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Interest rates, real estate and the U.S. dollar

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Rising real estate prices have come to symbolize the period of post-war prosperity. Since World War II, residential and commercial real estate prices have, with few exceptions, continued on an upward trajectory little impacted by the vicissitudes of the economy and financial markets. An increasing number of Americans have come to expect, even rely upon, this as a unique attribute of the U.S. real estate market. Certainly, it is not a characteristic of modern real estate markets in general as the collapse of the Japanese market in 1990 and the Hong Kong market in 1998 will attest. In fact, the bubble in the U.S. real estate market and its subsequent collapse may never have occurred if not for several rather important developments in global capital markets and in foreign exchange.

Exceptionally low interest rates, ready access to vast supplies of credit originating from overseas and an overvalued U.S. dollar all played a roll in the recent boom and bust in real estate. They will play an equally important roll in the future recovery.

The Asian Financial Crisis of 1997-98 triggered currency devaluations throughout south east Asian and emerging market throughout the world. In the years that followed the U.S. economy became the global buyers of last resort, supercharged by an ever-rising greenback. Strong U.S. growth, relatively high interest rates and a soaring stock market ensured the U.S. economy and the greenback would benefit from positive sentiment on behalf of foreign investors racked by tepid growth conditions and market instability elsewhere. As the NASDAQ peaked in early 2000, the subsequent collapse in equity prices prompted a shallow U.S. recession. It wasn't until the 9/11 attacks a year later until the Fed began to slash interest rates, which ultimately undermined the U.S. dollar. The combination of weak growth, low interest rates and lackluster stock market returns took its toll on the U.S. dollar. The Fed exacerbated matters by cutting the federal funds target rate to a 46-year low of 1%.

The rapid pace of globalization during this period saw China maintain a staggering pace of 10% real annual growth, which dates back almost 30 years. Foreign direct investment (FDI) from the U.S. to China has fed this remarkable surge in Chinese growth, as U.S. companies move factories to China to take advantage of inexpensive Chinese labor. China is the largest recipient of FDI in the world, largely from the U.S. China has a massive structural trade surplus, accounting for almost a third of the monthly U.S. trade deficit by itself. Net investment in portfolio investment is one-way street in practical terms until China liberalizes its capital account. Consequently, the demand for Chinese yuan (CNY) vastly outweighs the demand for U.S. dollars (USD). Chinese authorities intervene heavily in the foreign exchange markets each day to keep the CNY from rising too quickly against the USD.

While the CNY has appreciated against the USD at an annual pace of close to 10% recently, China is nonetheless forced to sell CNY/buy USD to the tune of approximately $2 billion per trading day to keep the CNY from appreciating even faster. The rapid accumulation of Chinese foreign exchange reserves, approaching a total of $2 trillion by the end of 2008, has forced China and other East Asian countries actively involved in intervention and reserve accumulation to buy dollar-denominated securities - largely U.S. treasury and agency bonds, but also U.S. corporate securities as well. The rapid rise in foreign buying of U.S. bonds over the past decade has kept buying pressure on long-dated U.S. bonds, which has kept bond prices higher and yields lower than they would have otherwise.

Fear that low interest rates and an inverted yield curve reflected increasing risks of deflation and recession, the Fed pushed interest rates to very low levels.

At the same time, sustained record levels of global growth fed commodity prices, providing the Middle East and other crude oil and commodity exports with unprecedented windfall profits. Coincidentally, these windfall profits were denominated in U.S. dollars as commodities are denominated in USD in international transactions. Low interest rates in the U.S. combined with an enormous supply of credit originating largely from China and the Middle East created the ideal environment for a real estate bubble. Not only in the U.S., but in many countries throughout the world such as the UK and Australia. While speculative excesses has been exposed and the real estate bubble appears to be correcting, there are several points to make in terms of identifying a future recovery. First, despite the crisis in the GSEs of Fannie Mae and Freddie Mac, international demand for U.S. Treasury and agency bonds remains robust. In fact, there is every reason to expect that the routing of excess savings from Asian and the Middle East will continue to flow into the U.S. bond market, keeping yields low and credit supplies ample.

Second, U.S. growth appears to have risen to the top of the G7 list While it is not expected to return to longer term growth trend levels for some time, it may very well outpace the rest of the G7 for the next several years, furling the U.S. stock market. While US interest rates are set to rise, this will be a positive development once the worse of the current financial crisis has passed - as real interest rates move into positive territory. Third, positive U.S. interest rate and growth differentials, coupled with a rebound in the U.S. stock market, will bolster the U.S. dollar off recent record lows and encourage private foreign investment in U.S. securities.

While a rebound in the U.S. real estate market may be as long as two years away, the good news is that the seeds of recovery from global capital markets are already materializing. However, the recovery in the US real estate market is expected to follow a different trajectory than that seen in Japan and Hong Kong over the past 10 years. Painful writedowns and balance sheet rebuilding on behalf of US corporations and households set the stage for a vigorous recovery fed by population growth and strong immigration trends. The irrational pessimism of today's financial markets is excepted to give way to renewed US prosperity in two years time buttressed by strong stock market performance and a strong dollar.

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