



Michael Aronstein: Optimism for Housing and the Economy

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Michael Aronstein is President of NY-based Marketfield Asset Management, where he oversees the management of their one-year-old Marketfield Fund (MFLDX), which has \$55 million under management. Aronstein has worked in the capital markets for 31 years, including a tenure at Merrill Lynch - heading its investment strategy research team. He has also worked in the private banking and hedge fund industry. We talked with Michael on October 8, 2008.

Have you ever experienced markets like we are seeing today?

Yes, in 1987 it was a similar environment. I was one of the managers of the top-performing fund in the US — possibly globally — at that time.

Last year we predicted there would be disastrous consequences in the aftermath of the credit frenzy that gripped Wall Street and much of the hedge fund universe and we probably came across as alarmists. But it is always very hard to get people to move. When people are on one side of the seesaw, you have to get very far out to the extreme to change their opinion.

What stage has the current US credit crisis reached?

We have gone through a long period where access to credit with overly favorable terms drove the financial side of economy. This drove a lot of growth on the real side of the economy. As the Fed funds rate was lowered to 1% in the early part of this decade, it forced people to take risk, and at the same time offered ironclad opportunities to speculate by taking advantage of the spread between cost of funds and the yields available. The whole system turned into a giant carry trade [where investors have borrowed at a low interest rate to invest in assets with higher yields]. That is what is now being unwound.

The housing market has unwound pretty fully, although not yet in New York, Beverly Hills, or London. Those markets still have a way to go before they reach bottom. But many homes near the median price or within the conforming price range are probably very near a low point. Housing affordability is near historically high levels in many of the most



overbuilt markets, including California, Arizona, Florida, and Nevada. Prices in these markets are down 30-70%.

The saga began on the downside with fundamental damage to the primary speculative collateral which centered on single- and multi-family homes and condos, and then progressed to the instruments within the capital markets used to finance the speculation. This is the normal cycle of impairment, as it spreads from merchant to financier. In last stage, the problem is in realm of finance. When it hits assets that are liquid, the change is abrupt, as compared to the gradual erosions that took place in the housing markets over the last 12-18 months.

The seizure of the credit markets is the terminal event. It is the end of the cycle.

How severe is the credit crisis in Europe, as compared to that in the US?

Not everything is rosy, and there is lot of risk in the marketplace. The main problem is the intransigence of the European Central Bankers (ECB). They hiked rates three months ago, and would not reverse that decision. They would not admit that they were wrong, implying that such an admission would be more distasteful than a collapse of their economies. They were dragged by their colleagues, who eventually forced a response. But short-term rates in Europe are still way too high.

The shape of the yield curve is one of the most important inputs to the profitability of the banking industry. Until 8am this morning, yield curves were flat or inverted yield curves for most of the countries in the European Union. [This interview took place on the day the Fed and the ECB lowered rates by 50 basis points.] This was completely reckless on the part of the ECB, and showed a profound lack of competence. In a way, this is not a surprise, since the ECB is filled by political appointments.

European yield curves are punishing the banking system. Banking is not a good business when the cost of funds is about the same as the returns on safe bonds. The ECB's actions – specifically, their rate cuts this morning - may be a step in the right direction, but Europe is really a mess administratively.



Coming back to the housing market, you mentioned that housing has become more affordable. But the affordability index, published by the National Association of Realtors, has proven to be a very ineffective measurement tool.

We do not look at the published affordability data. We look at markets that are really a problem. These markets have changed very dramatically. It is now close to an even tradeoff between owning and renting. The “own versus rent” cost differential was the metric we used when we were bearish three years ago. Our data is taken from actual figures, such as advertisements in newspapers. The data (two or three years ago) said that you could save 50% by renting instead of buying. The excuse everyone used to rush into the housing market was that, by renting, they were missing out on the chance to make money on a housing investment.

We are near the bottom of the housing cycle — perhaps not in terms of price but in terms of liquidity. Liquidity in housing is turnover – the buying and selling of houses. Turnover in housing will be very important to generate liquidity in the underlying mortgages, and will over time take the more problematic mortgages out of the system. Mortgages generated today are not a problem. The mortgages underlying most of the derivative instruments that have nearly destroyed Wall Street will, by their nature, diminish as liquidity runs its process and houses get refinanced.

The key point now is that the elements are in place to heal the basic problem, which is housing.

Let’s look beyond housing. Where is the rest of the economy and when do you expect a strong recovery?

In general terms, there is impairment in all sectors of the economy that rely on cheap and plentiful credit. This includes a lot of hedge funds (which is another bubble bursting), many leveraged REITs and commercial property owners, and everywhere else where the business model is based on finance-ability rather than the intrinsic value of the asset. The traditional aspects of the US economy: retail, manufacturing, and agriculture will be fine.

There will be a repatriation of manufacturing facilities into the US, due to logistical problems with moving high value-added goods and increasingly difficult problems managing offshore resources. Cost differentials are narrowing. It is not like it was eight years ago, when companies could hire engineers in India for the same wage as a clerical worker in the US. The incentives are gone. In a lot of ways, the last unexploited emerging



market is the Midwest of the US, especially within 200 miles of the Mississippi — the old manufacturing rust belt.

What do you see as catalysts for the next bull market?

The next bull market will be driven by US manufacturing. In the housing market, smaller houses are being built. People are no longer buying the largest house they can afford (which is what a lot of young people were told to do). They bought large house as a substitute for savings, and this will stop.

The proportion of income spent on shelter will decline, which is very positive for rest of the economy and is long overdue. There is still a shortage of skilled labor. For the last three to four years, young graduates went into training programs at Goldman Sachs or Blackstone. That opportunity is gone, and it will push talent to wealth-generating in a broader sense. Real wealth comes from productive capital stock, not from the movement of capital structure elements (such as leveraging assets or securitization). All that does is push chess pieces around the board, when the wealth is the chess pieces themselves.

How have you positioned your portfolio for these opportunities?

We are now 60% net long, after having been short to the maximum extent we are allowed. We have strong positions in home building and building products, railroads (which have been a disaster because they were a favorite of hedge funds), trucking, retail, and a fair number of consumer-related industries. We have very little money outside of the US now. We were very positive about the dollar for the last six months, and the dollar will continue to be strong, although not as dramatically as it was in the last month or so.

I have a real issue with emerging markets. I don't believe in decoupling. The emerging markets are too small, lack liquidity, and have too many investors that are overly aggressive. It will take a long time for these markets to settle down. There are huge differences in corporate governance between US and most emerging markets. Emerging markets trade at a discount for a reason. Some may snap back quite a bit in next rally, but I am not convinced of the long term value.

We own very few commodity names. A lot of commodity investing is based on emerging market decoupling. We have been short in commodities and emerging markets for the last couple of months.



Do you see inflation as a big threat to US market valuations?

Right now there is balance sheet deflation, which followed a period of balance sheet inflation. Balance sheet inflation is not measured well. No index captures balance sheet inflation, but in a lot of ways it is more pernicious and is the destructive part of inflation. For example, the extreme rise in housing prices was not reflected in reported CPI numbers. But it has been very destructive.

The Fed will be successful in slowing balance sheet deflation. Eventually we will see inflation, but that is not the issue now. There is runaway deflation now. We won't go from one extreme to another abruptly. There will be a change but it will be gradual.

Can you summarize your basic thesis for the market?

There are many complex factors at work in the market today. But my thesis is simple: at the core of the problem, the most leveraged asset in the economy is the single-family home, and for the most part it is at a price where it will provoke a more normal level of transactions. The Fed understands what is going on and they are fixing it, with virtually unlimited power.

Those in the Depression camp imply that the Fed is powerless. The Fed may have waited too long, but now they have the message. That is really all it boils it down to.

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