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Remember, 'free money' usually isn't

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Real Money

People naturally like other people who smile a lot because being around someone who looks like they feel good makes us feel good. Similarly, everyone likes to save money and even if we are not putting it away for a rainy day, getting a good deal on a new purchase makes us feel as if we are making money. When we refinance our home at lower interest rates, it appears that we are becoming more affluent. In 2002, $200 billion flowed into the economy as individuals revamped mortgages. It seems like a kind of party, with free money being given away as favors.

"Where does all this free money come from?" I asked myself. Being something of a skeptic, I figured somebody, somewhere, was going to have to pay the bill for this cash infusion into consumers' pockets. Visiting with a client, I was told that she had just taken on a new mortgage because her neighbor had said she could get a great rate. "Get a five-year adjustable-rate mortgage," she was told by the broker. It has the lowest charges and you get the lowest rate. A commercial banker friend of mine told me that her bank was not lending money to businesses as the rates were too low, and bingo, it all came together.

The simple answer is that individuals who are taking out adjustable-rate mortgages are unwittingly taking on the risk formerly borne by institutions. People with little familiarity with interest-rate cycles are being sold a tidy package that works now, but when interest rates rise, they will be facing a susbstantially higher monthly payment — maybe more than they can afford — or be forced to sell their homes into what may turn out to be a bad market, maybe even a terrible market.

There are some happy folks who go out and spend their monthly "savings" on good beer or a new car (at 0 percent financing, of course). These folks are just exchanging one kind of debt for another, but having a great time along the way. To those of you in this category, I tip my hat enviously and wish that I could lose myself in enjoying the moment. One-third of all people who refinance their homes use ARMs. Wittingly or not, if you have a variable-rate mortgage, you must believe that either housing prices always go up, that your personal incomes will go up, that interest rates will stay down, or that there is a Tooth Fairy.

If you have refinanced your old mortgage and increased the dollar amount of your new

Please see **RIKOON**, Page C-2

RIKOON

Continued from Page C-1

loan because even with the larger debt, your payments are lower than your old one, I recommend you to Math 101. The law of compounding interest (especially interest that is much more likely to increase than decrease) says that if you want to work for the rest of your life, occasionally extend out into the future the period of time that you must continue to make mortgage payments. To those in that boat, I say beware.

The cost of multiple military fronts, domestic security, tax cuts and minimal job creation (that is being polite) all point to rising interest rates. In fact, the harbinger of rising rates has already been felt in the bond market, as the bellwether U.S. Treasury bond had its greatest fall in price in late July since 1987. This is the time to lock in low rates, to sell long-term bonds, to exit from some bond funds and to start saving, because if history is any guide, the government will not be there to bail you out if you can't make your mortgage payments after rates go up.

Given the size of the government's debt problems, we might be asked to pony up some of our hard-earned Social Security to bail Uncle Sam out of his mess. Medicare, too, looks suspiciously open to pilfering by one set of politicians or another. Here are the facts:

The Congressional Budget oversight committee recently acknowledged that its previous estimates of how much in the hole we are as a nation was woefully inadequate. It is now said that we will be $400 billion in the red this year. If the economy does not grow by well over 2 percent this year, next year's shortfall will be 50 percent higher, or $600 billion. Who cares? You should, as interest rates will climb as our deficit grows. ARM holders need to encourage their representatives to have some discipline in terms of government spending.

It would be good to have an investment strategy in place, well-thought-out and ready when the bond market truly tanks. A recent article in the *Wall Street Journal* by the normally clear-thinking Jonathan Clements suggested that because bonds were ripe for a fall, stocks now represent a better value, even though by all traditional yardsticks, stocks remain overpriced, too. History shows that stocks will outperform bonds if they have a real rate of growth of 6 percent. If you can call 85 years of statistics "history," then he is probably right.

If however, we are in an economy that does not grow steadily at 6 percent or 4 percent or even at 2 percent, for a good long time, then we will be in for a hard landing. Hard landings are what used to be called recessions. Business cycles, like nature's cycles, are made up of excess and then droughts. What we are experiencing is an attempt by powerful men and women to mitigate the pain and suffering of investors because of market cycles. This is especially important when public-election and economic cycles coincide.

It seems to me that the more we mess with the markets, or interest rates, or nature, the more omnipotent we may appear, but the more vulnerable we are when reality resurfaces. One investment strategy to use in anticipation of a hard landing is cash and short-term bonds. They pay lousy rates, but it's something. This will make the most sense if we do not experience the growth needed to pay for our excess spending as individuals and as a political entity, which will create a bear market in stocks, bonds and real estate all at the same time.

The great hope for the stock, bond and housing market and for people with ARMs is that we grow ourselves out of the moribund state we find ourselves in. This is the underlying worldview of our nation's leaders and if they are right, then peace and prosperity will return to the world. Well, prosperity might come to just our nation, or then again, the benefits of growth may accrue only to a portion of our citizenry. It is possible that the kind of growth targeted by the administration might end up solely in the hands of a tiny sliver of our population, the uppermost 1 percent who control most of the capital. It has happened before.

The tremendous number of lost jobs in the current economy has helped some companies regain profitability. This might lift the stock market for a year or year and a half to come, maybe even through November 2004. If you are lucky enough to have a job, I suggest socking away as much dough as you can. Keep a couple of years worth of spending money close by. You never can tell when the next cycle will be felt in your back yard.

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