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Beyond the Rate – Chapter 12

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 12 and we'll be looking globalization and currency values. With a massive trade deficit and a falling US Dollar, inflation is inevitable and that's a major wild card for interest rates, house prices and financial markets here in America.

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 (in PDF format) for free download at my website at www.beyondtherate.com along with a bunch of other related materials and resources. You can also sign up for my monthly email newsletter at that website.

Everything we've discussed in the past two chapters was discussed within the context of the American economy. All of my references were of American phenomena; American financial markets, American interest rates, American housing prices. In Chapter 10, I defined the Baby Boom generation as a group of almost 76 million people born between 1946 and 1964. Well again, that's an American statistics. But most of these same realities have played out in other countries all around the world.

Just like any sociology experiment, a good sample size can tell you a lot about the total population. Fact is; the Baby Boom took place in almost every developed nation in the western world after World War II. The most notable exception was Japan but it's not surprising they had a lull in birthrates after two nuclear bombs were detonated on their soil. Optimism was NOT the word of the day over there. Uncertainty was. And that's not a good environment for young couples to expand their families. But everywhere else – across European countries as well as Canada and some Central American countries – birthrates went up dramatically. So in

many respects, the American marketplace serves as a good model for phenomena happening around the world.

The spending and savings patterns are fairly consistent across international borders as well. In fact, most European countries report savings rates far greater than ours here in America. So the enormous pool of capital that's been accumulating for the past 25 years is a result of much more than our domestic Baby Boomers. It's been happening all across the western world. And the wealth that's been created has only been magnified by the ready availability of energy – something we'll be discussing in more detail in Chapter 13. Anyway, the results have been similar as well, with rising P/E ratios and dropping interest rates characterizing the past 25 years for many countries around the world.

The interesting thing is that today's global economy allows all this surplus capital to flow easily from one country to another. So the fund managers and traders around the world decide where they think they can get the best return, and allocate their capital accordingly. Now, for us investing here in America, a return on our money is usually expressed as either an interest rate on a bond or savings account, a dividend payment on a share of stock, or a rise in the share price that stock or some sort of managed fund. But what if you were investing in a stock, bond or fund in a different country? In that case, your return would be the same interest rate, dividend or price appreciation we just discussed PLUS the change in the value of that country's currency while you held the investment.

Let's take an example. If you bought an investment in Germany and it paid you a 10% return during the following year, you'd think you got a 10% return, right? Well, not necessarily. What if the German mark went down in value during that same year, say by 5%? Well, the asset you purchased yielded a 10% return but you'd lose 5% when you liquidated the investment so your net gain would have been the remaining 5%. You see, when you buy a German stock, you're essentially buying German marks first and paying for them with US dollars. Then, the German marks are used to purchase the German investment. When you eventually sell the investment, you get German marks for it and those German marks are then converted back to US dollars. So the relative change in value of those two currencies play a major role in the return you end up with.

It's important to understand today's financial markets have an incredible selection of investments available and they're all formatted differently and executed in different ways. As always, there are exceptions to the example we just discussed. But for the most part, that's the way these things work. The German company (assuming it's not a multinational corporation) can't easily use US dollars because most of their employees and suppliers only want German marks, so the money you invest in that company, one way or another, is converted into German marks first.

Of course, when you buy stock on a stock exchange, you're not buying it directly from the company. Instead, you're buying it from someone who already owns that stock and wants to sell it. And that investor may want US dollars in exchange for the stock, eliminating that process. But the changes in currency values will have

already been incorporated into the price that investor is willing to accept for the stock in question.

There's been a lot of hype recently about the forex markets. The forex deals exclusively with the currency markets. Essentially, you're just buying and selling other currencies in the hopes it will appreciate while you're holding it so you can sell and make a profit on the differential. Currencies fluctuate up and down everyday, just like stock or bond markets. And sophisticated investors all around the world are always looking at the economic health of different countries to decide whether or not to invest in financial assets within those countries.

Now, that didn't used to be the case. For many years after World War II, currencies were fixed according to a predetermined exchange rate and the US dollar (which was chosen as the reserve currency) was tied directly to gold. Anyway, that structure created certain unearned advantages for some countries and left others with undeserved financial hardships, and the system was dismantled in the early 70s in favor of what they call "floating exchange rates". Ever since, the values of different currencies have fluctuated according to the same supply and demand forces that other financial assets (like stocks and bonds) are subject to.

If there are more people buying a particular currency than people selling it, the currency goes up in value. If there are more people selling the currency and nobody wants to buy it, the value drops until investors find the price attractive again. And what happens when your currency drops in value? Well, the prices of the products you sell to other countries goes down and the prices you have to pay for products produced in other countries goes up. And if your country imports a lot more products than they export (like ours), the price for the average product bought here at home starts to rise and you get inflation. Enter the US economy.

Most of us have heard on the news that America has an enormous trade deficit, one that exceeded \$725B in 2005 – a staggering number most of us can't even imagine. That means our country spent \$725B more on other countries' products than they spent on ours during 2005. And just like the international investments we discussed earlier, these transactions first involve an exchange between our currency and theirs. So if you want to buy a bottle of French wine, you first have to sell some US dollars and buy some French francs and then you can pay for the French wine with your newly purchase francs. Again, we don't see all those steps when we shop at stores but that's what actually takes place behind the scenes.

The trade deficit is an expression of the supply and demand relationship for our US currency. Right now, month after month, we're selling a LOT more dollars through product sales than other people are buying. That puts downward pressure on the value of our currency and the US dollar has seen a steady erosion in value ever since the year 2000.

Now, it gets a bit more complicated then that. There are really two different markets where currencies are exchanged. One is the product and service markets just mentioned. That's where American companies are selling products to foreign

buyers and foreign companies are selling products to buyers here in America. This is where the trade deficit comes in. It expresses the difference between our imports and exports in US dollars. But the second market is the capital market. That's where financial assets are bought and sold – investments.

The American economy is the largest single economy in the world, mostly because we have the largest population of any country in the developed world. Because of its size, the American economy is very stable year over year. That's why the US dollar was chosen as the reserve currency after World War II. Well, even after we went off the gold standard in the 70s, the American economy was still seen as the most stable place to invest excess capital, and some people still feel that way today.

Investors all over the world invest their money in American financial assets, more so than we Americans invest in other countries' financial assets and that creates a capital surplus. There's more money coming in than going out. In fact, a lot of the mortgage money that's been contributing to our low interest rates has been coming from foreign sources. So our massive trade deficit is balanced to some extent by a capital surplus. It's the net of these two markets (the trade markets and the capital markets) that determines the value of our US dollar in global markets.

People who follow these markets know that the US dollar fared pretty well during 2005. The biggest reason for that was because Alan Greenspan and the Federal Open Market Committee was aggressively raising interest rates while other countries delayed monetary tightening. As a result, investors around the world could get a superior return putting their money into certain American investments and the money started flowing into our country, supporting our dollar. Now, the European central banks have finally started raising their interest rates as well and we'll probably start seeing the American dollar sink again as the investment advantage disappears.

There's one major country that still fixes its currency to ours and that country is China. They do so because we're their biggest customer and they don't want their currency to rise, making Chinese exports more expensive in American stores. We all know how many products we buy everyday that are manufactured in China. So they fix the exchange rate by trading their currency for ours in global financial markets, offsetting the trade deficit. But since we buy so much of their products, the Chinese government has to sell massive amounts of their currency to buy US currency to keep the exchange rate unchanged.

The decline in value of the US dollar during 2001, 2002, 2003 & 2004 put enormous pressure on the Chinese government because it forced them to sell even more of their own currency, forcing a depreciation of their currency proportional to our own. And what did they do with all the US dollars they purchased? Well, they bought most of our government's debt, that's what. When our government reports a budget deficit, they're expressing the fact that they spent more money than they brought in through taxes. And to finance that deficit, they have to sell US

Treasuries – bonds – to raise the necessary money to bridge the gap. Well, as it turns out, China is one of the biggest purchasers of our US Treasuries these days.

It makes sense if you think about it. If China has to sell their currency and buy US dollars to keep the exchange rate stable, they end up accumulating a ton of US dollars. So what should they do with all that US cash? They can't spend US dollars in their own country so they lend it back to people in America who need to borrow money, namely the federal government. So China is one of the primary financiers of our government's irresponsible spending habits. They're the ones lending us the money. And year after year, our government sends money back to the Chinese and others to service all that debt. Today, about 10% of the taxes we pay goes towards paying the interest on our national debt and as interest rates continue to rise, we can expect that percentage to rise as well.

Anyway, as central banks around the developed world continue raising their rates and international demand for American products continues to decline, we can expect the dollar to start dropping again. Sooner or later, the supply chain will no longer be able to absorb import and commodity price increases and inflation will rise. That will raise interest rates because investors want a return on their investment beyond inflation. All of this will put a damper on the American economy, reducing profits for American companies and making US financial investments less attractive. If that reduces the capital surplus, we can expect the decline in the dollar's value to accelerate.

Yet again, I can be accused of being a dooms day practitioner and I apologize for that trend. But the point is that America is walking a precarious line right now and there will be some difficult decisions ahead for our politicians and monetary bureaucrats. The good news is that nobody wants the US dollar to tumble in value. We are the only developed nation running such a massive trade deficit and that deficit represents a trade surplus for all the countries that sell into the American marketplace. If our dollar drops significantly in value, it will jeopardize all those exports other countries have become accustomed to. Global financial stability requires a stable US dollar and there are plenty of stakeholders who will support the cause. The bad news is that these international stakeholders are gaining increasing leverage over the decisions our politicians make here at home.

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. You can also reach me by email at patrick@beyondtherate.com.

See you next time for Chapter 13. We'll be looking at oil and the availability of energy both now and in the future. We're approaching a major milestone in that department and the implications will be felt in every corner of our world. It's fascinating stuff. Stay tuned.

Bye for now.