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Beyond the Rate – Chapter 10

Is anyone telling the TRUTH in the mortgage business??

Hello and welcome to Beyond the Rate, a series of podcasts that are designed to educate the listener on the world of finance and in particular, the mortgage business. This is Chapter 10 and we'll be looking the future of interest rates, as determined by the supply and demand of investment capital in the bond markets.

My name is Patrick and I'm a Mortgage Banker here in the San Francisco Bay Area. I'm your host and I really encourage you to subscribe to this series for an informative and detailed account of how the mortgage industry operates and how to navigate through all the confusing programs and deceptive marketing techniques being used by some of today's Mortgage Brokers.

Please note that the text versions of these podcasts are now available for free download at my website at www.beyondtherate.com along with a bunch of related materials and resources. You can also sign up for my monthly email newsletter and/or a quarterly mailer at the site.

Okay, everybody. This Chapter's gonna be the most conceptual so far but it's also completely fascinating stuff so stay with me on this. Back in 1999, I read a book called "The Roaring 2000s" by Harry Dent Jr. It's a brilliant book and it's based on the premise that people go through a predictable spending cycle during their lives that peaks when their 46 years old. In other words, the average American reaches their PEAK spending year when they're 46. That's when they earn a good living and they're probably still paying their mortgage, maybe a car or two and supporting the lifestyles of a growing family – maybe even some college expenses.

So there's this curve of spending that increases as people grow older and it peaks at 46 years of age and then it slowly drops off again. Well, on top of that, we've got an incredible concentration of people who are all roughly the same age – the Baby Boomers. That's defined as all the babies that were born between 1946 and 1964 – almost 76 million Americans. So you can use that birth data to project what might happen to the greater economy as all those people go through life. Keep in mind that two thirds of GDP is made up of consumer spending. So just doing the straight math, we should expect a surge in consumer spending between 1992 and 2010 – that's just 46 years added to 1946 and 1964 respectively.

Well, the US Census Bureau obviously provides extensive data measuring all this stuff and its all free public information. Birth data, mortality statistics, immigration, income, spending – everything. So I started building a mathematical model back in 2001 that takes Harry Dent’s logic to a much more sophisticated level. The whole thing is built on a dynamic population platform that uses birth data, immigration statistics and the mortality curve to calculate the population at every single age and tracts all these people mathematically as they grow older.

Then, the model projects income and spending data (which is also tracked by age, by the way) on the population platform to determine how much money is being added to the pool of investment capital and how much is being taken away on a year-by-year basis. You see, as Harry Dent suggested, people go through different stages of their lives and their income, spending and savings behavior changes dramatically from one stage to another.

Here’s how it breaks down. And this stuff is all based on publicly available US Census Bureau information. The AVERAGE person spends MORE than they make between the age of 15 and 24. So they have NEGATIVE savings. They’re spending MORE than they earn. Somebody’s subsidizing these young people, right? I mean, the extra money has to come from somewhere, probably their parents. But it goes beyond that. This extra money isn’t sitting in a shoe box somewhere. It’s being pulled OUT of somebody’s bank account. So again, people between 15 and 24 have negative savings and that money, one way or another, is being taken out of various bank accounts.

Now, between the ages of 25 and 63, the AVERAGE person makes MORE than they spend. In fact, they both go up. They MAKE more money AND they SPEND more money. But their earnings grow faster than their spending and they end up with POSITIVE savings between the ages of 25 and 63. And as Harry Dent pointed out, the peak spending does indeed take place when people are about 46 or 47 years old. Anyway, the important thing is that their savings are positive during these middle years so that money is being DEPOSITED into bank accounts, one way or another.

And from 64 onwards, the average person once again has NEGATIVE savings so their spending MORE than they make. And again, that financial shortfall is coming out of bank accounts one way or another – probably retirement accounts. So you have this progression during life: negative savings in the early years, positive savings during the middle years and negative savings again during the twilight years. The way it works out, it’s these middle-aged people who end up balancing the negative savings of the young and the old.

Since we know exactly how many people are alive at every single age based on my population platform, we can calculate whether or not the total savings of these middle-aged people is more or less than the money being taken OUT by the other two groups. If it’s MORE, the total pool of investment capital would be increasing – there would be MORE money available – and you’d expect interest rates to go

down. If it's LESS, the pool of investment capital would be shrinking and you'd expect interest rates to go up. Remember, mortgage rates are the result of the supply and demand for money. If there's MORE money, you'd have to pay less for it. If there's LESS money, interest rates would get bid up and you'd have to pay MORE to borrow.

Now think back to the late 1970s and early 1980s – in fact, let's take 1979. Well, in 1979, the Baby Boomers were between 15 and 33 years old. MOST of them were in a period of negative savings, and they HAD been in that stage for a number of years already. So what would you expect in terms of interest rates at that time? Well, you'd expect them to be high, right? I mean, there must have been almost NO money out there. All these people had been taking money out of their bank accounts for years. The pool of investment capital out there must have been SERIOUSLY depleted.

Well, as we all know, interest rates were indeed very high in the late 1970s and early 1980s. We also know that interest rates have basically been dropping ever since. Yes, of course there were ups and downs along the way but the overall trend was down UNTIL 2003, and that's when it started going up again. So think about it. It makes sense, doesn't it? The Baby Boomers have been shoveling money into their savings accounts for the past 20 some years and low and behold, interest rates have been dropping. And what else has been happening?

Well if there's more money out there, you'd expect the prices for THINGS to go up, right? If people have more money, they'll BID up the price for commodities – commodities like houses, stocks, collectibles, gold – right? – things like that. Well, sure enough, these things have all taken place over the past 24 years or so. We'll talk more about that in Chapter 11.

Of course, it wasn't always a smooth ride and the money sometimes shifted from one place to another. For example, people tend to invest in stocks when they're a bit younger and then slowly move money over to bonds in their later years so it made sense that the stock market would peak slightly BEFORE the bond and housing markets. And when the stock market crashed in 2000 and 2001, people pulled their money out quickly and moved it all into real estate and the bond markets so interest rates dropped quickly and house prices soared. But it's all part of the same phenomena.

The Baby Boomers have been saving money for years. All that money has been accumulating in various savings vehicles all across the country. The whole thing has been magnified because there were similar population bubbles in Europe so they've been saving money at the same time. China, Japan and India have also been accumulating lots of cash and that's filtered into our system. And all that money has inflated prices for a variety of commodities and lowered interest rates for borrowing.

So what happens next? The Baby Boomers start retiring in 2011 and it continues all the way through 2029. And they'll all live for a long time too. The mortality

curve is getting longer every year. And frankly, the longer they live, the worse the effect will be. Their living expenses have to come from somewhere and you can bet they'll stop at nothing to get the bills paid during their retirement. So unfortunately, we've got some difficult years ahead of us. In fact, I recently read that over 1/2 the Fortune 500 companies have under-funded pension plans. So these companies will probably start having some major financial problems about 10 years from now.

I'm not trying to present a dooms day scenario but we all have to realize we've just finished one of the largest financial booms the world will ever see. It's unlikely there will ever be such a disproportionate concentration of people in a single age category. As the world population gets bigger, a concentration like that becomes harder and harder to achieve. And it's that disproportionate concentration that caused the economic pain during the 1970s and the severe recession of 1981 and it's also what caused the boom we've had ever since. Unfortunately, it's also what will cause the difficult times ahead.

So what does it all look like, exactly. Well, my model calculates modest appreciation in the real estate market up to and including 2012. After that, it calculates a largely sideways market for the following 15 years. During that time, interest rates will rise progressively and peak out in 2027, roughly three and a half percentage points higher than they are today for the 30-year fixed. So if 30-year fixed mortgages are about 6.5% today, I'd expect them to top out around 10% in the year 2027.

At that point, the oldest Baby Boomers will be 81 years old and the youngest will be 63. Believe it or not, things actually start getting better at that time because the Echo Baby Boomers (that's the children of the Baby Boomers and another population bubble, although not nearly as concentrated) well, they'll be flooding into their positive savings years about that time, offsetting the cash drain from their parents' retirement.

We all recently heard President Bush talking about Social Security reform. In all his speeches, he always gave grim statistics about the year 2026. He always said "by the year 2026, we'll be ..." blah, blah, blah. Why do you think he chose that year? Why do you think he chose 2026? Look, my model isn't unique. I'm sure there are plenty of Economists who have similar models that calculate out into the future based on expected population growth and well established spending and savings patterns. Bush was trying to convince us that Social Security is on a collision course and he chose the absolute worst year to demonstrate his point. That's as bad as it gets! 2026. That's it! After that, things slowly improve again.

Now, don't think I'm suggesting Social Security is in good shape. Absolutely not. There's no question in my mind that Social Security is heading for a complete disaster and I don't think it'll take 'til 2026 to get there. I think the melt down will begin around 2018 or so. Write it down. We'll see what happens. Time will tell, as it always does.

Listen. I'm absolutely not preaching my predictions as Gospel. I'm one person with one opinion. In the end, I'm just a Mortgage Banker with a somewhat geeky passion for demographics and macro economics. You probably have your own opinions and that's great. But you need to know that I have very specific reasons to give the advice I give and to recommend the loan programs I suggest. When my clients ask for my opinion, it's not just hear-say. It's not just some editorial content regurgitated from last night's news broadcast. I give my opinion based on a mathematical model I believe in. I know HOW it calculates. I know WHAT it calculates. And I'll stand by it until its proven wrong.

A couple last minute things. First of all, the model predicts long-range trends. Historically, there have been extended periods of time when actual interest rates were higher or lower than my model predicted. There's no question that other factors affect interest rates and those other factors can influence the market for years at a time. Nevertheless, the overall trends have been dead on and that's what I'm trying to share with you.

Secondly, I still believe real estate is a great investment, particularly because of the leverage it allows. When you put 5% down on a house, you're leveraging your money 20 to 1. When you invest in the stock market using MARGIN, everybody freaks out saying it's too risky. Well, that's only 2 to 1. In real estate, the leverage is far greater and nobody bats an eye. And that leverage along with the tax advantages of homeownership combine to make real estate a very attractive investment in all but the worst possible market conditions. Just don't expect the 15% or 20% annual appreciation rates we've seen over the past few years, that's all. Future rates of appreciation will be much, much lower.

Okay, so if you like what you hear on this podcast, please tell a friend about it. My goal is to become a recognized authority in my field without having to sacrifice my freedom to tell the truth, even if it reflects poorly on my industry. Technology like podcasts can help elevate new and innovative thinkers but we all have to play our part to help spread the word for those who deserve our endorsements. If I am deserving of yours, my thanks.

If you are considering a purchase or a refinance, please call me to discuss the options. I'm a Mortgage Banker. It's what I do for a living. Interest rates change everyday but I'll promise you two things; I'll tell you the truth and I'll do the best I can. My office phone number is 925-465-1223. Again, that's 925-465-1223. You can also reach me by email at patrick@beyondtherate.com.

See you next time for Chapter 11. We'll be looking the future of stock valuations. As we discussed in this chapter, the retiring baby boom generation will have a major impact on financial markets and stocks will be affected just as much as real estate. We'll take a closer look next week. It's fascinating stuff. Stay tuned.

Bye for now.