State of the Market 57:
Big trends: Part 2, Bending branches

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Anybody who's ever experienced an ice storm knows the dread of watching tree limbs bend as they take more and more weight, knowing there is nothing we can do, hoping against hope that we do not hear the hideous crack of breaking wood … but we know we will.

In addition to prevailing winds, some forces in America's macroeconomic and political environment inexorably add stress to the nation's ecosystems. We fool ourselves into thinking the branches can bend indefinitely … but deep down, we are waiting for the sudden, loud, permanent crack.

Here are nine bending branches.

1. Baby Boomers will live until bankruptcy

Theirs, their children's, or the health care system's.

Housing's world, in three parts

State of the Market is currently publishing a three-part series on the big trends in affordable housing, consisting of:

- ***Part 1: Prevailing winds (SoM 56)***, forces acting for decades regardless of surface froth.
- ***Part 2: Bending branches***, pressures accumulating that must eventually crack, but when and how is unknowable.
- ***Part 3: Meteor strikes***, highly disruptive isolated events that may happen tomorrow … or never.

These trends don't tell you what to do, but they *do* give you scenarios against which to evaluate your strategies, past, present, and future. For recommendations, you'll have to wait for Part 4.

An unpleasant sound is coming.

Until perhaps thirty years ago, the Biblical three-score-years-and-ten was the nation's good working assumption for our retirement and health-care systems: 25 years from birth to productive employment, 40 years of solid, productive, job-secure work, then retirement at 65 and 5-10 golden years before succumbing to what was then politely called 'death of old age.'

Now the combination of better nutrition, reductions in smoking and other life-shortening habits, and the advance of medical technology means we've pushed back the end of healthspan (the interval of independent adult living), and we've extended the interval of assisted lifespan. For some Americans today, life can continue as long as we have the money to pay for machines and caregivers to keep our withering corpus going.

Aside from its implications for changing residential configurations (covered in *SoM 53: Housing's Stairway to Heaven)*, our stubborn health has destroyed the demographics and economics of our grandfathers' model. That

means your retirement benefits are going to be cut. The coming cuts could be direct (through contractual restructuring), indirect (through low-yielding investment portfolios), or invisible (through returning inflation), but the branch can bend only so far … cuts there will be, and they will be massive.

Abrupt health-care cuts will accelerate the retrofitting of existing elderly properties (and Naturally Occurring Retirement Communities) to make them physically and mentally healthier environments for seniors, with implications to be discussed in Part 4.

2. Public employee pensions will be cut, and city governments will shrink

Starting thirty years ago, private-sector employers steadily migrated away from defined-benefit plans (because such plans were a foolish bet for companies) and moved to defined-contribution plans such as §401k. Public-sector funds, exempt from ERISA (good politics, bad policy), clung to their guaranteed-pension model, chasing ever-higher and less-likely yields until now these pension funds and their cities are insolvent.

This bending branch is cracking now. Bankrupt San Bernardino has sued CalPERS; Detroit's emergency manager took that city into bankruptcy in part to bring its public-employee pensions along. Such events will disrupt cities' service delivery options … and the most bust will become the fastest innovators, willing to try the most radical solutions.

3. Sin prohibition will often be replaced with sin taxation

Though America some time ago lost the war on drugs, the nation has yet to sign the peace treaty recognizing the new frontiers. It's in our national economic interest to do so, because what is legalized can be taxed. For cash-strapped cities and cities, legalization is a clear economic winner, replacing a budget cost (the lumbering armature of enforcement) with a revenue generator (regulation and taxation).

Already this is happening with marijuana; the sex business will be next (the clue is they're now being called 'sex workers'). This will give states the excuse they need to parole thousands of inmates who are costing the public money to incarcerate; California is under a Supreme Court order to relieve prison overcrowding … or release 15,000 inmates back into the population.

As these specialized trades move from illegal to legal, they will become eligible or even target populations for affordable and service-enriched housing.

4. 'Negative asset' affordable housing properties will be abandoned

Some properties have negative value; when that value becomes too great, their owners abandon them. This applies to:

- ***Post-mature FmHA §515 rural properties***. With property management a money-loser, rents capped by USDA rules, and prepayment prohibited by ELIHPA, their owners have nowhere to go except the great step-up in basis in the sky.
- ***Under-sized public housing authorities***. HUD's RAD demonstration (see *SoM 45: Public housing's RAD-ical revolution*), though flawed, has been a huge success, with demand now 2½ times the original 60,000-unit demonstration. And even that is only a fraction of the properties that need help.
- ***Small naturally occurring affordable housing (NOAH)*** in weaker markets, where entropies of small scale because

insupportable as regulation and risk increase.

Right now abandonment is seen as a consequence of failing cities; soon it will be recognized as the inevitable end for unadopted orphan properties (see *SoM 49: Orphan Properties*). When property is abandoned, eventually the city takes it *in rem* for real estate taxes … and then the property, instead of disappearing, becomes yet another problem for the city to deal with.

5. Resident services' unfunded mandate will come to a crunch

Once upon a time, we thought that 'decent, safe, and sanitary' affordable housing was the end in itself – but now we know that if a property simply warehouses the poor, the people fail, the property fails, and the neighborhood fails.

Affordable home as a safe locus of life improvement (compared with the baseline) means that more and more affordable properties must have a strong and resident-centric services component. If these services are essential to making the property a social and neighborhood success, they must be funded every year, and there are no reliable mechanisms to do this.

Many states' QAPs incentivize or mandate resident services while being airily unconcerned how these will be funded long-term. That's a form of economic hypocrisy that whose brunt owners bear … and when they stop doing so, many a governor and state health secretary will suddenly have to redirect the health-care budget into housing-based services.

6. Student-loan repayments will be cut or restructured

The Millennials' student-loan burden (currently $1 trillion and rising) is not being matched by rising income expectations. This sheepskin serfdom is causing Millennials to delay marriage, household formation, and the creation of new demand for residential housing – especially as these young adults no longer believe that homeownership is a key to long-term family wealth-building.

One can just about equate the increase in student loan debt to the decrease in aggregate residential property values, and trace the Millennials' unwillingness to pay for the latter on their indenture for the former.

Maybe the Millennials will all move into micro-apartments; maybe a sudden burst of economic growth will get them out from under their debt burdens, or maybe they'll just take revenge on us by letting inflation rise so much it devalues their debts … but one way or another, to get the residential economy moving again, the nation needs this generation of Americans to be out from a debt burden they can't realistically expect to pay. When this happens, home prices and especially rents will jump.

7. E-commerce will compel large-scale repurposing of retail into residential

Back when I matriculated, Harvard Square was a regional shopping destination of specialty bookstores; they're all Pinkberry, Starbucks, the Gap, or ATMs. Once the Square held two movie theaters totaling a dozen screens; now it has zero. The demise of these uses is rapidly depopulating shopping mega-malls.

All of them have been done in by broadband and electronics, which bring the entire retail catalog to the palm of one's hand. Couple that with disruptive retailer-delivery models (Amazon, Peapod, UPS) and we have completely reversed the traditional model of shopping: instead of people going to the goods, the goods now come to the people.

As more and more buying is done in the home, residential layouts are being repurposed … and as less and less of it is done in stores, the concrete islands known as malls in their tarmac oceans need to be repurposed … and they will have to be reinvented as residential. This is a huge challenge because the big boxes don't lend themselves to that reconfiguration, but when their price drops far enough, the economics will eventually work.

8. Budget deficits will force big tax increases and big spending cuts

I've written so many times that interest rates must rise soon that *eventually* I must be right … and every 100 basis point rise in the Treasury rate costs us $170 billion annually. We won't make that up by half measures, and when it happens, taxes have to rise *a lot*, spending has to be cut *a lot*, and inflation will have to spike.

The inevitability of dramatic budgetary change is an overladen bending branch; the form it takes is a meteor strike (or exploding firecracker) known as an election.

9. Fannie and Freddie will exit from conservatorship, largely intact

After listing all these branches bending under the weight of unsustainable costs, let us end on a happy (if baffling) note: Fannie Mae and Freddie Mac will exit from conservatorship … largely intact.

In the six years since these two GSEs were forced into conservatorship because they absorbed $180 billion in losses, they have stabilized and as of today, Fannie/ Freddie have cost taxpayers *zero* – actually, they're still returning big dividends back to Treasury.

While remarkable, this is also ironic, for as Fannie/ Freddie regain their economic viability, the political pressure to rein them in eases even faster – and with the Congress and Administration at loggerheads on so many other things, the GSEs can look forward to a sustained run of three more years to consolidate their position before facing any exit.

Since the scary days of summer 2008, secondary market liquidity has been saved, and with it the residential property market and quite probably the American economy. That was unequivocally a good thing. Whether we will later rue the missed opportunity to bridle the GSEs as a bad thing may have to wait until the next global liquidity crisis.

I'll be back in a month with *Meteor Strikes*.