

Thursday, June 12, 2008

The Domino Effect

If someone offered you the chance to have your future salaries right now, rather than having to wait until you had earned them, would you take them? If you were told that you could spend this money today and not have to wait for all the things you wanted to buy, would you leap at the chance? Even if you were told that you would be charged for this opportunity, would it still look like it was too good to miss?

This is effectively what happened to people everywhere who found that they could borrow large sums of money much more easily than they'd been able to in the past, and ordinary people in many countries around the world took up this offer and started spending their future earnings. It is this extra spending capacity that has largely powered the economies of the western world for the past decade. The average person has seen their spending power explode, and they have been shopping like a lucky lottery winner.

The BMW 3-series now outsells the Ford Mondeo in the UK, as buyers have traded up. It has become common place to spend over £1000 on a plasma screen, compared to a few hundred pounds that we used to pay for a television. Designer clothes are no longer the preserve of the wealthy and people have been able to copy the look of their favourite celebrities. Harvey Nichols, the 'international luxury lifestyle store', has found new custom in places outside of London, such as Leeds and Manchester. Shopping in the UK and the US has changed in less than a decade, all because of the instant boost to spending power that credit has provided.

This was always going to be a one-off hit, a step increase in spending rather than a gradual increase made possible due to rising productivity, innovation or plain old hard work, and therefore it was never going to be sustainable indefinitely. Eventually the money tap was shut off as confidence in the concept diminished and this left a stark contrast between the before and after situations. Since the dotcom bubble popped there has hardly been any let up in the increased spending of people in Europe, the UK and the US. Even in the mini recession that the US experienced after 2001 US retail sales kept growing. "Never underestimate the resilience of the American consumer" is what they say.

For the last few years incomes have grown very gradually in the developed economies of the west, rising slightly faster than the official inflation figures. If you believe the official statistics of 2-3% inflation then real incomes have probably increased by 1-2% per year. If you don't believe the official inflation figures (and many people don't) then you would see that real incomes for many people, depending on their spending patterns, have probably decreased in recent years, meaning that people have actually become poorer in terms of their earning power. But not in terms of their spending power or their ability to raise money. Rising property prices have made people feel wealthier and have enabled them to borrow money more easily against their assets. They have 'money' but it is tied up in their homes so they have to borrow from banks etc to release it. Technically, even though they are deemed to have this money, they have to pay someone else (in the form of interest and other loan fees) in order to be able to spend it. Is this real wealth if you have to pay someone else to

access it? Isn't it still just borrowing someone else's money?

In any event, borrowing has increased massively in all parts of our daily life. Loans are now used regularly to buy cars, televisions, stocks, holidays, even plastic surgery. Almost anything can be bought on a credit card and, whereas in France you have to buy a credit card from your bank, in the UK they are positively throwing them at customers. Or at least they were until the credit crunch arrived. Lenders have started to realise that offering people such huge spending power with little regard for their ability to repay the debt could be bad business practise, and now new credit card approvals have diminished significantly and some card providers have cancelled the cards of their existing customers. Lending volumes for car finance, personal unsecured loans and mortgages has shrunk significantly.

The end of the credit boom has been accompanied by the rapidly rising cost of living for many people as food and energy costs have shot up at the same time as lending rates. People are finding their disposable incomes are shrinking rapidly and are struggling to maintain their former lifestyles. In the US credit cards are increasingly being used to pay for bare necessities such as food because more people are finding it difficult to make their salary last the entire month, and this has recently started happening in the UK. Traditionally supermarkets are usually busiest at the start of the month, shortly after people have been paid, but Walmart has said that they are finding their stores are less and less busy towards the end of the month and this monthly decline in spending is starting earlier and earlier. Consumers are also making a conscious effort to use their cars less because the cost of a tank of petrol is starting to look a bit scary. Everyone is cutting back.

This leads me on to the domino effect that we are seeing around the world, and that we will continue to see for some time. The credit crunch was triggered by defaults on sub-prime mortgages but this is only the tip of the iceberg, the iceberg being the huge amount of debt that has been taken on by consumers. Defaults on US sub-prime debt caused panic in credit markets and pushed up interest rates or caused financial institutions to reign in their lending practices. Higher interest rates are bad for new homeowners and existing homeowners trying to refinance, something that has become commonplace. Some homeowners don't immediately want to refinance but they are on short-term fixed rates that are coming off very low teaser rates and they are being reset at much higher rates, forcing the borrower to take some form of action as their repayments start to balloon. It isn't just sub-prime borrowers that are finding higher lending rates a problem.

Higher rates and a lack of available borrowing have hit many areas of the real economy. People are handing the keys of their house to the lenders and walking away if they can't make the payments on the mortgage and they have gone into negative equity. Defaults on car loans, credit cards, home equity withdrawal loans and personal loans are all rising and could be a new wave of problems for the financial markets to rival sub-prime mortgages. Borrowing against certain smaller cap stocks has been withdrawn or loan-to-value ratios have been decreased for those trading on margin.

The commercial property market in the UK has experienced a large drop in valuations as consumers slow their spending and job losses start to look more likely, reducing the demand for shopping centres and office blocks. The speculative element of this market has

almost been wiped out as investors find it difficult to raise finance. The same thing is happening across much of the globe.

The dearth of mortgage products, coupled with reduced ability to afford monthly payments for luxuries, has seen a big drop in demand for overseas property. An area such as the South of France where more than half of property purchases have been made by foreigners is hit particularly hard as supply suddenly begins to outstrip demand. It almost becomes a downward spiral because the lack of demand from new buyers starts to hit valuations of existing properties and once prices are falling, as they are in Spain, France, Ireland and the US, people realise that property prices don't only go up. Falling property prices and rising interest rates are a killer combination for a society raised on property ownership, such as the UK, and owning a second home starts to look like an expensive millstone around the neck.

Risk aversion in financial markets has also caused big swings in exchange rates and has seen safe haven currencies appreciate against less fundamentally sound currencies. One place this has important ramifications is Eastern Europe where many home buyers have taken mortgages in low-yielding Swiss Francs, to reduce their interest payments compared to borrowing in the local currency. 85% of household and corporate borrowing in Latvia, for example, is in foreign currencies. 80% of mortgages taken out in Hungary in 2007 were in Swiss Francs. The problem comes when the exchange rate moves and the Swiss Franc appreciates. This effectively increases the size of the loan when converted back into the home currency and at some point the banks start to worry when the size of the loan moves closer to the value of the property against which it is backed. I wouldn't be surprised if some lenders are attempting to postpone having to value their loan-to-value ratios on mortgages they have given because they could be forced to call in those loans where the equity in the property has been wiped out. Foreign currency mortgages were always considered high risk but they appear to have proliferated in some Eastern Europe countries as immature financial service industries expanded at breakneck speeds and we could still see a serious issue emerge for those lenders who are the big players in these markets.

The domino effect has seen sub-primes losses spill over into prime mortgages, credit cards, car finance and personal loan losses. It has hit residential property, commercial property, holiday homes, private equity borrowing and corporate lending. The impact in the property and financial markets has also had a knock-on effect on spending on the high street and is affecting every sector where people spend money. After years of very low consumer price inflation alongside high asset price inflation, we are now seeing the opposite: high consumer price inflation and asset price deflation. This is not good news for countries such as the UK and US where domestic consumer spending makes up the bulk of economic activity.

The domino effect is also evident across borders because problems in the US have had huge impacts in other countries. Swiss banks have written off billions from their investments, the Spanish property market has been left with a massive oversupply of stock it can't shift, the Irish stock market has lost one third of its value since last summer because of its focus on financial and construction stocks and the UK is facing a crisis of confidence in the economy because the mortgage market has dried up.

According to some economists, Asian and Middle Eastern countries appear to have decoupled from the problems elsewhere but many of these countries have currencies that are pegged to the US Dollar. Prices are rising at above 10% per year in Saudi Arabia, Qatar and the UAE. Even with inflation raging at danger levels, these countries have been forced to lower interest rates as the US has done, even though their economies have been overheating. One wonders how long this anomaly can last before something snaps.

The financial world today is an incredibly complex array of different flows of money, it is all far more connected than people realise. Pensioners in Norway were shocked to find their retirement funds had been invested in US sub-prime mortgages. The residents of Vallejo, California, were definitely surprised when their town filed for bankruptcy in May this year, blaming a big decline in housing-related tax revenues. Confidence in property markets has taken a knock all over the world as investors have been painfully reminded that property prices are not a one-way bet. A common phrase in the financial world is "when the US sneezes, the rest of the world catches a cold." This is still true today and the only cure for a world hooked on credit is for it to go 'cold turkey'. Painful, but almost certainly necessary.