

“When real estate investors can’t refinance a mortgage, the property is forced on the market and prices slide. This is where we are today.”

INTERVIEW WITH BOB F. BAUR, CHIEF GLOBAL ECONOMIST, PRINCIPAL GLOBAL INVESTORS

The basic scenario for the world economy is still very unclear. The Real Estate Magazin took the opportunity to talk with Bob F. Baur, Chief Global Economist of Principal Global Investors to look ahead.



Bob F. Baur, Chief Global Economist,
Principal Global Investors

REAL ESTATE MAGAZIN: You were talking of a crisis that built over 30 years. Could you summarize the main points for our readers?

BAUR: Over the last 30 years, four trends brought about amazing changes to the global economy: deregulation, freer trade, collapse of communism and socialism and the revolution in technology and communication. China, India and the former Soviet Union opened their borders to the outside world, which resulted in adding three billion people to the global marketplace and one and a half billion to the global workforce. Production of services exploded but savings soared too, as a lack of a social safety net prompted the new workers to save large parts of their income. In order to increase aggregate demand for the rising levels of production, markets created conditions to encourage more consumption. This led to a number of consequences.

Not only did inflation levels drop, but the cost of production fell as productivity rose and these lower prices promoted consumption. Interest rates declined, promoting borrowing to consume. While this was happening asset prices increased, discouraging people from making savings from their current income. Commodity prices also increased, which gave commodity economies more means to consume. Finally, emerging market exchange rates were undervalued, giving greater purchasing power to developed country

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consumers. The result was the greatest global economic boom in history – but it went too far and resulted in a number of unintended consequences. Lending standards fell and rather than lend for their own portfolio, banks lent for origination, which triggered an agency problem. Investors “reached for yield” and poured money into newer, largely untested – and what turned out to be risky – securities based on company ratings. Despite this, rating companies did not account properly for potential losses and rating models were estimated over too short a period. Basically, rating companies had conflicts of interest.

This is when global imbalances developed. In adjusting to this, consumption and debt growth in the US needed to slow, the lower dollar needed to promote exports and investment, and in China net exports needed to be replaced by local domestic demand as the driver of economic growth. Saving rates also needed to fall. The boom unravelled because the economic conditions that were created to prompt consumers to purchase the output of the three billion new entrants to the global marketplace were carried to unstable lengths: too much debt with too narrow risk premiums. When the Fed raised interest rates and commodity prices soared, mortgage defaults and foreclosures spread. Investors turned risk averse as forced sales brought prices of all assets down at the same time...all assets except safe havens like the dollar and US Treasury bills, notes and bonds. Finally, the Lehman bankruptcy led to more destabilisation and an almost complete seizure of credit markets.

When credit markets seize as they did in September and October, it’s like having a heart attack as credit is the lifeblood for every economy; when it quits flowing, the heart stops. When lenders refuse to lend or grant letters of credit, trade collapses as a result, payrolls and inventories are slashed and capex slows. When businesses can’t borrow to meet everyday expenses, inventories and payrolls are slashed. When importers can’t get letters of credit, shipments stop and international trade collapses. When real estate investors can’t

refinance a mortgage, the property is forced on the market and prices slide. And this is where we are today.

REAL ESTATE MAGAZIN: What role do Emerging Markets play in our scenario?

BAUR: Emerging markets are at the heart of the issue. The prosperity that spread around the world over the global boom was unparalleled in history. The growth was real and millions of people were able to bootstrap their way up out of poverty. However, we are seeing rebalancing beginning to happen. China is starting to encourage domestic demand and create a social safety net to lower savings rates. This process of more people trying to become part of a broad global middle class could potentially continue and as a result, commodity demand will be strong in the long term.

REAL ESTATE MAGAZIN: What is the good news in the current environment?

BAUR: There are a number of things that the headlines detailing depression don't mention. Firstly, the fixed income market has been slowly healing. In the US, commercial paper is being traded without much assistance from the Fed. Credit spreads on investment grade bonds have narrowed significantly and large bond issuance is meeting strong buyer demand. The bond market did not follow the stock market on its leg down in January. Secondly, stock markets no longer crash on each piece of bad news. The Shanghai composite index has actually made a four month upside breakout. China led on the way down and maybe it will lead on the way back.

The South Korean KOSPI index is also performing better than counterparts in developed markets. U.S. small-cap and mid-cap stocks as well as technology and consumer discretionary sectors are doing better than broad large-cap indices. Historically these results are more typical in upturns than in bear markets. Furthermore, the changes wrought by Chinese authorities to stimulate the economy are gaining some traction. The main PMI rose to 45.3 in January, up from 41.2 last month and lower in the month before. Real retail sales over the New Year were much stronger than in the same period in 2008. Steel production is up, as is electricity usage, for the first time in several months. New lending is soaring, up almost 1500% compared to over a year ago. As well as this, 49% of small and medium-sized businesses have reported that it is easier to get credit and real estate transactions, rising for the first time in many months. Those are only a few of the "green shoots" that may be starting to sprout. However it is important to note that it will still take a gardener's tender loving care and watering in order for them to flourish.

REAL ESTATE MAGAZIN: Is the housing market finally set for a return to normal?

BAUR: It's certainly part of the long-term solution. If house prices continue to fall, it will maintain the negative feedback loop into defaults, foreclosures, loss of bank capital and lower consumer



spending. In the US for example, housing is still contracting but pending home sales are up significantly, while existing home sales are also much better than expected. The average household's ability to afford a home is at a record high and inventories of new homes are off more than 50% from their peak. Surveys show more consumers believe it is a good time to buy a house than in many months. However, it is possible that much of this moderation is based on a meager hope for government action to restructure U.S. banks...and if that doesn't occur, the January plunge will resume.

REAL ESTATE MAGAZIN: Looking ahead, a crisis has always got its winners. Where do we find them?

BAUR: Unless one thinks that this crisis will rival the 1930s economic environment, there must be value in parts of both the stock and bond markets. I still like US commodity companies, basic materials, energy, technology and especially exports; as domestic demand ramps up in emerging markets, many of the dollars held could be used to buy goods and services from the US, rather than investing in the US. Many credit markets are currently priced for Armageddon – but it is hard to see the eventual outcome to be as bad as current prices reflect. Of course, for an asset that is trading at a "value" price to be a good buy today, the negative potential outcome that is reflected in the price has to fail for this to occur.

The interview was conducted by Frank Schnattinger.