

The Wednesday Wrap

by Bill Fisher

January, 2003

KEY RATES

▶ 30-YEAR TREASURY BOND

4.78% [-] [12/31/02]

▶ 10-YEAR TREASURY NOTE

3.82% [-] [12/31/02]

▶ 1-YEAR TREASURY SECURITY

1.41% [-] weekly
1.49% [=] monthly
[12/30/02]

▶ 6-MONTH/YEAR LIBOR

1.380/1.443 [-] [12/31/02 data]

▶ 11TH DIST. COST OF FUNDS

2.708% [-] [for use in Dec 2002]

▶ LOWEST RATES (Realty Times)

5.58% [-] 30-yr fixed
5.32% [=] 15-yr fixed
4.07% [=] 1-yr adjustable
5.88% [-] 30-yr jumbo
[12/31/02]

▶ FED FUNDS TARGET RATE

1.25% [-] [since 11/6/02]

▶ PRIME RATE

4.75% [-] [since 12/12/01]

▶ WEEKLY MBA MORTGAGE APPLICATIONS SURVEY

908.3 [-] [week ending 12/20/02]

▶ CONVENTIONAL LOAN LIMITS FOR 2003

\$322,700 – Single-family residence
\$413,100 – 2-family residence

\$499,300 – 3-family residence
\$620,500 – 4-family residence

VA - \$240,000
FHA - \$283,000

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Also available: The Creative Connection, a general-audience real estate prospecting newsletter that we've been producing since 1980; for info, call Mike Eggers at (949) 493-2100



Wrapman's email: bill@cco.net

Phone: (360) 459-3079

[written December 31, 2002]

COMMENTARY....

I am writing this on the last day of 2002—a particularly edgy time for viewing the nation's economy...but still a relatively wonderful time to be looking at the real estate market.

Why the edginess? The foremost reason is that we are balanced on the edge of a possible war and, for the financial markets, that is tantamount to balancing on the edge of a cliff. The sense of uncertainty is chilling the markets today, undercutting any possibility of sustained improvement in the stock markets, pushing up the price of gold (which has become far more of an indicator of panic in the markets than of nascent inflationary worries), and making even the real estate market difficult to predict.

Given that this is a huge matter, and given that its ramifications in the economy could be very important to all of us, I find no way to avoid the subject of a threatened war in Iraq. Bear with me. I realize that there are passionately-held opinions on this matter, and though I'm not inclined to join a debate at the moment, I hope to be able to spark further thought and, if I'm extremely lucky, help you to prepare for what seems to be coming.

Lucky? Indeed—because anything I say here is

primarily a guess. Granted it's a fairly well-educated guess, but no one—not even one of those often-quoted “highly-placed sources in Washington” can do anything but guess about where we will be in a couple of months.

I'm not a highly-placed source. I obviously don't have the ear of President Bush or any of his advisors. I just read a lot. Because I do a great deal of research for the newsletters I write, I have that luxury. I read.

Perhaps the most crucial question is this: *Why do we want to go to war with Iraq?* And for many, the answer is all too obvious—but not, frankly, for the financial markets, which are terrified by the prospect of war.

The answers most often given:

First, Saddam is a monster who must be taken from a position of power, both for the sake of his country and for the world. This tends to line up with the fantasy that Iraqis will line the streets in joy, welcoming our troops. *Won't happen.* And very few people believe that we would unleash our vastly expensive military machine because Saddam is a bloodthirsty jerk. There are plenty of other jerks leading countries like North Korea, Libya, Burma, etc. What's so special about this particular jerk?

Second, therefore, is the issue of oil. Cynics argue that our military is setting out to fight a proxy battle for American oil companies, which stand to reap huge profits if we can gain control of the Iraqi oil fields. Many people all over the world believe this to be true. I believe it to be, at best, a

far too simplistic version of what's happening.

Third, then, is the issue of WMD—weapons of mass destruction—and just how much Saddam has developed, whether he might plan to use them on the United States, whether he might pass them on to terrorist organizations that might use them on the United States. This is the Bush Administration's main concern (in its public utterances), and it does give one pause, to say the least.

The main problems with this argument, so far, are (1) that we have a U.N. inspections team at work today and it hasn't found any smoking guns, (2) Saddam is himself very unlikely to risk the reprisals that would come from initiating the use of WMD against America (unless he has been backed into a corner and has nothing further to lose), and (3) the links between Iraq and the terrorist organizations we are most concerned about evaporate when examined closely. The fact is, Saddam is just the kind of leader Osama bin Laden disapproves of; Islamic teachings hold that the ultimate leaders in a nation must be religious leaders. (But there is a danger that the differences between Saddam and Osama could be narrowed if we attack Iraq because we would be attacking Muslims.)

If those are the reasons, it is difficult to find a satisfying risk/reward ratio. As world class conservative investor Jim Rogers wrote recently in *Worth* magazine, “The risks are clear. I'm not sure what we gain, even if things work exactly as Washington hopes.”

An important American member of the earlier U.N.

inspections team (Scott Ritter, former Marine, current Republican) notes, the inspections process deserves every chance it can get. By and large, it works. (He also notes that the earlier team wasn't kicked out by Saddam, it came home on advice from the U.S. that we were about to start a bombing campaign, authorized by Clinton.) Jim Rogers, who recently went around the world in his own vehicles, getting as close to the people as he could, writes:

“When President Bush says that some cultures hate us for our democracy and freedom, he's just wrong. Everywhere I went in the Middle East, people told me how much they loved Americans; the hatred is directed at U.S. policy. Guess what was the favorite country of young Arabs and Muslims, according to a study by the British Council after the 9/11 attacks—yes, the USA. Why not build on that goodwill rather than create a backlash that will last a generation? Patience paid off in South Africa, Russia, Poland, and China; we are now beloved in those countries.”

Why, then, invade Iraq just now? The answer that most satisfies this avid reader is in two reports advising a military strike against Iran which the Bush administration has had since before the 9/11 fiasco changed the face of our nation. One was an admirable study by members of the Institute for National Strategic Studies, part of the Pentagon's National Defense University, and it can be found at www.ndu.edu/inss/press/Spelrepts/SR_03.htm. The other was a paper written for future members of the Bush administration by,

among others, current assistant secretary of defense Paul Wolfowitz.

The Pentagon document is a closely-reasoned study. Its argument is that we have no choice but to be involved in Middle East affairs because (1) they are so volatile, (2) many of the leaders are so unstable, and (3) we have crucial oil interests there. To simplify the argument, the study's conclusion was that we could gain a great deal by overpowering Saddam's regime in Iraq. Saddam, after all, is the loosest of the loose cannons on the Middle Eastern deck. It is because of Saddam that we have bases and forces in Saudi Arabia, whose aging leaders are likely to be replaced relatively soon and perhaps by Islamic fundamentalists for whom (as for Osama) the presence of the U.S. military in the nation of Mecca is a hated abomination.

The theory was that, by stabilizing Iraq and maintaining quiet control of that country, we could ease out of Saudi Arabia and thus lessen the tensions throughout the Middle East, and end up even better-positioned to respond militarily to any future threats.

The Wolfowitz study seems to take this idea several steps further, asserting that the U.S.A. must now take responsibility for maintaining peace in the world and, indeed, for spreading the benefits of free market economics. This latter point found its way into a recent national security strategy release from the Bush administration: "Free markets and free trade are key priorities of our national security strategy," the document states, suggesting that we will use

our military to make sure the world's markets are free. The document further suggests that other nations' tax codes are crucial to our national security, insisting on "tax policies—particularly lower marginal tax rates—that improve incentives for work and investment."

The Wolfowitz doctrine seems to have inspired the thinking that may be most important in the Bush administration's desire to depose Saddam. What we find is that this doctrine—perhaps justifiably referred to as a Pax Americana policy by its critics—incorporates all of the reasons cited above: Saddam is a jerk. We can't allow him to have WMDs. We are far better positioned strategically if Iraq is an ally, not a loose cannon. And one of the reasons we're far better positioned is that we can be more assured of a continuing access to oil.

Now, it isn't my intention to argue the merits and demerits of an apparent Pax Americana policy, except to say that it looks—from the perspective of a little nation being told by America how its economy and tax codes, among other things, should operate—a bit like having your overbearing mother-in-law move into your house.

Okay—having said all this, I find I'm reasonably convinced that we will initiate air strikes by the end of February. I wish I were reasonably convinced that this administration will hold to the idea of easing our presence out of Saudi Arabia and making it known that we intend to do that. Failing that, I am very concerned about the possible retaliatory actions that could be initiated by Iraqi terrorists and other terrorists, some possibly in

our own country. These could do even more damage to our economy than they do to our population. (What I keep noticing, though, is that our deeper challenge here is to learn to rise above fear. It sometimes feels as if our nation and culture are being tested in many complex ways.)

"Certain economic factors are impossible to ignore," Jim Rogers writes. "We are the world's largest debtor nation, and this war could get very expensive. The Gulf War threw a strong U.S. economy into recession, and that was a short, simple war at a time when the rest of the world was growing—the opposite of today. I'm concerned about the stability of the dollar. Many nations appear to be pulling their money out of the United States for fear that the dollar will continue to stumble or that our government will freeze foreign assets, even those of our allies. (Hey, we've done it before.) What if this leads to a run on the dollar? We have to attract \$1.7 billion of foreign capital every working day just to finance this year's [2002's] trade deficit. The need to service previous deficits makes it even more. Next year will be worse, not better."

So here we begin to focus on economic matters, and I feel slightly more confident about my guesses.

The dollar's value has already been in decline. The value of gold, the panic indicator, has climbed from a relatively recent \$270-280 to \$340-350, and is threatening to break out even higher. The price of oil is threatening to rise further. And we are running up big deficits federally.

All of this is potentially very inflationary stuff. We could

see the bid prices for U.S. Treasury securities rise—and interest rates with them—as fewer bidders demand better returns for their investment in U.S. debt. That would push rates higher...perhaps seriously higher over time. Meanwhile, the declining value of the dollar would make Treasury securities even less attractive to foreign investors. And we could see money rush toward the old safe haven of gold, taking gold's price higher and higher.

At the same time, however, the Fed would most likely want to keep rates as low as possible because the economy could worsen—with consumers far less ready to part with their cash and businesses unready to attempt expansion.

We would therefore have strong forces pushing interest rates in two directions at once. My guess is that inflationary forces would win—though they wouldn't take rates terribly high unless a war in Iraq turned into a quagmire. My reasoning is that you really can't force investors bidding at Treasury auctions to accept low yields (i.e., low interest rate returns on their investments) in a climate of fear and/or when there are seriously fewer investors doing the bidding.

So where does that leave the real estate market?

This is a complex matter. The simplest answer is that the real estate market would probably remain quite strong if interest rates remain attractive, but it would probably slow very noticeably if rates rise...and slow severely if rates skyrocket.

Let's go with the most likely scenario—at least for the

relatively short term: rates rise a bit, but not more than, say, 200 basis points. If this is so, I believe that the real estate market will remain quite strong (though not as strong as it has been in the past three years) for many of the same reasons that gold will very likely continue to increase in value: It is one of the most solid places to put your money in uncertain economic times.

But I want to take this a step further. I want to suggest that our entire economy may undergo some very profound fundamental changes—and that, indeed, we've been in the midst of those changes for well over a year.

Let me put it this way. For a great many decades now, the core of this nation's economy—at least in the eyes of its biggest players—has been the stock and bond markets. Bottom line, this economy started and ended on Wall Street. Investment advisors assumed that we should put our money, first and foremost, into shares of stock—also known as equities—giving us participation in the growing profitability of American companies. Real estate, on the other hand, was an investment for crazies and a small cadre of real estate and construction experts.

My argument is difficult to prove scientifically, but I think we're moving in the direction of what could be called a "direct-value" economy and somewhat away from an "arm's-length" economy.

Now, it may be that I'm just finding a fancy way of describing a natural swing from a hot stock market, which had everybody's attention for several years,

to a hot real estate market, which still has everyone's attention today. But I sense that it runs deeper than that. Increasingly, for example, it seems that big corporations have lost their relevance to the daily lives of people like you and me. It is, after all, small businesses that employ the lion's share of the population and generate by far the largest percentage of new business hirings. And it is big corporations that have fallen behind the innovation curve and have lost the knack for bringing to market products and services that best meet our changing needs and wishes. I mean, who really wants to put taxpayer money into fossil fuel companies when we're on the verge of having alternative fuel devices that work better, cheaper and cleaner? Foreign companies like British Petroleum and Royal Dutch Shell are admitting this in their advertising these days.

Based on the economic data for the past two years or more, it appears that real estate—Main Street (and My Street) instead of Wall Street—is the heart of our economy. This may be just another way of saying that we have learned to invest in how and where we live, rather than in the Wall Street casinos. (My stockbroker would take great exception to that last sentence, and I don't mean to suggest that there aren't any fabulous companies to invest in. I just mean to suggest that our focus has moved, quite literally, closer to home.)

The great possibility is this: We will find ourselves detaching more and more from the distant economy and attaching more and more to the local economy, *starting at home*. Our homes have, over the past few years, have buffered us from the egregious

excesses of certain corporations, the astonishing decline of values in the stock markets, and the slowing of the overall economy. And while we have been worried about the ever-present possibility of terrorist attacks—and have thus been reluctant to fly, to travel for vacations, to do a lot of the away-from-home activities we used to do all the time—we've become more mindful of the great value in simply staying at home.

Because the technology is ready as we speak, we are likely to start disconnecting from the great utilities network, using fuel cell technology for our cars and for other at-home energy uses. With worries about the quality of our foods on the rise, we are likely to turn more and more to local food producers; we are also likely to get very protective about our water source, and to use recent technologies to filter the water delivered to our homes.

And I suspect that we are discovering two absolutely essential things that we've been in denial about. First, as my accountant worded it, our happiness is not directly proportional to the amount of money we make. Time with family and those closest to us is crucial, as is creative time alone; it's what a fulfilling life is all about. Most of us are increasingly willing to pay for a more fulfilling life with slight pay cuts—and less time commuting.

Second, we're learning that democracy is a lot of work, as is the maintenance and enrichment of our freedoms. Like the quality of our health, we can't leave the quality of our democracy to other people. It may be easier to roll over and let others make the rules and enforce them, but that is not democracy...and I don't think many of us are willing to let go of the ideals brought to life by those who founded this great nation.

It may be boring and sometimes contentious to attend homeowners' association meetings, to get involved in local school boards and local politics, but that is where we belong if we want a democracy. And that, increasingly, is where I think we'll be found.

All of this is community-based and home-based. That's where it's happening; that's where it *will* happen. This is an extremely exciting time to be alive, though potentially it will have its difficulties and traumas and major confusions. We are not watchers and reactors. We are the players in this drama. Insofar as possible, let's make it a comedy, not a tragedy.

HAPPY NEW YEAR!

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