BRADY INVESTMENT COUNSEL LLC
DAVID P. BRADY, PRESIDENT

Question from My Daughter:

-----Original Message-----
From: Brady Daughter [mailto:]
Sent: Tuesday, September 23, 2008 11:16 AM
To: david.brady@bradyinvestmentcounsel.com
Subject: quick q...

Hey Dad,
sry i didnt get back to you on sunday- ive been really busy, ive just gotten swamped with a bunch of homework, the biggest being my informative speech for communications my quick q is...
ok for math class i have to research whats going on with the economy, which i have been doing; watching the news, reading the newspapers etc. but its slightly confusing because there seems to be no middle ground. either i read something that says were all headed toward economic disaster, the country will collapse and life as we know it will end etc. or its how some people dont even think the US is in a recession anyways i was just wondering what your view was on the economy and what you think needs to happen, also what you think of the propsed government buy out..

…ill talk to you later hope your having a great day love…

Answer:

Dear Daughter,

Funny you should ask. I just sent a plan to solve the crisis and save capitalism in the U.S. the Op-Ed folks at the Wall Street Journal. Let's see if they publish it. (See Plan under the Media tab on our site.)

The issue is made complex by the news media but at the heart, it is pretty straight forward. The Federal Reserve Bank created too much money between 1999 and 2004. Back then, folks had just lost a bunch of money in the stock market after the Tech Bubble collapsed in 2000 and 2001. They needed a place to invest all this new money the Fed was supplying, so they turned to real estate. This increased demand for real estate bid housing prices up to uneconomic levels. However, banks in spite of all their experience, continued to lend against unrealistically and unsustainably high home prices. Not only that, banks lowered their lending standards as the market became more risky (A good bank would stop lending in risky/speculative markets.) For awhile in 2005 & 06, anybody with a pulse could get a loan to buy a house. The fireman, who saved our dog Evan, is also a real estate agent. He told me in 2005, folks would line up outside of new condo developments Chicago and get in fights while waiting to buy condos. This type of activity only encouraged aggressive builders to build new projects and aggressive lenders to supply the money to build these projects by making more loans that would eventually go bad. Now, in 2008, something like 7,000 new condos are projected to come on the Chicago market and there have only been 300-400 sold year-to-date. Another 8,000 condos will come on in 2009. In addition, I have a friend in Phoenix who told me there are entire subdivisions with 100s of homes and no one lives there. Brand new ghost towns!

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In 2006 a new Fed chairman began to raise interest rates and better control the supply of money in the economy. The impact was to reduce the supply of dollars available to buy more new houses. Think of housing speculation as a game of Hot Potato. You have fun passing the potato around but don't want to be left holding it. Real estate speculators had fun buying and quickly selling houses at higher prices until prices stopped going up. Then the real estate speculators headed for the door (and I mean door in the singular), dumping their holdings as fast as they could. As you know, if you try to sell something as big as a house fast, you are going to lose money. The problem was there were no buyers. Turns out during the price run up, the speculators were passing these houses among themselves. Since there were no real buyers involved I call this artificial demand. The smart money knew prices were too high and stayed away. As housing prices fell, people stopped paying their loans. The logic goes, “Why would you pay your loan when the loan amount is greater that the house value?” This means the banks started to lose money. When the bank originally made the loan, the bank expected to be paid back the loan amount with interest. As loans go bad, neither happens. This means banks are in big trouble.

Banks in big trouble are a problem for the entire economy. Banks lend money to businesses on a short-term basis so businesses can do things like pays bills and meet payrolls. Banks also lend long-term for businesses to invest and grow. When banks are in trouble, neither lending type happens. This is very bad for the economy and limits growth. A healthy economy needs to grow for incomes and standards of living to rise. (You want your children to be better off than you.) If a business can't meet its payroll, its workers can't buy groceries. If groceries aren't bought then the grocery store lays off workers and so on.

There are a lot more details. But, in order to solve the problem you have to start with a philosophy. I believe in capitalism. My plan allows the market to work to solve the problem but will take time. The Government's current proposal, which is essentially to print $1.0 trillion (seriously, trillion) and buy the mistakes (loans secured by unrealistically high/overstated home values) from the banks. But not all banks made bad loans and sour real estate investments at the market peak. Many handled their affairs well while others made loans to everyone who walked in the door. The poorly run banks should be required to fail. The healthy banks should be able to grow.

A big problem with the Government's solution is the message it sends: "O.K. banks, go out and lend like crazy, bank executives pay yourselves $100s of millions of dollars and don't worry. When things go bad we will bail you out." That is not capitalism. It is socialism. Further, the Government plan does nothing to prevent this from happening again. In fact, their plan will actually guarantee it all happens again some 10-20 years from now.

There are lots and lots of details but just remember this: Banks made bad loans and now they Government wants to bail them out. We need a market-based solution that solves the problem, puts people to work, prevents going into a deep recession and prevents the problem from happening again. Getting the solution right is much more important than getting a solution fast.

Call with questions.

Love, Dad

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