How the Current Crisis is Different from the Great Depression

By Rich Lashley

UNEMPLOYMENT:

It's at normal levels today in comparison to averages for most of the 70s, 80s, 90s and 00s.

- Unemployment rates: 1978=6.0%; 1988=4.4%; 2003=5.7%; 2008=6.0%; peak of 10.8% in 1982; Great Depression peak=25% and many employed workers were government make work program workers.

GDP:

During the Great Depression, nominal GDP dropped by 36% from 1929 to 1933. With most likelihood, we are going to grow nominal GDP in 2008 and 2009 and 2010 even if real GDP drops. If a drop in nominal GDP does occur, the probability of a 36% decline is unlikely given the recent steps we have seen by the Treasury to shore up the markets. Contributors such as inflation, household formations, population growth, productivity, and other factors will cause GDP to grow in the years to come, unless a dramatic change in monetary policy and demographics occur. With all probability, the value of real estate will be higher 10 years from now and probably 5 years from now due to those same factors. We need to have about 1.5 million net new homes built per annum to accommodate our natural household formations and growth. Supply and demand will work over time.

- Nominal GDP (i.e. not inflation adjusted): 1978=$2.4 tril; 1988=$5.4 tril; 1998=$9.5 tril; 2003=$11.2 tril; 2008=$14.3 tril);

DISPOSABLE PERSONAL INCOME:

Although we are unsure what the actual figures for personal disposable income were during the Great Depression, they were clearly down more than the 36% drop in GDP. Over the last 30 years we have actually seen personal disposable income rise.

- Disposable Personal Income: 1978=$1.6 tril; 1988=$3.4 tril; 1998=$6.0 tril; 2003=$8.2 tril; 2008=$10.8 tril.

TOTAL HOUSEHOLD NET WORTH:

As a whole, the United States has amassed huge net worth over the past 5, 10, 20, 30 years.

- 1978=$7.2 tril; 1988=$18.3 tril; 1998=$36.7 tril; 2003=$44.3 tril; 2008=$56 tril

Current total assets of $70.5 tril dwarfs the total debt of $14.5 tril, as of June 30, 2008, and is significantly more than the expected losses on mortgages. A few hundred billion lost to the subprime crisis and foreclosed homes is relatively immaterial in the scheme of things, yet we have panicked ourselves into runs on money market funds, banks, payment systems, the stock market, the bond market, etc. The losses from the panic outweigh the real losses by 10 to 1.

BANK FAILURES:

- Number of banks at the peak (1921)= 31,000

- Number of failures from 1921 to 1929=6,000

- Number of failures from 1929 to 1934=9,000

- Number of banks left standing in 1934=16,000

- Approximately 48% of the banks (in numbers) failed in the Great Depression

If we have 500 failures out of 8500 banks existing today I would be shocked. It will be more like 100-150 over this cycle, so call it 2% failure rate not 48% as occurred in the Great Depression. My worst case scenario, 500 failures is 6%, would be a disaster for sure but 1/8 of what failed in Great Depression.

Recall that approximately 2,500 banks/thrifts failed in the 1985 to 1994 RTC cycle. This was approximately 15% of the banks/thrifts in existence at that time, which is far worse than today.

FORECLOSURES:

- Normal foreclosure rates for the US are about 250,000 foreclosures per year (death, divorce, layoffs, sickness, etc).

- We are probably going to have 900,000 actual foreclosures in 2008 after having approximately 405,000 in 2007 and 268,000 in 2006.

Lets call the extraordinary foreclosures approximately 650,000 homes (900k-250k), which is less than 1% of the households in the US that own a home (approx 70 million houses) and about 1.3% of the households with mortgages outstanding (about 50 million). In aggregate dollars, we are talking about total losses on these mortgages of approx $60 billion (650k homes x $200k average mortgage x 50% loss rate =$65 billion of losses). In reality, this country's banks/fixed income investors/creditors/FNMA/FRE/FHA can afford the hit on $65 billion this year. It will probably peak in 2009 at about 50% higher amounts, or roughly $100 billion in 2009 for a total of $165 billion in ‘08 and ‘09 (and I exaggerated the numbers by using the $200k average loan and the 50% loss rate, which is not that high). As you can see, I cannot come up with the $600 billion to $1.5 trillion losses that many others are coming up with. The mark-to-market writeoffs may be much higher already but the underlying actual loss rates, not mark-to-market or distressed asset sales, are not there. We are panicking ourselves into a multi trillion dollar problem to solve at best a $200 billion problem.

There is massive double and triple counting of losses. Think of a mortgage securitization for $1 billion. Class A-1 has top 60%, A-2 has next 25% and A-3 has next 10%; the sub and equity pieces have the bottom 5%. If delinquents then rise, the classes trade down in value. The A-1 trades down to 75%, A-2 to 55%, A-3 to 40% and the stubs go to 15% which equals 36% on a mark to market basis or $360 million. If the actual loss rates come in at 12%, $120 million in my example, the mark-to-market loss will be 3x the actual loss. The A-1, A-2 will get paid in full and A-3 gets 30% on the $1.00, while sub and equity gets wiped out. The actual recovery on the A-3 will be higher because of excess interest cash flows, mortgage insurance recoveries, etc. My numbers are not from a real deal, but I bet they are not far off the mark. Either way, I can assure you that the mark to market far exceeds the actual losses. It gets worse, because the same classes get put in an SIV funded with asset backed commercial paper and the SIV fails, because the rating agencies downgrade the mortgage paper and the SIV. The holders of the SIV asset backed commercial paper take a mark-to-market loss or a real loss when they dump their position and so does the SIV. As a result, we double and triple count again the same underlying loss on the underlying paper in that case. The bottom line is that we have a dislocation in how this stuff is financed as much as we do a real hit from actual underlying losses. The panic and unwinding is making it far worse than if we just let the actual losses fall thru the system. The good news for the US is that much of the actual losses are held by non-US holders.

As of June 30, 2008 the US banking system has less than $10 billion of foreclose home REO inventory on the books. This is immaterial to a $13 trillion asset industry with $200 billion of pretax preprovision earnings power per annum and it's nowhere near the numbers being thrown around in the media.

STOCK MARKET:

In the Great Depression, the market dropped peak to trough 89%! We are down about 33% peak to trough in the S&P 500. Most recession bear markets eat up about 25-40%, so this is not historically unusual. It's not fun, but it's not the Great Depression. I am not saying this is not painful or real, but we are losing perspective.

REAL ESTATE:

Any reasonable person would realize that the extraordinary appreciation from 2003 to 2006/07 was not realistic and we were front loading appreciation from the future. Clearly real estate values will be flat to down, but if we look back 5 years from now we could draw a trendline from 2001 to 2013 and it will average out to be a "normal" level of appreciation, with an overshoot on upside followed by reversion to the mean or an overshoot on downside. Why is this so unexpected or abnormal? House values will track growth in income and GDP and inflation over time.