

Exactly When Will Interest Rate Increases Stop? **by John V. Kamin**

Wall Streeters and other analysts are floating opinions to answer the unanswerable, "When will the FOMC stop boosting interest rates?"

FORECAST: This economist's opinion? FOMC and Greenspan will stop boosting interest rates when they stop home prices from rising. The Feds don't exactly want to "kill" the housing market, but they clearly want to cool down housing price rises!

PREDICTION: You can't fine-tune planned "cooldowns". Past experience shows that similar attempts may result in unintended after effects that can last for years! The after effects may grip the nation's economy so tightly, and with such mis-estimated time lags, that the well-intentioned moves by the Central Bank can backfire! Historical example: after the Market Crash of 1929-1933, the Fed tightened credit. (Banks were over-extended and many had failed.) Result of tightening? Many more banks began to fail! Prices in the construction market affect the economy. A cooldown will sabotage those "debt-consolidating consumers" who have grown used to refinancing their homes, using the proceeds of ever-larger home refinancing and growing equities as a cast ATM machine!

"Sell your worst properties now, the problem properties, the slums, the vacant lots" to build some opportunity money, capital, to use during the next real estate downturn, whether it occurs in one, two or four years.

Unpredictable after effects alone could make the economic consequences of a cooling normal real estate downturn into an economy-busting surge in unemployment! Hope not. But beware. After all, it has been the housing and construction markets that have propped up and extended the current 2003-2005 USA housing boom and kept the USA economy growing out of recession!

Outlook 2006-2010

PREDICTION: Current abnormally long upturn in the economic and housing cycle is due to change. We're already seeing some warning signals among our indicators. This is not the time to be "property rich but cash poor". You'll need adequate resources to ride out the next recession, especially if the FOMC keeps tightening and especially if lender scrutiny toughens qualifications for new loans during 2005-2010. Assume nothing.

Set aside sizable extra bucks that you can use as opportunity money during the next recession to make some acquisitions. You don't want to be stuck at the end of the borrowing line when lenders tighten over the next two years - 2006-2007! The Forecaster Moneyletter says, "Sell your worst (problem) properties now, but keep the best." Dump the dogs, build some cash-form resources by 2005 before the need arises and before the property markets cool.

Killer Rate-Hike. Will FOMC Boost Rates So High That They'll Kill The Real Estate Boom?

Its crystal clear now with multiple interest rates hikes by the Federal Open Market Committee that interest rates are rising. As a Forecaster reader, you were warned of this months and years in advance, about coming rising interest rates and coming rate boosts, right? Most believed us, due to our economic training and experience and credibility over decades.

The Federal Reserve Board has been boosting interest rates every meeting. Dr. Alan Greenspan is getting ready to retire in a few months. Interest rates have been pushed down earlier in this cycle to 1% on FFR (Federal Funds Rate). Now the FFR is under 4% but still rising, the rate at which the Federal government loans money to banks for short-term loans. Also rising, about 1% higher, is the Discount Rate, the overnight rate at which banks with extra money loan money to other banks that need it.

Mortgage rates and long-term rates are still at historically low levels, so homebuyers can seize advantage.

PREDICTION: Soon, long-term rates will be on the rise once again.

FORECAST: Those who took out ARMs (Adjustable Rate Mortgages) are going to get some nasty monthly payment surprises as their mortgage payments are boosted over the next six to 12 months. Sizeable boosts! GOOD BET: You probably haven't read all the fine print in that ARM you signed for, so you're not yet really clear how large the adjustable mortgage boosts will be. They could be substantial.

What Happens If The Inflation Rate (CPI) Starts to Increase?

FORECAST: The FOMC will keep raising rates, even more, at their monthly and semi-monthly meetings, to "head off inflation". Raising rates is one of their main tools to "calm inflation".

I could give you anecdotal evidence that inflation is already much higher than the official BLS numbers indicate. Chances are you could tell me the similar things. If you're paying \$1 more for gasoline, 50% more for fresh veggies at the market, 25% more on your house and car insurance, 25% more on junior's and sis's tuition, way more for your prescriptions, know that inflation is not 2% or 2.5% per year. If we tried, I'll bet you and I could make up a much longer list, such as car repairs, cleaners, etc.

"Toolkit" a Bit "Scary"?

History Details Self-Inflicted Credit Crunches

The Federal Reserve Board of Governors has other tools to deal with inflation. They could restrict borrowing. They could restrict credit card terms and issuance. They could restrict mortgage loans. If a number of loans were starting to go bad or unpaid, they could even force their member bankers to get them to "tighten up" credit and new loans on individuals and businesses. They could require banks to maintain higher reserves. I think you'd be amazed to find what small percentage of savings and checking accounts are now held as withdrawal reserves by member banks. Basically, banks are borrowing short term (including your checking and saving deposits) and lending long term to make the "spread" between what they pay out on deposits and what they collect in interest. The FRB can tell banks to "adjust" the ratio between short-term borrowing and long term lending. FRB can tell banks to get property and other non-bank assets "off the books". It was during the late 1980s and early 1990s that the Resolution Trust Corporation was formed, and the RTC was charged with the task of disposing of houses, land, property and business buildings, foreclosed upon by the banks for unpaid loans.

Japanese banks weren't told to liquidate bad loans by their Central Bank, because of conflicting daibatsus, and Japan suffered a 10-year economic recession as a consequence! Will That Happen Again?

Probably not. Most real estate downturns have been caused by oversupply and overbuilding. That does not seem to be the case yet in the USA 2005. But it could be the case in 2006 to 2008. We'll help you maintain a watchful eye. During the 1980s and early 1990s, as lending dried up while builders overbuilt, many contractors simply went out of business, as their obligations went unpaid. The FDIC took over the FSLIC (Federal Savings & Loan Insurance Corporation). I could write a book about this, but enough said.

Point is, the real estate cycle is subject to change. The liquidity of resales of existing houses and new houses can change from reasonably liquid today to quite illiquid in 2006, 2007 or 2008.

Those buyers with 0% to 5% down can become "walk-aways" on houses they can no longer afford, which they bought on huge ARMs with still-to-be-boosted huge monthly payments.

We all hope credit crunches won't happen, but history indicates they do bear careful watching. Things can change in just a few months, rapidly. Sometimes the changes that occur are so rapid that they don't give the FRB much time to respond with the tools at their disposal.

Time Travel Equals Time Lags

Banking tools at FRB's disposal have long time lags between the time tools are implemented, used, and the time credit changes take effect; not instantaneous changes even with a responsive FRB led by bright, thoughtful, well-intentioned members of the FOMC.

Ever try to sell property in a property downturn? It becomes very difficult indeed to impossible without cutting sale prices, without deep discounting and stretched out tough negotiation. Careful. It's not the kind of situation where you want to be "property rich but cash poor".

Again, our unchanging Forecaster Moneyletter advice is consistent during the last year or two, "Sell your worst properties now, the problem properties, the slums, the vacant lots" to build some opportunity money, capital, to use during the next real estate downturn, whether it occurs in one, two or four years.

Sprucing up and selling properties takes time. Even if they're spruced up during the downturn, due to oversupply, increased listings, sometimes inept agents or plain naiveté inexperience, it becomes very hard to get the most money out. Careful.

Our advice also remains: keep your best properties now, the non-problem properties, for increased cash flow and for increased inflation protection through coming years.

Dump the worst, keep the best, while you can. Don't become overextended; trees do not grow to the sky.

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