

## Capital Keeps Falling on My Head

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**By John Mauldin**

Are we overbought and overvalued? Maybe. Is inflation coming under control? Maybe not. Did housing construction rebound last month? No. The only rebound was in the statistics. (I know readers will be shocked to learn that some statistics just may not actually be what the headline says.) We look at all this and more as we ponder a world awash in liquidity.

### **Nothing's Worrying Me**

One of the more interesting reads I get each week is a column from Dow Jones columnist Jakab Spencer. He has a knack for finding the unusual, and this week his talent was on full display. He did a piece on Sam Zell's latest Christmas card.

I have written (somewhere) about Sam Zell, also known as The Gravedancer. He earned this name for his flair for picking up distressed properties and turning them into profitable enterprises. His flagship vehicle is Equity Office Properties Trust (EOP). There is a bidding war for EOP, with Vornado Realty (VNO) now offering \$37.6 billion, which would make it the largest buyout deal ever. This is not some high tech growth stock. This is a very rich 22 times 2007 earnings for real estate.

When Sam Zell is selling, the rest of the investment world should take notice. Sometimes they do ring a bell. But that is not what we ask today. The more pertinent question is why would investors accept such low future returns? Do they really think there is something that Sam Zell is missing? And who are those masked men with the billions?

Sam Zell sent a Christmas card to his friends with a song called Capital Keeps Falling on My Head to the tune of Raindrops Keeps Falling on My Head. You can listen at <http://www.yieldsz.com/>. It is really worth the time. I mean, you really need to listen. It is quite thought-provoking as well as a lot of fun.

“What lies ahead: we're old -- the western world is aging, we'll need income from our pension funds, where's it coming from? The yields we see won't fuel no party... And there's one thing I know -- To get things back to normal it's a long haul that's global. Yields won't improve 'til growth soaks up this liquid freefall. Capital keeps raining on my head. So much is out there that the world is out of whack. When will we see balance

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back? It's gonna be a long time 'til returns meet expectations. We need to be prepared for slim annuities..."

"Nothing's worrying me," is how B.J. Thomas ends the original version. That ending keeps playing in my head. Investors cannot be worried by much to look at real estate at 22 times projected future earnings. Or emerging market debt at little more than what you get for US government debt. Yields on all manner of investments have been compressed.

How? As Zell says, "Illiquid assets have been alchemized into currency in play competing for returns."

### A Eurasian Savings Glut

Charles Dumas, director and head of world service of the venerable and well respected institutional research firm Lombard Street Research suggests that it is the Eurasian Savings Glut which is responsible for serial bubble blowing and the current low yields and seemingly endless supply of financing. ([www.lombardstreetresearch.com](http://www.lombardstreetresearch.com) to see their work))

"The Eurasian savings glut has been blowing bubbles via the Goldilocks mechanism wherever it can locate a balance sheet ready to be trashed with excess debt. The (Faustian?) bargain is that you get both spending in excess of your income growth as well as tremendous growth of real and nominal asset values. Who could resist? Few have. But the major balances sheets in deficit countries – businesses in 1998-2000, households ever since – have taken the license as far as they should: and then, as is traditional, beyond. How else do you find out what the limits are, except by going too far? The stock market has played second fiddle to housing for most of 2003-2006, but is still enjoying a last 'surge' as housing falls back. And business profitability and balance sheets have been radically improved, so much of the recent gains will probably be held onto, in sharp contrast to 2000-2002. In that sense it is not a bubble, simply a boom. (The bubble is in peripheral markets and commodities.) The boom should last for a few more months yet, but is unlikely to make it through to 2008."

Dumas sees a better 2007 than I do, with a slowdown not coming until later this year, but sees a possible hard landing in 2008.

"Why did the US housing slump fail to deal the economy a knock-out blow? The explanation lies in a mix of rude corporate health; yet further flushing of liquidity into the global system by a renewed rise in the Eurasian Savings Glut; and the resulting strong flow of labour income, concentrated among the high-income beneficiaries of the financial boom. Goldilocks now seems more likely to go out with a whimper than a bang. But she is not quite going yet.

"The Savings Glut has permitted deficit countries (and their citizens) a startlingly benign combination of spending much more than their income, rapid gains in real and

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nominal asset values, and low inflation. This is Goldilocks. In the US case, all three seem likely to persist until mid-year (or so) but their force is fading. A curious thing about the Savings Glut has been its ability to ‘push on a piece of string.’ Even now, with the US housing boom relapsed into slump: the switch of asset price gains to stock markets, commercial real estate and elsewhere has generated just enough spending to keep US growth at or above its 3% trend rate. But the wealth effect on spending from such asset prices is weaker than the ‘heavy lifting’ achieved by the housing boom. The economy could slow below trend from mid-year, feeling the slow-burn effects of declining house prices. As the absence of a major source of demand is increasingly felt, a hard landing could develop in 2008.”

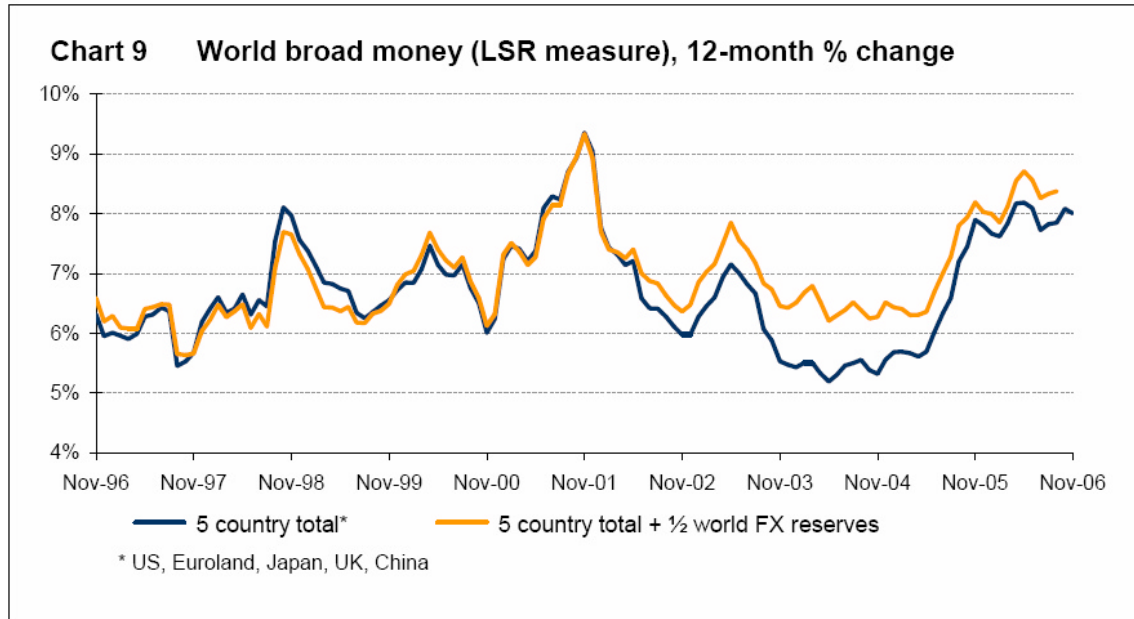
Dumas first started talking about the Savings Glut in September 2004. His latest book is titled “The Bill From the China Shop, How Asia’s Savings Glut Threatens the World Economy.” ([www.amazon.com](http://www.amazon.com))

So why is Sam Zell getting \$37 billion at what is under a 5% return on current cash flow?? Because there is money looking for a home and returns. Dumas says US homeowners are borrowing less, so the savings glut means investors have to be and are willing to take less return on their capital. If you are a pension fund or insurance company, you have to put that money to work.

“The foundation of the flood of liquidity in the world (Chart 9 below) remains the Eurasian savings glut, now rising again after stagnating between 2005 and 2006. As long as deficit countries have sectors – business, households or governments – willing to borrow and provide the savings glut with a home, the flow of capital boosts asset prices, providing the incentive to borrow. This virtuous circle is the process that has underpinned Goldilocks. The problem is that it means stable, on-trend growth requires rising debt ratios to GDP.

“Ultimately this has to stop. The exhaustion of the debt capacity in US housing was always likely to be the beginning of the end of Goldilocks. It still looks that way – especially as the resumed growth of the Eurasian saving glut means the deficits to be absorbed by borrowers are now larger. But the slowdown in the US economy has not been a straight-line process, and the enlarged savings glut, and capital flow, is having a peculiar effect, in the absence of the previous US housing boom: it is in a sense forcing stock markets (and commercial property) into leveraged booms in order to create borrowing elsewhere, as the US household credit spree fades.”

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### Overvalued, Overbought and Overbullish

And all that money looking for a home has the US stock market at what John Hussman's research indicates is overvalued, overbought and over bullish.

Hussman sets three definitions for these conditions. The market is overvalued when the peak earnings to price ratio on the S&P 500 is over 18. It is overbought when the S&P 500 is at four year highs and at least 5% higher than 6 months prior, and overbullish is when Investors Intelligence percentage of bullish advisors is over 53%. He coined the term "ovoboby" to describe the period when all three of his criteria are met.

That doesn't seem like terribly strenuous criteria to me, but those three conditions show up together very few times over the past 40 years, roughly 8 times (there were a few times when the conditions showed up within a few weeks of each other).

What happened afterward? The stock market declined, usually quite quickly. You can see the actual periods at <http://www.hussmanfunds.com/wmc/wmc070115.htm> .  
Quoting:

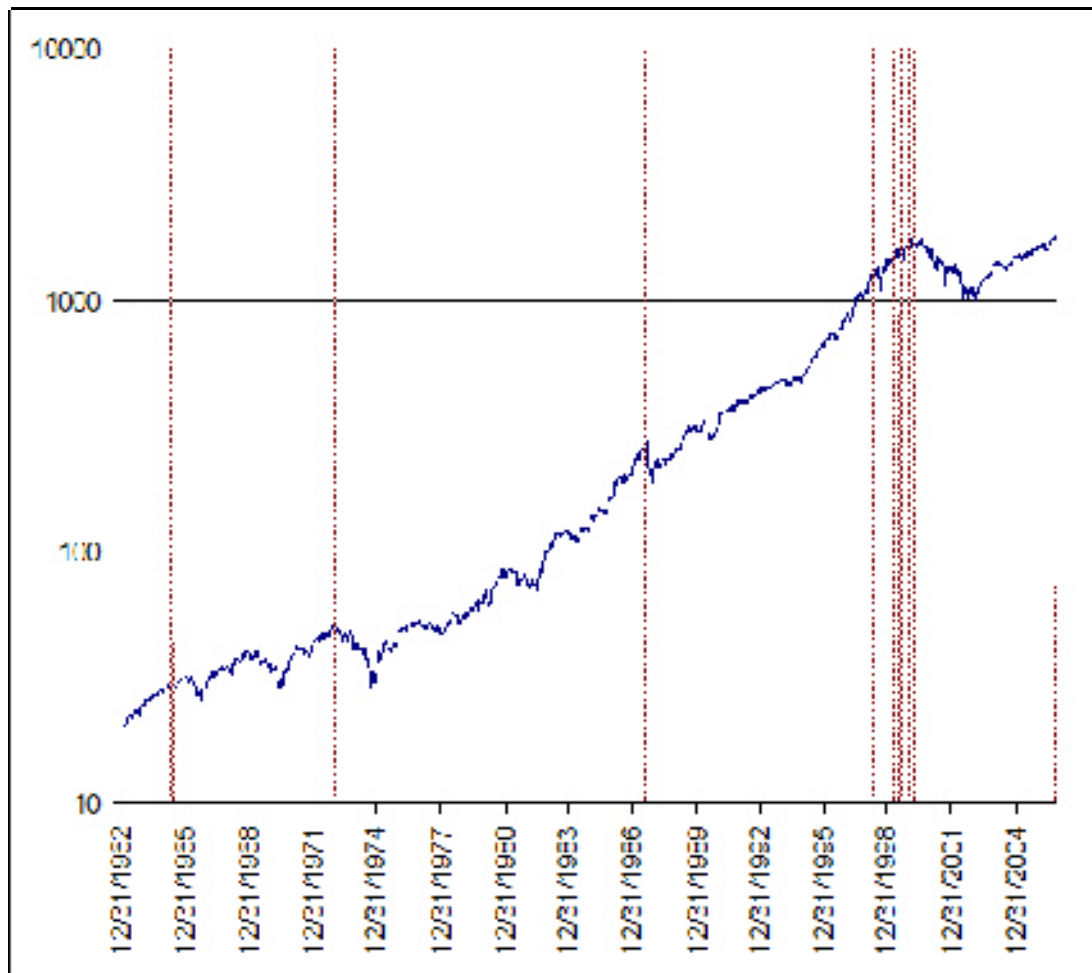
"Reviewing the foregoing instances carefully, one of the striking features that emerges is the abruptness of the declines. -10.5% in 30 days, -12.3% in 50 days, -36.1% in 38 days, and so forth. The first several days of decline from a market peak has often erased weeks and sometimes months of prior net gains. It's that tendency for abrupt declines from overvalued, overbought, overbullish conditions that has held us to a defensive position despite market action that otherwise looks "good" and has repeatedly produced marginal new highs.

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“Normally, market internals deteriorate in a way that provides more time to establish a defensive position – market breadth lags, divergences develop across various industries and security types, price/volume action shows signs of distribution and so forth.

“The overvalued, overbought, overbullish syndrome may present none of those warnings, particularly when there is even modest upward movement in Treasury yields.”

Looking at the graph below let’s you see what happens following the onset of the three simultaneous. Notice that the market can keep right on going up and maybe for quite some time, but that a correction is on its way.



And yes, we are once again at a place where all three conditions are at high levels simultaneously. Typically, the Dow has advanced 2-3% after the onset of the “ovoboby” condition, and then the correction ensued. The current “ovoboby” condition has shown up three times in the last two months: November 17, December 8 and most recently January 12. We’re up about 2% from November. Food for thought.

**When Housing Up 4.5% Is Really Down 4.1%**

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Sometimes you really just have to look under the hood of some of the headlines. I must admit I was rather surprised to read yesterday that housing starts were up 4.5% in December. With both of new and existing home inventories rising, this just did not make sense. But there it was. The TV pundits and the financial press were full of analysts telling us we have seen the bottom in housing.

So much for my thoughts of a housing led recession. Was it the weather? Overly optimistic builders? Or was I just wrong and the bottom in the housing slowdown had been reached quicker than it has in previous housing slowdowns.

It turns out that new home construction did not rise. In fact, if you look at the data, new home construction was down by 4.1%. What was up was multi-family apartment construction which by a very robust 19%.

And that makes perfect sense. Look at the CPI data released yesterday. What has been consistently the biggest source of inflation for the past two years? Rent, or rather, homeowner equivalent rent. It was up over 4% over the last 12 months.

The demand for housing is falling and sub-prime mortgages are harder to get. But people have to live somewhere. The population is growing and the demand for a place to live will rise. And the demand will be in rental units.

Rising prices? Increased demand? Money is cheap and willing to take lower returns? And there are a lot of construction firms that I bet are willing to put in lower bids as new home construction is down. There is a need to keep your employees working. That sounds like a recipe for a lot of people to decide to start building apartments.

But there is one more factor. There is a glut of condominiums almost everywhere. If you go to Google and type in "housing foreclosures" you find several stories in the past few days of high end condominium developers changing their project to lower priced apartment complexes. They have a great deal invested in land and planning and have to do something. Banks are not lending for condominiums without significant guarantees.

Of course, a lot of new apartments means that prices will not rise as much because of more supply. And that means that those looking for housing will have more options, which won't help housing sales.

What triggered my interest in housing foreclosures? Headlines in the business section for the Fort Worth Star-Telegram say that February listings for housing foreclosures are up 15.7% to a new record high. Looking at the plethora of stories on Google, you find that is the case all over the nation.

The stories have a similar ring to them. You can substitute place and data, but they all seem to have a quote like this from the Star-Telegram:

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“...the main factors are job loss, serious illness or divorce. But in recent years, people have run into trouble when the interest rates have risen on their adjustable rate mortgages. Higher energy prices have also been a factor.”

There was a different culprit in Las Vegas and a few markets where “investors” came in and bought homes expecting to flip them before they had to actually take out that mortgage. There was 1 home in the foreclosure process for every 277 households in Clark County (Las Vegas). That is significant.

### Inflation and the Fed: Pay Attention Here

As noted above, we got the inflation data, and it is marginally better than last month. But it still shows core inflation at 2.6% year over year and at about the same annualized level for the month. We are still well above the comfort zone for the Fed.

There were by my count six speeches by Federal Reserve figures this week. Four of them told us that the Fed is concerned about inflation. San Francisco Fed President Janet Yellen laid out the problem faced by the Fed. Essentially, employment is low and wages are rising, which may put upward pressure on prices. This is a recurrent theme for the past many months.

I think you have to take them (Fed governors) at their word. They have said it in so many different ways that to change their tune will really hurt their inflation fighting credentials. It will take some significant show of economic weakness for the Fed to cut rates prior to inflation going below 2% for more than a month or two. We are going to be a 5.25% for at least the next three meetings, barring some real quick downturn that does not seem to be in the cards right now.

### The Rodeo and South Africa

I was born on dairy not too far from Fort Worth, although Dad sold the land a few years later. (If we had kept those 300 acres we would be a much wealthier family today. They are pulling a lot of natural gas from that land, and Ross Perot is developing all around it. Who knew?) I grew up in a small town called Bridgeport out in the near west of Texas. We lived on the edge of town, and I roamed free over neighbor ranches and farms. We would go to rodeos and county fairs for entertainment.

It was a good way to grow up, and one that seems alien to my kids when I talk about it now. But I do try to take them to the occasional state fair and some of the live stock exhibits from time to time. There is something about cattle ranching that is a little bit nostalgic for me. Not enough to make me ever want to pull up stakes and buy a ranch. Way too much work and the nostalgia would get old way too quick.

But every now and then you need to take a trip back in time and remember your roots. Good friends John and Metta Collier have invited me to be their guest at the Fort Worth Rodeo tomorrow night. John is a rancher down around Stephenville, but his real

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forte is telling some of the best stories anywhere. His grandfather helped start the rodeo back in the 1930s and John still has the best front row seats in the house handed down through the family. I am taking my youngest son as a surprise (Dad, the rodeo?), but I bet he has a blast, as John can get us in the back to see everything. The Fort Worth Rodeo is one of the biggest in the world, and quite the show. I am looking forward to it.

The weather here has been cold and nasty. But next Thursday I head for South Africa and summer, getting there on Friday afternoon. My partner in South Africa, Prieur du Plessis of Plexus Asset Management has planned a rather aggressive schedule. (Plexus is the equivalent of Morningstar in South Africa, among other things.) He wrote me with the latest itinerary:

“There are 31 meetings [so far] in total, including appointments with the Minister of Finance, the head of the Financial Services Board (i.e. the South African financial services regulator), politicians, principal officers of some of the largest pension plans, a number of the top local entrepreneurs and 11 investment seminars for about 500 people in total.

“To top it all, you will be interviewed on national TV, national radio and by three financial magazines and two newspapers. And oh yes, you are also the keynote speaker at the prestigious Raging Bull Awards dinner where excellence in the local investment management industry is lauded.

“You are going to have a very busy time, giving credence to the saying that Africa is not for sissies. But then again, we know that they breed them tough in Texas!”

I am actually quite jazzed about it. I have been to 15 countries in Africa, but it will be my first time to get to Durban and Cape Town. And to get on the time zone, we will take a couple of days at Itaga Game Park before we start the non-stop fun and games. I get back two weeks later in time to write a regular weekly e-letter. And then I may take a day or two off. We'll see.

Nothing's worrying me. Have a good week.

Your wondering where he put his big belt buckle analyst,

John Mauldin