

## SMOKE AND MIRRORS



SO HOW IS IT THAT the U.S. government is reporting a white-hot housing industry accompanied by record job growth, and at the same time, yours truly is pointing out the widening crack in the foundation that holds the economy up? Easy — it's all true; the devil's in the details. It's done with smoke and mirrors.

All of the glowing economic news that is being reported is more or less true. *Why* it's true is the critical part of the reporting that seems to lack mention. We talked earlier about the fact that government relies on the poor memories of its citizens regarding past history — say, three weeks ago. Otherwise it could become somewhat obvious that all these illustrious reports are a bit of a ruse. (That's a nice way of saying that they're being somewhat reckless with the truth.)

The cliché, “kitchen sink economy,” has been used to infer that since the stock market collapse of 2000, business and government have thrown everything but the kitchen sink at the economy in a resuscitation effort. That is a graphic description that couldn't be more accurate.

While we take an up-close-and-personal look at exactly what all has been thrown at reviving the great machine, keep in mind the side effects of induced inflation. The old people and the kids get hurt, those in the middle *think* that they are being helped, and what happens to the rich? You're on to that one — they get richer. Even economic wars experience casualties. But then we covered that. Now if *all* old people and kids got hurt in the game of inflation, it wouldn't be such a popular sport. But then we covered that too. *All* would suggest that Big Business, the politicians, and the college economics professors were

joining us for the game — they're not. So let's take down the mirrors, blow away the smoke, and put a little light on the subject.

I mentioned the fact that General Motors, Ford, and Delphi, if not circling the drain, are certainly on that end of the tub. United, Delta, U.S. Air, and Northwest Airlines are in or just emerging from bankruptcy. Fuel of every description has gone berserk. Steel, copper, gold, platinum, lumber, aluminum, cement, beef, dairy products, education, and insurance are near record highs. I could go on and on, but I don't need to. I'm sure that at some time during the last year, all of you have been to the grocery, the gas station, the home improvement store, paid your home heating bill, and have attempted to balance your checkbook.

It is interesting that inflation, according to the consumer price index (CPI), for all of 2006, was reported as being 2.5% on a consumer level. We could have really been in trouble if inflation had been reported at say, 3%. Of course, the 2.5% growth in consumer prices doesn't include food or fuel. It does include housing, but that calculation was changed to Government Math in 1983. Rather than use the actual rise in the cost of current housing, after 1983, the government began measuring *rents* instead. You think I'm making this up, don't you? Huh-uh. That particular policy change was made due to the fact that voters don't like high inflation. If the government included food, fuel, and housing *fairly*, it would be evident that we *have* high inflation! That's a no brainer; give the people what they want. The government doesn't change the questions, they change the answers.

With core inflation for 2006 remaining at a low 2.5%, and early projections for 2007 being the same, those people who aren't dependent on fuel, food, or housing are in pretty darn good shape. Embalming fluid has that effect, doesn't it?

Do you ever wonder where these Government Math people come from? There is a special oral test that each of them have to pass for entry into the inner sanctum of the Advanced Government Math Headquarters. It goes like this: The examiner calls the brilliant mathematician prospect in and asks, "Reginald,

what is two times two?” Reginald, or “Reggie,” as the boys down at the country club call him, gets a puzzled look on his face and says, “I’m thinking...maybe four?” The interviewer then says, “Thank you, Reginald, don’t call us, we’ll call you.”

This process is repeated until such a time that a special person who comprehends the complexities of Government Math arrives on the scene. The interviewer asks the special person, “Scamway, what is two times two?” Scamway looks slowly in all directions, and after being assured that they are alone, gets up and closes the office door. He comes back, leans across the desk, and whispers, “What do you want it be?” *Torture numbers, and they’ll confess to anything.* — Gregg Easterbrook

Meanwhile, back at the ranch, G.M. and Ford are breaking out the life vests, and the market for iPods, Xboxes, and giant plasma screen TVs is nothing less than spectacular. If this is starting to appear to you as if the places where we make money are in trouble and the places where we spend that money for entertainment are on a roll, you’d be correct. “So how can that work?” You ask. About as well as it did for the Romans, and it’s not called the *fall* of the Roman Empire for nothing. Remember, when I say that “all is *not* well,” I am NEVER inferring that everyone involved in our system of commerce is sharing the pain equally. Here’s a typical headline:

“Breaking news: As thousands of workers are asked to take a 95% pay reduction in light of Schmuckco Manufacturing’s \$1.2 billion loss last quarter, company President, Will B. Alright, was awarded \$20 million as a bonus for agreeing to remain with the beleaguered company and assist in drafting an equitable workout plan.”

In a news interview following the announcement, Mr. B. Alright stated, “It could have been worse; I could have only gotten \$10 million.” When asked what he thought of the plight of the workers, B. Alright responded, “I’d like to give them a hand, but I just can’t reach that far. Ha-ha, just kidding.” B. Alright continued by saying, “Schmuckco cannot be expected to take responsibility for our employees’ failure to structure their personal lives at a level where losing their jobs and retirement

would inconvenience them. After all, if you take away my money, my golden parachute pension plan, and my second home in Aspen, we're all in the same boat." "And there you have it, back to you in Washington, Dan."

"So," you say, "we know all about the position of the rich and famous, but you still haven't told us where all the jobs and money are coming from." We're going to have to go back and visit Earl and family to find that out.

The Scottish-born poet and novelist Andrew Lang said, "He uses statistics as a drunken man uses lampposts — for support rather than illumination." The American rendition of this quote is most surely, "Feed them bull and keep them in the dark." As for us, we need to change our diet and put a little light on the subject.

Money makes the world go round. Not literally, but it does make our commerce go around. It's a matter of providing the people more and more money and they'll spend it. That seems simple enough. All that is required is a perpetual supply of money and the means to pass it out. That brings us back to Earl and the year 2001.

Not that the economy had been all that whoopee for the period *preceding* the attack of 9/11/01. The United States had experienced a serious stock market collapse in 2000, referred to as the "Dot Com bubble bursting," and the country was still trying to trim up the haircut that American investors had taken on that one. Interestingly enough, a bunch of seemingly brilliant young upstarts, who either got out of the market early or were lucky enough to be between scams (I meant to say "investments"), became millionaires, which proves that "lucky" really is better than "good." It was after the attack on 9/11, though, that things really got dicey. The country fell into a state of paralysis and the money quit flowing.

The Fed (you remember those guys) had noticed that the 2000 stock market collapse was not a good thing. Fed governors pick up on such things about six months after the natives in New Guinea have the news. Once alerted to the fact that immediate action should have been taken six months prior, the

Fed sprang into action — at least as close to “springing” as quasi-government people can simulate.

The Fed’s standard method of reestablishing a paralyzed society to its former “borrow and spend like a madman” is complex beyond the average American citizen’s comprehension. That’s why we have Fed governors to handle the heavy thinking. We will, however, overcome by reducing the process to an understandable format with Mikeronomics. I can do that, because I’m not your average citizen. I’ve had countless people tell me over the years that I’m not even *close* to being average.

Here’s an example of the way it works. The Fed governors get together and the Fed Chairman opens by saying, “I have received word from a source in New Guinea that the fund rate is too high. How low do you think we should go?” The governors at this point rear back in their chairs and assume a posture of divine intelligence and philosophical thought for a period of time that rivals the mini Ice Age, after which they declare with grave seriousness, “We don’t have a clue.” The Chairman then turns to the secretary and says, “Monica, do you remember what we did the last time that this happened?” The secretary answers, “Uh...that was last month, sir, and reading directly from the minutes, all of you decided ‘to just keep lowering the rate until those suckers start borrowing again.’” “Awesome idea,” the Chairman announced. “And better news yet, we’re going to get out of here early today.”

Beginning in January of 2001, the Fed lowered the federal funds rate ten consecutive times, from 6% to 1.75%. You can see that this downward fishing expedition started a full eight months prior to the attack on 9/11. Even with the federal rate for funds sitting at 1.75%, a recovery did not appear imminent. By June 2003, the Fed had reduced the rate to 1%, the lowest since 1958.

Just prior to the economy being officially pronounced dead, a faint pulse was found. This period is often referred to as “the recovery that almost wasn’t.” I’d say that was putting it mildly. Mr. Bill Clinton was the President from January 20, 1993, to January 20, 2001. The Dot Com bubble had burst, the fishing

expedition for reviving the economy had begun, and Mr. Clinton was luckily term limited and could later say, “I don’t know what happened, it was alright when I left.” *Hasta luego.*

The continual downward rate in interest did eventually breathe some life back into the economy, and no doubt the citizenry (and the illegal aliens) were once more spending money like drunken sailors. For those of you who take offense to the seemingly derogatory term “drunken sailor,” I apologize. However, and admittedly on more than one occasion, I *was* one. And I can personally attest to the fact that the former suggestion that drunken sailors spend money with reckless abandon is a fairly accurate depiction.

Did I tell you why the stock market collapsed in 2000? To begin with, the whole thing was based on Charles Ponzi’s business plan, but that’s not the point that I want to make. In April 2000, the natives were already a little restless when the government released a surprisingly bad inflation report. Okay, *terrible* inflation report. All of the seasoned investors, which in 2000 meant that you had read the book *How to Become a Multi-Millionaire by Next Week in Dot Com Stocks*, did what anyone who realizes that they have just lost their life savings would do: PANIC. And panic they did, followed by the NASDAQ dropping 1,125 points and the DOW dropping 805 points in one week.

A lot of these seasoned investors that we spoke about had borrowed the money to get in on this unbelievable *gain*, which was now unbelievably *gone*. “Hey, isn’t that what the investors did in the market crash of 1929?” Yes, they did, which proves that lightning really can strike in the same place twice.

It is truly important to understand the magnitude of difficulty that our government and Big Business had in reviving the economy after the 2000 crash. Consider this: in order to induce the public to borrow money, the Fed had reduced the funds rate to 1% in the year 2003! That move was a last resort, last-ditch effort. When the Fed got down to 1%, something had to catch fire soon. This is similar to the movie plot where the hero is freezing to death in a blizzard and has only one match — combustion is essential.

So what do low, low, interest rates accomplish? Not only is borrow and spend like a madman back in style, so is inflation. To compensate, Earl puts the night shift back on.

The sword of low interest-induced inflation is sharp on both sides. When the Fed rate is 1%, the folks that have interest-bearing investments are making zip point, *nada*. Of course, most of them were probably old people who didn't plan well.

The real point is that jump-starting the economy has become more and more difficult. The year 2003 was not all that long ago, and we darn near lost our last match. The government is still counting on you not to remember that. But we're going to let them down this time, aren't we?

During the same period that the Fed governors were doing their part by lowering the funds rate to 1%, the United States was engaged in a war over in Afghanistan, and eventually in Iraq. U.S. troops are still present in both areas at the time of this writing. Oh, no — I'm not going *there*. Whether the war is right or wrong is not going to be debated in these pages. It is the benefit of the war economy that I need to point out. I will say one thing, if we run out of gas in the good ol' U.S. of A., an economic war will come to a town near you quicker than a dog pound cat. I'm not necessarily talking about the gas that makes a car go; I'm talking about the gas that makes an economy go.

The effect that a war has on the economy is broad, and for our limited discussion, we can focus mainly on the fact that the government spends billions and billions of dollars on the effort. Thousands of civilians work at producing everything from bombs to buns, resulting in an expanded work force. Reserve soldiers, sailors, and airmen, who would normally be working, have been called away to serve. This creates vacancies in the jobs that they left behind, and the hiring of replacement personnel is required. The net effect is that thousands more people are on the payrolls of American companies and the Federal Government. "So when the new employment figures are given, does it discount those working purely due to the war effort?" You gotta be kidding! Jobs are hard enough to come by these days without doing any sorting; they count 'em where they find 'em.

Now, some of you mentioned the white-hot housing... “Whoa, whoa, hold on there. What happens when the war is over? Won’t the replacement jobs go away and the military spending be diminished?” If I was taking a wild guess I would say, absolutely, you can bet your bottom dollar on it. That is, however, not necessarily the worst effect. The government spent billions and billions of dollars on the war effort, right? The government doesn’t have any money. They have you and Earl. “Oh, jeez, we knew you were going to say that, and we just got the dang Visa card paid off.”

Government debt and your credit card have more in common than you might think. When our government charges incessantly on their credit card (the National Debt), just like you, they also have to make a minimum monthly interest payment. The principal difference is, *you* have a *limit* on your card.

It isn’t totally accurate to say that spending will go down after the war effort is ended. It *should* go down. However, *sufficient money to keep the show on the road has to come from somewhere*. Either the government has to continue to fund America’s economy (on credit) or the private sector economy has to grow to a level that will produce sufficient *viable* jobs and taxes to offset the current deficits in government spending. What’s that called? Sure, same answer, growth, growth, and more growth, and then additional growth. I’m thinking that we probably can’t depend on G.M. and Ford to do that. Maybe the iPods, Xboxes, and plasma screen TVs will get the job done...oh, that’s right; those things are made in China.

If all else fails (which it had), lower the interest rate, fan the flames of inflation, and heat up the domestic housing market. That ought to get the job done, at least long enough for the present administration to say, “It was alright when I left.”

The housing market has been nothing but hot. Millions of Americans are making a better-than-average living building new homes in every corner of the country. Personal wealth in the form of reported home equity is climbing at a staggering rate. There are books, videos, and live seminars that explain the goriest details of how to make a small fortune in real estate.

Actually, it's easy to make a small fortune in real estate; go into it with a large fortune and limited knowledge and you will soon have a very small fortune.

"Flipping properties" is a household phrase today. This is America's future right here and now, and it's hotter than a two-dollar pistol. In some parts of Florida, houses are being bought in the morning and sold for a profit in the afternoon. Walt Disney created Fantasyland; America's housing industry stole his thunder. The Great American Dream is back on track like lightning in a jar. Let's see if we can keep from getting electrocuted.

If you aren't somewhat convinced by this point that exponential growth is never going to work long term, maybe I can muster up a more convincing argument using housing as an example. We all know something about housing. For instance, not having any is inconvenient. Camping can be fun for the weekend, but after about three days, a person can lose a little enthusiasm for eating burnt weiners in the rain and having your clothes and hair smell like what's being served for dinner at Tex's barbeque.

Housing, then, is no doubt a necessity. But is it necessary for each occupant to have 1,000 square feet of personal living space? Sure, it would be nice, but can we afford it and at the same time keep the general economy on track? What say we reduce this thing down to a common-sense format to get a more realistic view of the big picture?

Housing is as old as mankind. The necessity for housing has never changed. The earliest humans utilized housing as a means of climate control and to keep the critters out of their stuff. People thousands of years ago actually invented the mobile home (and were robbed of the credit for doing so, I might add). The principal difference back then was that the owner provided the necessary propulsion for the tepee or tent. "Well, Mom, I think we better move today. You round up the kids and I'll grab the house." Pretty darn convenient, and no taxes or mortgage payments at all.

Housing today provides the same basic elements that it provided the earliest man—climate control and keeping the critters

out of our stuff, and boy do we have stuff. Somewhere between a tent and a 40,000 square foot mansion is the perfect domicile. I really don't like continually being the messenger of bad news, and I do keep promising some good news for some of you, but this just isn't the place to do it. Housing is a serious issue that is going to have HUGE future implications. You really do need to at least take a look at the downside. Not to worry, I'm not going to suggest that your future involve a portable house.

Housing is, of course, included in the sector of goods described as durable. My wife and I spent 15 happy years in a home that was constructed in 1926. Surely that qualifies as durable. We had made improvements and modifications over the years, but by and large, it was the same farmhouse that was originally built in '26. We weren't too cheap to buy a new house; it's that we didn't NEED a new house. We were warm and dry and successfully fended off the critters.

We have established that houses meet the criteria for durable goods, with the exception of the disposable homes that were discussed in an earlier chapter. That being said, and hazarding a guess that no one wants to purposely corner the market on vacant homes, the housing market needs constant population growth to survive. Simply put, homes need homeowners.

Fortunately for us, the average lifespan for Americans keeps increasing. If folks had an earlier demise, their homes would become available for the live ones much sooner, and fewer new homes would be needed. Thankfully, Dad and Mom, Grandpa and Grandma, and Great-Grandma and Great-Grandpa are all still using their homes simultaneously and won't let the kids move in with them, which, in turn, increases demand for new housing.

We need continual increases in prospective new homeowners in order to keep all the workers who build homes *working*. This goes for all the people who make the things that we build homes with, such as windows, doors, carpet, drywall, roofing, cement, lumber, and towel bars. So here is the question: what happens when everyone who wants a home has one?

Let's just kid ourselves a little and say that that will never happen. Ha-ha. To help us believe that demand will never

decrease, let's also say that we will become much more tolerant to immigration and allow 2 million people to come to the United States every year. Now, here's the new question: what happens when everyone who can *afford* a new home has one? Yep, same answer to both questions: OH, MY GOD!

Let's go even further out on our precarious limb and say the economy is going to get sooooo good, and that immigration is going to be increased by sooooo much, that we will never reach a point that housing demand will decline. That will, in turn, keep all the people who build homes, and all the people who make things to build homes with, working forever. Would everyone who believes even one teensy weensy bit of that last statement hold up your hands? For those two people who have their hands up, you have just passed through Fantasyland and gone into the Twilight Zone. What goes up, must come down.

"So now, Mr. I Have Some Bad News, you never answered our question of where are all of the home buyers are coming from?" They were here all the time. They just couldn't afford a house. "So the economy is improving at that, huh?" No, but the mortgage rates certainly are. We have determined that inflation has existed ever since the government needed a way to get more money, which is forever. Wages had inflated along with everything else, but not nearly as fast as home prices. Mortgage interest had also increased over the years, and the combination was putting the squeeze play on housing in the form of unaffordability.

The Fed realized that simply lowering the price of housing would temporarily get them out of a bind. Acting on this new stroke of brilliance, the Fed asked America's builders to consider lowering their profits and therefore reducing the price of housing. The builders discussed the possibility for 10 seconds and said, "Does the mental institution know that you people are out?"

The Fed took that as a no. Going back to the drawing board, a new plan was hatched. As we saw previously, the Fed rode the time machine back to 1958 and made money sooooo cheap that people who really couldn't afford a house could buy one

anyway. And, the people who already had a home could buy a bigger improved model. A lot bigger.

Remember, some of these Fed governors only needed one more clean shirt until retirement, so long-term planning had, let's say, lost some of its appeal. I know there are some people out there saying that the federal funds rate does not control long-term mortgage interest and primarily affects only short-term rates. And, that T-bills and bond rates correlate more closely to the rates charged for long-term debt.

That is fundamentally true, but the correlation between short-term and long-term interest rates is nonetheless closely associated, and for our discussion, we aren't going into a lengthy dissertation about every factor that affects rates. I do point out that it was not by coincidence that 30-year fixed mortgage rates dropped to a 45-year record low of 4.75% in June 2003, right along with the Federal Funds rate of 1% at the same time.

The result of the Fed tweaking the system provided lower mortgage rates and allowed the opportunity for thousands of additional Americans to purchase new housing. But the sword was sharp on both sides, and those who had previously counted on interest income became casualties of the Fed's financial policy.

To sweeten the pot, a couple of other characters named Fannie Mae and Freddie Mac (corporations who purchase mortgage loans in the secondary market) provided the necessary backing to keep the show on the road.

Further assistance was given to those who REALLY couldn't afford a home by offering 3- and 5-year adjustable rate loans, and interest-only mortgages. Heck, the way this thing is going, three years from now the homes would be worth 50% more and the person borrowing the money would surely be making higher wages to support the higher payments. A common phrase for this type of creative financing was borrowed from the game of craps, and is stated as "betting on the come." And all this time I thought gambling was illegal.

The time machine to 1958 had hit warp speed. The re-finance business for existing mortgages went absolutely

berserko. Thousands of additional people were employed in the businesses of appraisal, mortgage loans, home inspection, real estate, title companies, and an endless list of others. All we need is more people and more money to keep this puppy running like a greyhound.

Where was it that the people got all this money to buy new houses? Right, they borrowed it; for a long, long time. Okay, now that everyone in America can get into a home by taking advantage of zero down and interest only loans, I want to talk about a new problem of which I will wager you have never read a word. I'm not referring to the fact that the 3- and 5-year adjustable rate mortgages will soon ratchet upward and that the payments will have gone up far faster than wages, or that the interest-only mortgages will be even worse. I'm not even referring to the fact that taxes, utilities, and insurance will continue to outpace income.

It's that all of these people who now have HUGE house payments have promised to make those payments for 30 years or more. Many *existing* homeowners have cumulatively taken out an estimated \$2 TRILLION in home equity loans, on *top* of their mortgages!

The MAJORITY of the average homeowners' income will service the *single* purpose of paying for, and maintaining, shelter. "And your point is?" And my point is, if an inordinate amount of a family's income is going purely to service home debt, where is money NOT going? Savings comes to mind.

On the surface, this may not seem like a big problem, but it is. Building a home has the most benefit to our economy during construction. This offers work to countless people such as the developers, builders, real estate agents, title companies, appraisers, engineers, and building suppliers. However, after the home is complete, the majority of the financial benefit to society ceases to exist. All of the aforementioned occupations have to go find another new homeowner if they want to collect another paycheck next Friday.

Once the home is complete, most of the homeowner's money is being devoted to interest, and only benefits the lender.

Therefore, having an inordinate portion of the general public's earnings committed long term to any single purpose has the effect of robbing money from other sectors within that same economy. The cumulative effect of funneling the majority of a family's earnings into shelter alone creates the very real possibility of bankrupting entire sectors of nonessential commerce.

This of course would not be the case if incomes could constantly grow, but even Earl has some limitations, particularly in this current era of world trade. Government reports for the third quarter of 2005 stated that for the first time since 1932, savings had gone negative in the United States. The average person is spending more annually than they are making. This is a startling statistic, and yet gets little press. Why? It's bad news for business.

A writer for the *Wall Street Journal* declared that he thought perhaps in 2006 Americans would save more money. I can see that. With all the bargains that we are receiving on fuel, groceries, utilities, housing, and transportation, saving more in future years should prove a cinch. Well..., maybe not. Year end figures for 2006 disclosed that negative savings dropped even further into the red ink. I think the *Journal* author has potential for passing the Government Math test.

The fact that personal savings have dipped below zero for two consecutive years is not a coincidence or a temporary situation. Hidden costs of inflation are pushing everyday living expenses beyond average current incomes. Our lifestyles will have to change; like the weary boxer, growth will fail to answer the bell in the very near future.

We're going to have to come back to real estate in a later chapter when we discuss what not to do. But before we leave this subject, hold your nose and we'll swallow one more dose of bad news. The great real estate boom that has allowed our domestic economy to stagger back onto its feet is ill founded for more reasons than I have pages to write on. For those of you who didn't enter the Twilight Zone earlier on this subject, it won't surprise you to learn that there is a predictable end, and it isn't pretty.

There is an enormous difference between commercial/industrial, and residential real estate in regard to how each serves the public good. Residential real estate serves only to provide shelter to the individual members of our society, and as we saw, it has the greatest benefit to public good (in regard to commerce) during construction.

Commercial/industrial real estate, on the other hand, represents the very heart of the commerce that provides the incomes used to pay the new homeowners mortgages. Growth in commercial/industrial real estate, then, is essential to supporting the income required for growth in the residential real estate sector. (The picky mortgage people insist that having a job helps a person qualify for the loan.) The current boom that we are experiencing, and the record-beating inflation in real estate, are by and large confined to the residential sector. Even the Government Math gurus may not be able to spin that information into a positive. What am I thinking? Of course they can.

As building costs continue to escalate, which they must, and as interest rates continue to climb, which they will, and as qualified buyers begin to diminish, which has already begun — what happens? Those people who entered the real estate market utterly dependent on continual increases in their home values and personal wages will realize that they have taken a very costly gamble. The Federal Government's purposeful introduction of inflation by slashing interest rates to 1958 lows, combined with relaxing lending standards, will be the undoing of thousands of homeowners who are up to their eyeballs in housing debt.

Here's the question again: "If 500 workers are building an unsold condo project, what do they do after they finish?" Go fishing. You can *eat* those things, you know.