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Mo' Money

By virtually any measure the American public today is by far the wealthiest in human history, not the least in terms of financial capital. When too much money chases too few sound opportunities, invariably the "good buys" disappear and risks increase. Today, this circumstance would seem to prevail across most asset classes.

In recent numbers of these *Reports,* we reviewed the current valuations of two classes of widely held assets, stocks and bonds, in relation to their historical performance. Simply stated, stock prices remain historically high despite the recent bear market reverses; and bonds today would seem to carry markedly greater interest-rate risk than they have in four decades. The charts below show the U.S. dollar prices or price indexes in current and constant dollars of three other classes of assets—Swiss francs, real estate, and gold—that in previous market cycles have been widely viewed as long-term hedges against losses in the purchasing power of the dollar.

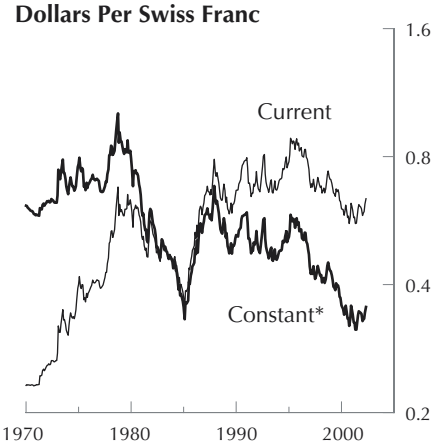
Since the abandonment of the international gold standard in 1933, all world currencies have lost value in real terms, although some, such as the Swiss franc and the former Deutsche mark, historically retained value better than the U.S. dollar and most other fiat currencies. As shown in Chart 1, the Swiss franc appreciated sharply against the U.S. dollar following the collapse of the Bretton Woods regime in 1971, retreated in the early 1980s, and returned again to new current-dollar highs in the late 1980s. Subsequently, and especially following the introduction of the euro, the Swiss currency has lost ground against the dollar in both current and constant dollars. In terms of constant dollars, the Swiss franc now is below its dollar-exchange level in the early 1970s and markedly below its 1979-80 all-time highs against the dollar.

The larger point, however, is that even when the Swiss franc has appreciated sharply against the dollar (as it did between 1985 and 1990) its purchasing power—just as that of all fiat currencies—has continued to erode erratically. The Swiss currency has lost roughly 80 percent of its real value since the suspension of gold convertibility. The remaining question is not whether the Swiss franc will "reverse course" and begin to increase in purchasing power, which would imply a genuine deflation (something that has never occurred with a fiat currency). Rather, it is how quickly its real value might drop in relation to the downside risks of other wasting assets.

Apparently today many believe that real estate, the most tangible of all assets, is among the safest of all investments (especially following the stock market reverses of late) and a reliable store of value. To be sure, land will not "go away." Historically its use as an investment holding, however, has been problematic: real property involves sometimes very significant carrying costs, has no guaranteed liquidity, extraordinary volatility in regional markets, and great sensitivity to regulatory issues (*e.g.*, environmental, occupancy, and tenant-rights laws), interest-rate movements, tax measures, and the like. The value of real property today depends not only on its "location, location, location" but also on a myriad of extra-market statutory and administrative factors. Historically, real property holdings required that owners devote time to managing their property, a burden that many did not wish or were unequipped to assume. To a large extent this concern has been obviated by the proliferation of real estate investment trust (REIT) offerings in the financial markets, and today it is not just developers and professional property managers but also neophyte investors who are fronting the money for all manner of real estate investments.

Throughout the 1970s and much of the 1980s, it was widely believed that real es-

Chart 1
Dollars Per Swiss Franc



* Constant (1982-1984) Dollars.

Chart 2
Total Value of Land
(Billions of Dollars)

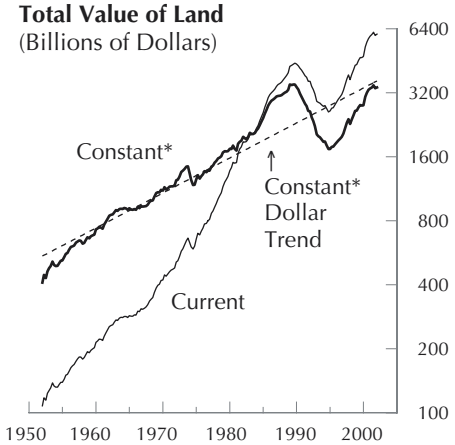
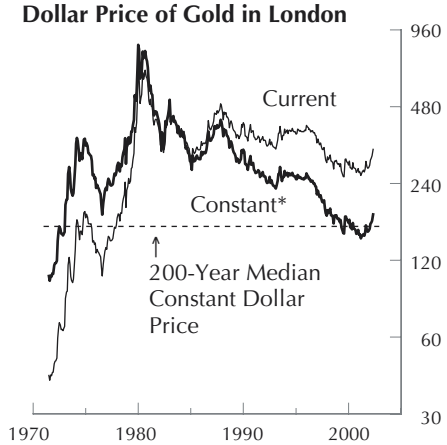


Chart 3
Dollar Price of Gold in London



tate prices could only go up and that real estate therefore was a foolproof investment. The real estate bust of the late 1980s and early 1990s belied such notions, but conventional wisdom still seems to hold that over the long run "you can't go wrong in real estate." Presumably, many who have grown shy of the stock market still regard real estate (especially their residences) as a sound store of value investment. As we have noted in an earlier number of these *Reports*, however, residential real estate prices recently have been propelled by today's low interest rates, which will not last forever. Some homeowners could be in for a serious shock.

In practice, measuring the performance of aggregate real estate investment in the United States is anything but simple. For one, even though land and structures are the most tangible of all assets, there are no adequate measures of their value over time, even in the United States, and the values shown here (derived from the Flow of Funds data) are at best rough approximations. More confounding, so far as determining their investment performance is concerned, most real estate transactions reports are not easily accessible, as are the corporate financial statements from which return-on-investment data for many assets are derived.

While the Flow of Funds balance sheets record the market value of real estate and the replacement value of structures, they do not report the amounts of capital invested in improvements. Inasmuch as the overwhelming proportion of real estate transactions take place between private individuals and the most pertinent information about them (contained in tax returns that report net gains) is not available, currently there simply is no way to compute accurately the return on real estate investment in the United States for any length of time. Eventually, the performance record of REIT products as reported in the several REIT indexes now available should overcome this difficulty. But to date those indexes are of short duration (about ten years)—and yield no information about their long-term prospects. Successful promotions may add luster to the promise of huge gains in the real estate markets—but it often has been only in real estate debacles such as the S&L meltdown scandals that the bottom line has been grudgingly revealed.

Even so, changes in the market value of the land component of real estate investment still may provide a rough approximation of the relative valuation of this asset class, even though calculating that value also must remain imprecise. Chart 2 shows the current and constant-dollar market value of all land in the United States, excluding farmland and land held by corporate financial businesses and the government, with a 50-year trend plotted for the constant-dollar curve. These values were derived from the Flow of Funds data and were calculated as a residual after the "replacement cost of structures" was subtracted from the total value of real estate for non-farm, non-financial holders. Almost surely, this procedure, which imputes possibly much higher values to structures than the reported market value of real estate incorporates, tends to understate markedly the actual value of land. Even so, the data may suggest an approximate relative valuation for this asset class.

As Chart 2 shows, after soaring in the early and mid-1980s, and then plummeting in the late 1980s and early 1990s, the market value of land in constant-dollar terms has recovered to its 50-year trend. In short, while an investment in land may not be the "good buy" it was in the early 1990s, in relation to its long-term trend (and allowing for the imprecision of the residual data that tend to understate land prices), it probably is closer to its long-term trend than some other asset classes, such as stocks.

As shown in Chart 3, in both current and constant dollars gold prices drifted erratically downward after skyrocketing during the 1970s. Although gold was still worth more than in 1971, when the government abandoned all efforts to hold its price at $35 per ounce, by the late 1990s the dollar gold price in real terms had retreated to the level prevailing shortly before the first "oil shock" in 1973. For purposes of this discussion, the more significant point is that the purchasing power of gold had returned to its long-term level—it had regressed to its more than 200-year mean (the horizontal line in the panel). During the past two years the price of gold has recovered somewhat, but in relation to its long-term mean, it currently is neither markedly "over-valued" or "under-valued."

Too Much Money Chasing Too Few Opportunities

In short, unlike in 1974, when gold was relatively cheap, 1982 when stocks were a bargain and long bonds paid 16 percent, 1985 when the Swiss franc was at lows against the dollar, or the early 1950s when real property in many of today's most high-priced locales could be had for a song, today no asset class would seem to offer exceptional value.

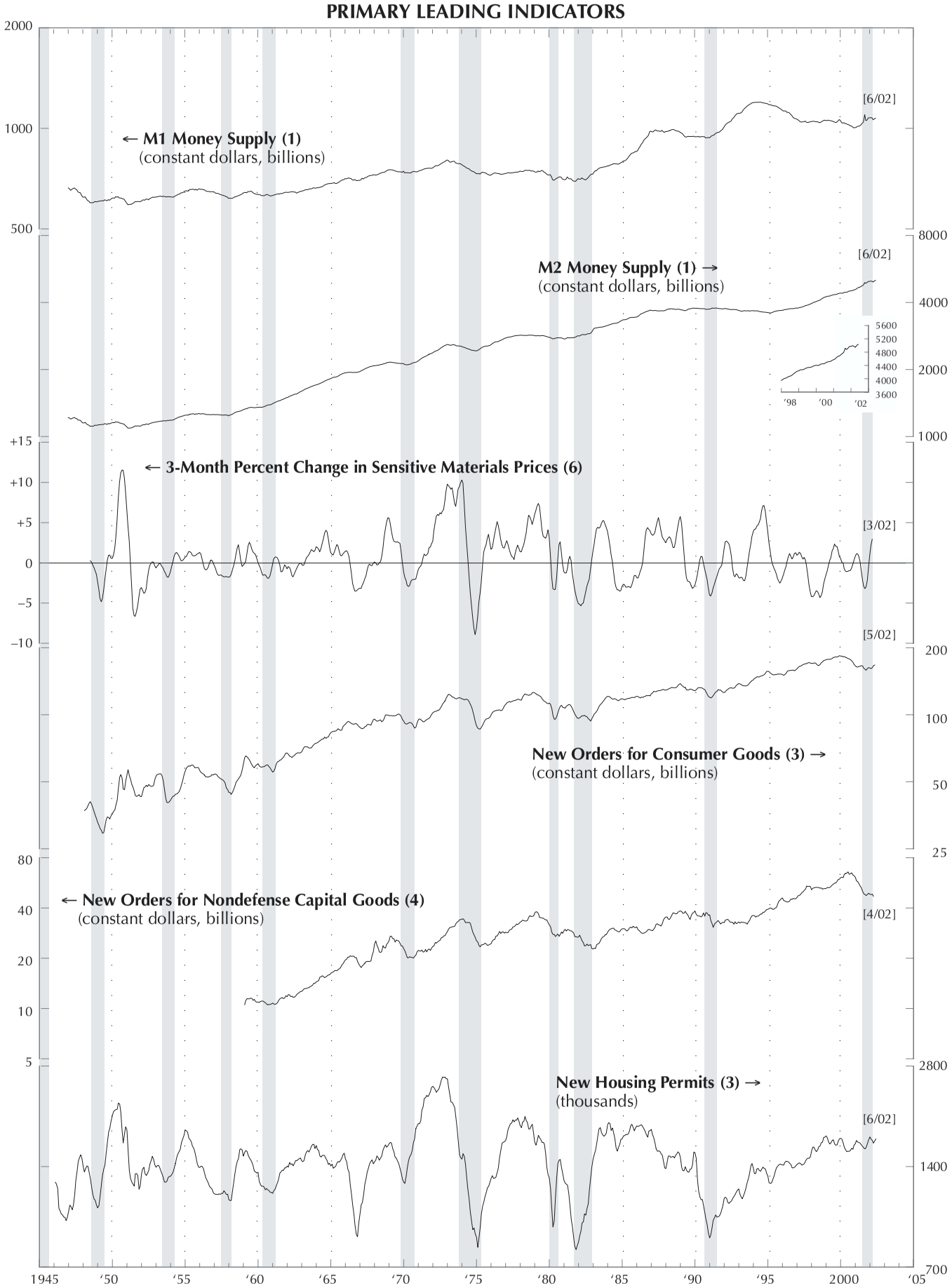
Despite the sharp reverses they have experienced, in relation to their long-term trends many of the assets favored by savers and investors would still appear to be far above their historic lows. (No investment today is riskless, including U.S. Treasury securities that continue to carry inflation risk and even gold, which, while priced favorably in relation to other assets today still carries the risk of confiscation—U.S. citizens were not allowed to own gold between 1934 and 1974).

No one can tell how long this circumstance, in which too much money is chasing too few sound opportunities and which at bottom reflects a relative dearth of sound investment opportunities here and elsewhere, might prevail. Nobody knows when the rest of the world—which under more favorable conditions would see huge capital inflows instead of outflows—might "get its act together" and provide an outlet for "excess" funds that now enter the domestic financial markets.

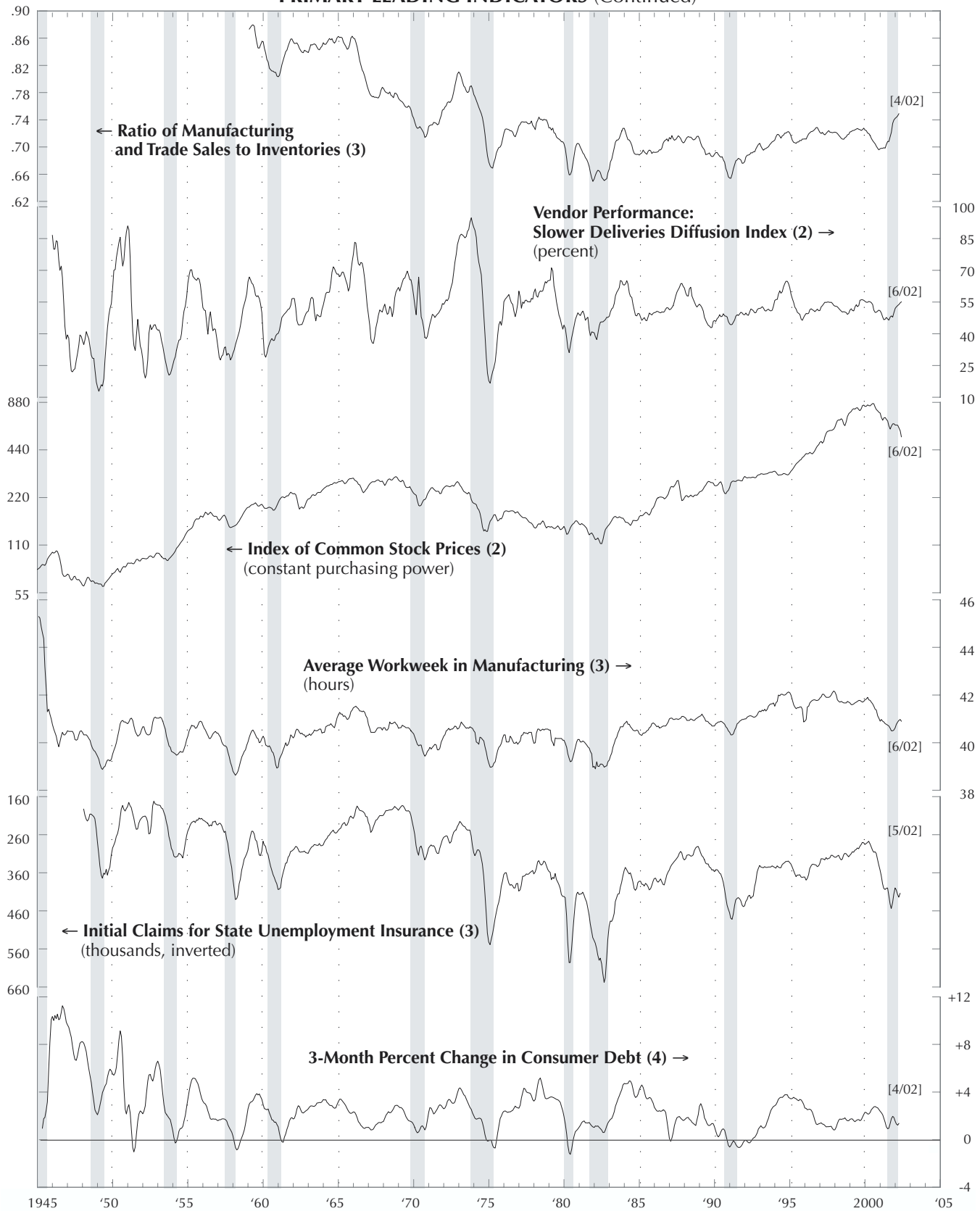
Moreover, regardless of how events turn elsewhere, any number of tax incentives here at home encourage inexperienced "investors" who cannot afford even short-term reverses to throw money at the market no matter how disaffected they may be with the behavior of Wall Street's villain of the day. Whether Martha Stewart actually gets to redecorate a prison cell remains to be seen. But the public's apparent anticipation of the event, which would seem to suggest a certain alienation from the Wall Street crowd, has not as yet markedly dampened their "faith" in the long run prospects of the financial markets or their confidence in the current money-credit regime. To the extent that they have qualms about, say, the stock market, they apparently are fleeing to bonds or, in the current interest-rate and tax environment, taking on huge mortgages to finance up-scale residences. (A significant portion of spending on new housing construction might properly be classified as consumption rather than investment.)

The Temptations of Low Interest Rates

Ironically in view of the government's repeated attempts to stimulate the economy and the financial markets by means of Keynesian easy money policy, it is the current low-interest environment that may pose the most immediate risk to many people. Particularly for elders who depend on current income from their investments, the precipitous drop over the past year and a half in interest paid on savings accounts, Treasury bills, and other short-term or demand-deposit accounts, as well as on certificates of deposit has been dire. Those who invested mainly in T-bills or CDs, for example, may have seen their income cut by as much as three quarters (rates have plunged from over 6 percent to around 1.5 percent). The dan-

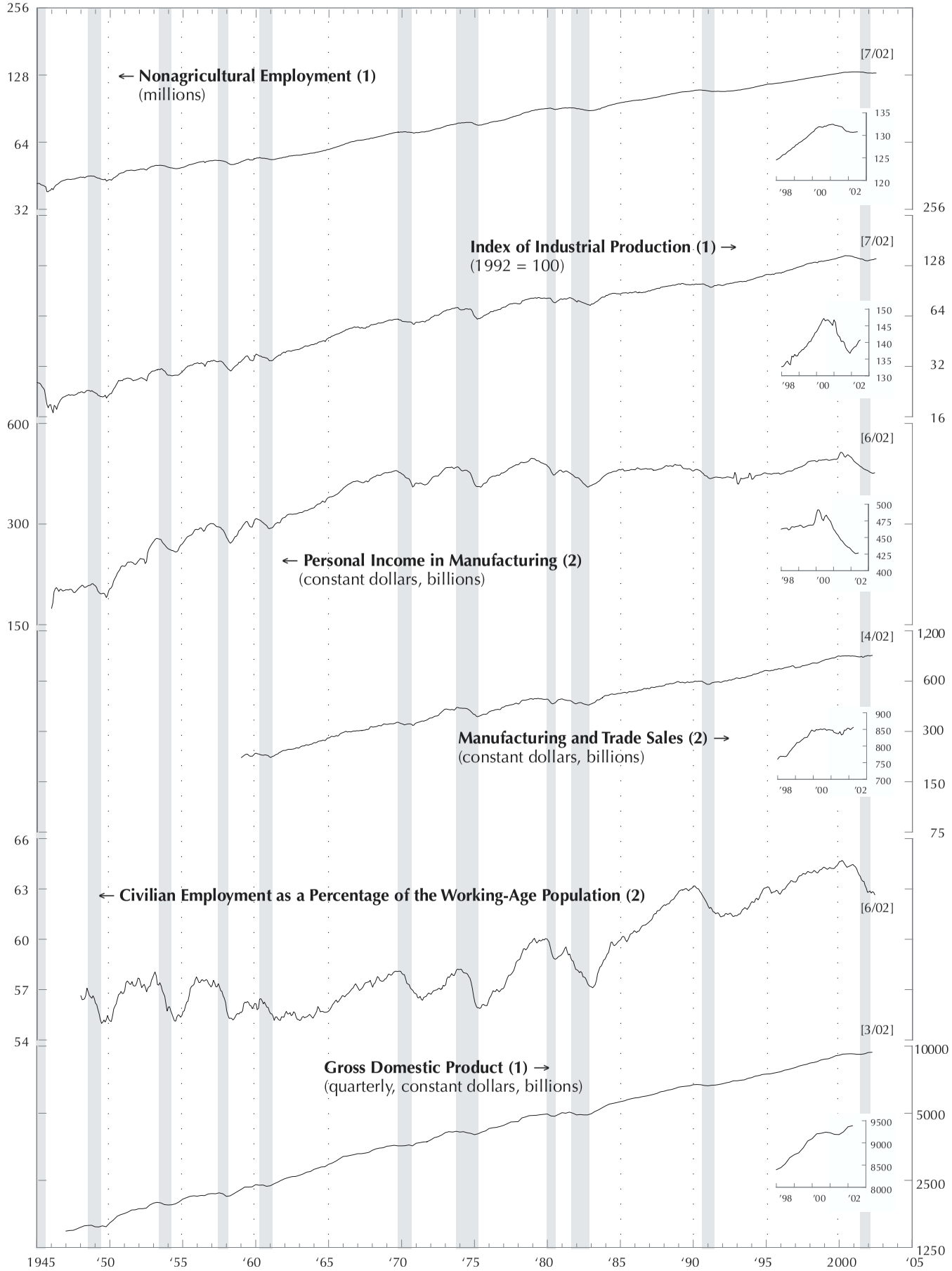

PRIMARY LEADING INDICATORS
← M1 Money Supply (1)
(constant dollars, billions)
[6/02]
M2 Money Supply (1) →
(constant dollars, billions)
[6/02]
← 3-Month Percent Change in Sensitive Materials Prices (6)
[3/02]
New Orders for Consumer Goods (3) →
(constant dollars, billions)
[5/02]
← New Orders for Nondefense Capital Goods (4)
(constant dollars, billions)
[4/02]
New Housing Permits (3) →
(thousands)
[6/02]
2000
1000
500
8000
4000
2000
1000
+15
+10
+5
0
–5
–10
200
100
50
25
80
40
20
10
5
2800
1400
700
5600
5200
4800
4400
4000
3600
'98
'00
'02
1945
'50
'55
'60
'65
'70
'75
'80
'85
'90
'95
2000
'05

PRIMARY LEADING INDICATORS (Continued)

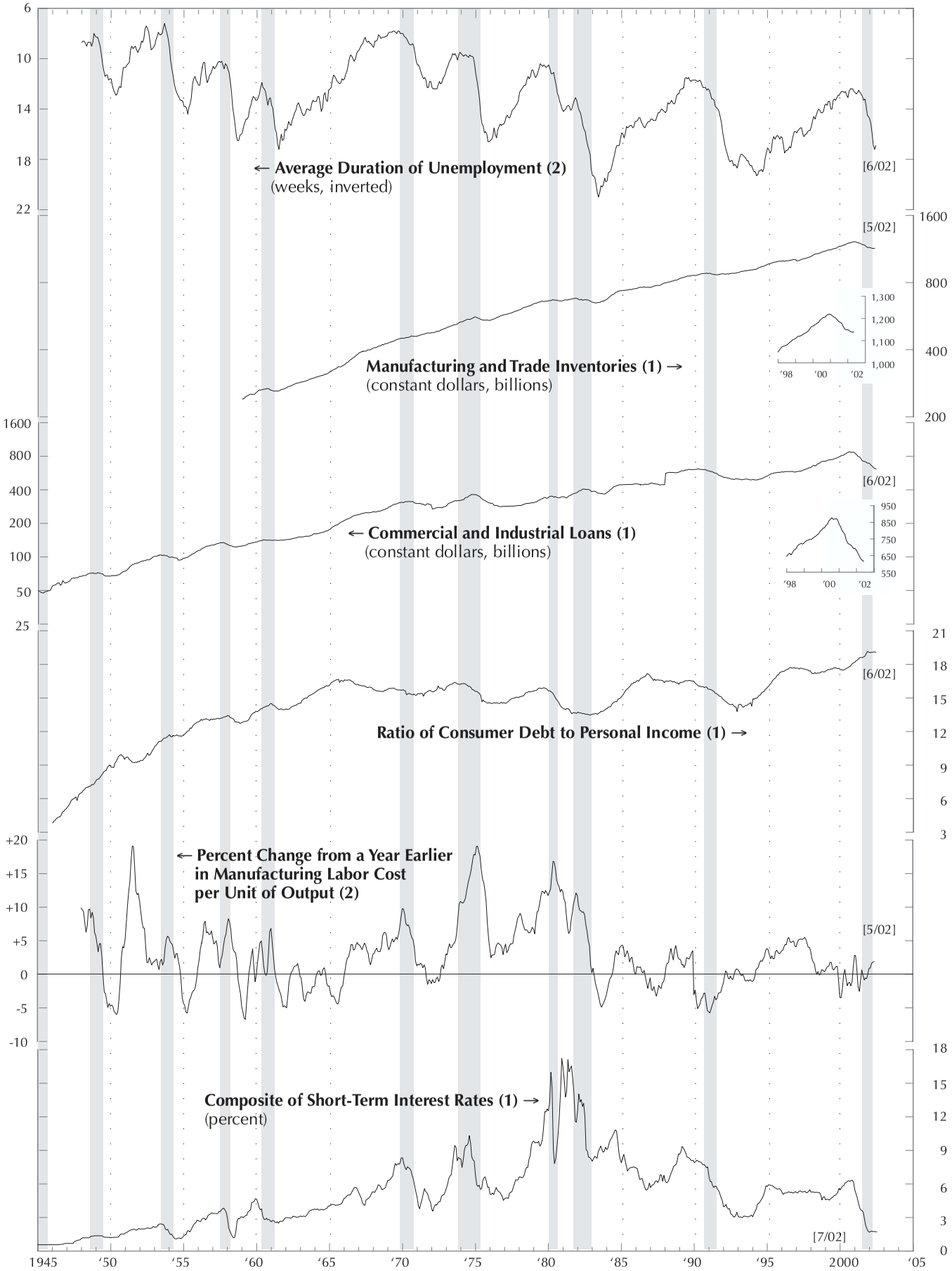


Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research. 2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data. The number in brackets is the latest month for which the moving average is plotted. 3) The insets in selected charts show recent trends more clearly. These insets have arithmetic scales, even when the main chart is plotted on a ratio scale.

PRIMARY ROUGHLY COINCIDENT INDICATORS



PRIMARY LAGGING INDICATORS



ger, of course, is that they may be tempted to restore their income stream by resort to far riskier issues than is prudent for their situation—say in deep discount junk bonds or highly leveraged securities.

Even today's low-interest mortgage rates, which are heralded by most economists (and all realtors) as a boon to the housing markets and therefore the economy as a whole, contain unanticipated risks. For the binge of mortgage refinancing that has contributed to soaring bank profits and propelled residential real estate prices higher has had at least one other consequence. Reportedly, many mortgage holders have taken the new low rates as an opportunity to "monetize" their personal debt. In short, refinancing for many has not alleviated the burden of debt, but has simply put more cash in their pockets to fund higher consumption.

Hiding It Under the Mattress

This situation, which seems mainly a product of today's fiat money-credit system, would seem to contrast sharply with the experience of Depression-era savers and investors, whose response to the vicissitudes of the market then was unmistakably hostile to the barons of Wall Street, bankers, and financial institutions in general. During the Great Depression and for decades afterward, many American savers harbored a profound distrust of both brokers and bankers. In the wake of the stock market crash, bank runs and failures, foreclosed mortgages, lost savings, and President Roosevelt's fabled bank holiday—when no one could get deposits out of even failing banks—by the mid-1930s many had concluded that the safest place for their funds was at home under the mattress.

With prices actually dropping, a mortgage was anathema and storing cash at home or in some other secure location may very well have been preferable to placing funds with shaky financial institutions that might not be expected to survive the nation's worst economic calamity.

For most, "hiding it under the mattress" is neither prudent nor practical in today's world. Today, most transactions are cashless, and those who deal mainly in cash become targets of official scrutiny—as suspected drug dealers, money launderers, tax evaders and the like. And unlike the deflationary 1930s, today's chronic monetary inflating guarantees that cash kept under the mattress for any length of time will lose purchasing power.

Rather, today's financial environment would seem to require first and foremost a disciplined long-term approach to virtually *any* investment strategy. As often as not, however, scarce opportunities encourage imprudent behavior, and today is no exception.

A Genuinely Safe "Investment"

In today's risky financial world, for many there still is one genuinely safe "investment." Very simply, instead of monetizing personal debt to finance more consumption, almost any debtor can guarantee an after-tax return equal to the interest paid on a credit account by investing funds that might otherwise go into a lower-yielding asset to reduce the outstanding balance owed.

On most credit card accounts, which reportedly now carry average balances in the thousands of dollars, the guaranteed annual yield on such an investment ranges between 9 and 20 or more percent, depending on the rate now charged. Not only is this return vastly greater than anything available in today's market, but it will be highest for the least creditworthy. In short, it is a "socially responsible" form of investment that is guaranteed to benefit most those with the greatest debt burden—if they exercise the required discipline.

For most mortgage holders, assuming there is no pre-payment penalty, an investment in paying down the outstanding principal balance probably will yield, on an adjusted (for the reduction in deductible interest payments) after-tax basis, somewhere between 4 and 6 percent.

In today's market, one could do much worse. ❑

BUSINESS-CYCLE CONDITIONS

Although robust expansion is not likely to be forthcoming in the near term, the prospects for further economic growth remain favorable.

Added to the pounding Wall Street has taken in recent weeks, the latest round of news that the Index of Consumer Sentiment is at a six-month low and that the Conference Board's leading index decreased 0.4 percent in July, certainly is grounds for concern. However, despite some weakness among this month's latest batch of data, our statistical series indicate that the recovery is likely to continue.

Three of our twelve primary leading indicators reached new highs, including *M2 money supply*, the 3-month *change in sensitive materials prices*, and the *ratio of manufacturing and trade sales to inventories*. (M2 and all other dollar-denominated series are reported in constant dollars.) All three series remain appraised as clearly expanding. Six other leaders are expanding, two are contracting, and one is indeterminate.

Although *vendor performance*—the percentage of purchasing managers reporting slower deliveries from their suppliers—decreased from 55.2 to 54.9, the series has a clearly established upward trend. *Initial claims for state unemployment* (inverted) now also is clearly expanding. New claims in June averaged 393,100 per week.

New orders for consumer goods decreased, as did *new housing permits*. The former series decreased 2.5 percent, whereas the latter fell 0.5 percent to a seasonally adjusted annual rate of 1,698,000. However, both series remain appraised as probably expanding.

The *average workweek in manufacturing*, which decreased from 41.1 hours to 40.7 hours, was downgraded to probably expanding after being upgraded last month. Although *M1 money supply* increased in May and June, the series also remains appraised as probably expanding.

New orders for non-defense capital goods plunged 9.1 percent in June and was downgraded to probably contracting. Owing to a late release of the CPI, there were no new data for the *index of 500 common stock prices* last month. Data reported since then reveal that the series decreased 6.1 percent in June and another 10.9 percent in July, establishing a clear downtrend for the series.

One series remains indeterminate. The heavily-smoothed 3-month *percent change in consumer debt* increased for the fourth consecutive month, but the amounts have been too small to clarify its cyclical status.

As a result of this month's changes, 82 percent (nine out of eleven) of the leading indicators for which a cyclical trend is apparent are appraised as expanding, down from 90 percent (nine out of ten) in July. The cyclical score, which is based on a separate, purely mathematical analysis of the leaders, was unchanged at 54. Although this month's base data raise concern, no statistical warrant yet exists for revising our assertion that the recovery is likely to continue.

There was modest improvement among the six roughly coincident indicators this month. *Industrial production* increased for the seventh consecutive month, rising 0.2 percent in July, with 60.5 percent of industries reporting increased production (over six-month spans). Although *manufacturing and trade sales* fell 0.2 percent, the series' 2-month moving average reached a new cyclical high. Both series are clearly expanding.

Gross Domestic Product (GDP) growth slowed from an annual rate of 5.0 percent in the first quarter of 2002 to just 1.1 percent in the second quarter. The series remains appraised as clearly expanding. Revised estimates indicate that the downturn was longer and deeper than originally reported last year. New GDP data show that the economy contracted in each of the first three quarters of the year (not just the third), and growth for 2001 was 0.3 percent, down from 1.2 percent.

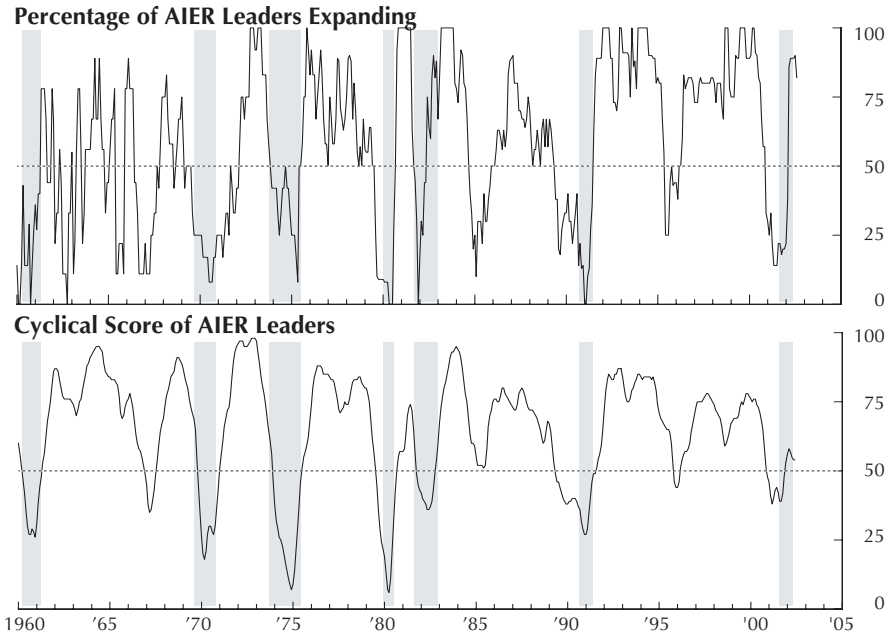
Nonagricultural employment was flat in July, increasing a mere 6,000 jobs. Gains in the service sector were offset by losses in both construction and in manufacturing, which shed 30,000 and 7,000 workers, respectively. The job situation has changed little since February and the series remains indeterminate. *Personal income in manufacturing* increased 0.2 percent in July, matching June's gain. The improvements warranted upgrading the series from clearly contracting to indeterminate.

The only downgrade among the coincidents this month involved the *civilian employment to population ratio*, which fell to 62.6 percent and is now clearly contracting. This month's changes increased the percentage of roughly coincident indicators expanding to 75 (three out of four) from 60 (three out of five).

Three of the six lagging indicators have clearly established downtrends, namely *manufacturing and trade inventories*, *commercial and industrial loans*, and the *percent change from a year earlier in manufacturing labor cost per unit of output*. After decreasing in July to 16.4 weeks, some doubt now exists as to whether the *average duration of unemployment* (inverted) is contracting.

The decrease in the *ratio of consumer debt to personal income* was sufficient to render its cyclical status indeterminate However, as can be seen in the accompanying historical charts, the series remains near its record high. In contrast, the *composite of short-term interest rates*, at 1.71 percent, continues to linger near its 40-year low, where it remains indeterminate. At its policy meeting on August 13, the Federal Reserve kept its target for the federal funds rate unchanged at 1.75 percent, but changed its policy stance from neutral to accommodative.

Overall, 0 percent (zero out of four) of the lagging indicators with an apparent cyclical trend are appraised as expanding, compared with 20 percent (one out of five) last month. Except for the possible debt overhang among households, there are no signs of recovery-thwarting bottlenecks developing. On the other hand, the apparent weakness is also evidence that this recovery has been relatively feeble. ❑



Statistical Indicators of Business-Cycle Changes

Change in Base Data Apr.	May	Jun.	Jul.		*Cyclical Status* Jun.	Jul.	Aug.
				Primary Leading Indicators			
-	+	+		M1 money supply	+?	+?	+?
-	+	+		M2 money supply	+?	+	+
+	-	-		Change in sensitive materials prices	+	+	+
+	-	-		New orders for consumer goods	?	+?	+?
+	+	-		New orders for nondefense capital goods	?	?	-?
+	+	+	-	New housing permits	+?	+?	+?
+	-			Ratio of manufacturing and trade sales to inventories	+	+	+
+	+	+	-	Vendor performance	+	+	+
-	-	-	-	Index of common stock prices (constant purchasing power)	-?	-	-
-	nc	+	-	Average workweek in manufacturing	+?	+	+?
-	+	+		Initial claims for unemployment insurance (inverted)	+?	+?	+
+	+	+		Change in consumer debt	?	?	?
				Percentage expanding cyclically	*89*	*90*	*82*
				Primary Roughly Coincident Indicators			
-	+	+	+	Nonagricultural employment	?	?	?
+	+	+	+	Index of industrial production	+	+	+
-	-[r]	+	+	Personal income in manufacturing	-	-	?
+	-			Manufacturing and trade sales	+?	+?	+
-	+	-	-	Civilian employment to population ratio	-?	-?	-
+	+	+		Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	*60*	*60*	*75*
				Primary Lagging Indicators			
-	-	-	+	Average duration of unemployment (inverted)	-	-	-?
-	+			Manufacturing and trade inventories	-	-	-
-	-	-		Commercial and industrial loans	-	-	-
+	+	-		Ratio of consumer debt to personal income	?	+	?
-	+	-		Change in labor cost per unit of output, manufacturing	-	-	-
-	+	-	-	Composite of short-term interest rates	?	?	?
				Percentage expanding cyclically	*0*	*20*	*0*

nc No change. [r] Revised.

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

PRICE OF GOLD

	2000	*2001*	—— *2002* ——	
	Aug. 24	*Aug. 23*	*Aug. 15*	*Aug. 22*
Final fixing in London	$272.60	$274.85	$312.65	$305.40

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