

# COMSTOCK PARTNERS, INC.

## The Bubble, Deflation, and Implications for Real Estate

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We have written many research pieces and daily comments describing what we believe to be the highest probability outcome from the most outrageous financial mania in all history. We concluded that the excess capacity and record debt levels that were associated with the mania would produce deflation here in the U.S. and possibly worldwide. This paper will discuss each of these areas and also direct your attention to the implications for real estate and housing prices.

### The Bubble

The mania that took place during the 1990's will go down as the largest bubble in all of financial history. At the peak price earnings multiples were unfathomable with the NASDAQ trading at 245 times earnings and the S&P trading in excess of 35 times earnings. The 245 times earnings of NASDAQ were unprecedented since the NASDAQ traded in a range of 15 to 30 times earnings from its inception in 1971 to the mid 1990's, when every man woman and child in America wanted to own a piece of Cisco, Dell, Microsoft, Intel, JDS 3Uniphase, etc. We are sure the history books will be replete with examples of true greed and/or ignorance from the best and brightest people in America. Many of them had Ivy League educations and had studied the basic fundamentals of common stocks and what drove their returns. They threw the investment books of the past out the window and decided to come up with metrics of their own in order to justify prices that make no sense. They were taught that stock splits should mean nothing whatsoever in the valuation of a common stock, and that the only purpose of splits was to make it easier for individuals to buy 100 shares. Yet every time a company announced a split the stock would soar in price. They were taught that the P/E of the major indices range from 10 when stocks were inexpensive to 20 when there was irrational exuberance. Yet as the S&P 500 P/E rose above 20 and then 30 they actually believed that there was a "new era", or "new paradigm" and that the old fogies who thought that historical P/E ranges meant something were crazy. They started valuing companies on whether they beat the "whisper number" and how many eyeballs were logging into an Internet site. Imagine how any strategist could have been bullish as the market rose to triple and in some cases quadruple levels seen in normal times.

Even now business schools all over the country are looking back at what took place during the bubble and are more than likely knee slapping and belly laughing at how insane the environment was. They will find it very hard to believe, and in hindsight wish they were managing money since it would have been so easy to see the errors of the best and brightest. It is too bad, because they will never again see that type of mania in their life times. Also in hindsight, they could have looked back at valuation levels of individual stocks and wish they would have been around to sell or sell short ridiculously valued stocks. The most egregious examples of greed were the business-to-business Internet stocks, like I Two Technologies, Ariba, or Commerce One. These companies were in the business of facilitating business purchases through the Internet and each one sold at valuations exceeding \$48 billion when there were no earnings and in some cases very little revenue. Other companies that come to mind are CMGI and Internet Capital Group, which did nothing but invest their capital in start up Internet companies that for the most part had no revenues or earnings. At one time the capitalization levels of these two companies were \$125 billion. This valuation level was higher than the combined capitalization of International Paper, Alcoa, GM, Honeywell, AT&T, and Eastman Kodak. But that was when the stock of CMGI traded at 163 and Internet Capital Group traded at 212. Now CMGI trades around 85 cents and Internet Capital Group trades around 33 cents. Priceline, which did nothing except sell airline tickets over the Internet and had no planes, no pilots, no baggage handlers, or maintenance men, was worth more than the entire airline industry-by a lot!

Is it possible that the consequences of a financial mania that ludicrous can end with the mildest recession in history in 2001? Debt increases and mergers and acquisitions, whereby one overpriced company bought another overpriced company, were the typical market transactions. After selling overpriced stock to the public as IPOs, the shenanigans investment bankers used to manipulate new issues to triple and quadruple the IPO price (the same day of the offering) were amazing. They would only allocate new offerings if the client paid substantial commissions to the underwriters and then insisted that the buyers of the IPO also buy more shares wherever the stock opened after the IPO. Of course this activity only encouraged the public to chase the new offerings to an eventual horrible outcome. There were exceptions made to purchasing in the aftermarket, but you had to be a prospective client who could flip the IPO for a

substantial gain at the public's expense. The investment bankers were able to convince the best minds in the country that they were getting a great deal on the initial public offerings even as all understood that many of these companies had no earnings and some had no revenues. When the mania ended the debt load remained and as the stocks crumbled individual investors were left holding the bag. Is it possible that this mania could end without the debt contracting or the individual investor disgorging themselves of the stocks and stock mutual funds they rushed in to buy at any cost? We don't think so!

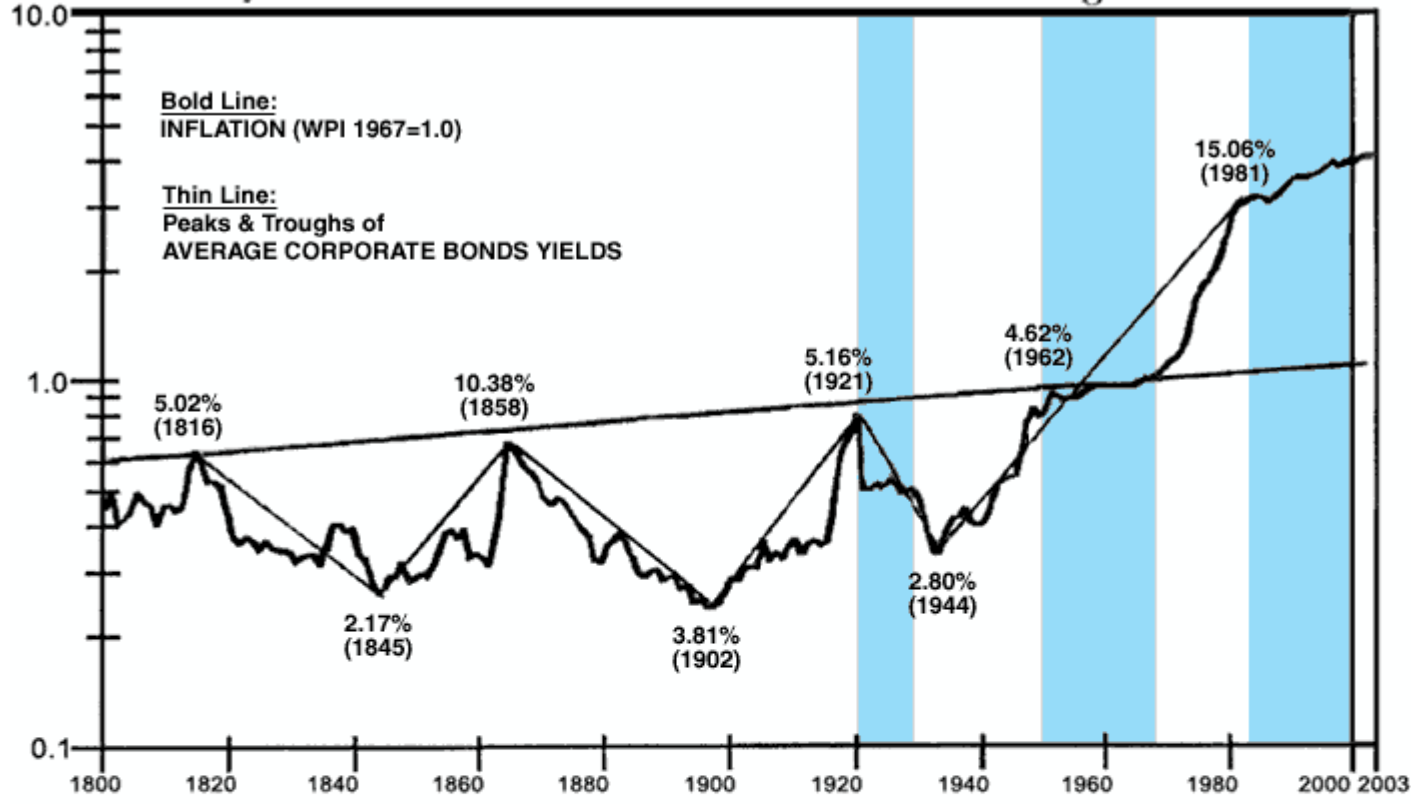
## History of Debt and Deflation

The U.S. has a history of major inflation followed by massive deflation for the past 200 years. These inflationary periods were accompanied by increasing debt and rising inflation while the deflationary periods were associated with decreasing debt and interest rates. In between the inflations and deflations we experienced periods of disinflation, which just happened to coincide with all the gains in the stock market over the past 100 years. The periods of inflation and/or deflation were not what you would call beneficial to the stock market. We have been experiencing disinflation for the past couple of decades (the best environment for common stocks), but we would not bet on this environment to continue and we expect to fall into a deflationary period shortly.

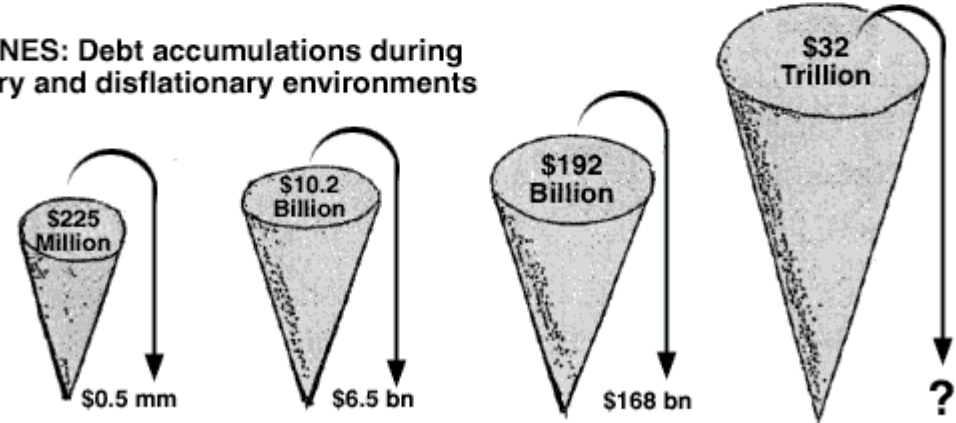
Inflation is an abnormal increase in the available money and credit beyond the proportion of available goods, resulting in a sharp and continuing rise in the general price level. Deflation, on the other hand, is a reduction in available money and credit that results in a decrease in the price level. In other words, deflation is the destruction or elimination of the build up in debt associated with inflation. Because of the relatively recent events of the 1970s almost everyone is familiar with what happens during periods of inflation. What occurs during deflation is less familiar since the last time it happened was during the 1930s. Precipitating the deflation of the 1930s was the inability of the banks to lend out money supplied by the Fed. While the banks had the funds to lend, qualified borrowers didn't want the money and the others were not creditworthy. This could have taken place because of job losses, business failure, or the bank not wanting to loan the money to non-credit worthy borrowers. And if you think about it, why should they? The goods they would have purchased with the money borrowed were declining in value due to excess capacity and deflationary conditions.

Concentrating on the chart attached below we will describe the flow of debt and interest rates as well as the producer price index. The first period of inflation on the chart started in 1800 and lasted until 1816 when interest rates peaked at 5.02% and debt peaked at \$225 million. The deflation that followed lasted until 1845 with interest rates troughing at 2.17% and debt declining to \$500,000. The next inflationary period took interest rates all the way up to 10.38% (just about double the highest rate from 1800 to 1970) in 1858, while the debt rose to \$10.2 billion. This debt declined to \$6.5 billion in the following deflation while interest rates declined to 3.18% in 1902. The inflation that followed took the interest rates up to 5.16% in 1921 while the debt grew to \$192 billion. The next deflation brought the debt down to \$168 billion and interest rates to 2.80% in 1944. From 1944 inflation grew until 1949 when it leveled off into another disinflationary period where stocks prospered until 1966. Anyone who studied financial history would have believed the debt would peak and we would enter another period of deflation. However, with the build up in liquidity that took place during the war, there remained enough liquidity to enable a continuation of borrowing and spending. So, instead of falling back into deflation, inflation accelerated from 1966 to 1981 with the PPI tripling before leveling off again. From 1981 to the present we have been experiencing a disinflationary period associated with bull markets. And we had a doozy! In fact, the debt levels continued to grow just as they did in the other disinflationary periods such as 1920 to 1929 and 1949 to 1966, two periods that also witnessed tremendous stock market returns. These disinflationary periods are circled in the Debt Cone chart, which is attached at the end of the text. You will find that these disinflationary periods alone accounted for the entire gain in the stock market averages for the 203-year period of time.

### A History of Wholesale Prices/Interest Rate Peaks & Troughs



#### DEBT CONES: Debt accumulations during inflationary and disflationary environments

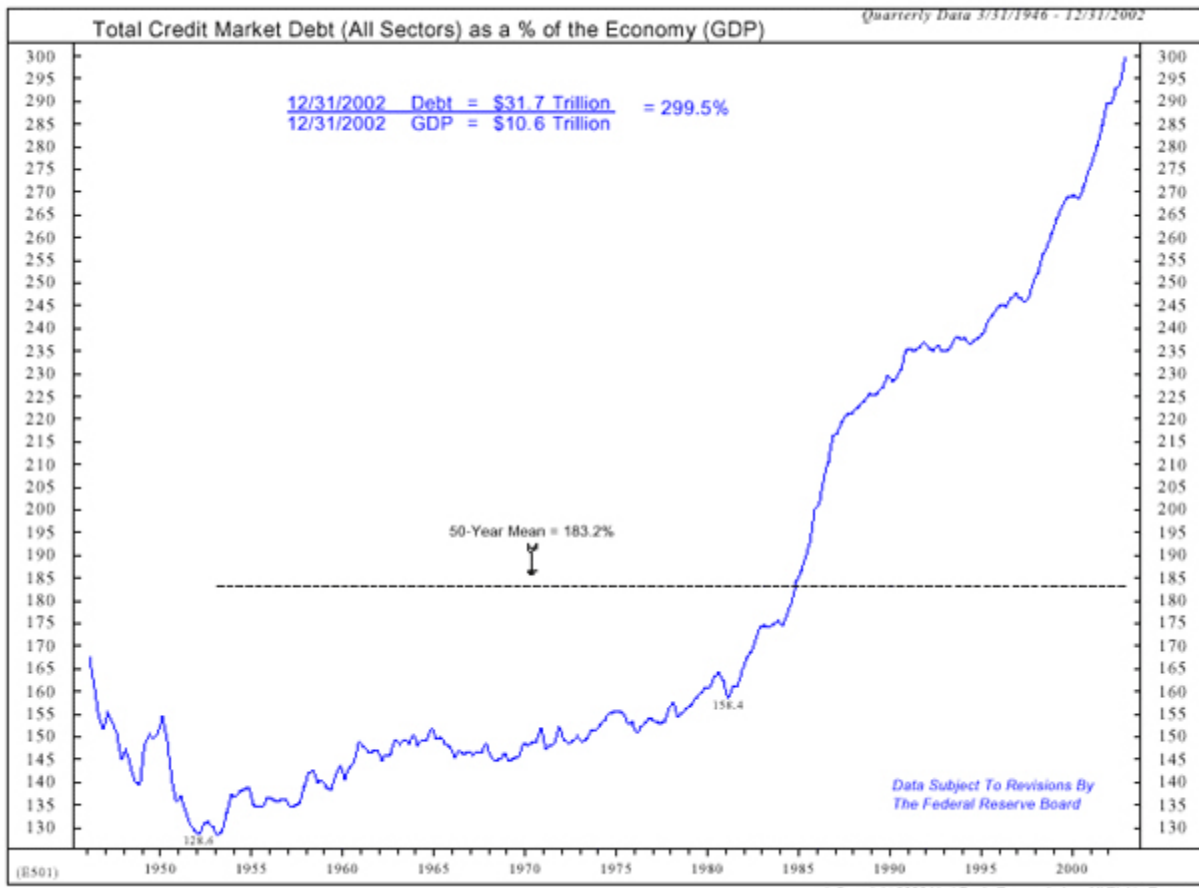
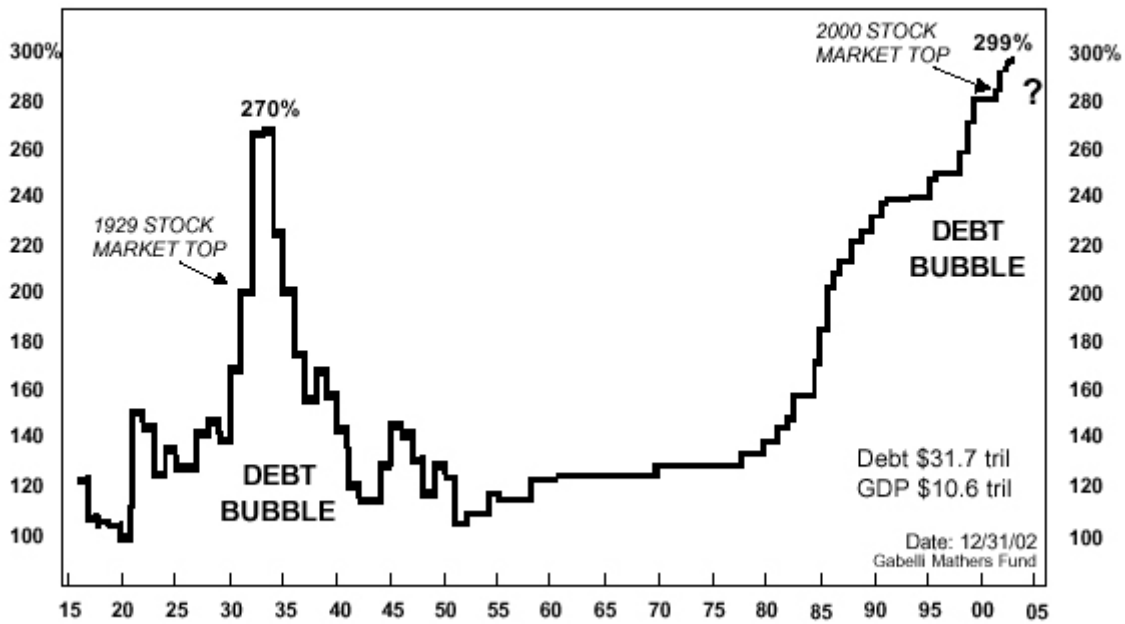


**The 200 year history of US inflation is replete with massive inflations followed by massive deflations. The shaded zone areas are disflationary periods of time which are accompanied by phenomenal returns in the stock market.**

Sources: Department of Commerce, The National Bureau of Economic Research, Moody's

The debt grew to approximately \$20 trillion relative to the GDP of \$8 trillion in the first quarter of 1997 and continued to grow in the financial mania to the present level of almost \$32 trillion with \$10.6 trillion of GDP (GDP is essentially the revenue generated that could be used to pay down the debt). Nobody knows if this is the limit to the debt-to-GDP ratio that will lead to deflation, but the bursting of the bubble leads us to believe that we are very close. Keep in mind that the growth of debt from \$20 trillion to \$32 trillion over the past 6 years with the GDP growing at \$2.5 trillion catapulted the debt-to-GDP ratio from 2.5-to-1 to 2.8-to-1 in six years. Is this the limit? Who knows, but if it ever ends, there couldn't be a more logical time than right now! Again, only because of the fact that the bubble in U.S. stocks has burst in a way similar to the U.S. in 1929 and Japan in 1989, we could conclude that the debt is starting a major decline.

**TOTAL CREDIT MARKET DEBT (ALL SECTORS) AS % OF U.S. GDP**



Other important signals preceding a debt decline would be the money supply peaking and the velocity of money contracting. The charts of these two indicators of potential deflation are shown at the end of this paper.

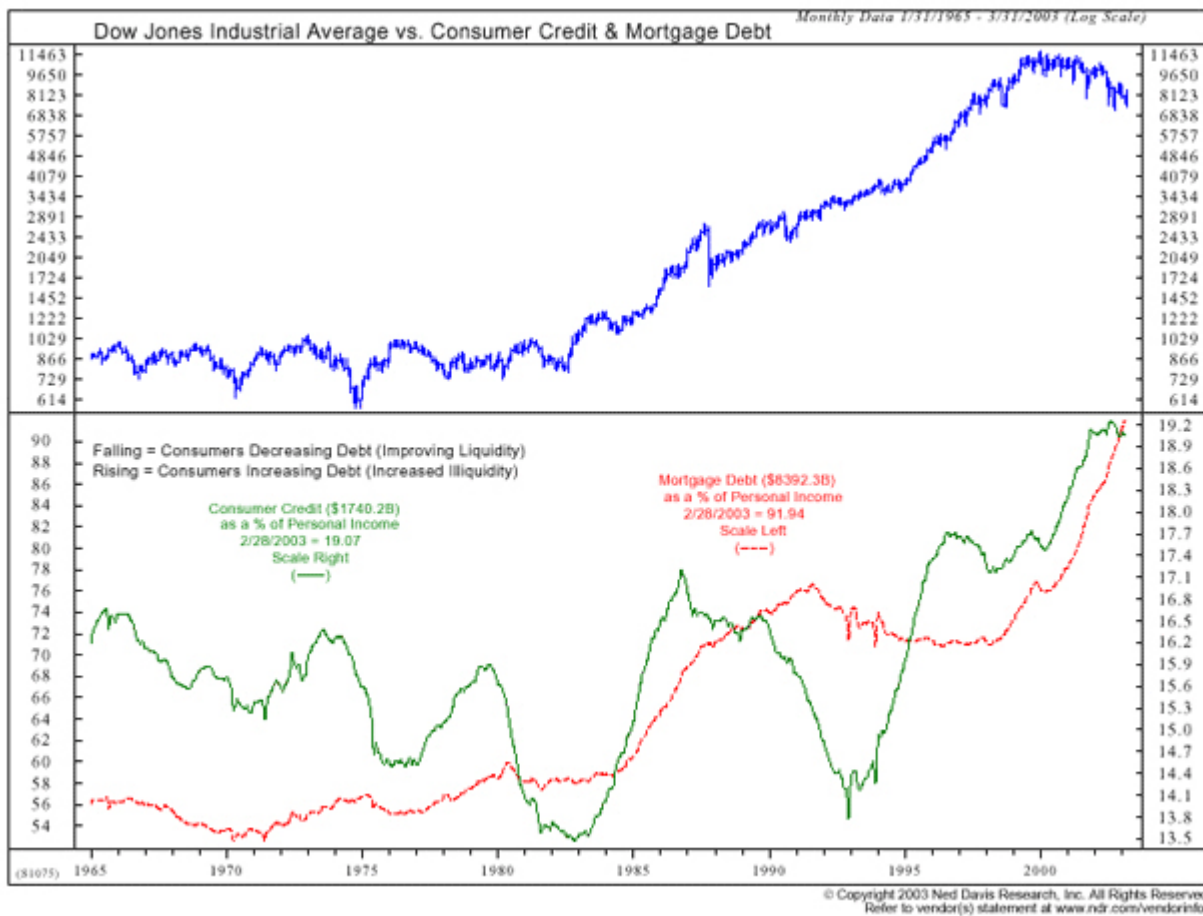
**Why Real Estate Might be the Catalyst for the Next Deflationary Period**

Anytime you want to find the most vulnerable segment for an implosion of a debt bubble, just identify the main asset that the lending institutions are using as collateral in making new loans. Recent history is replete with numerous

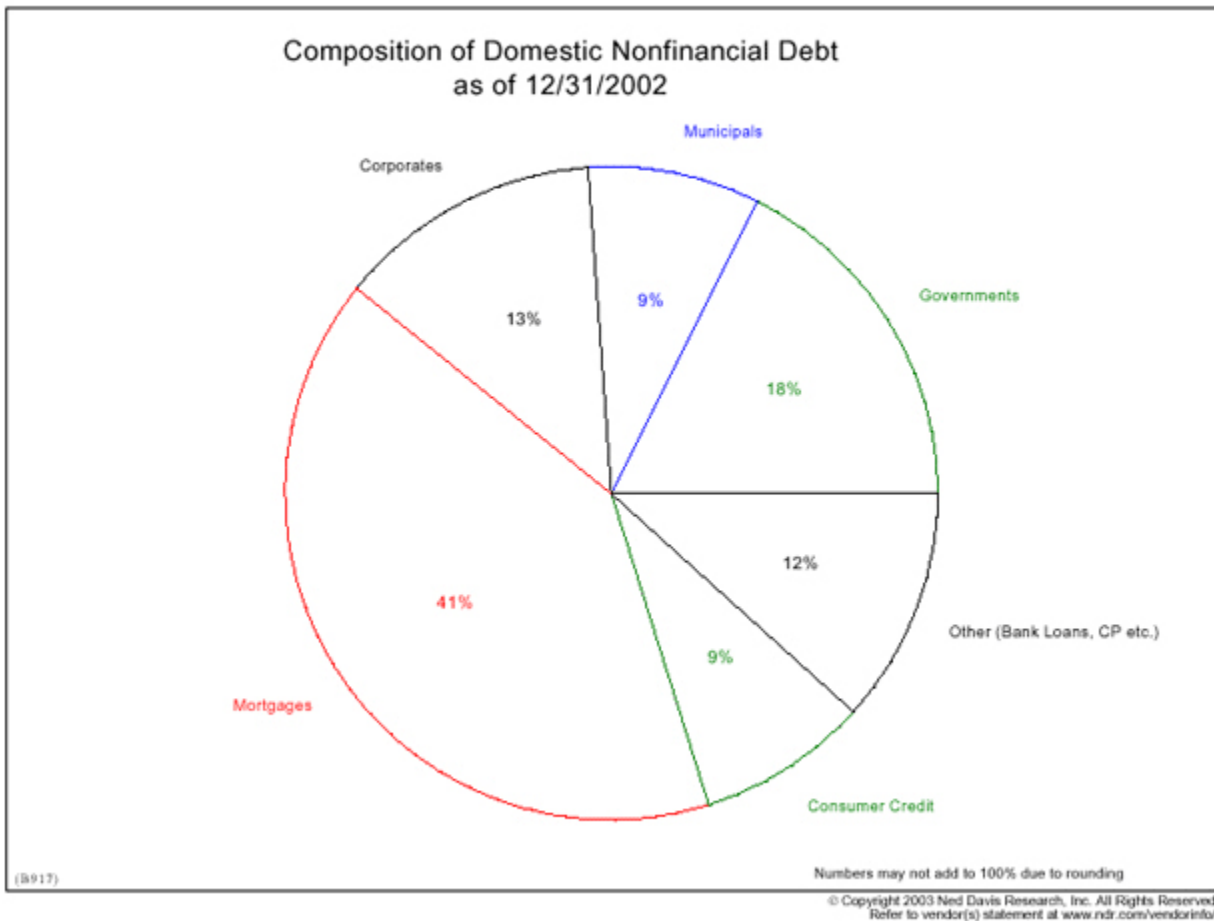
examples. The banks couldn't wait to loan money to the LDCs (lesser developed countries) in the mid 1970's because of the fact that governments could always print money if they had a problem with too much debt. Walter Wriston of Citibank was the largest proponent of the theory. They found out the hard way that this was not the panacea that most bankers thought as these countries used the printing press to substantially depreciate their currencies. Then the banks loaned money to the farm belt since it was obvious in the late 1970's that inflation would bail out any problems with farmers. This turned out to be even worse than the LDCs. The banks were loaning money to a segment of the economy that had no chance to pay down the debt. The income from the crops they were growing and selling couldn't possibly justify the cost of the real estate that was skyrocketing at the time. At the time, Merrill Lynch even tried to sell a limited partnership on farmland to its clients. We believe the plan was stopped in its tracks only by a very sharp client (Mr. Dwayne Andreas, then CEO of Archer Daniels Midland) who warned them how dangerous it would be to do the deal with the price of farmland so high relative to the money the farmers could receive for the crops they grew. Naturally, this also blew up in the lenders' face and they had to find another segment of the economy to keep the debt bubble going. Voila, energy! The lenders saw that the OPEC agreement in the mid 1970's would be a "no-brainer", since there were many forecasts by experts that the price of oil would rise to \$100 a barrel and there would be no problem getting their money back with interest. This also turned out to be a mistake since the oil price stopped rising as exploration activities soared and energy users found ways to alleviate the pain through energy-saving engines and appliances, wood stoves, sweaters, and whatever else it took to stop the rise in energy in its tracks.

This was followed by massive loans to the "rust belt" manufacturers in the mid-west, and this turned out to be a mistake also. The following area of concentration was the junk bonds and LBOs (leveraged buyouts). Mike Milken was a hero at the time and the banks concurred that they couldn't lose this time for sure. Well, we all know what happened to Mike Milken, and the banks should have learned another lesson. If the banks consistently found that the areas and segments that they lent to never seem to work out, you would think that they would learn to stop concentrating in just one area or segment. But believe it or not, they never seem to learn that the only reason the collateral behind the loans rose in value was because the money that was loaned supported the collateral. What area do you think the most money is being loaned to now? You guessed it, real estate in any form. Houses, apartments, office buildings, and raw land can't miss. Everything else seems to be wilting away, but not real estate!

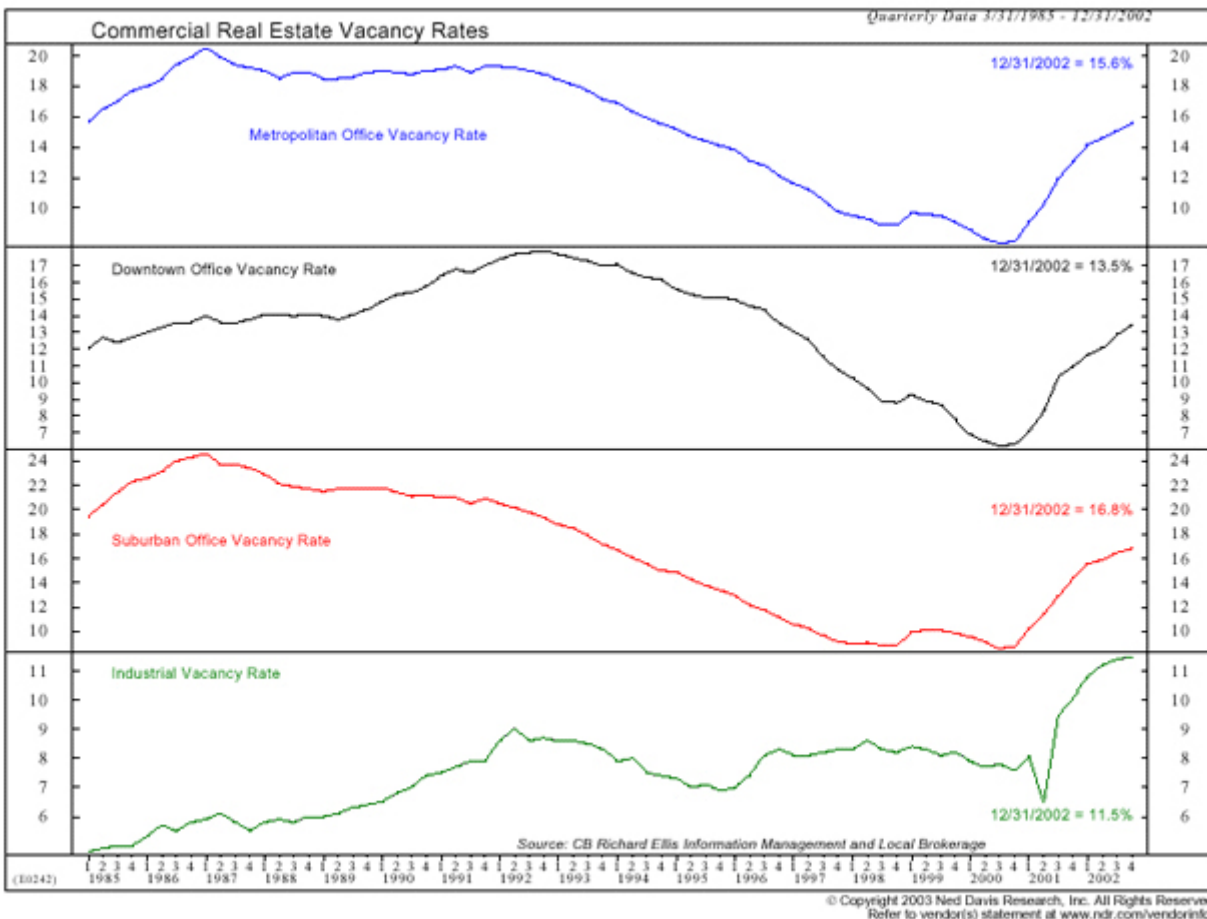
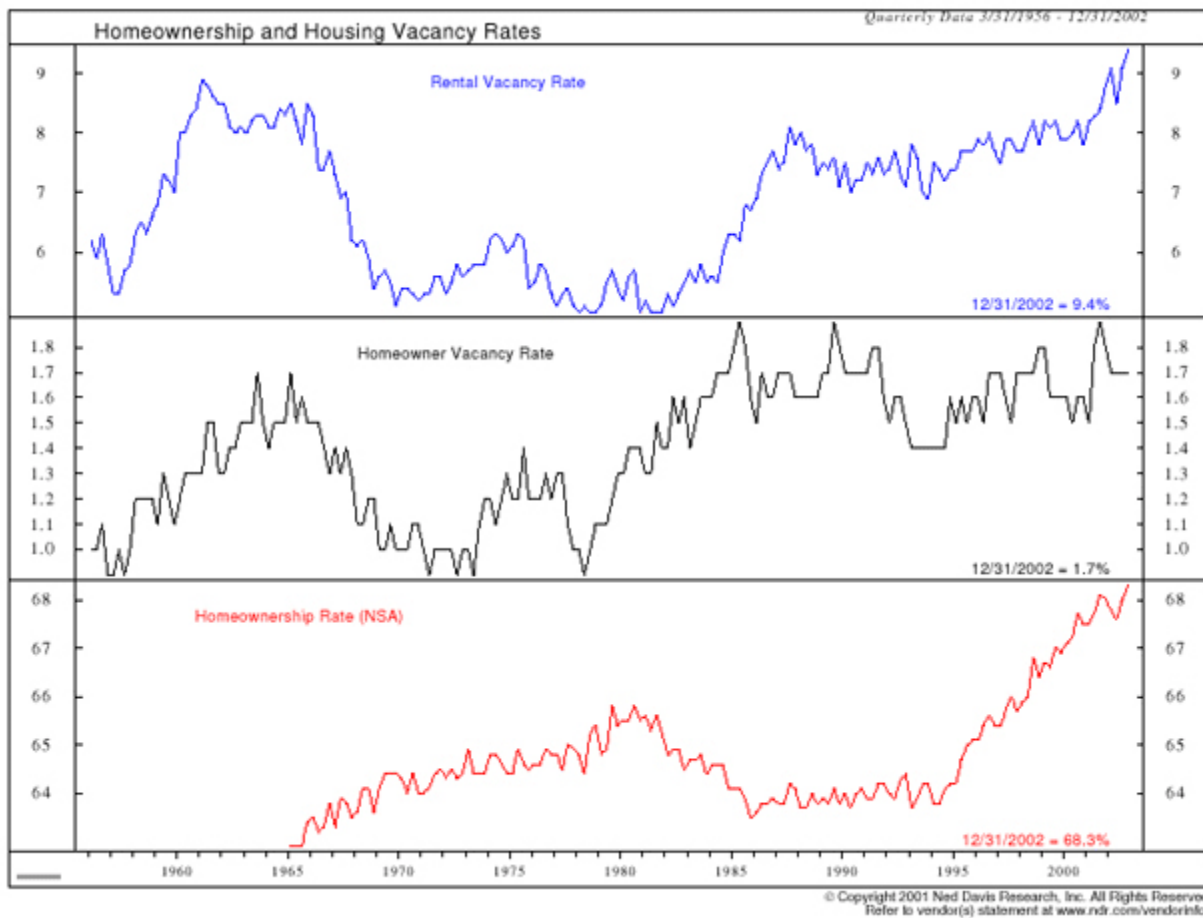
Now, take a guess at what segment dominates domestic non-financial debt? What area is over 40% of total domestic non-financial debt? You guessed it--Mortgages! What area now do you think will be the catalyst for the next deflationary period? You guessed it again-Real Estate! Now maybe we are wrong on this, but we are highly confident in the final outcome even if we are early. We believe that just like the farmland that became too expensive relative to the prices received from crops, the price of real estate can't be justified by the amount of rents received. We look at this in the same way as the P/E of a common stock. If the price of the company's stock is way out of line with earnings, that stock will eventually decline. On our home page in the section titled "Comstock in the News" is an interview with Barron's that touches on the dilemma of real estate and housing. The Center of Economic Policy Research put out a paper comparing the cost of renting a home to the cost of owning a home. They looked at the situation just as we do. They concluded that the gap between the two is now about the largest ever. Comstock was written up in Barron's magazine in 1988 discussing this same theme and the gap was wide then, but it is even wider now! This gap can only be filled by rentals rising or home prices falling. With vacancies increasing in every area of real estate, we doubt that the gap will be filled by rents increasing. There is no other solution to this problem except for housing prices to fall, and that won't be a pretty picture since it seems that every homeowner in America has been borrowing money on the equity of their homes.



The Mortgage Bankers Association of America estimates that the total volume of mortgage loans in 2002 is a record \$2.5 trillion. The Federal Reserve estimates that homeowners raised \$130 billion last year through home equity loans and lines of credit. (Total cash-outs of all home refinancing could be as high as \$250 billion.) Many of these home equity loans are used in place of credit card debt since the interest rates are much more favorable. However, while credit card lenders can only sue a borrower and request a lien on the property, the problem with home equity loans is that the bank can seize the property. This would very rarely be a problem with housing prices going up, and home prices have increased over 40% on average since 1997, with some areas like New York (especially Long Island), Phoenix, and Denver increasing much more than the average. However, there are other areas where the home prices have softened, such as the Midwest (St. Paul, and Indianapolis) and Southeast. In these areas the banks have their hands full as delinquencies and foreclosures are rampant. Just last month the U.S. hit a near record delinquency rate and a record foreclosure rate, with almost all coming from the areas of soft home prices. If home prices that have been skyrocketing start to fall we could have a snowball effect and delinquencies and foreclosures could really get out of hand.



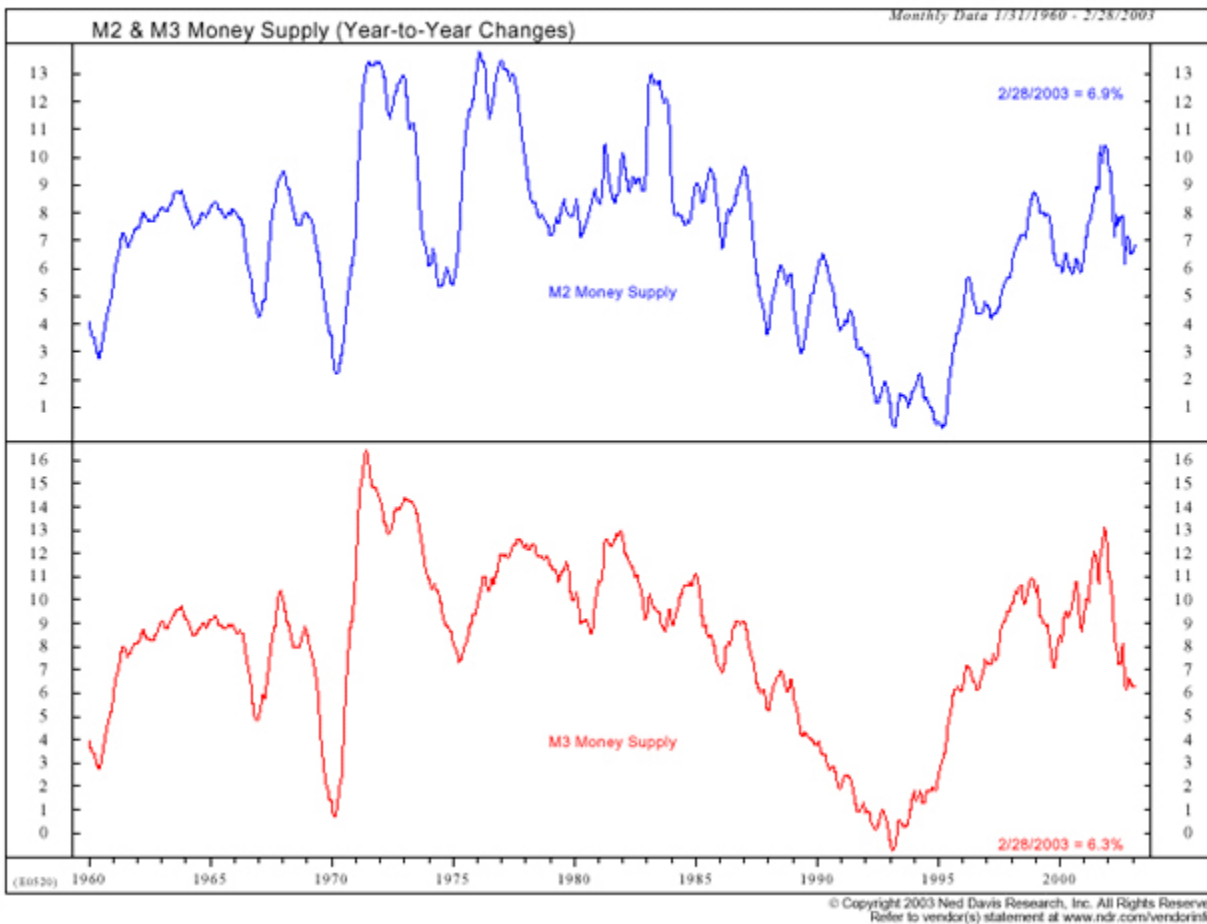
The real estate problem we see is not confined to housing alone, as office buildings and apartments are having their own problems. Only yesterday it was reported in the Wall Street Journal that the U.S. office-vacancy rate rose to 16.2% in the first quarter. This was the ninth straight quarter of rising vacancies and declining rents. It started in the first quarter of 2001 along with the start of the recession, but just like the job market, it seems to have remained in a recession. Apartment landlords also saw vacancy rates on average in the U.S. climb to their highest level in a decade. The apartment-vacancy rate for the nation's top-50 metropolitan areas rose to 6.8% in the first quarter, from 6.3% in the fourth quarter of 2002 and 5.7% a year earlier. Effective rents fell .3% from the fourth quarter and .1% from a year earlier to \$845 a month.

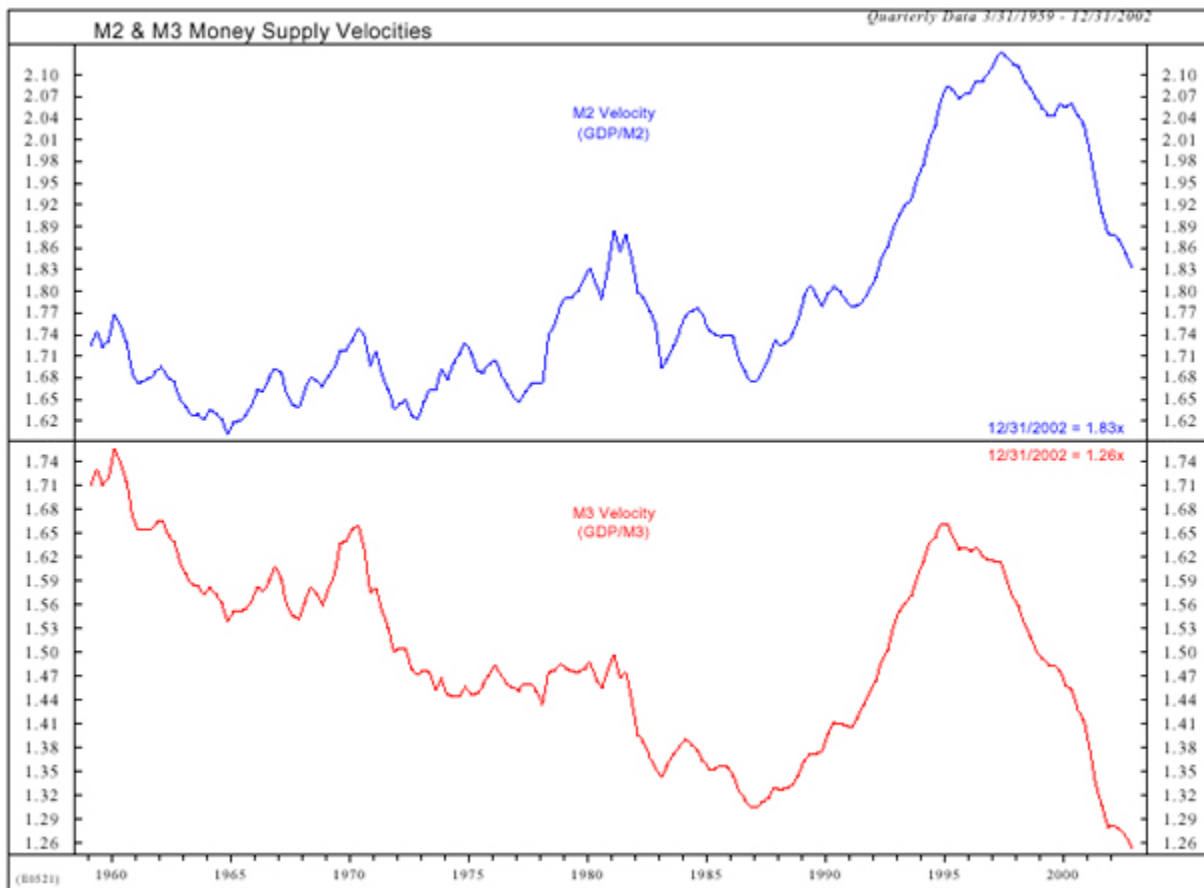


Right now real estate and housing are the pillars of the individual's investment portfolio, and if that cracks, it could be the catalyst that throws the U.S. into the same economic quagmire that it went through 74 years ago. When you look



at the record foreclosures and near record delinquencies on mortgage debt as well as rising vacancy rates in every area of real estate you start to come to the conclusion that the banks and other lending institutions could be making the same mistake again.





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