

Profitable Strategies to Use When the Real Estate Cycle Changes

By John V. Kamin

What if you could borrow short-term money at, say, 3% or 4% interest and then lend it out at 6% to 13% interest longer term? That's precisely what many savings banks, mortgage brokers, hedge funds and other institutions are doing.

They make their substantial profits on the "spread" between their borrowing costs and their lending income inflow. This is one form of what analysts call "derivatives", a broad description.

I don't want to scare you. But I do want to motivate you to think about implementing strategies that will benefit you, medium term to longer term, when the business cycle and the property cycle change.

Every so often, the economic cycle traps the players. Then they are caught between rising short-terms cost and locked in unraisable low, long-term rates on the money they lent out. Soon, it is costing middlemen more to borrow short term themselves on Variable Rate loans to keep the money flowing on the Fixed Rate loans they made to others. They become "squeezed" between rising costs and shrinking profits.

The Big Question for 2006!

Here's one more way the squeeze play might be worked on currently unsuspecting "newbies" in the financial industry at the time they least expect it!

Example: People are asking whether successor Fed Head Dr. Bernanke will keep raising interest rates. When they ask this economist, I reply, "He's a numbers man. When the numbers coming in tell him to stop raising rates, that's when he will do so. Not before." He may not know what that point is due to lack of incoming future data. Therefore, how can we know what he will decide at some future time when he does not yet have the future numbers he needs to decide - nor do we?

The Equation Key – Logic Rules Numbers

Higher rising interest rates equals credit restrictions on borrowers. Borrowers' restrictions lead to potential recession. A downturn can lead to restricted homebuilding/construction loans which could lead to a housing bubble.

A glut of sudden new listings for sale (as loans tighten) could result in frantic borrowers. Increased borrowing demand for costlier loans can easily lead to new restrictions on home equity loans and tougher qualifying. That's the squeeze play.

Recently, I have been meeting some people who are "cash poor but property rich". They are refusing to lock in low interest rates on Fixed Rate mortgages sticking with their Variable Rate (lower-cost VRM) mortgages. When I mention that their cash position is very low, say 1% to 2% of net worth or less, they reply, "I can always get a home equity loan on this property and a second mortgage on that other property".

The lesson? Even high net worth individuals with good jobs can get caught in the squeeze play. As soon as they are caught, it becomes obvious to lenders whom those strapped borrowers approach, that the borrowers are cash poor in relation to liquid assets.

Bank lenders love home equity loans at the present time and will pile on a new loan up to 95% to 100% or more of a property's "market value". Lenders love those second loans because they can charge a much higher rate of interest.

Can Squeeze Occur?

What if the rate on seconds jumps to 16%, 19% or even exceeds 20% for the strapped, needy and now-desperate borrowers.

That's what happened in previous bubbles during the 1973-1974 melt-down. It also happened in the 1980-1982 melt-down. More recently, the squeeze did not take place in the 2000-2001 tech-wreck. Dr. Greenspan quickly slammed down the interest rates well below market rates to as low as 1% on six month T-bills after the tech-wreck and 9/11. Now the FRB is playing "catch-up" to get government rates closer up to marketplace rates. But this is precisely the action that traps those optimists who borrowed cheaply short-term to lend longer-term!

Do you have substantial cash-form assets or parked money so that you could weather the rising rate-spread for two or three years?

Question to you: What would you do if your mortgage interest rate gets hoisted 3% to 4% or more?!

Do you have substantial cash-form assets or parked money so that you could weather the rising rate-spread for two or three years? For those in the lending industry, what would happen if the housing bubble suddenly bursts; if the real estate cycle turned down; when routine refinancings became problematical and the economy tipped over into recession just before the next major election? What if the home equity/refinancing route was cut off for your escape? How would you survive? What if the mortgage lending business suddenly was subject to layoffs as had previously plagued aerospace, Wall Street industries and big steel plants in past decades?

I don't want to scare you. But I do want to motivate you to think about implementing strategies that will benefit you, medium term to longer term, when the business cycle and the property cycle change. For example, if the Iraq War pull-out is further delayed, if additional \$100 billions are spent for Iraq and \$100 billions more red ink result from natural disasters such as hurricanes, promises made and interest rates start climbing just as you need more money, will you be prepared?

Workable Strategies for 2006 to 2010

- A) Gold in the form of gold coins carefully set aside for months in advance is a traditional inflation hedge as well as a money source (sold easily enough) when cash has to be raised.
- B) TLCs (Tax Lien Certificates) - paying up other people's delinquent property taxes is one parking place for presently-unneeded funds. TLCs can benefit you with a double-digit interest rate return (10% to 18% interest allowed) on one year to five year money. If you buy a bunch of TLCs at county auctions secured by valuable properties, priority liens on TLCs can wipe out current mortgages, second mortgages and even get you those properties free and clear if delinquent taxpayers don't pay up in a timely manner.
- C) Other pursuits often get better during recession instead of worse. Economists call them "contracyclical trends". For example: if the economy cools down and people have more time on their hands, coin collecting and the antique business may get a burst of enthusiasm. No one has much time for hobbies (or fewer do) when the economy is booming or overheated and workers are putting in extra weeks, working 60 to 70 hours per week and hanging on by their fingernails.
- D) A more mundane form of building up cash-form assets practiced by the public is normal savings accounts and CDs. While their yields may be low, (around 4% maximum), even on six month T-bills, the taxable interest on parked money at least gives them a shot at trying to keep earning something to offset inflation, even if interest paid out is not quite enough to prosper.
- E) When do you get the most for your money? Usually in a real estate downturn. You have more listings to choose from, more NTS (Need to be Sold) properties and you can negotiate better discounts from even low appraised values! This can even occur during inflation. Contractor deals and remodelers seeking work can

- be negotiated for less!
- F) The Myth. The general public believes that a recession and inflation cannot occur at the same time. Even many leaders believe that. Contrary Opinion: The evidence demonstrates differently. History shows that indeed inflation and recession can occur at the same time. History also shows (as in 1979-1980 with Carter at the helm) that interest rates can soar while inflation and recession are occurring at the same time.
 - G) A study of fiat money economies in many developed nations (currency units unbacked by gold and silver) shows that inflation occurs both good times and bad.
 - H) How do politicians and other leaders try to lift a national economy out of recession? They “re-inflate”. That’s what Roosevelt did. That’s what Keynes advised. So, even if leaders somehow manage to cool inflation during recession, once the recessionary effects are felt by the public (think, voters), leaders will do anything (including hefty re-inflation) to get the economy moving again. They often raise taxes “to help the poor” which further sinks the economy. They may even declare debt moratoriums as Roosevelt did, which further scares off potential lenders.

Summary

I could go on with a long list of past economic blunders. But even if you didn’t get much inflation with a recession (unlikely), you’d be almost guaranteed to get more inflation to “cure” a lengthy recession.

More contrary evidence. Wars are costly, whether paid for by borrowed money, current red ink or using up cash reserves. The longer wars go on, the more they cost. The “light at the end of the tunnel” may be barely visible in an ever-lengthening tunnel.

Historical evidence. When the Vietnam War was ending in 1973-1974, American adults expected a “peace dividend”. What happened? There was no peace dividend. It never showed up at the party. By 1975-1976, this was clear. Gerald Ford was fired (not re-elected) and President Jimmy Carter took over in 1977-1980.

Carter decided to cut back on the military. Shortly thereafter, military armories were running out of ammo and F-15 Fighter Wings in Germany and elsewhere were cannibalizing planes to get spare parts just to keep the other F-15’s in their Fighter Wing intact and flying! Budget-cutter Carter saved some money by cutting down on spare part re-orders, but cannibalizing planes that cost \$50 million to \$100 million each just build? Sure would have paid for a lot of spare parts instead!

More evidence. Brushfire wars and other situations break out. Carter became a victim of the Iranian Hostage Crisis. Several expeditions designed to rescue American hostages held by Iran turned into costly disasters! The point is, whether its natural disasters, hurricanes, USA’s enemies’ activity or massive Enron-style bankruptcies, there are always “coyotes” and other predators lurking in the financial underbrush. There always have been in the past and I expect there will be in the years immediately ahead from 2006-2056.

President Clinton promised to have troops sent to split-up Yugoslavia Civil War back home within one year. USA troops are still there!

Seize Control of Assets

Lesson: Since leaders don’t ask you first, are stingy with their release of actual information on what’s going on and wouldn’t act upon your opinion even if they had asked for it, it’s up to you to take responsibility for your own assets, risk-avoidance and protection.

Our Forecaster motto is: “Take control of your assets”. Sure, maybe you could turn your net worth over to a third party and they might do a better job. But, they might not.

Here in the Hollywood area, it’s quite common for movie stars, athletes earning millions and others to be forced to file bankruptcy when they turn over all of their finances to third parties for a few years, even if the stars are earning millions per year! Take responsibility. Take control of your own assets.

Make decisions. Go for the growth. Avoid large risks for small profits. Instead, shoot for 100% to 1,000% gains.

Build up some opportunity money handily so that you'll be ready to take advantage in the unexpected twists and turns of the business cycle, the economic cycle, the interest rate cycle and the real estate cycle. Contrarian strategy suggests that you must have opportunity money available when sudden opportunities occur. I like to buy property when others hate real estate. Not when everyone loves it! That's when the flippers and dippers and loan-loader-uppers get trapped in a web of their own making.

What the Media Doesn't Tell You

Early December, there were many TV programs, radio news announcements and even newspaper articles about the "end of the housing boom", the "bubble bursting" and other such nonsense. Here's what they failed to tell you.

New housing starts, a job-creator for the USA economy are still running at record busting rates of 1.7 million units per year. These are still record in spite of being down a couple percent from November. Never before have housing starts run this high at these rates over a full year in USA history.

What's True, What is Not

Here's something else they didn't bring out about the latest numbers on resales, used houses. Unlike new houses, the job creators, sales of used houses may or may not provide a boost to the national economy. You must segregate these figures (new housing starts, permits from resales of used houses) because they mean entirely different things in economic and monetary forecasts.

What they didn't tell you about resales was that they are also running at a record-busting rate of seven million per year over the past year. Never before have resales of used housing run at such high rates!

The general impression I see being created in the media and among commentators is that they can hardly wait for the "housing bubble to burst". It's not happening. It's a non-event.

True, there is more remodeling going on. True, listings are up, but very slightly. It is also true that prices are still increasing. There are more overly optimistic sellers out there pricing their properties way ahead of the market. Real estate brokers are quite happy about the slight increase in listings because it gives the agents more "inventory" to resell. Inventory which has been scarce over the last three years.

Houses - the Newest Cash Machine?

It is also true there are more people looking for "flipper" profits.

Novices have been so astounded by the price increases on their used and new homes that many of them may be trying to resell them and get out with a quick profit of \$50,000, \$100,000 or more. Other long-time homeowners are also startled, but pleased, about the sharp increases in home values, both used and new, and many have undoubtedly used their houses as an ATM machine, taking on home equity loans and second loans, etc. Then, when owners spend the borrowed money, these new loans on their homes provide the cash to prop the economy for purchases of cars, vacations, tuitions, clothing and paying off credit card bills.

Watch Out Later

Forecast: When and if housing prices do start to sag and go down, when sales of new and used homes drop 20%, these current "props" my undercut the entire economic scene at that time (not today); then the USA economy may slip into recession. When? Could be a year from now; could be two or three years from now. But at the present moment, the belief that the housing bubble has somehow "popped" is simply not borne out by the numbers. It's nonsense.

Forecast: The current economic upturn is now 31 months old. Anyone who tells you the Bush tax cuts are now working is blowing smoke and doesn't know what he is saying!

Prediction: The upturn cycle will eventually end and new tax cuts/extensions will be needed to encourage businesses to create more jobs and industries to risk their scarce capital.

True, these record-breaking new and resale housing numbers could slide somewhat in coming months (10%?). But in this economist's view, housing is still in an intact uptrend, although the feverish pace of 2005 may be less feverish during the first of 2006. But still at record rates.

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