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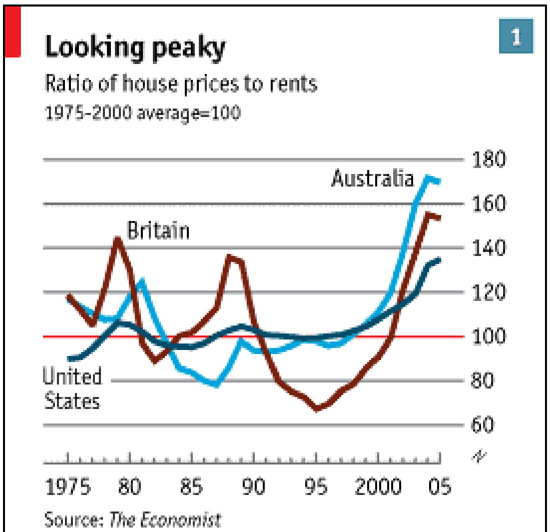
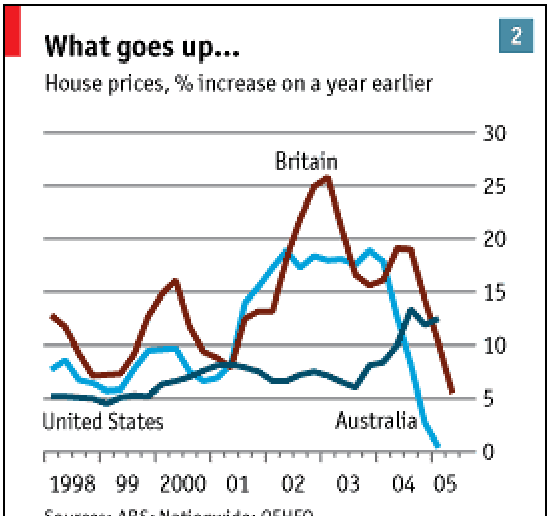
ALL ABOARD THE HOME WRECK EXPRESS

I had hoped to avoid the topic of the global housing mania for at least another week, but it has forced itself upon us from every direction, not least *The Economist* and *Barron's*. "According to estimates by *The Economist*, the total value of residential property in developed economies rose by more than US$30trn over the past five years, to over US$70trn, an increase equivalent to 100% of those countries' combined GDPs. Not only does this dwarf any previous house-price boom, it is larger than the global stock market bubble of the late 1990s (an increase over five years of 80% of GDP) or America's stock market bubble in the late 1920s (55% of GDP). In other words, it looks like the biggest bubble in history." Such hyperbole cannot easily be dismissed. What residential housing shares with equities is a capacity for sharp price appreciation *of the whole asset class* on the basis of transactions involving a tiny proportion of the asset stock. In the case of unrealised gains on equities, only the favoured few are able to use these as collateral for other purchases. In the case of real estate, the opportunities for additional borrowing (equity withdrawal) are widely available. Hence the macroeconomic impact of a 10% increase in real house prices is many times larger than that of a 10% increase in real equity prices. Conversely, the same is true of a 10% real price decline. In Australia and the UK, this scenario looks to be a distinct possibility. Asking prices for UK homes have hit a brick wall (excuse the expression) this Spring, reducing their annual inflation rate to 2.4%. Sharp decelerations in house prices in Ireland and New Zealand suggest that they will be next. But far and away the most significant context for the evaporation of house price revaluation is the US. The overvaluation of house prices in relation to rents, shown in the left hand panel, is less severe in America but this conceals some diverse experiences between the coastal states and the interior. So, the critical question revolves around the dynamics of the US housing mania: how long can it continue and what will be the consequences of its demise? The answer to the first has as much to do with



Source: *The Economist*



Sources: ABS; Nationwide; OFHEO

international appetites for US asset-backed securities as with the domestic demand for property. The thirst for MBS paper – yielding the magic 6% – creates a demand for structured product that requires new mortgages to be originated, typically in the most outrageously-priced districts. James Montier, in a recent strategy piece for DrKW, draws the parallel between investors who were "happy to buy firms with no track record of earnings and value them on the basis of clicks and eyeballs during the dot.com years" and borrowers taking on interest-only adjustable rate mortgages with a loan to value ratio of over 90% and an income gearing of 4 or 5. He might equally have made the comparison with the MBS investors who fail to question the lending standards that are feeding their pipeline. US Fed governor Susan Schmidt Bies expressed concern last week over "affordability products", namely interest-only loans, negative amortizations and second mortgages with high loan-to-value ratios, noting that sub-prime lending is growing faster than prime lending and that ARMs account for 40% of new loans, the highest rate since 1994. Montier chronicles the growth of sub-prime lending from 8% of total in 2002 to 17% of total last year, and from US$235bn in 2002 to US$550bn in 2004.

The consequences of removing the quantitative housing credit stimulus from the US economy, let alone replacing a positive with a negative, seem to be massive. Household purchasing power and employment incomes would be reduced significantly. This is the discontinuity scenario that has the capacity to shatter the reputations of the forecasters. Doubtless we shall return to this topic soon.

OIL MARKET: TIGHT AS A DRUM

This reassessment from Raymond James Associates, Inc: "Going forward, we believe that the oil markets have entered a new paradigm where chronically low excess OPEC production capacity will likely lead to increased price volatility, along with generally higher average prices. Meanwhile, non-OPEC supply is facing an uphill battle, with most mature producing regions in decline and *dramatically decreasing growth rates in Russia*. Additionally, we had expected Saudi Arabia to be able to increase capacity by 0.5MMBbls/day annually for the next two years, but this now seems too optimistic." "All this leads us to raise our long-term oil price deck again, from US$47 to US$52."

JON THORN ON THE RELIANCE RESOLUTION

Jon has drawn our attention to the favourable outlook for the Indian equity market in the light of the agreement that ends the 7-month feud between the Ambani brothers and which brought about an exodus of foreign investors from the stock. As India's largest non-state company, its fortunes are intertwined with the Indian stock market. Jon comments: "We are currently waiting for the details of the final financial settlement and will be watching to ensure that our Shareholder interests are not in any way impacted but at this stage that seems to be OK. We hope this should be positive for the Market, as Reliance is a sentiment mover. Also it has just started to rain in Bombay which also usually has a positive effect on Market sentiment (when the Monsoon starts there)."

MARC FABER ON THE CASE FOR AGRICULTURAL COMMODITIES

This section of the latest GBD Report begins on page 12 and Marc assembles some diverse elements of the case for agricultural commodities such as corn, wheat and soybeans. To summarise, as best I can, the first argument is that the climate has entered a more extreme and unpredictable phase as identified some time ago by Evelyn Browning-Garris, whose Browning Newsletter we distribute. Heat waves and droughts are becoming more common and more likely to disrupt the raising of crops. Second, Marc cites evidence that the area harvested for wheat is in decline, having peaked in the late-1970s at levels about 13% higher than in 2002. Wheat yields per unit area have levelled off in recent years after a monotonic increase averaging 2.2% per annum since 1960. Third, unlike industrial metals, agricultural product prices have yet to respond to the prospect of disrupted and/or stagnant supply. Marc warns that investment opportunities in these commodities are few, but mentions a couple of possible ways to gain exposure.

UK PUBLIC FINANCES: RESPITE OVER

Soaring oil tax revenues have been very helpful to the UK Exchequer in the past 18 months, helping to give the impression of stabilisation in the public finances. The release of the May figures this week has brought us down to earth with a bump. Total current receipts of central government rose 7% last year but are now decelerating as the growth of oil tax revenues fails to match the uplift last year and as VAT revenue growth mimics the path of retail sales value growth. Current expenditures, which grew by almost 10% in 2003, have slowed to a 5% pace but this will not be sufficient to stabilise the deficit in 2005-06. Either spending must be cut or taxes will rise. With perfect timing, the Inland Revenue has announced that the income tax burden has become even more concentrated on higher-rate taxpayers. Just 3.6m people are paying £73.2bn of income tax, representing 55% of the total. This year it is expected that 200,000 more people will be drawn into the higher-rate (40%) tax bracket, giving Gordon Brown the benefit of fiscal drag (also known as bracket-creep).

FINALLY

A few places remain for the dinner with Charles Peabody on Tuesday 5th July in The Library, at the Lowndes Hotel. In view of the importance of US housing, mortgage securities and structured products to the financial and economic outlook, I urge any waverers to sign up as soon as possible. Names to Patricia, please.

Peter Warburton

UK RULES EU?

As Europe continues to recoil from the 'double whammy' of the constitutional rejection and the failure to agree a budget, the recriminations have begun to fly. Every EU member is keen to blame someone else, but most are united in blaming the UK. It is easy to see why Tony Blair should carry the can for the budget failure. After all he was the one who vetoed it, making it is easy for the others to single out the UK for the accusation of being selfish and greedy. It is harder to see that the failure of the constitutional referenda was Tony's fault, but that is the way it is seen in Europe: 'If only Tony Blair hadn't promised a referendum in the UK, Jacques Chirac, who had adamantly opposed the idea, would not have felt obligated to hold a referendum in France, too'. The rest, as they say, is *histoire*.

But, with a little time for reflection, the verdict has become less harsh. *Der Spiegel*'s roundup of the European press concluded that, "Sifting through the wreckage of last week's European Union summit in Brussels, German editorialists find two areas of agreement … First, Tony Blair did act like a schmuck. Second, he's totally right about the colossal agricultural budget – it needs to be axed." There is an increasing recognition that the 'winds of change' are beginning to blow through the EU. The Blair/Brown vision of a reformed EU may not be popular in the EU's heartland at the moment but, as *Berliner Zeitung* put it, "In the Netherlands, Sweden and possibly Spain, it has potentially strong allies for this concept. The idea is that Schröder and Chirac will soon be replaced by more pro-British leaders." With most of the new EU members also sympathetic, there is still hope that something positive can emerge from the debacle – if only the EU can survive the next couple of years.

EU RULES UK?

But should the UK even want the EU to survive? Patrick Minford of Cardiff Business School is the man to provide a whole-heartedly jaundiced answer. The title of his recent book 'Should Britain leave the EU? An economic analysis of a troubled relationship' rather gives his prejudices away, but the work is typically thorough and closely argued, even if its bias is transparent. The book received wide press coverage, but the best synopsis came from the man himself in a recent *Guardian Unlimited* article. Professor Minford tots up the costs to the UK of the EU's raft of protectionist measures (the CAP is only a small part of it): "Add them all up and you get an alarming potential total of up to 20% of national income". There are at least two serious points here. First, while Minford's maths may be elastic, the costs of regulation and protection are indisputably large. And, secondly, the solution: "we must hope that we can press our EU partners to adopt free markets and competition". That could yet prove to be Tony Blair's great legacy – if only the EU can survive the next couple of years.

Robin Aspinall

CHINA: LONG AND WINDING ROAD

The western view of China's development is still moving through the range of emotions. Initial amazement at the raw energy and sheer size of the numbers has given way to fears of being overtaken in the great economic race. Now that fear is giving way again to, if not cynicism, at least a willingness to look a little more carefully at the numbers. The *FT*'s 20 June edition reflects this mood with a full-page analysis article on China's leading state banks: 'China's banks smarten up as they switch from state control to commercial lending'.

The article is generally optimistic, reporting on substantial restructuring steps taken by Chinese banks in recent years: ICBC has cut its workforce by 130,000 from 500,000 over five years; the big four have reduced the number of branches from 160,000 in 1997 to 80,000 in 2003; and (the reason for the article) foreigners are being allowed to invest, with Bank of America announcing its purchase of a 9% stake in CCB. Nonperforming loans have also been reduced: ICBC's bad loan ratio has been cut from 47.5% in 1999 to 19% at end 2004. A dramatic improvement, but there is clearly still a long road to travel.

In fact, the stakes are seen as high, not just for China but for the whole world: "failure to fix the banking sector would eventually become a significant drag on China's economy… prolonged Chinese slowdown would deprive the global economy of a big engine of growth… fallout would hit international commodity prices… as well as depress exports, especially from Japan and south-east Asia." What is the likelihood of success? That thought is not followed up, but a managing director of Citigroup in Hong Kong is quoted as saying that the frequency and seriousness of recent corruption scandals at state banks "raise questions about… the inevitability of a banking crisis".

JAPAN: … HAS LEFT A POOL OF TEARS

If China has a long and winding road to travel to sort out its banking system, it is as nothing compared with the daunting pilgrimage to Japan's holy land of sound government finances. The first step of that pilgrimage was taken this week with the issuing of a series of proposals by the tax commission. Both the *Nikkei* and the *FT* report on these proposals (the *Nikkei*, not surprisingly, at greater length), though neither offers much comment. Rather, there is a sense of stunned silence as they attempt to understand the implications of a package with a lot of details. The *FT* article is in the 22 June edition and is optimistically entitled 'Japan plans overhaul of tax system'.

Three things are clear. First, this is just the start of a marathon. The aim is to undertake drastic reform of the tax system in four or five years, according to the commission chairman (well, you weren't expecting a sense of urgency, were you?). Second, Mrs Watanabe is going to have to get used to paying more tax. The *FT* reports a comment by Mr Ishi, chairman of the commission, that the tax burden would have to be raised from 36% of GDP to 50% if public services are not to be slashed. This week's plans focus on income tax, but there is also already talk of a hike in the consumption tax. Third, there is likely to be much barging and crashing before even the first 100 metres of the marathon can be run. The *Nikkei* heads an analysis column 'Tax Panel's Reform Proposals Face Uncertain Future', which says it all in anticipation of political and popular debate starting. It is heartening that the country should actually be looking seriously at the route map. That is not (yet) the same as a willingness or determination to embark on it.

Robert Brooke

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