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Consumer spending and our old cash cow

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While on vacation last week, I drove through Miami out to the Florida Keys. I love to see parts of old Florida, and the Keys are about as eclectic as it gets. Passing by dive shops, fish restaurants, and tucked away marinas, I noted a small bank, painted in bright Bahamian colors, with a black and white spotted ATM out front. Over the black and white spots was painted the name "Cash Cow." I chuckled at the ATM as a cash cow, and quickly turned my thoughts towards the home as another cash cow, particularly given the huge residential down turn that Florida has had.

According to the most recent Case Shiller report, from February '08 to February '09, Miami has lost 30% of its value in residential real estate. This compares most unfavorably to the Boston area which only is 7%. Case Shiller shows the national average is an 18.7% drop during the same time frame.

However, for the first time in one and a half years, prices fell less quickly this month than last month. In other words, there is potential good news that the decreases in value may be occurring at a less rapid pace. We will know more as the early summer moves on, but there is reason for optimism. If this is true, and decreases become less precipitous month over month, it could be a bottoming and a flattening of residential real estate value in the next year.

Both the federal funding and policy will of course help in this stabilization. The program is now in place to incentivize mortgage servicers to rewrite loans that are delinquent. The plan is to provide funds to both the servicers and home owners to try to prevent foreclosures of homes. One of the criticisms of the plan has been that second mortgages were not addressed. Second mortgages were often placed on houses as home equity loans, and the holders of these second mortgages vary from groups of individuals to pension funds. They lobbied to include second mortgages in the plan, since the home equity loans were extremely vulnerable. It appears their efforts are successful, and the plan will be modified to include second mortgages.

About 50% of the first mortgage delinquencies are from people who also have home equity loans. As we know, some people used the loans to fund the down payment on the first mortgage, creating essentially 100% mortgage with no equity. Others borrowed against their homes for funds for remodeling and decorating. But many others borrowed simply to buy consumer items such as cars, electronics, boats, and other toys. The Gross Domestic Product is comprised of about 70% of consumer spending such as this, and our retail growth was being funded by home equity loans, that is, our "cash cow."

The Case Shiller report also says that, on average, home prices are back to 2003 levels. If we are able to stabilize over the next year, perhaps we will only slip back one more year to 2002 values. Therefore, in order to get back to 2006 peaks, where equity loans were funding our insatiable appetite for consumer goods, it would take at least four years of new rapid housing value growth. This is unlikely to happen, so a more realistic scenario is that it will take anywhere from five to ten years to work our way back to peak levels of value...and significant equity. In other words, there will

be no equity lines to fund retail growth in the near future.
Further, even under less dire circumstances, it is clear that debt is harder to get, with much more stringent approval criteria and conditions. Individual credit ratings may have suffered because of delinquencies, which, even if rectified, will leave a history of late payments. Finally, even if people were able to borrow against their houses, many would choose not to, based upon the worry and pain they may have endured while facing foreclosure.
Thus, we are beginning to stabilize residential mortgages, precluding some foreclosures, and in turn helping stabilize banks that are heavily invested. This is all good news, and the stock market is reflecting this to a small degree. However, there is little chance we can return to the retail boom times of the past few years, without the house as cash cow. Easy credit is gone, and so is a high level discretionary spending for sometime to come.

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