Cheap Money and Crowd Mania

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Back in 1978 a little known maverick out in Beverly Hills California was emerging as a powerful force in the world of high finance. When most of the major money players were operating out of either New York or San Francisco, Michael Milken was creating a niche high yield bond operation in southern California that would become the center of the universe for the merger and acquisition game, namely leveraged buyouts (LBO's). From the early eighties until 1989 Milken was a major influence on the market for high yield junk bonds which grew from $15 billion to close to $190 billion[1]. When the fantastic reign of Michael Milken and Drexel Burnham Lambert, the company he worked for, came to an end, the junk bond market seized up and bids for these bonds dried up almost overnight. The market value of all outstanding junk issues at that time collapsed by some $80 billion and defaults over two years came to nearly $18 billion[2]. Shady dealings by Milken and his crew as well as overleveraged deals that made little sense caused the fallout that ensued. The merger activity that prevailed during the height of the LBO craze captivated many of the *yuppies* of the era. It was the development of a new source of financing that drove prices for corporate assets higher during this period. Certainly, decreasing interest and inflation rates contributed to a fertile environment for such activity.

Like the corporate bond market of the early eighties, the mortgage market of the early nineties was ripe for some changes. After a disastrous market in real estate from 1990 through 1993 that ruined many banks and savings and loans, market participants soon began to underwrite mortgages in brand new ways. One of the biggest innovations was the pooling and selling of mortgages on Wall Street. This new way of financing home loans largely expanded the pool of available capital. Next came the introduction of various altered term structures; 3/5/7 year ARMs, balloon payment notes and, more recently, interest only and negative amortization loans. These enhancements along with home equity loans and lines of credit have made it infinity easier to finance and *leverage* real estate. In addition *declining interest rates* and favorable tax treatment have added to the mania of real estate investment. It has the *umaenies*[3] mesmerized. The mortgage market has developed in an almost parallel way to the high yield bond market of the eighties. Its growth has funded a spectacular advance in home (and other real estate) prices nationwide. As with the maturation of the high yield market, the mortgage market is allowing the funding of many real estate assets that make little sense. Negative cash flows for residential investment property, low cap rates for commercial properties (sometimes below long term treasury yields) and exorbitant prices for residential real estate on both coasts are symptomatic of the problem. Many of the same fundamental financing errors in the LBO craze are asserting themselves now in real estate. The differences can be found in the size of the market for mortgage pools. Where the junk bond market grew to $190 billion before its initial collapse, wiping away $80 billion in investor capital, the mortgage market has grown to about $7.5 trillion. And although it is unlikely to experience the magnitude of declines we saw in junk bonds in the eighties, just a 10% to 15% decline in pricing would dwarf the dollar value of declines we saw at that time.

There is almost no scrutiny of the mortgage originators either. The poor judgment that accompanies individuals on the receiving end of such a boom is well documented. We cannot look to these companies or their executives to warn of rampant excesses. It may be in our best interest to follow the major players to see how they are acting. How has Fannie Mae's stock done lately? How are other major players positioned for, not just a rise in rates, but also a widening of mortgage product spreads?

A final thought for the newest landlords among us. With as much as 25% of home purchases this year for *investment purposes*[4], these should not be few. Ask yourself, in an era of extremely easy money where the rate of home ownership has gone from 65% to over 68%[5] in 5 years and just about anyone who wants to own a home can, who will be your tenants? They'll be the unfortunate few who could not make home ownership a reality. I doubt these people will be the epitome of the ideal tenants. I think most of us know how this story ends!

1. *Den of Thieves*, James B. Stewart 1992

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2. Bids on high yield bonds went to 60% on average, with as much as 10% going into default. *Edward I. Altman, Stern School of Business, NYU*

3. Upper middle-aged empty nesters

4. NAR website

5. WWW.census.gov