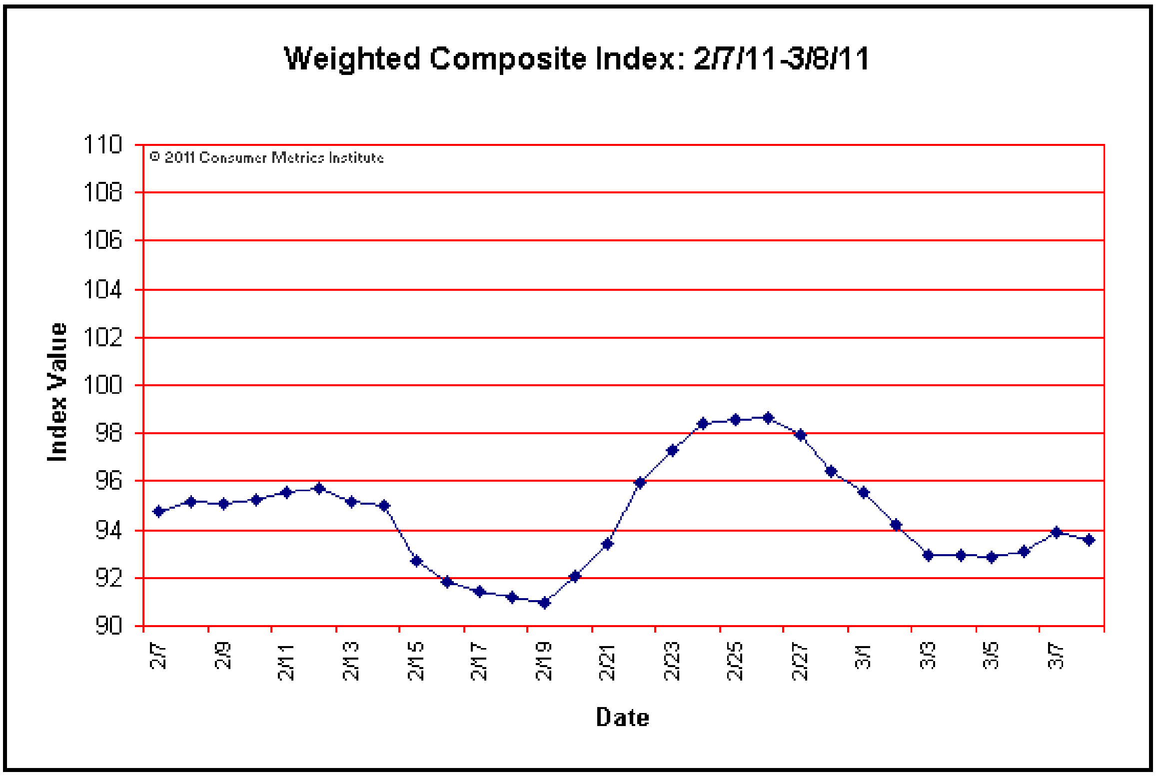
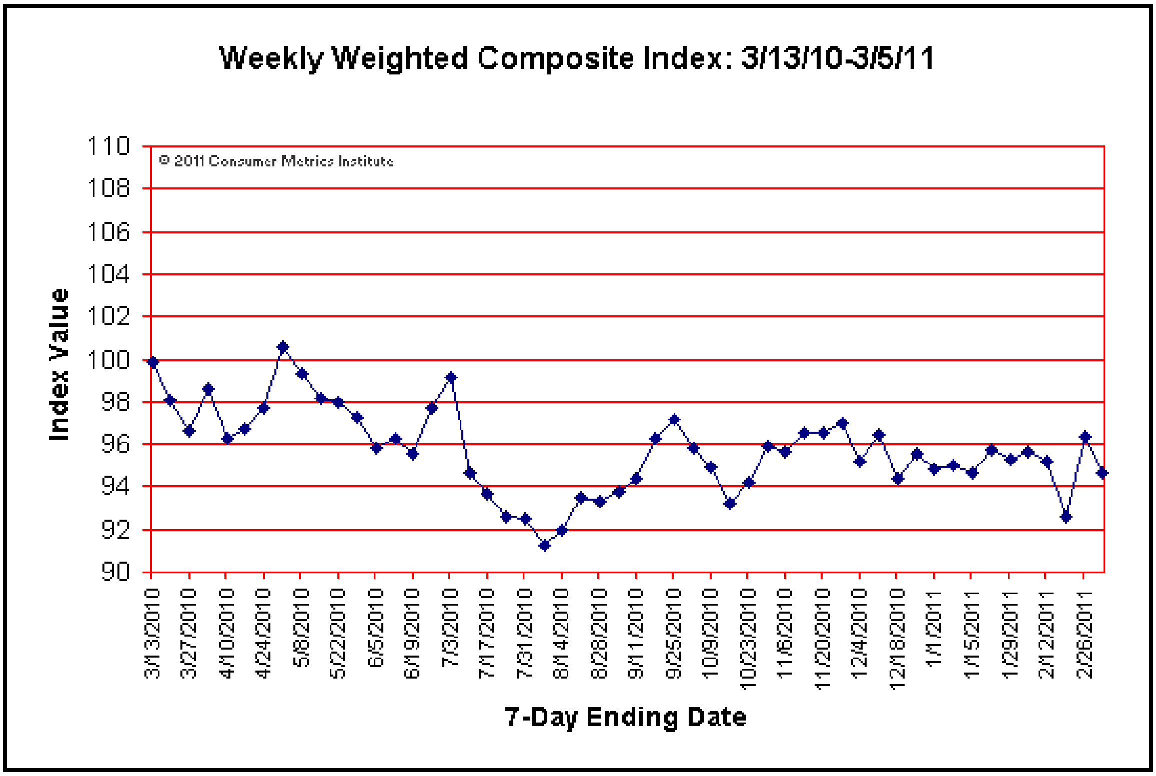
# Consumer Metrics Institute Members News

## February 23, 2011: Recent Downturns in Our Indexes & the Fallacy Revisited

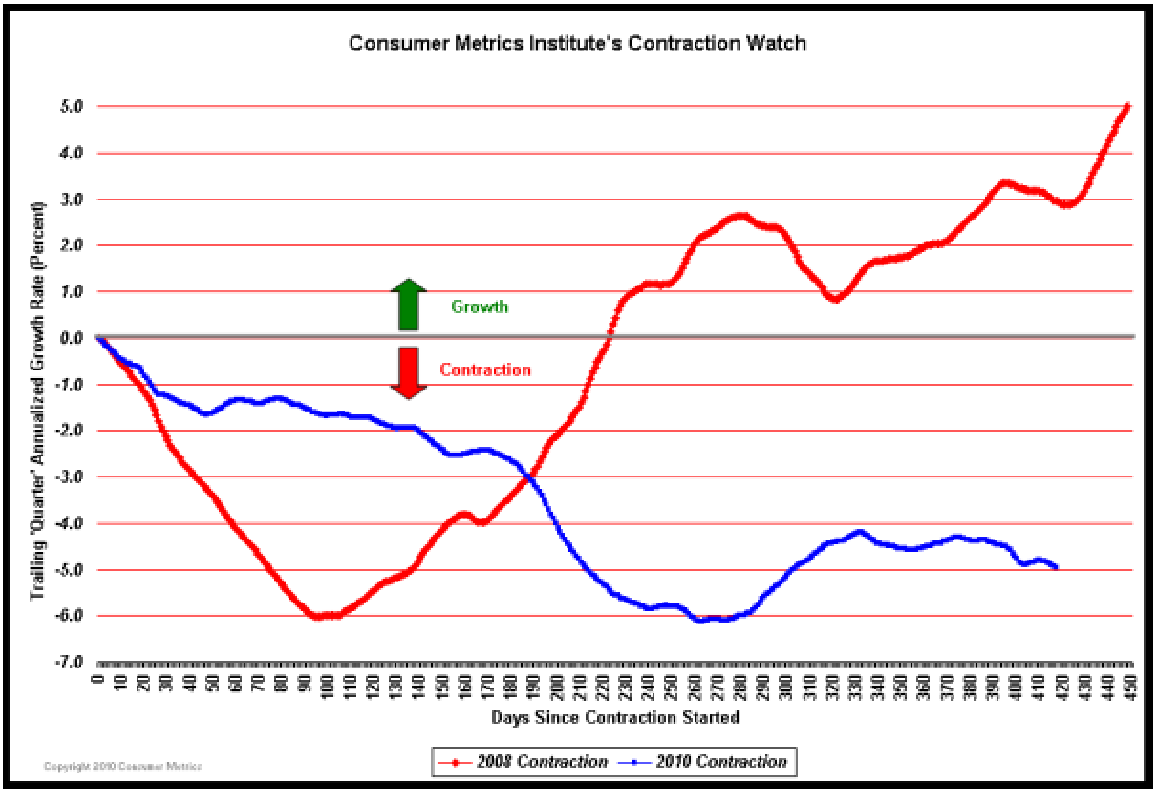
A number of our indexes have recently turned sharply lower. The changes in the activity that we monitor can be clearly seen in the very short term daily Weighted Composite Index:



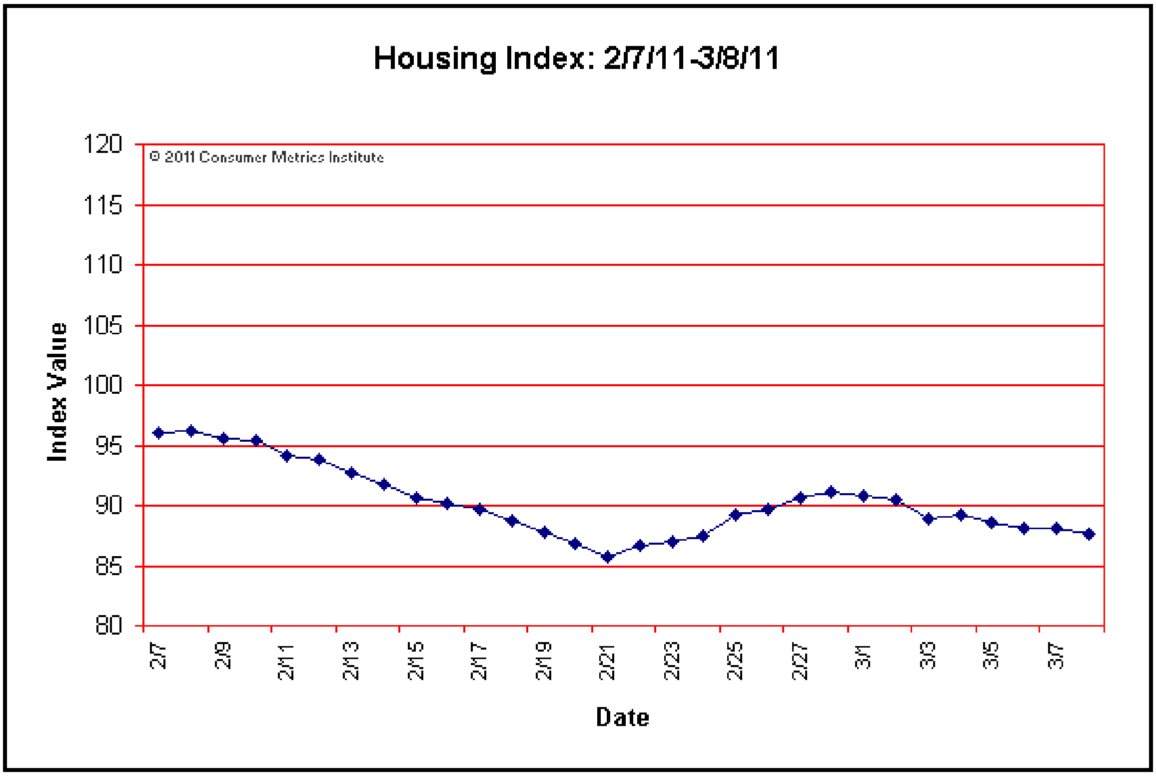

It is also strikingly evident in the longer term Weekly Weighted Composite Index:



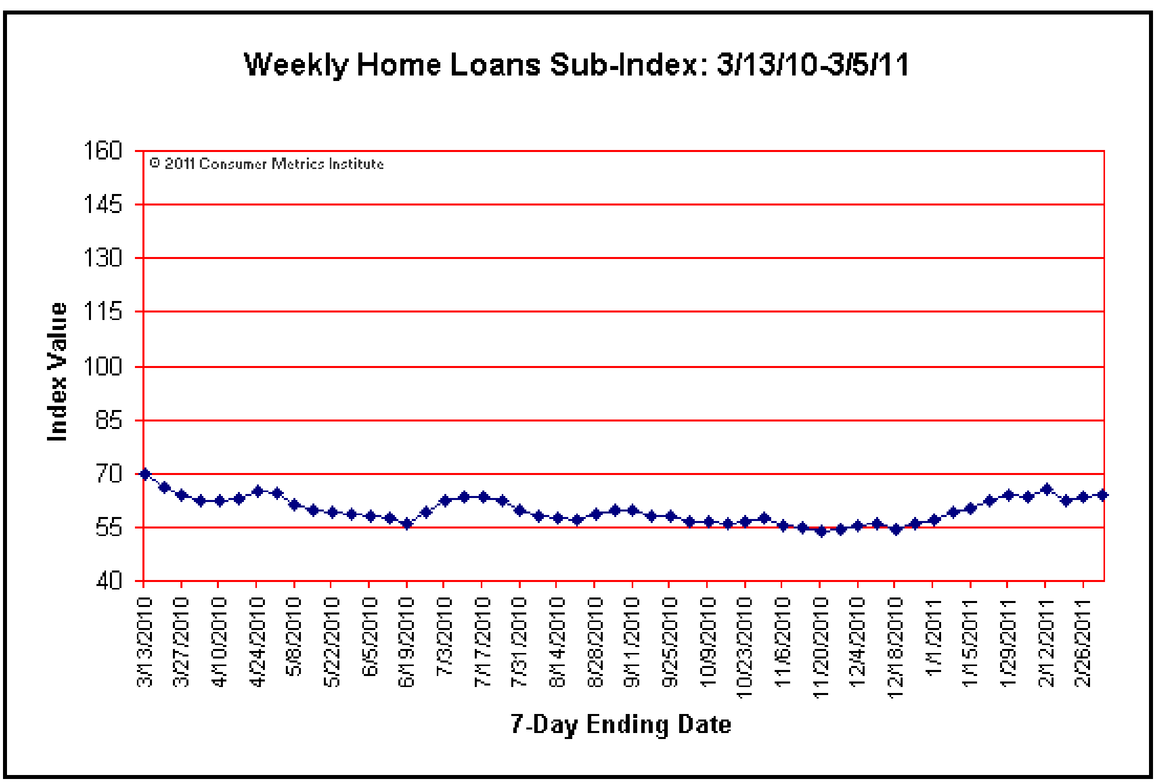

and in our "Contraction Watch," which follows the 91-day "trailing" average of the Weighted Composite Index (AKA our "Daily Growth Index") and compares it on a day-by-day basis with the same index during the dip created by the "Great Recession":



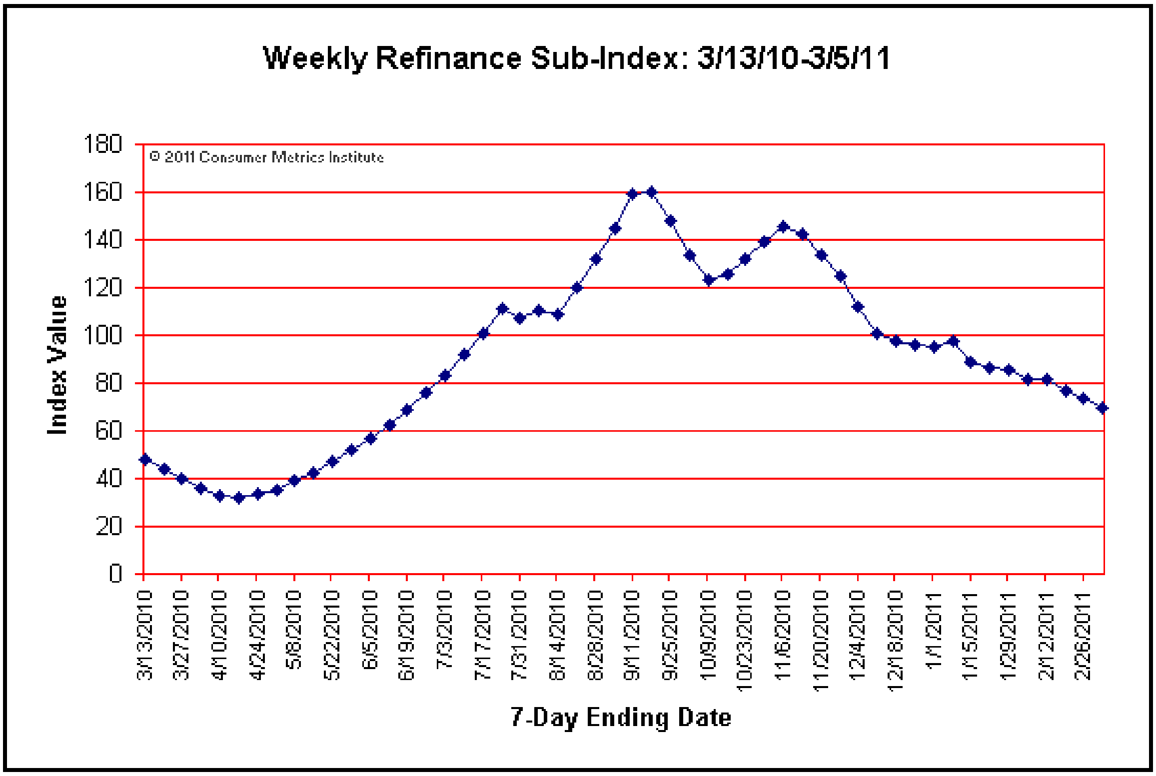

Although there are several sources for the renewed decline, the bulk of it can be attributed to a further deterioration of most aspects of the housing market. Our overall Housing Index reflects that weakening:




And even though the demand for new loans for newly acquired homes has remained more-or-less flat (at highly depressed levels):



the refinancing activities that had provided at least some support for the overall index for the past several quarters has now dropped into significant year-over-year contraction:




As we have mentioned several times before, the weightings involved in our "Weighted Composite Index" mirror those currently used by the BEA to "deflate" their GDP numbers from "nominal" current-dollar measurements to the "real" inflation-adjusted "chained" 2005-dollars (based on the BEA's 2005 NIPA tables). As a consequence our weightings assume that the housing sector is (or rather should be) an important part of the economy -- just as it was in 2005. Although this is demonstrably no longer true, we are reluctant to consider 2008 (or 2010, for that matter) to be the new baseline definition of the economy.

We have also suggested before that the widely reported consumer "recovery" exemplified by the November surge in holiday sales might have been "borrowed" from later time periods. If so, the "borrowed" budgetary funds will probably start to be repaid when the credit-card float expires and the initial impact of the 2% New Year's take-home boost begins to fade. That time may well be now.

And recently the main-stream media has been studying a phenomena that they have dubbed "Frugal Fatigue," the inclination of consumers to relapse to their spendthrift ways after periods of fiscal belt tightening -- similar to eventual dietary relapses after even the most fervent New Year's resolutions. We think that the analogy to periodic diets misses the longer term and sometimes involuntary nature of much of the recent consumer frugality. A closer analogy would be a medically prescribed diet to address newly diagnosed diabetes -- with dire consequences accompanying any relapses in resolve.

**Bastiat's Window Dressing**

We have received a great many comments about both our original efforts at quantifying the impact of mortgage defaults on the consumer economy, and our subsequent response to suggestions that any perceived stimulative effect was merely a contemporary manifestation of Bastiat's "Broken Window Fallacy."

Some people have suggested that we were defending the actions of the defaulters on the grounds that the "found money" was good for the economy. On one hand we are flattered by all the attention, but on the other hand we sense a need to set the record straight on several of the issues that were raised:

-- Initially, we were merely trying to quantify the economic impact of an unprecedented default rate -- some $90 billion per year in missed mortgage payments, of which perhaps 25% to 50% might end up being spent on discretionary consumer durable goods (representing a potential temporary 2% to 4% bump in that spending).

-- We then expanded the observation to determine whether some of that money was stimulating consumer spending in ways that were not previously recognized. The irony here, of course, is that our own data on discretionary consumer spending is headed the other direction -- an irony which nobody seems to have noticed.

There were no moral implications in our initial exercise, but somehow the use of the term "stimulating" was construed to be a defense of the defaulters, implying that their actions were ultimately benefiting the common good. In fact, we were only attempting to quantify the discretionary consumer spending aspect of the defaults -- while not examining the "whole" economic impact of the defaults, nor the long term repercussions of the defaults for the banking system.

Nevertheless, several people have characterized the "free rent" as defacto "stealing" from the banks -- thereby destroying at least a portion of their capital and weakening the economy (and hence making the default-stimulation of the consumer economy a form of the fallacy described in Bastiat's parable). Although there is absolutely no doubt that the entire economy has suffered a loss as a result of the housing disaster, we are not comfortable with characterizing the banking losses as "theft" for several reasons:

-- We feel that the banks are not the victims of the defaulters; they are actually the victims of their own bad underwriting practices. With some rare exceptions (specifically those "strategic defaulters" who are gaming the foreclosure process for personal gain) the vast majority of defaulters are failing to make payments simply because there is no money left to pay. Using a historical example, it is unlikely that anybody would think that Depression era farmers (like John Steinbeck's Joad family) were "stealing" from the banks. Similarly, for the most part there is no large scale consumer instigated fraud/theft going on here, just banks suffering the consequences of politically motivated underwriting standards and unprecedented post-bubble declines in residential real estate values. For many of the defaulters there is literally no "found money" -- just a slightly less hopeless list of monthly cash demands.

-- To reiterate the point, no "theft" occurs if business transactions are made in good faith yet ultimately fail as a consequence of a changed economic environment. There is a distinction in law between bad judgment and premeditated fraudulent behavior.

-- We still feel that ultimately the banks won't be left holding the bag -- the U.S. taxpayers will bear that honor. This exercise is simply another form of transfer payments, triggered by bad judgments. We feel that the taxpayers' ultimate loss of mortgage assets is a loss in the same sense that extended unemployment benefits are a collective loss of productive capital. Fortunately or unfortunately, civilized societies sometimes collectively bail out unfortunate individual circumstances.

-- If there is any "theft" involved in this debacle, at least some of it was on the part of the banks during the origination process -- as part of an egregious moral hazard that the banks effectively transferred to the taxpayers when writing unconscionable (but at the time highly profitable) loans.

-- Furthermore, if the banks are suffering any losses from the "free rent" period, those losses are certainly being exacerbated by the banks' failures to work with the homeowners to mitigate those damages by keeping the homes occupied at some affordable rent. Banks are to some extent responsible for the properties remaining either "rent free" or unproductively vacant -- if for no other reason than incompetent loan documentation. In fact, during this incarnation of Bastiat's parable the greatest real losses to the societal economic capital may well be the bank's inability to generate rents from their inventory of vacant homes.

-- And finally, we have not ignored the moral implications of the defaults. We have always maintained that the defaulters are setting the unfortunate precedence (and perhaps generational mind-set) that the repayments of debt obligations are optional and voluntary. A reasonable post-Dickensian society must tolerate some level of debt forgiveness, but large scale defaulting would be disastrous. We have repeatedly cited that as one of the real "losses" from this whole debacle.

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