fairly low; therefore, the rate of inflation has generally been a positive indicator. However, if the inflation rate increased "too much," this could be a negative factor for the economy.

Because of the overall increase in employment (ie, decreasing unemployment), low interest rates, a low inflation rate and other positive signs, some economists suggest that the American economy has a very impressive likelihood to have a positive growth rate for 2004, growing at a projected 4.5%. (See this position by Jeff Thredgold, economist for Vectra Bank, in his publication, *Insight* (Winter, 2004).)

Notwithstanding some of the above-mentioned positions by DeLisle and Thredgold, there are "mixed messages." [See the article by Tom Locke, "Hearing Mixed Messages? Deciphering the Economy," *Denver Business Journal* A9 (March 12-18, 2004)]. The Locke article pointed out that these "mixed messages" include increasing defaults by consumers, a limited amount of job growth, a drop in production, reduction in available venture capital, and many other "negative" factors.

"Positive" signs, as noted, include reduced unemployment. The increase in housing prices, general growth in venture capital, positive spur in consumer confidence, as well as many other favorable factors, boost the economic outlook. The most often-cited economist is Federal Reserve Chairman, Alan Greenspan, who warned investors in 1997 that the stock market was being pushed to levels that were unreasonable. In fact, Mr. Greenspan noted that there was an "irrational exuberance" within the marketplace.

The question remains as to whether the U.S. economy is in an "irrational exuberance" stage (using the label by Mr. Greenspan), or whether it is demonstrating a very rational "exuberance." Do consumers have a rational exuberance in the marketplace? In the best-selling book by author and Pulitzer Prize winner, Thomas Friedman, *The Lexus and the Olive Tree* (1999), Mr. Friedman referred to this concept. In Chapter 17 of this Work, page 367, Mr.

Friedman referenced this "irrational exuberance" as raised by Mr. Greenspan. Mr. Friedman wrote: "Dear Mr. Greenspan, I have a terrible problem. I'm feeling irrationally exuberant about the U.S. stock market, and I just can't shake it. I know you've said 'irrational exuberance' is bad for my health, and I've tried everything: Hypnosis, Valium, short selling, even reading your speeches from 1987. But nothing works. Every time I come to Europe or visit Japan, I return home itching to invest more in the U.S. market."

This tongue-in-cheek position by Mr. Friedman focused on whether one should have "rational" or "irrational" "exuberance" as to our economy A review of various newspapers and reporting sources leaves one confused as to whether one should or should not be confident with an "exuberance" in the U.S. economy.

II. READING THE TEA LEAVES

Many factors indicated earlier could be considered either positive or negative, depending on the reporting position.

A. RESIDENTIAL HOMES

Interest rates remain still relatively low; they are the lowest interest rates in the market in the last 40+ years. Even with slightly increasing long-term mortgage interest rates, overall interest rates are still very low. Does this indicate that one should be "exuberant" on the "positive" side, because interest rates are still very low? Or, does this mean that consumers should feel less "exuberant," because interest rates are increasing? As interest rates increase, signals from various parts of the market include a general slowing of the U.S. economy, greater restrictions on consumers' ability to acquire housing, and the "snowball" or "domino" effect of fewer prospective homebuyers. This in turn, impacts many other facets of home ownership (such as purchasing home furnishings, repairs, etc), and other parts of the market.

On the "optimistic" side of the market economy, home sales and increased home acquisitions have been very strong for several years. These strengths, in turn, generated support for other types of purchases in areas such as retail sales.

A "counter" to such "positive" position is the impact on consumer confidence and spending when the general U.S. market substantially slows. In February, 2004, Chief Economist for the National Association of Home Builders (NAHB), Mr. David Seiders, reported that there was a decline in home sales. This might not appear to be a "negative" position, since home sales have been very strong over the last number of years. However, this is still an "actual" decrease; therefore, this might be treated in some reporting agencies as an overall "negative" position, if it portends a downward trend.

B. DEBT

The issue that Mr. Greenspan raised in the debt area is another factor of concern. In early February 2004, Chairman Greenspan voiced his concern to members of the U.S. Congress that the major mortgage entities of FANNIE MAE and FREDDIE MAC were too aggressive in their activities. Because of the size of these two entities, involving trillions of dollars, a failure by either or both of them could substantially impact the financial position of the United States, warned Greenspan.

If the market is "positive," maybe there is less concern with this issue. However, Mr. Greenspan indicated that he was concerned with the economy because of the amount of debt involved. When such position is coupled with other legislation, such as H.R. 3755, an Act to provide for a zero dollar down payment for home purchases through FHA, there is additional concern of potential financial difficulties that may be later faced by the general U.S. economy.

Increasing home prices, increased interest rates, and an increase in the debt level raises awareness of a potential "bubble" in housing markets. [Regarding this concern, see the Note, "Cracks In the Brickwork?" *The Economist*, page 51 (January 3, 2004)]. This article focused on the risk of falling home prices, following a very strong increase in pricing in such countries as Australia, Great Britain, and the United States. The article also characterizes housing prices as being dangerously overvalued in six housing markets, including the United States, Australia, Great Britain, Ireland, The Netherlands, and Spain. The question raised was whether "cracks" were starting to appear as to pricing of homes, and whether there would be an actual overall decrease in value and pricing of homes. The concluding line in this article, on page 52, stated: "But in many big cities there must be a high risk that prices will fall." This raises broader economic consequences.

C. STOCKS AND BONDS

Mr. Warren Buffett, known as the "Sage of Omaha," and head of Berkshire Hathaway, noted the high price of many

stocks. Because of these risk concerns, the comment in the above-captioned article was that Berkshire was "holding" $36 billion of cash. (Some might argue that there is very little interest being paid on "cash holdings." The response by Mr. Buffett was simple enough: ". . . the pain of doing something stupid is potentially worse.")

Diane Vazza, a manager of Standard & Poors, noted that although bond defaults are falling, the only reason was because of favorable interest rates. Her comment was: "Trouble is brewing. . . ."

D. FORECLOSURES

Foreclosures are rising in many cities. For example, in Denver, Colorado, foreclosures are already hitting very high levels. In fact, Denver has experienced its highest level of foreclosures in 13 years. Many other cities in the U.S.A are facing this same issue.

E. CONSUMER DEBT

An additional area that has been reported is the ability of consumers to gain more spending power by refinancing real estate, especially via the principal residence of the consumer. The ability to "pull cash" from the equity of the home and utilize that cash to satisfy spending needs (and desires) as well as debt requirements has directed attention to this "warning sign." Other warning signs include substantially increased credit card debt, increasing interest rates on credit card balances, and other debts that consumers are facing.

F. GOVERNMENT ISSUES

Even beyond direct consumer issues, when looking to the United States government, and state and local governments, there is concern with debt in the economy. There is no question that growth in the U.S. economy at 4.5% is a positive sign. However, because of deficit spending caused largely by a "weak" economy over the last few years, additional spending necessitated by the war in Iraq, other U.S. commitments abroad, tax reduction, etc, there is greater strain placed on the U.S. economy. With the reduction of tax revenues for the Federal government, along with revenues for state and local governments, there has been additional concern and strain on the economy.

These economic strains have been further magnified by recent Federal tax refunds to taxpayers. The intent, when approving the refunds, was to have taxpayers help "stimulate" consumer spending, and, in turn, stimulate the economy. Whether such acts will prove to be fruitful is not the current issue. The issue at hand is that there has been a reduction in the revenue stream for Federal, state and local governments; and there has been an increase in spending by the Federal government. There have been further strains on the economy, at Federal, state and local levels, due to other factors, such as increasing terrorism alerts, unemployment, aging of the general population, medical costs and health concerns for consumers, etc. These issues, and many others, have challenged and adversely impacted the economy.

Along these lines, see the article by David Lereah, Senior Vice President and Chief Economist for the National Association of Realtors (NAR), *Realtor* magazine, page 18 (April, 2004). In this article, Mr. Lereah labeled the "trillion-dollar question" as: "What happens when the effects of the tax cut and Federal spending, which have swollen the budget deficit—and the Fed's policy wears off?"

As noted by Mr. Lereah, the question is whether there will be an increase and expansion of corporate profits, job creation, strong consumer spending, and whether other positive signs will emerge to help the economy move in a positive, growth direction. If such favorable events occur, the budget deficit can be reduced and the economy will be postured for a positive position to continue low interest rates and, in turn, to continue a favorable housing market, along with other positive results.

The "counter" position is also of concern: If the expansion cannot be sustained, if jobs are not created, if consumer confidence is down, if the Federal Government is not able to gain economic support, these factors spell a great deal of trouble, arguably, to the Federal Government, and, in turn, to state and local governments. Most state and local governments are in a dire economic position at this time; they are attempting to find ways to cut their budgets to deal with the decreased economic positions. Unlike the U.S. government, states and municipalities have statutory requirements for balanced budgets.

G. INTEREST RATES: A REFOCUS

Although low interest rates have been extremely favorable to the economy, interest rates are rising now, and will generally continue to rise. How much those interest rates will increase, and how quickly they will rise, are key questions. A dramatic increase of interest rates over a short period of

time would be a major, negative blow to the economic posture of the United States. [For comments on these issues and related points, such as inflation, see the article by Raymond G. Torto, "Inflation Again," TWR-About Real Estate Report, in the *CBRE/Torto Wheaton Research Report*, Volume 5, No. 15 (issued April 19, 2004).]

III. CONCLUSION

As stated at the beginning of this Note—and nothing has changed in these few pages—we are all uncertain as to exactly where the economy will move in the next few months.

There are more challenges to consider. In the article by Brian Miller, "More Challenges Ahead," [*Real Estate Forum* 30 (December, 2003)], Mr. Miller noted: "Despite signs the economy is improving, the experts say it will be some time before the property markets begin to turn around." As Mr. Miller pointed out in his discussions from many real estate experts, there are many factors to consider. The jobless recovery issue, the outsourcing of jobs to India and elsewhere, and many other factors need to be considered. Some argue that it will take many years for the U.S. economy to improve. This may mean part of the issue is longevity. As Ms. Jeanne Myerson (one of the parties involved in discussing the economy with Mr. Miller) commented: "Stay alive 'til 2008" is the key.

PROJECTIONS FOR THE ECONOMY

Assumptions made by most prognosticators are normally "hedging" positions that assume certain factors. For example, in most projections for the economy, there is an assumption that there will not be major terrorism activities in the United States and that interest rates will rise, slowly. But, what if these "assumptions" are faulty? What about other assumptions?

In an article by Byron Wien, U.S. Senior Investment Strategist with Morgan Stanley (see the web site under www.morganstanley.com/ourviews), there were a number of items noted as potential "surprises."

Many economists assume that job growth will reasonably continue, capital will be reasonably available, interest rates will remain reasonably low, and so forth. However, possible events such as additional terrorism, increasing deficits in foreign trade and domestic trade, escalating problems in Iraq, negative consumer confidence levels, financial scandals, and higher energy prices should give us pause.

The summary outlook for the economy remains: "Uncertainty." It appears that we know many factors that will influence how the economy reacts, and whether we will be in a generally "positive" or "negative" position as to the economy. The continuing problem is that we are not certain which factors will arise, which factors will move, and the degree and speed of movement of those factors. Such factors, especially changes in interest rates, war in Iraq, and terrorism issues continue to cloud the vision for projecting the economic position of the U.S.A.

The often-cited retort continues to be applicable to Bube—and all of us: "Wait and see."■