The Hangover

By Craig Phillips, CFP

No, we're not talking about the movie or the sequel but rather the current dividing line among the world's economies.

Normally, as investment advisors we look at the Developed countries and the Emerging (or Developing) countries when allocating a portfolio. However, at least for the near term we must look at things differently and consider those countries who had a debt bubble and a debt burst and are now suffering from a "debt hangover".

On the other side of this new line are those countries that did ***not*** have a debt bubble and debt burst and therefor are ***not*** suffering from a "debt hangover". Many Emerging markets, especially in Asia, had their debt bubble in 1996, their debt burst in 1997 and have been pretty much on good behavior ever since so they find themselves today in better shape than we are here in the U.S., the U.K. and much of Europe. The notable exception in Europe being Germany. Basically, much of what we consider the Developed world is suffering from this "debt hangover" these days.

There are some other exceptions. Canada maintained this odd Canadian custom as a requirement for a mortgage - a down payment! So they did not participate in the housing bubble and burst. The same is true in Australia.

A debt hangover is very much like the hangover we might experience if we overindulge the evening before. And with both types of hangover there are three things that we think about at the time that are simply ***not true***:

1. ***"I'm going to die!"*** Just as nobody actually dies from a hangover, we did not slide into total economic collapse during the recent economic crisis. We often felt that way during 2007-2008 but it didn't happen.

2. ***"There is something I can do right away to make it better".*** Not true in either case. You have to work through it. It takes time.

3. ***"I have learned my lesson and won't do it again".*** Also, not true in either case. We will repeat this type of behavior sometime in the future.

We hear many people arguing whether housing prices are "real" today or were they "real" in 2006 at the top of the bubble. It is very clear that real estate prices are fairly priced today. The prices are back to the normal ratio of income to house prices. Looking back, 2006 was clearly an absolute bubble on the upside and set us up for the burst that followed.

For 20 years home ownership in the U.S. was 64%, which we now know was consistent with what people could afford. But then our friends in Washington decided that was not good enough so they went on a program to drive up the home ownership dramatically higher by having Fanny and Freddie ease the regulations for mortgages and a variety of other measures that managed to get home ownership up to 70%. Today, the homeownership rate is around 66%, down from 70%, pretty much back where it started. So it is clear that all we can afford is somewhere between a 64% to 66% ownership rate[1].

But along the way up and back down incredible financial damage was done by thinking that the market was wrong...and Washington knows better. Have we learned our lesson? Probably yes over the short term, certainly not over the long term.

[1] 2010 Housing Vacancy Survey, conducted by the US Census Bureau in conjunction with the Current Population Survey.