Junior and the Boomers; a Misdirected Work Activity

Once upon a time there was an island inhabited by a young Yuppie, "Junior", and ten older men, the "Boomers," nearing retirement. Junior wanted a $10,000,000 house, so he asked the Boomers to build it for him. The Boomers were discussing concerns about Junior's ability to repay when suddenly "Godspan" spoke from the heavens and said interest rates are officially 0.1%. Elated, Junior quickly calculated that he could afford the house by paying an interest-only monthly mortgage of approx. $1,000, which he could readily afford. Concerned, the Boomers asked Godspan who was going to buy the mortgage-backed securities to fund Junior's mansion. Godspan responded reassuringly not to worry…. "***You*** would purchase the securities". Once the house was completed they would each have bonds worth $1,000,000, thus they could all retire as millionaires. The Boomers expressed concern about the yield on the bonds. Godspan again reassured them not to worry…. Just look at the past 20 years…you will either gain in asset valuation, if interest rates drop, or gain income from higher yields, if interest rates rise. Either way you'll be fine, if you just keep thinking long-term. Begrudgingly the Boomers agreed to buy the bonds. Keeping the vision of achieving millionaire status soon and having faith in the omnipotent Godspan motivated them.

A year later the Boomers had toiled and used their last bit of working-life energy to complete Junior's mansion. Junior was ecstatic at closing. He gained ownership of the dream house that he could afford. The Boomers were giddy because they were all now millionaires…!

The next day one of the Boomers wanted to cash in his bond and spend some of his hard earned money. Much to his surprise there was no one interested in buying his $1,000,000 bond. He quickly learned that the $100 monthly stream of income was all that he was going to receive. Godspan was nowhere to be found. Godspan's replacement, an Austrian economist, quickly calculated the real valuation of his $1,000,000 bond to be approx. $25,000 at market interest rates, and informed the bewildered Boomer that the difference of $975,000 was an illusion.

In fact, the Austrian economist explained to the Boomer that all he **might** physically receive is 1/10th of the future stream of Goods and Services that Junior was **willing** to pay to his creditors. If Junior becomes ill or loses interest in repaying his debt, then the repossessed house could certainly accommodate the shelter needs for the ten Boomers, but they were wondering who was going to maintain the home, grow and serve food, care for them in times of illness, pump the gas, feed the dog, and change tires on their motor homes…

Further, the Austrian explained, if they did not experience Godspan's monetary distortion of low interest rates and an abundance of liquidity, they might have actually calculated in advance the investment in a $10,000,000 home for Junior would have been unsound. Further, had they invested their time into building a sophisticated robot company that Junior could have run by himself to provide all the needed Goods and Services in the Boomers retirement, the story would be quite different. Now, instead of having a Goods and Service producing enterprise that could serve their needs, they have a massive depreciating home that produces nothing **and** needs significant maintenance to keep up.

The Boomers soon perished because they could not physically help themselves. Junior reclaimed the home because the owners were gone, and spent the rest of his life as a slave to his castle attempting to maintain and heat it…

Godspan preserved his legacy because he left a note reminding all that had Martha Stewart been more forthright in disclosing her insider trading source, the economy would not have collapsed, and he would not have been compelled to intervene with lowering interest rates accompanied by a flood of liquidity that encouraged the malinvestment and fatal misallocation of resources in the first place…

An Alternate Continuing Scenario…

Soon after Junior moved into his wonderful new home he wanted to elevate his means of mobility and leisure up to his new jet-set castle lifestyle… Note: The "island" has now increased in scope to include a few other inhabitants…

Junior's Refinance; <u>Decoupling</u> Debt from GDP and the Bubble is Born

Junior wanted another $10,000,000 for cars, vacations, and a yacht. Thanks to Godspan continuing his expansionist monetary policy, Junior's home is now "worth" $20,000,000…! With a new 0.05% interest rate on a 1-Yr Interest-Only ARM loan, Junior could handily afford the $20,000,000 loan. Goldman Sucks Brokerage was happy to package Junior's $20,000,000 new loan with dozens of other similar loans, then peddle Collateralized Debt Obligation (CDO) tranches off to Mr. Chan from China who supplied $10,000,000 in funds collateralized by Junior's now $20,000,000 castle. Incredibly, Goldman Sucks Brokerage cleverly offered new enhanced $1,000,000 bonds in exchange for each of the Boomer's existing $1,000,000 bonds! Sucks promised them they would receive ***market rate yields*** as soon as Junior's ARM rate reset kicks in next year. A **$10,000,000 Bubble** was just created out of this creative financing! Everyone wins!

- Junior gets another cool $10,000,000 without lifting a finger! Further, he fully expects his castle to continue "creating wealth" every year, enabling him an annual new cash-out refinance at the same 0.05% interest rate or lower so he may purchase yet more goodies to maintain his enhanced lifestyle. Finally, he can rest assured that by selling the wealth-creating home at any time he could fully repay the ever-increasing mortgage, and retire debt free!!
- The Boomers win because they are confident once Junior's ARM rate kicks up to the market interest rate of 8.0%, they will enjoy a comfortable $80,000 per year in yield income alone from their $1,000,000 bonds. They're even more excited because they can bequeath the bond to any charity upon their deaths and know they will be remembered for a generous lasting legacy.
- Mr. Chan wins because he will soon enjoy the same 8.0% yield income as the Boomers, hence an annual $800,000 income. Further he is very happy his investment is in a historically strong currency such as the Dollar. In fact, the Dollar is backed by the "full faith and credit of the U.S. Government", which enjoys a status of having the lowest default risk on earth!
- Goldman Sucks is not only happy receiving their CDO investment packaging and peddling-fee incomes, but they sleep well at night knowing their new efficient highly productive "financial engineering" efforts helped everyone out.
- Everybody's happy!!!

CAN YOU SEE THE DISCONNECT???

Due to Godspan's artificial suppression of interest rates enabling floods of money and credit (liquidity), the bond market yields were held below natural market rate levels. This expansion of liquidity tends to increase demand and prices for the interest-sensitive housing markets. As the home prices escalate due to the artificially created demand shocks, the "home prices never go down" mindset becomes entrenched. People come to believe their homes actually create wealth, and are less inclined to save income. The self-perpetuating cycle of easy-money, higher home prices, more easy-money, higher home prices, ever more easy-money, and higher home prices continues until the creditors holding mortgage and debt securities begin to wonder if the puffed value homes are legitimate security collateral.

At this stage junior now has a $20,000,000 Debt secured by a house with a real value of only $10,000,000. We have also DOUBLED the problem for the Boomers and Mr. Chan in their retirement. They will likely receive nothing for producing $20,000,000 of goods…

At some point the entire credit market freezes up. Liquidity begins drying up, home values drop, etc., as the process moves into a self-perpetuating reverse mode. Of course, in time, once the bubbles overcorrect, the process will begin all over again… How sad!

By Russell Randall; 9-9-2005
Updated with the "Alternate Continuing Scenario" on 3-5-2008