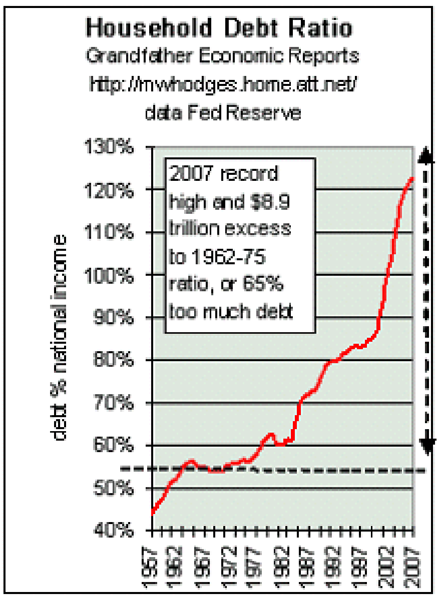
The Great Consumer Crash Of 2009

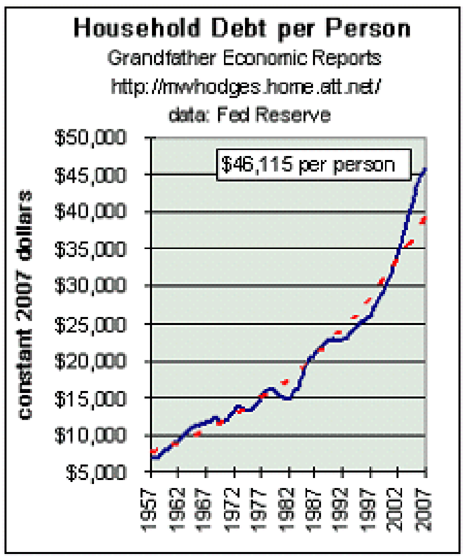
by James Quinn Thursday, 14 August 2008 16:20

James Quinn is senior director of strategic planning, the Wharton School, University of Pennsylvania.

"It is easy to ignore the storm if you look at the opposite horizon. When the storm reaches your location there can be no more ignorance."

I hate to tell you, but the storm has reached your location and it is a Category 5 hurricane. The levees are leaking. Ignore it at your own peril. The 6,000 sq ft McMansion buying, BMW leasing, $5 Starbucks latte drinking, granite countertop upgrading, home equity borrowing days are coming to an end. The American consumer will not go without a fight. For the last seven years the American consumer has carried the weight of the world on its shoulders. This has been a heavy burden, but when you take steroids it doesn't seem so heavy. The steroid of choice for the American consumer has been debt. We have utilized home equity loans, cash out refinancing, credit card debt, and auto loans to live above our means. It has been a fun ride, but the ride is over. We can't get steroids from our dealer (banks) anymore.





After examining these charts it is clear to me that the tremendous prosperity that began during the Reagan years of the early 1980's has been a false prosperity built upon easy credit. Household debt reached $13.8 trillion in 2007, with $10.5 trillion of that mortgage debt. The leading edge of the baby boomers turned 30 years of age in the late 1970's, just as the usage of debt began to accelerate. Debt took off like a rocket ship after 9/11 with the President urging Americans to spend and Alan Greenspan lowering interest rates to 1%. Only in the bizzaro world of America in the last 7 years, while in the midst of 2 foreign wars, would a President urge his citizens to show their patriotism by buying cars and TVs. When did our priorities become so warped?

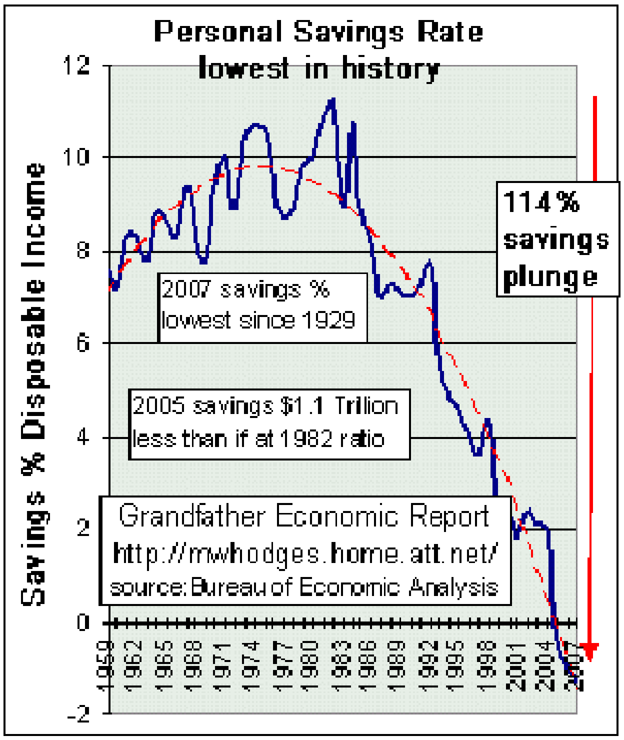
How Did I Get Here

And you may find yourself behind the wheel of a large automobile
And you may find yourself in a beautiful house, with a beautiful wife
And you may ask yourself-Well...How did I get here?

And you may ask yourself
Where is that large automobile?
And you may tell yourself
This is not my beautiful house!

And you may tell yourself
This is not my beautiful wife!
- Talking Heads, David Byrne lyrics to Once in a Lifetime

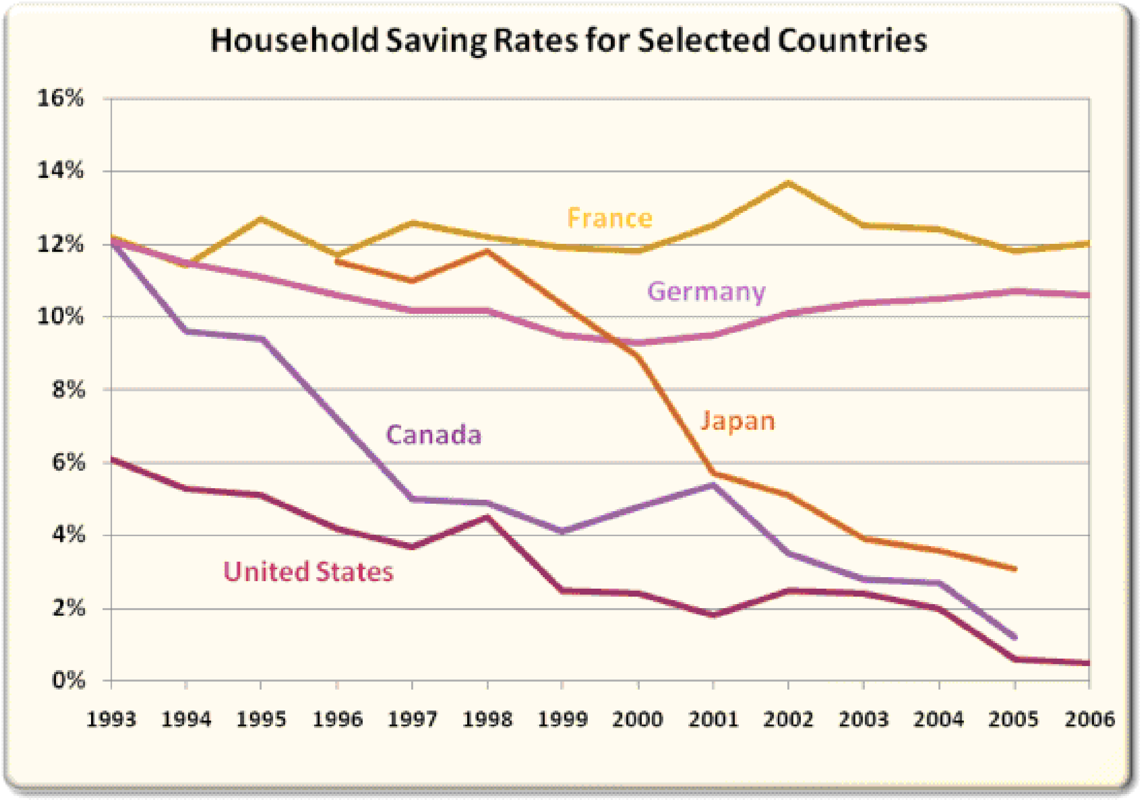
By 2005 practically everyone had a large automobile and a beautiful house. By 2010 many of these people will be asking where is that large automobile and will realize as the sheriff escorts them out of their house that this is not my beautiful house. There is plenty of blame to go round for this predicament. According to Northern Trust economist Paul Kasriel, “We’re a what’s my monthly payment nation. The idea is to have my monthly payments as high as I can take. If you cut interest rates, I’ll get a bigger car.” Major banks offer credit cards using your home equity as a way to pay everyday expenses like groceries, gas and clothes. Eating your house was never so easy.



I have been accused by many of my friends and family as someone who sees the glass as half empty. I disagree with their assessment. I see the glass as it is. I find myself scratching my head trying to figure out why a society that always saved for a rainy day, consistently saving between 8% and 11% of their disposable income, now has a negative savings rate. I believe that keeping up with the Jones’ is the primary reason that Americans have taken on so much debt.

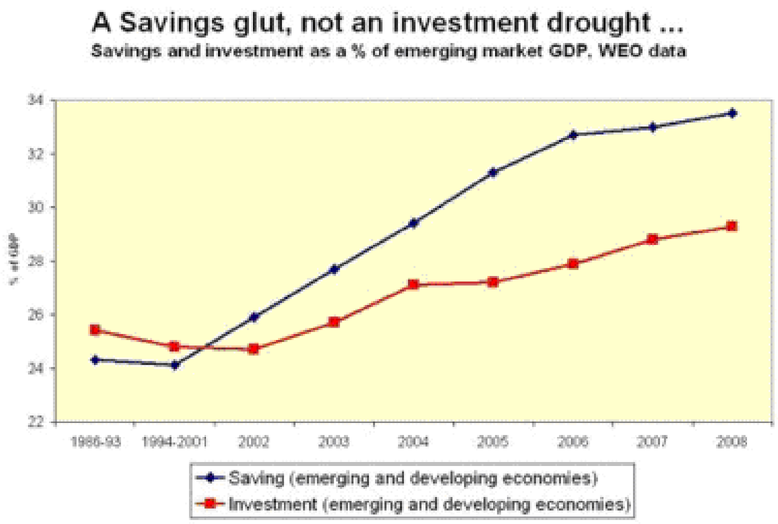
The authors of the book, **Why Middle Class Mothers and Fathers Are Going Broke** contend that the costs of housing and a good education for their children are killing them. It now takes two incomes to provide what one income provided 30 years ago: a middle-class house in a safe neighborhood with a decent public school. Bidding wars erupted for homes in what are thought to be good school districts, making homes in those areas ever more expensive. A phenomenon called “expenditure cascade” has occurred in the U.S. according to Cornell Professor Robert Frank. When top earners build large multi-million dollar mansions, they shift the frame of reference for those just below them on the income scale. Those people then respond by building bigger houses and so on down the food chain. This has resulted in families living on the edge. If one parent loses their job, it’s an easy slide into bankruptcy.

The U.S. is the country in the developed world with the lowest savings rate. Canada and Japan are trying to keep pace. Germany and France have social programs which allow for more savings. We may come in last in savings, but no other country in the world can spend like us. Our motto is live for today, the government will bail me out in the future.



Source: Organization for Economic Cooperation and Development (2007)
OECD Economic Outlook: December No. 82 – Volume 2007 Issue 2

We have outsourced our savings to the emerging economies, along with our manufacturing jobs. The Chinese are saving the money we've paid them for flat screen TVs and the Middle Eastern countries are saving the money we've paid them for oil. You need savings in order to increase investment. The emerging markets are making the vast majority of the investments in the world. While the U.S. endlessly debates drilling and construction of nuclear plants (none built in U.S. since 1987) and oil refineries (none built in U.S. since 1977), China brought four oil refineries online in 2008 and plans to build 30 nuclear reactors in the next twelve years. The Asian Century has begun, but the U.S. has tried to keep up by using debt. It will not work. If anything, this has accelerated the shift of power to Asia.



Source: Creditwritedowns.com

Positive Feedback Loop

The last thing that anyone thought would result while watching the Twin Towers collapse on September 11, 2001 was the greatest housing boom in the history of the world. When a country goes to war, it usually asks its citizens to sacrifice.

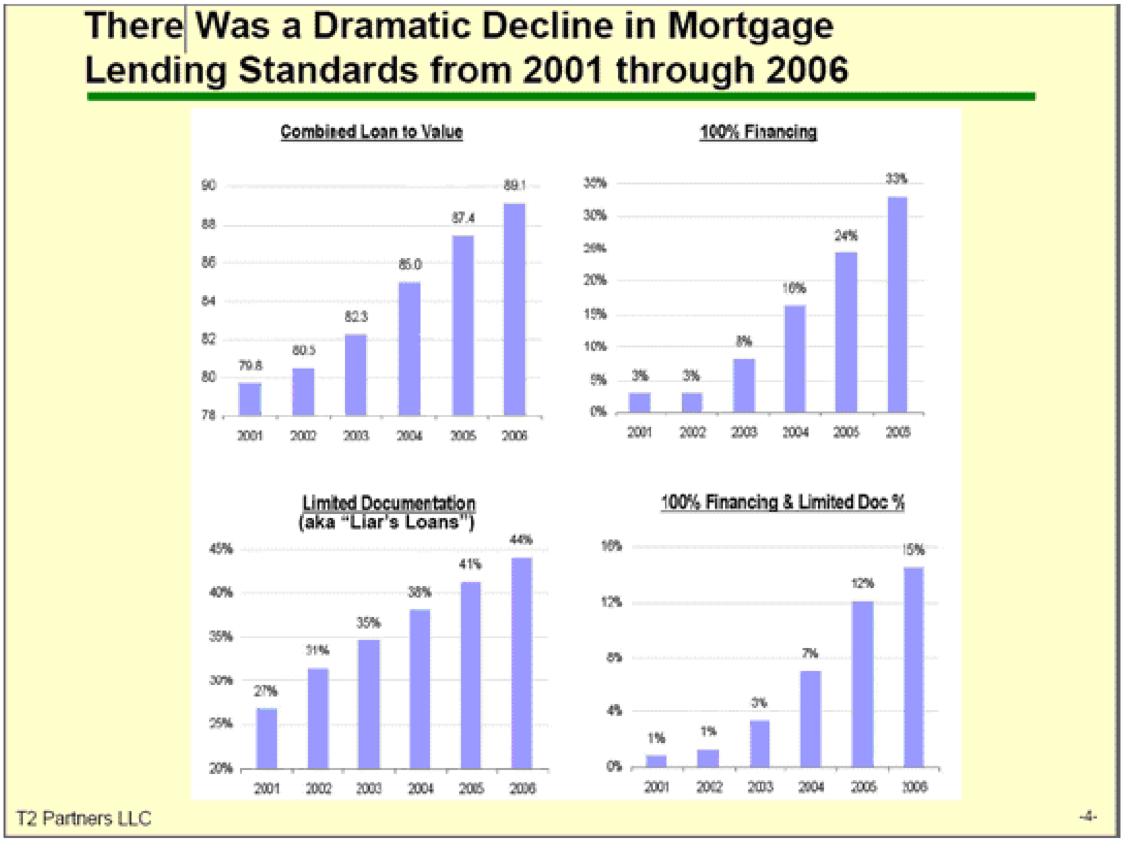
"I have nothing to offer but blood, toil, tears, and sweat. We have before us an ordeal of the most grievous kind. We have before us many, many months of struggle and
suffering."
- Winston Churchill – May 13, 1940

In the true spirit of Winston Churchill, President Bush could have paraphrased Churchill by saying: I have nothing to offer but tax cuts, tax rebates, 0% auto financing, and no-doc mortgages. Americans grieved for a few weeks and then did their patriotic part by buying everything they could get their hands on. As Alan Greenspan denies causing the housing crisis today, his words from November 2002 come back to haunt him, "our extraordinary housing boom…financed by very large increases in mortgage debt, cannot continue indefinitely into the future." After making this statement, he proceeded to slash the discount rate to 1% in June 2003 and left it at that level for a year. This began the positive feedback loop:

1. The Federal government cut taxes and sent rebates to all Americans.
2. The Federal Reserve cut interest rates to 1%.
3. Government officials urged Americans to spend in order to defeat terrorism.
4. Alan Greenspan told people that adjustable rate mortgages were a good thing.
5. Congress and President Bush believed that everyone should own a home and pressured lenders to provide mortgages to low income people.
6. GM, Ford, and Chrysler offered 0% financing on their cars through their finance arms, while also encouraging low rate leases. Credit card companies sent out 5.3 billion offers in 2007. In 1968, when the credit card was a new concept, total credit debt was $8 billion. Now the total exceeds $880 billion, according to the Federal Reserve.

7. Wall Street created new investment vehicles that allowed mortgages to be packaged and sold to investors throughout the world with investment grade ratings provided by Moody's and S&P, for a price.

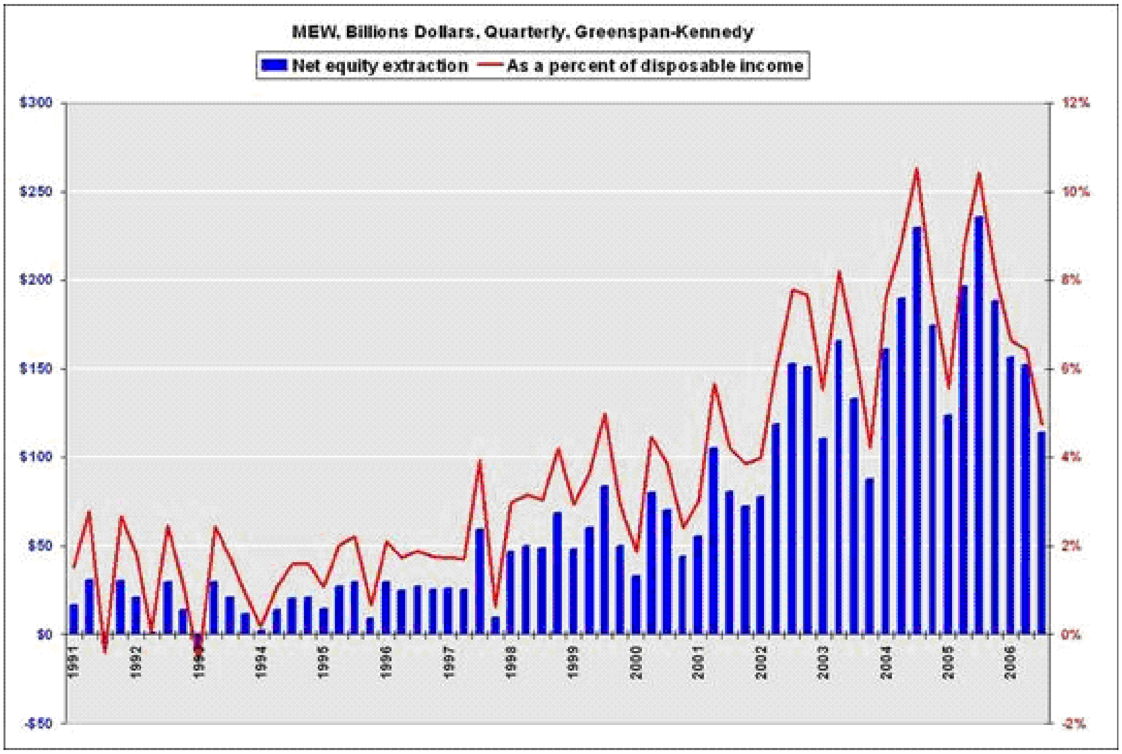
8. Mortgage companies and lenders developed ARMs, Option ARMs, teaser rate loans, no-doc loans, negative amortization loans and 100% financing loans.



9. Low income people started buying homes, with these exotic mortgage products, from middle income people. Middle income people started to buy larger houses from rich people, boosting demand for new homes. Rich people bought mansions and second homes. Bidding wars for houses were common.

10. The demand caused by this influx of new home buyers drove prices skyward, with home prices doubling in five years. This price rise brought in the speculators/flippers, who began to buy multiple houses with nothing down, pre-construction, with plans to sell them for a profit without ever moving into them.

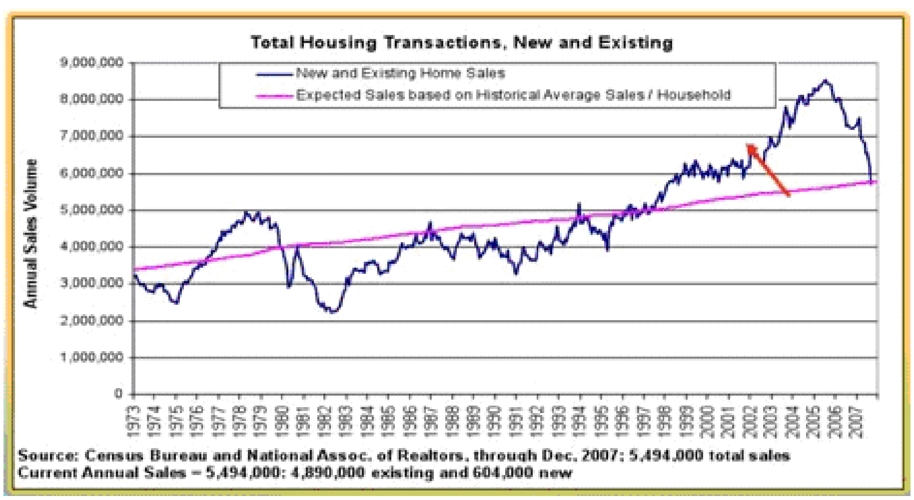
11. Average Americans who saw their paper wealth growing rapidly, as their home value increased, took advantage of this by refinancing their mortgages and extracting the equity from their homes and spending it. The chart below shows that in 2004 and 2005, Americans sucked $800 billion from their homes in each year.



Source: Calculated Risk.com

12. Homebuilders throughout the U.S., but particularly in California, Arizona, Florida, and Nevada, went on the biggest building binge in the history of the U.S. These builders either believed their own bull about demographics, or just decided to ride the wave as far as it would take them. This binge led to 8.5 million total home sales in 2005, about 3.5 million more than what would have been expected based on historical rates.

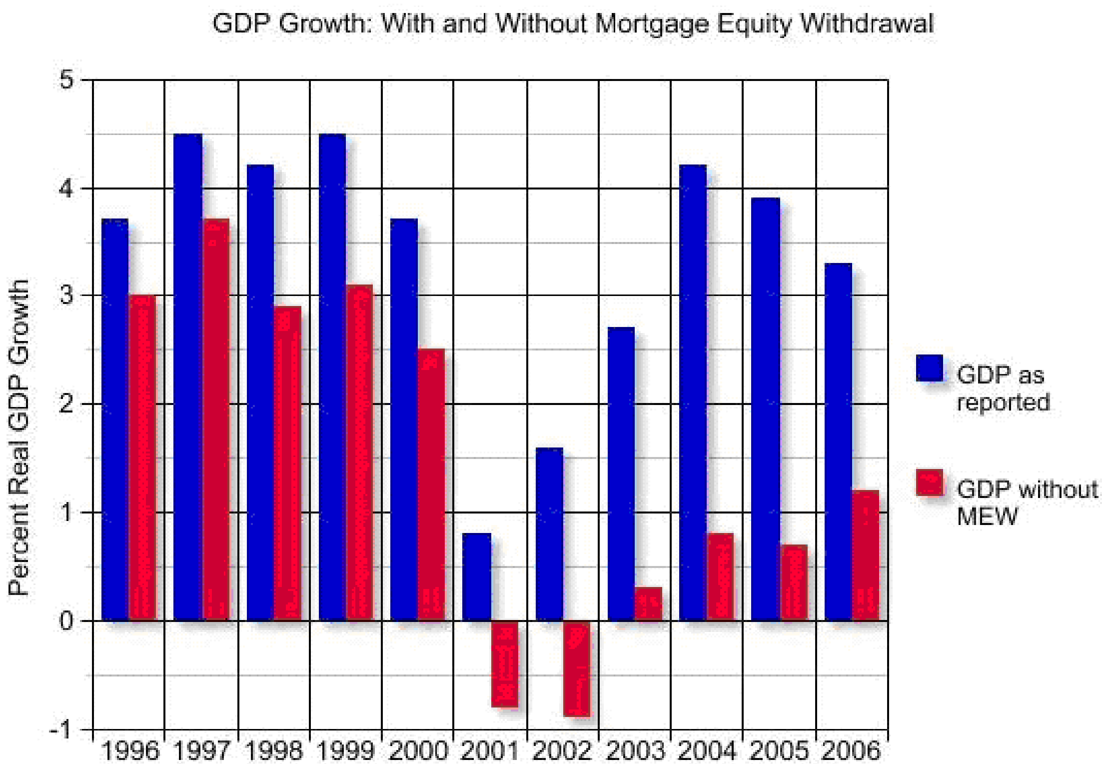
We had an Investor-driven Transaction bubble: In 2005, there were 48% more transactions than there should have been.



13. The massive number of excess home sales and equity withdrawal led to huge demand for home furnishings, remodeling services, appliances, electronic gadgets, BMWs, and exotic vacations. This led to massive expansion by retail

and restaurant chains based on extrapolation of this demand.

14. Retailers, homebuilders, restaurants, and car makers extrapolated the false demand far into the future. There are now over 7,000 Wal-Marts, 6,000 CVSs, and 30,000 McDonalds. Any company that built their business on false assumptions and excess debt will be meeting their maker, shortly.
15. Because the originators of virtually all loans to consumers were immediately selling the loans off, they had no incentive to follow any guidelines or due diligence when issuing the loans. Anyone with a pulse could get a mortgage, car loan, or credit card. Unscrupulous mortgage brokers popped up everywhere, luring uneducated and willing people to join the party. Greedy appraisers went along with the scam by overvaluing houses to whatever the banks desired.
16. The debt induced spending that occurred from 2001 until 2007 accounted for virtually all the GDP growth over this time. Without the mortgage equity withdrawal, the U.S. would have had less than 1% average GDP growth for the entire period.



Source: John Mauldin

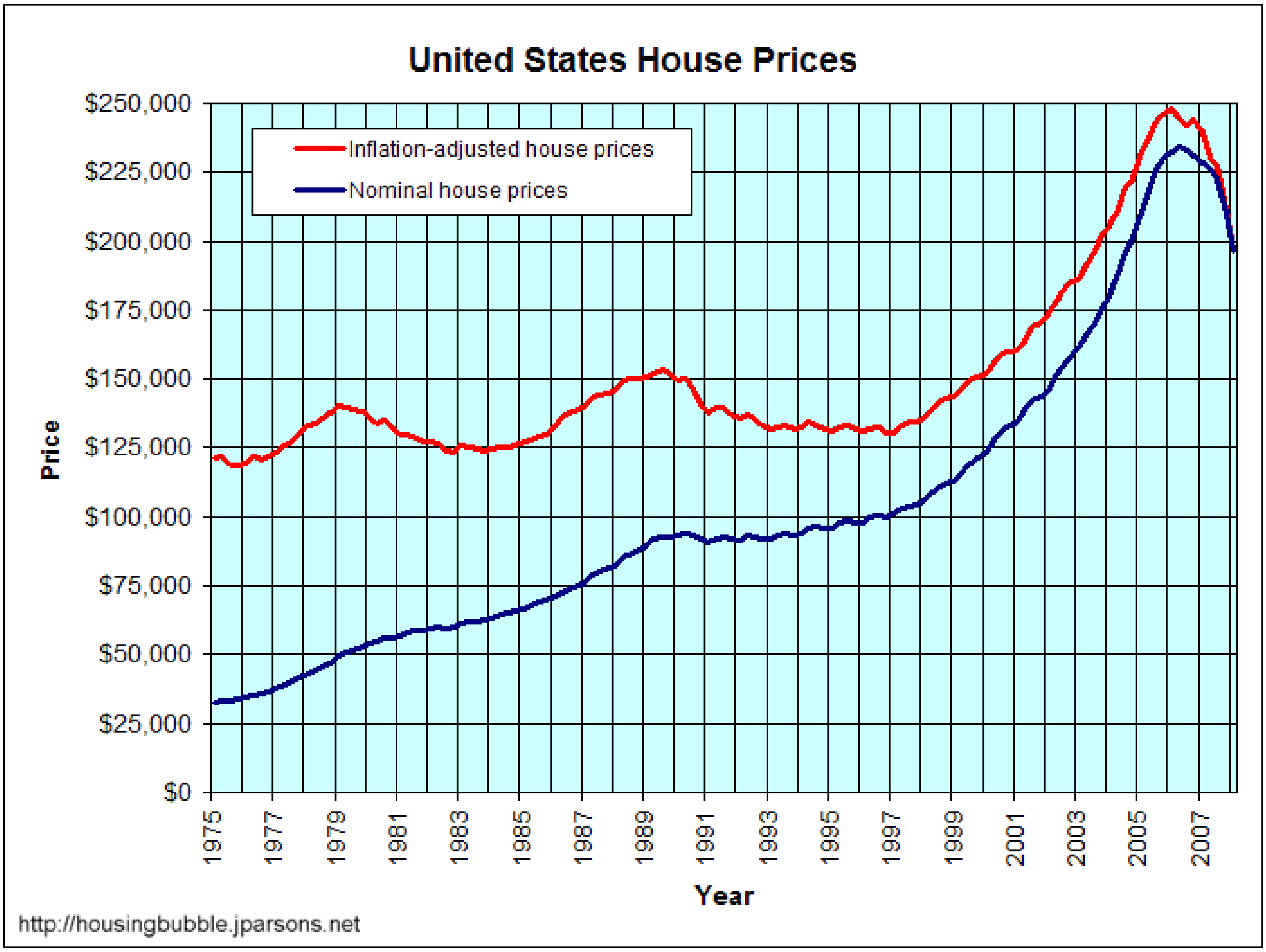
Negative Feedback Loop – Underway

The pseudo-wealth that has been created in the last seven years has begun to unwind, but will increase in speed in 2009. You only know how you've lived your life over the last seven years. Your neighbor who has been getting their house upgraded, sending their kids to private school, driving a BMW, and taking exotic vacations may have been living the high life on debt. As usual, Warren Buffet's wisdom comes in handy.

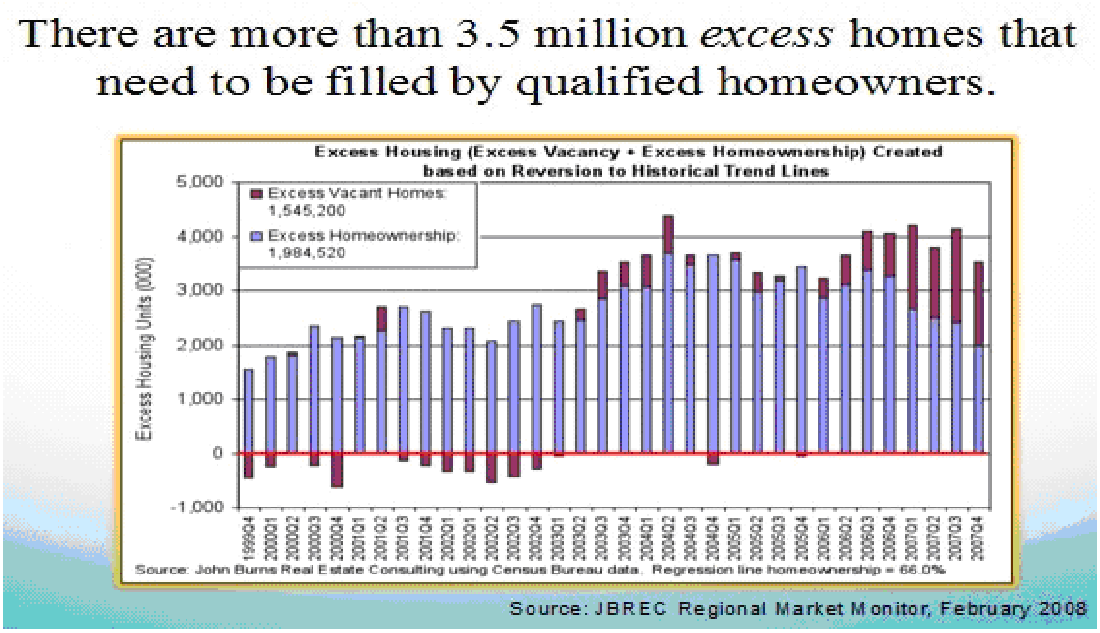
"Only when the tide goes out do you discover who's been swimming naked."

The tide is on its way out, and the naked swimmers are numbered in the millions. Mohamed El-Erian, the number two man at PIMCO, fears a negative feedback loop consuming the country. I believe we have begun the negative feedback loop and it is starting to accelerate. The stages are as follows:

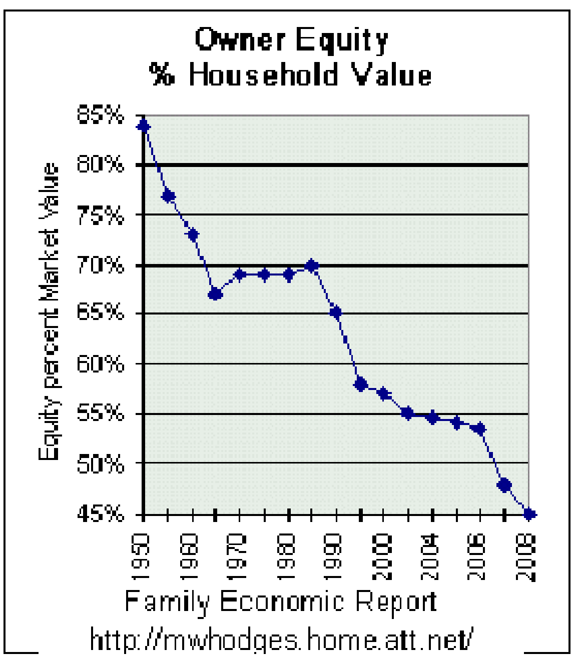
- Home prices reached an unsustainable level in 2006. Prices had gone parabolic between 2001 and 2006, with the average price reaching above $225,000. In 2001, prices were just above $125,000. As the pundits keep looking for a bottom in housing, the chart below clearly shows there is a long way to go.



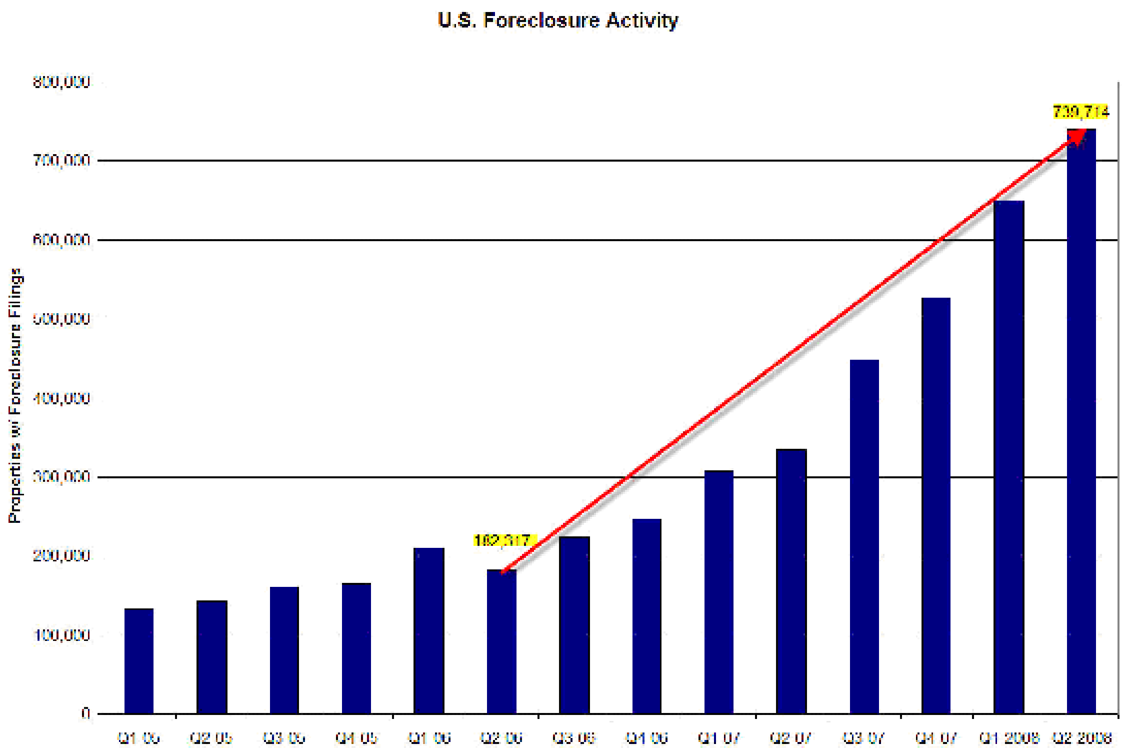
- The massive overbuilding based on false demand has led to 3.5 million excess homes in the U.S. based upon historical trends. The most shocking fact is that there are 1.5 million vacant homes. This oversupply can only be corrected by massive price decreases.



. With the tremendous price increases in houses over the last decade, you would think that equity would be at all-time highs. But no, owner equity as a percentage of house value has reached an all-time low of 45%. People have sucked the equity out of their homes and spent it faster than the prices were rising. The problem is that house prices can and will fall, debt remains like an anchor around your neck until paid off or it drags you down into bankruptcy.



. The millions of exotic mortgages (subprime, alt-A, ARMs, no-doc, and negative amortization), which have started to blow up, has led to a tsunami of foreclosures. In 2005 there were less than 600,000 foreclosures in the U.S. In the 1st two quarters of 2008 there have been more than 1,350,000 foreclosures, with the pace accelerating. Approximately 15% of all subprime mortgages and 7% of all Alt-A mortgages are in delinquency. According to UBS, 27.2% of subprime mortgages originated in 2007 by Washington Mutual are in delinquency. Washington Mutual is the poster child for how not to run a savings and loan.



Source: MBA

The combination of oversupply, over-leverage, and foreclosure tsunami has now taken on a life of its own. Home prices have been spiraling downward for two years to the point where 29% of all households that purchased in the last five years owe more than their house is worth according to Zillow, the home valuation company. For those who bought in 2006, 45% have negative equity. It is now making economic sense for people to just walk away from their house and send the keys to the lender. This is referred to as 'jingle mail'.

The ongoing housing price decreases are now affecting prime mortgages, home equity loans, and home equity lines of credit. Prime mortgages for less than $417,000 had a delinquency rate of 2.44% in May, up 77% from last year. Prime jumbo loans over $417,000 had a 4.03% delinquency rate in May, up 263% from last year. According to the ABA, 1.1% of all home equity lines are in delinquency, the highest level since 1987.

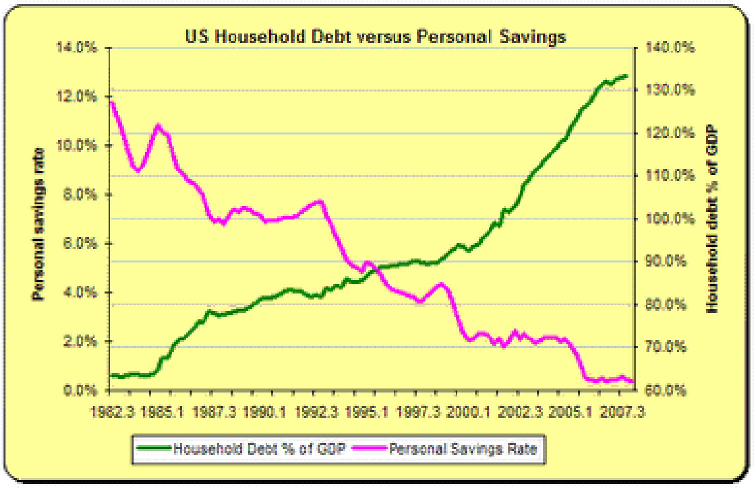
Consumers have dramatically increased the use of credit cards, now that the housing ATM has run out of cash. The average American household has credit card debt of $9,840 versus $2,966 in 1990, at an average interest rate of 19%. Credit card delinquencies have increased to 4.51% in the 1st quarter. Amex just announced a major unexpected write-off because its prime customers have hit the wall and are defaulting. Consumers used their credit and debit cards to buy $51 billion of fast food in 2006 according to Carddata. According to the Federal Reserve, 40% of American families spend more than they earn. This has led to the result in the chart below. The reversal of this trend will be necessary but traumatic. It has already begun, with the savings rate increasing to 2.6% in early 2008. David Rosenberg, the brilliant economist from Merrill Lynch, describes what has happened and what is to come:

> "This is an epic event; we're talking about the end of a 20-year secular credit expansion that went absolutely parabolic from 2001-2007."

> "Before the US economy can truly begin to expand again, the savings rate must rise to pre-bubble levels of 8pc, that the US housing stocks must fall to below eight months' supply, and that the household interest coverage ratio must fall from 14pc to 10.5pc."

"It's important to note what sort of surgery that is going to require. We will probably have to eliminate $2 trillion of household debt to get there," he predicts, saying this will happen either through debt being written off, as major financial institutions continue to do, or for consumers themselves to shrink their own "balance sheets".

> The elimination of $2 trillion of household debt will lead to the closing of thousands of retail stores, strip malls, restaurants, and bank branches. There should be a lot of vacant buildings available in the next few years, and a few suspicious fires.



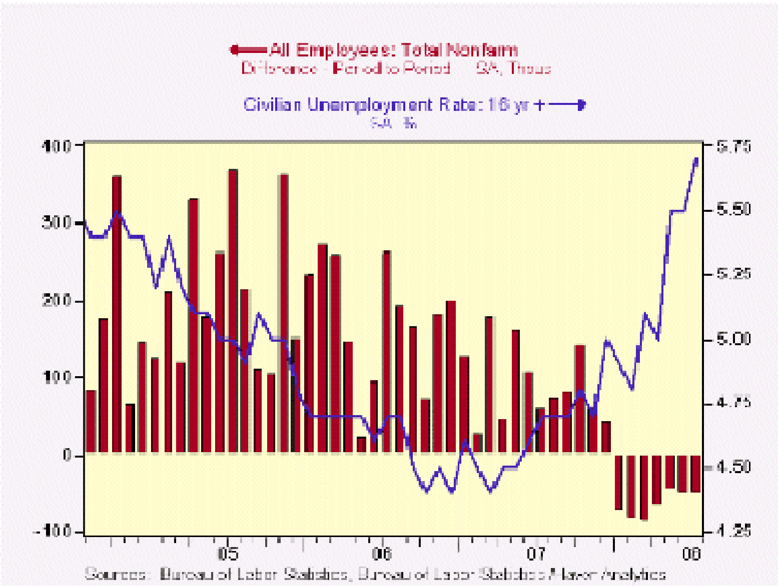
Source: Creditwritedowns.com

Banks are doing what they usually do. They are closing the barn door after the pigs have escaped. As their losses have crossed the $500 billion mark, it is getting tougher for them to convince more suckers to buy their stock. They have so much toxic waste "assets" on and off their books at inflated values that they can not or will not lend. The Federal Reserve reported that banks have tightened standards for all loans in record numbers. After giving loans to anyone with a pulse for the last five years, this information is refreshing. But based on the well qualified assessments of Bridgewater Associates and NYU economist Nouriel Roubini, there is still $1.0 to $1.5 trillion in losses to go. Bank lending to consumers will be subdued for years.

Firm	Writedown & Loss	Capital Raised
Citigroup	55.1	49.1
Merrill Lynch	51.8	29.9
UBS	44.2	28.3
HSBC	27.4	3.9
Wachovia	22.5	11
Bank of America	21.2	20.7
IKB Deutsche	15.3	12.6
Royal Bank of Scotland	14.9	24.3
Washington Mutual	14.8	12.1
Morgan Stanley	14.4	5.6
JPMorgan Chase	14.3	7.9
Deutsche Bank	10.8	3.2
Credit Suisse	10.5	2.7
Wells Fargo	10	4.1
Barclays	9.1	18.6
Lehman Brothers	8.2	13.9
...		
TOTAL	501.1	352.9

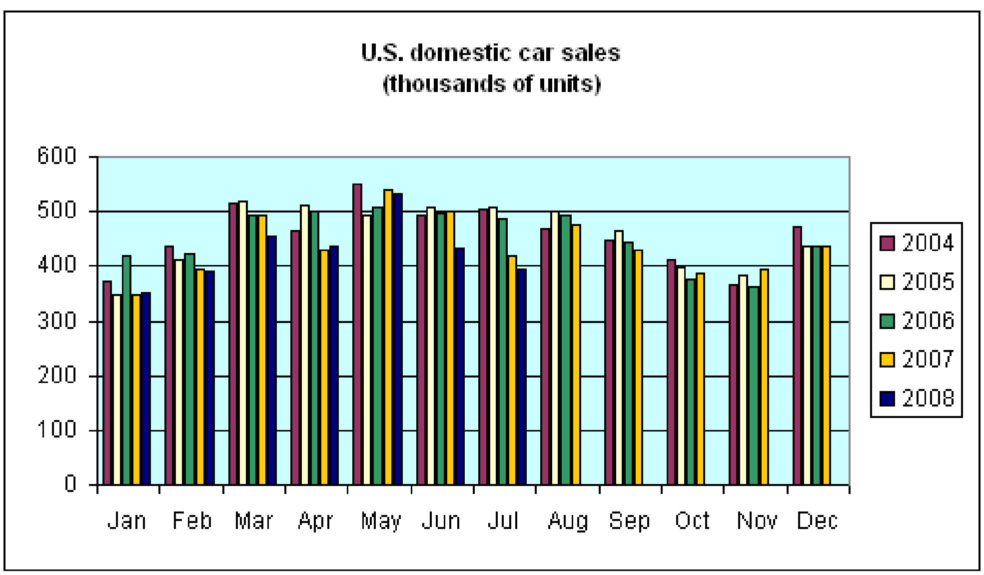
Source: Mike Shedlock

Government unemployment figures have begun to skyrocket, while the true unadjusted unemployment figures point to a major recession. If the number of people who have given up looking for a job were included, the official 5.7% unemployment rate would jump to 14%. People without jobs can't spend money or make mortgage payments. With the deep recession that I anticipate, the official figures will reach 7%. This will result in lower consumption.



Source: Haver Analytics

Car sales have plummeted. The major car manufacturers have stopped leasing cars to consumers. J.D. Power and Associates forecasts car sales of 14.2 million units in 2008, a 12% decrease over the 16.1 million units in 2007. This would be the lowest level since 1993. For many years, virtually anyone could lease a luxury automobile and appear to be successful. In 2007, one of every five new vehicles was leased. When that current lease runs out, good luck trying to get a new one. Chrysler, GMAC, Wells Fargo and others will no longer offer auto leasing. They have taken massive losses due to the huge decline in residual value not accounted for in their nice little financial models. You can't give away a truck that gets 10 MPG today. Expect to see more junkers on the road.



Source: J.D. Power

Retail store closings and retail bankruptcies have begun to accelerate. This will lead to hundreds of thousands in job losses. Barry Ritholtz recently documented the fate of many retailers so far:

Ann Taylor closing 117 stores nationwide

Bombay Company: to close all 384 U.S.-based Bombay Company stores.

Cache, a women's retailer is closing 20 to 23 stores this year

CompUSA (CLOSED).

Disney Store owner has the right to close 98 stores.

Dillard's Inc. will close another six stores this year.

Eddie Bauer to close more stores after closing 27 stores in the first quarter

Ethan Allen Interiors: plans to close 12 of 300 stores to cut costs.

Foot Locker to close 140 stores

Gap Inc. closing 85 stores

Home Depot store closings 15 of them amid a slumping US economy and housing market. The move will affect 1,300 employees. It is the first time the world's largest home improvement store chain has ever closed a flagship store.

J. C. Penney, Lowe's and Office Depot are all scaling back

Lane Bryant, Fashion Bug, Catherines closing 150 stores nationwide

Levitz - the furniture retailer, announced it was going out of business and closing all 76 of its stores in December. The retailer dates back to 1910.
Macy's - 9 stores closed

Movie Gallery – video rental company plans to close 400 of 3,500 Movie Gallery and Hollywood Video stores in addition to the 520 locations the video rental chain closed last fall as part of bankruptcy.

Pacific Sunwear - 153 Demo stores closing

Pep Boys - 33 stores of auto parts supplier closing

Sprint Nextel - 125 retail locations to close with 4,000 employees following 5,000 layoffs last year

Talbots, J. Jill closing stores. Talbots will close all 78 of its kids and men's stores plus another 22 underperforming stores. The 22 stores will be a mix of Talbots women's and J. Jill

Wickes Furniture is going out of business and closing all of its stores. The 37-year-old retailer that targets middle-income customers, filed for bankruptcy protection last month.

Wilsons the Leather Experts – closing 158 stores

Zales, Piercing Pagoda plans to close 82 stores by July 31 followed by closing another 23 underperforming stores.

I know **Linens & Things** just went **belly up**, and **Steve & Barrys** recently filed for bankruptcy protection and sale.

12. Mall owners and commercial developers are on the brink of bankruptcy. Commercial developer CB Richard Ellis didn't sound too optimistic in their recent 10Q filing:

"We are highly leveraged and have significant debt service obligations. Although our management believes that the incurrence of long-term indebtedness has been important in the development of our business, including facilitating our acquisitions of Insignia and Trammell Crow Company, the cash flow necessary to service this debt is not available for other general corporate purposes, which may limit our flexibility in planning for, or reacting to, changes in our business and in the commercial real estate services industry. Notwithstanding the actions described above, however, our level of indebtedness and the operating and financial restrictions in our debt agreements both place constraints on the operation of our business."

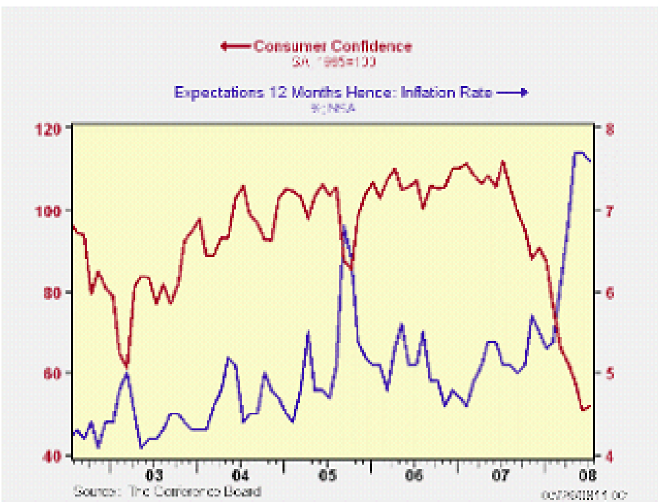
General Growth, a mall developer, looks like a prime candidate for bankruptcy based on their recent 10Q info. Mike Shedlock assesses their situation:

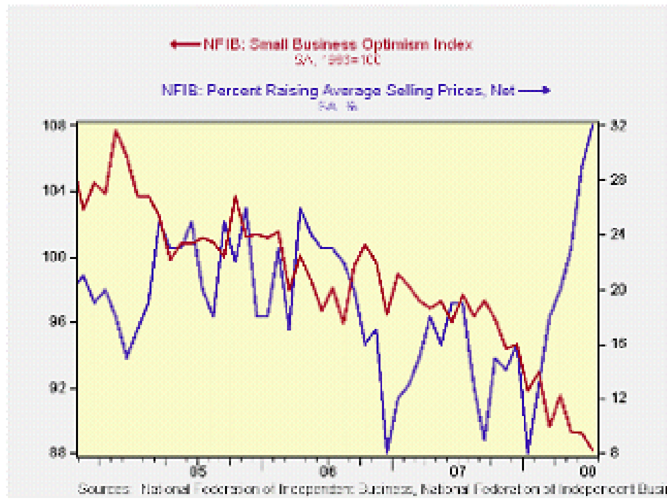
"Interest expense for 3 months ending June 30, 2008 was $312,943,000.Net Income for 3 months ending June 30, 2008 was

$34,082,000 Earnings per share from continuing operations was $.01 Earnings per share from discontinued operations was $.12 If the cost to refinance $18 billion were to rise to 8.0%, interest expense would rise by 50% to a whopping $469,414,000 per quarter. Even 7% would be a killer based on the numbers presented above."

Given that the Shopping Center Economic Model Is History and credit is tightening everywhere, General Growth Properties is going to be in deep trouble if credit conditions remain as they are, or even if they improve slightly. I expect credit conditions to worsen."

Consumer and business confidence is shot. Consumer confidence is at multi-decade low levels. Small business confidence is also at historic lows. Small businesses do most of the hiring in the U.S. Consumers and businesses are correct in their assessment of the situation. It is our political and corporate "leaders" that are in denial.





Source: Haver Analytics

In conclusion, the gathering storm has arrived. It will be long, painful and destructive. Those who prepared for the storm by not taking on excessive debt and living above their means, will ride it out unscathed. Those who built their house on sand by leveraging up and living the "good" life, will see their house swept out to sea. The storm will pass and we will rebuild. Our country is resilient. The purging of this massive debt will result in the creative destruction that is the hallmark of American capitalism. New opportunities, new technologies and a new attitude will put us back on course.

There has been and will be resistance to the inevitable deep recession that is coming. The American consumer is not cutting back willingly. They are being dragged kicking and screaming towards the joys of frugality. The "material generation" needs to dematerialize. My biggest concern is that our politician leaders and their cronies running our government will continue to try and reverse the normal capitalistic course of recession and expansion. Companies need to fail, housing needs to find its bottom based on supply, demand and price. Those who gambled must be allowed to lose and suffer the consequences. If the government attempts to shift the losses to those who lived lifestyles of thrift, an angry uprising will ensue. Government intervention in this natural process could lead to a decade long depression. Let's hope that reasonable heads prevail.

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