



AKROS CAPITAL, LLC

## Confusing Reality with a Perfect World

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"We've never had a decline in house prices on a nationwide basis. So, what I think what is more likely is that house prices will slow, maybe stabilize, might slow consumption spending a bit. I don't think it's gonna drive the economy too far from its full employment path, though."

*– Federal Reserve Chairman Ben Bernanke, July 1, 2005*

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In a perfect world, house prices never decline. One can buy a house with no money down and cover the mortgage payments using a home-equity line of credit. Any excess appreciation beyond that can be borrowed against and spent. In such a world, the worst-case scenario is that house prices may temporarily "stabilize, might slow consumption spending a bit." However, by no means does this ever "drive the economy too far from its full employment path."

Within a year after Chairman Bernanke's comments, the perfect world he described was beginning to unravel. House prices were falling and jobs related to real estate were disappearing. Since early 2006, the homebuilding industry has lost about one-third of its 3.5 million jobs, while employment in the mortgage industry is down by about half from 504,500. Membership in the National Association of Realtors is down 22% from its 2006 peak of 1.35 million.

Job losses have spread to other housing-dependent industries such as home furnishings, appliances, electronics and the retailers who sell their products. The 2008 bankruptcies of Linens 'n Things and Circuit City Stores provide two high-profile examples of retail-industry fallout from the housing bubble's collapse.

"Some of those shopping centers in the high-growth markets of Arizona and California, where they were expecting the house tops to grow out to them, were stranded and it never happened."

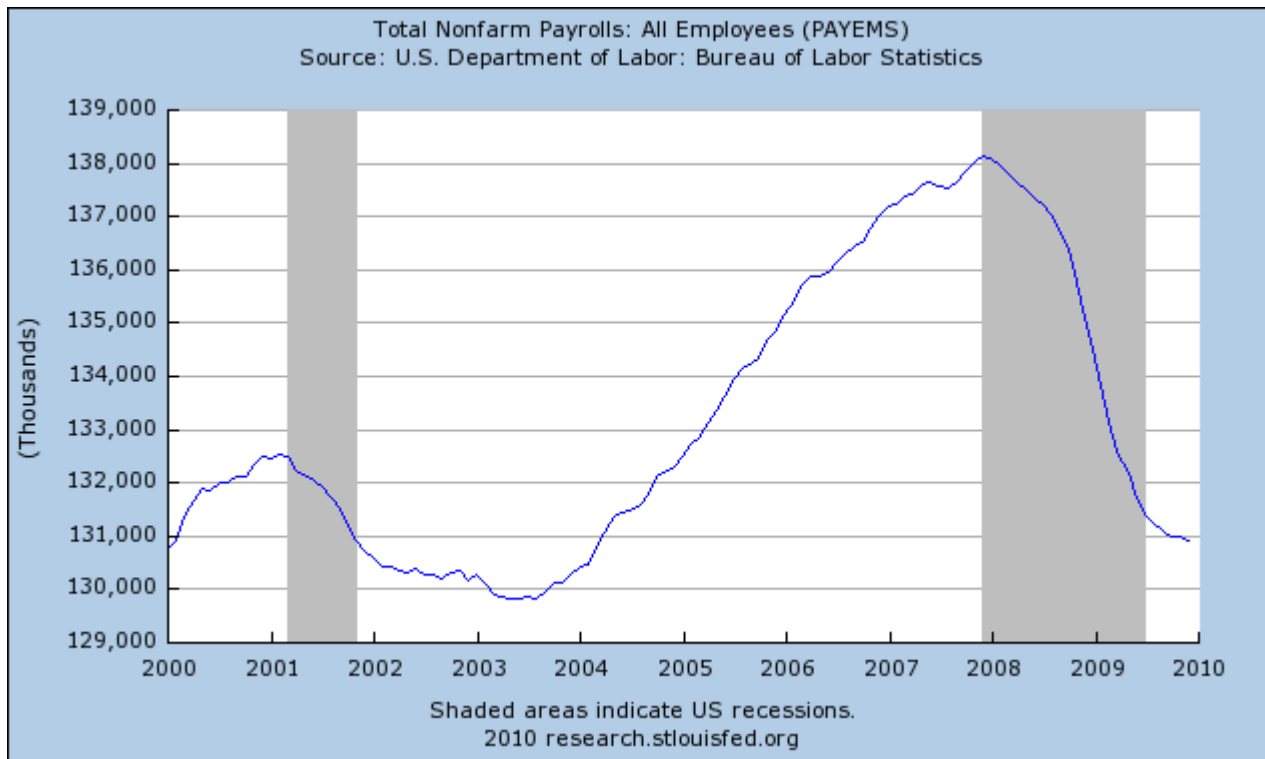
*– Jay Brinkmann, Chief Economist, Mortgage Bankers Association*

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Although 4.4 million retail jobs were created between 2000 and 2007, all of that job growth has been erased. Retail-sector employment is back to its 1998 level of 14.6 million and likely to show sluggish growth at best. Last week the Commerce Department reported that retail sales fell 6.2% in 2009, the biggest full-year decline in records dating back to 1992. The only other year in which retail sales fell on an annual basis was 2008, which saw a 0.5% decline. For the month of December, retail sales fell 0.3%, while sales excluding autos dropped 0.2%.

## A Decade of Job Growth Wiped Away

Nonfarm-payroll employment over the past 10 years is plotted in the graph below. Note that the graph begins and ends around the same level of just under 131 million. By the end of the decade, all of the jobs that had been created were gone.



Bubble jobs related to real estate are not coming back. Jobs that depend on discretionary spending will return only slowly because attitudes have changed: Burdened with debt, consumers no longer want to spend money they do not have on things they do not need.

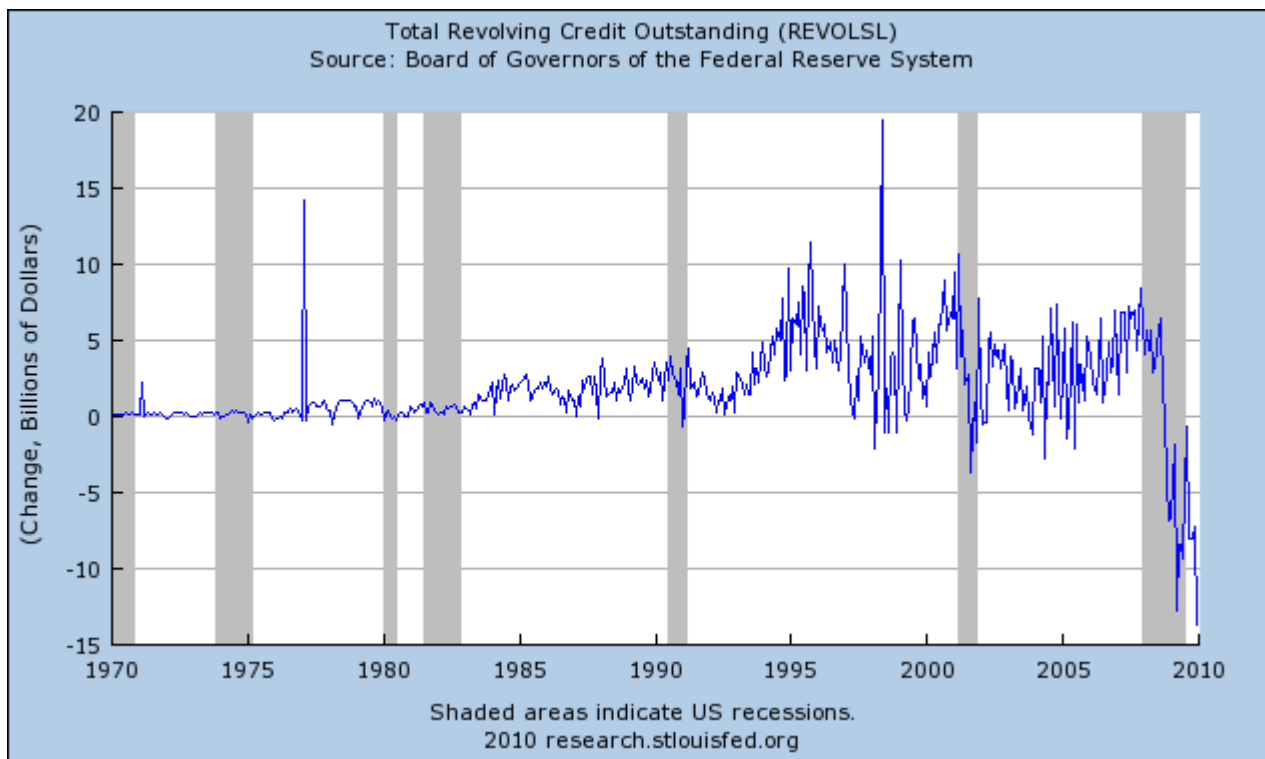
Despite a larger population and extraordinary incentives from dealers and the government, 2009 light-vehicle sales barely exceeded 1982's total of 10.357 million. December's seasonally adjusted annual rate of 11.25 million is down from prerecession levels of 16 million and remains below the rate necessary to replace the approximately 12 million vehicles taken out of service each year. U.S. auto plants currently employ only half as many workers as they did following the 2001 recession and will not be a significant source of job growth anytime soon.

The most recent employment report showed no significant improvement. The unemployment rate held steady at 10.0% in December, but only because the number of Americans classified as "not in labor force" swelled by 843,000. Even including new entrants, the civilian labor force shrank by 661,000. Total unemployment now stands at 15.3 million (26.5 million if marginally attached workers and the 9.2 million involuntary part-timers are included). The average length of unemployment increased to 29.1 weeks, and what little hiring did occur was largely among temporary workers, whose ranks increased by 47,000.

## Consumer Credit Still Contracting

Perhaps nowhere are changing attitudes toward borrowing and spending better reflected than in the Federal Reserve's most recent report on consumer credit. November's decline of \$17.3 billion in total consumer credit was the largest such drop since records have been kept starting in 1943. In percentage terms, the 8.5% annual rate of contraction was the sharpest since credit declined at a 9.2% rate in May 1980. Consumer credit has fallen for a record 10 straight months, surpassing the old mark of seven consecutive declines first set in 1943.

Revolving credit, the category of consumer credit that includes credit cards, fell for a record 14<sup>th</sup> consecutive month. As shown in the following graph, revolving credit in November fell by \$13.7 billion, which was the most ever in dollar terms.



Past economic recoveries have been led by expansions of consumer credit for purchases of big-ticket items such as autos and other durable goods. However, that clearly is not happening now. Investors counting on a V-shaped recovery apparently believe this time will be different.

## Perfection Restored?

While most would interpret the evidence presented thus far as a series of negatives, the financial markets apparently do not agree. The U.S. stock market in particular appears priced for a level of perfection to be found only in a new, updated version of the perfect world. The difference this time around is the government has replaced perpetually rising house prices as the source of "free money."

In this new perfect world, high unemployment is good because it keeps payrolls thin, labor costs low, productivity high, corporate profits rising and the Fed on hold. Job growth is bad because when companies are forced to hire, it hurts their bottom lines. In the new perfect world, any declines in consumer spending attributable to unemployment are more than made up for by the government, which functions as the borrower, lender and spender of last resort. Because there are so few other creditworthy borrowers, the government can borrow unlimited amounts at low interest rates. In the new perfect world, the stock and bond markets provide the only sensible outlets for investment because short-term interest rates are near zero, and starting a business in the new perfect economy would not be profitable without a government-stimulus contract or subsidy.

To the extent that reality coincides with the new perfect world, all will be well for the foreseeable future. More likely than not, however, this new perfect world ultimately may prove as illusory as the previous one.

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