State of the Market 58:
Big trends: Part 3, Meteor strikes

By David A. Smith

I'm against fashionable thinking. – Herman Kahn

We know they're there, circling in the darkness. Now and then we can spot them as they follow their own perturbed and perturbing orbits, looping closer, zooming by, then disappearing. They're the asteroids, and if they're due to hit us, we can't dodge them, and they'll disrupt our ecosystem permanently.

Submitted for your edification are eight big asteroids floating in the meteor strike zone.

Housing's world, in three parts

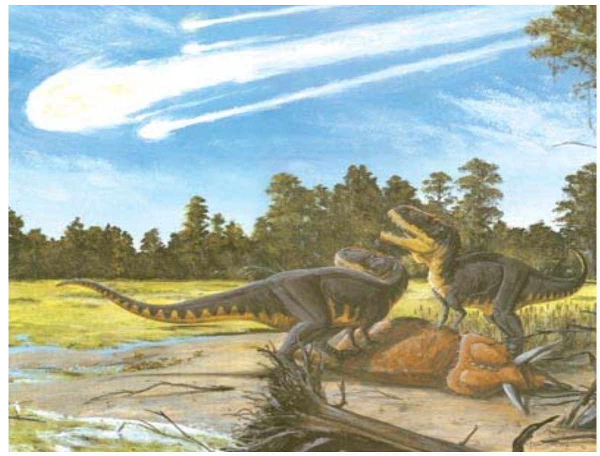
State of the Market is currently publishing a three-part series on the big trends in affordable housing, consisting of:

- ***Part 1: Prevailing winds (SoM 56)***, forces acting for decades regardless of surface froth.
- ***Part 2: Bending branches (SoM 57)***, pressures accumulating that must eventually crack, but when and how is unknowable.
- ***Part 3: Meteor strikes (SoM 58)***, 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.

1. Attila the Fed spikes interest rates

The meteor. Faced with a rush of capital out of the United States (China darkly suspected) and a Friday Treasury auction implosion, out of nowhere the Federal Reserve boosts interest rates 300 basis points across the board – and,



"Phew! Good thing it missed us!"
"Yeah, for a minute I thought we were in trouble."

echoing Mario Draghi, states it will "do whatever it takes" to sell the paper.

The immediate shocks. The interest rate spike kicks the economy into recession; drops the values of income-producing properties and puts large tranches of commercial loans into delinquency and potential default; drops the price of all fixed-income securities; and collapses LIHTC prices back to 70¢. Within a week, all forms of credit tighten severely.

Now what? For the LIHTC industry, is it 2008 all over again, with the entire financial sector will be repeating 2008's asset implosion? Does inflation return with a vengeance? Do we re-enact the late 1970s' stagflation, with costs rising fast even as incomes drag, so the entire LIHTC inventory is caught in a statutory default-forcing whipsaw?

2. Fannie/ Freddie fully privatized

The meteor. By solid majorities, a Republican-controlled Congress sends the president

legislation to withdraw the Federal support for (now profitable[1]) Fannie Mae and Freddie over a five-year period, which the lame-duck president, hoarding his limited political capital, chooses not to veto.

The immediate shocks. Fannie Mae and Freddie Mac immediately cease issuing new 30-year fixed-rate loans; while maintaining a 30-year amortization period, they shorten loan terms to 10 or 15 years. For long-term fixed-rate financing, the only open windows are now FHA, stampeded with new applications, and the state housing finance agencies (HFAs).

Now what? How do the HFAs cope with the flood of demand for tax-exempt bonds? Are the bonds used to support single-family home prices rather than multifamily rentals? Do developers buy (or will they be forced to buy) expensive interest rate caps or hedges? Do equity investors negotiate no-limit operating deficit guarantees to cover potentially increased debt service?

3. Community Reinvestment Act 2.0

The meteor. Desperate for revenue increases that can actually be signed into law, the Congress and President comprehensively remake CRA with (a) substantial expansion of entities subject to CRA, in a manner similar to the TARP expansion, to cover any form of financial institution, including investment banks, non-depositary banks, credit card companies, and corporate or retail-finance entities (like GECC or Wal-Mart), and (b) elimination of geography-defined target zones in favor of people-based (household income) metrics.

The immediate shocks. Whole swathes of the financial sector instantly need CRA equity investments, spurring dramatic new interest in LIHTC, New Markets Tax Credit, and others. LIHTC CRA pricing eliminates the geography premium, and heretofore underpriced markets see immediate price jumps, while the premiums formerly enjoyed by coastal megacities disappear.

Now what? Does the quest for new CRA investment lead to effective pay-for-success (P4S) financial instruments such as social impact bonds (SIBs)? Do states expand inclusionary zoning laws to overlay state-level CRA's onto the Federal standard?

4. 'Fair use' privacy waiver

The meteor. The Supreme Court rules that in the absence of an explicit opt-out, all data captured electronically in a public setting, such as security cameras, cell phone GPS locations, Facebook pages, or internet search histories, (a) is not inherently private, (b) is not copyrighted or copyrightable, and (c) is not subject to Fourth Amendment ('unreasonable search and seizure') protections. Instead, all unprotected electronic data is now public domain.

The immediate shocks. Big data is fully legitimized. Coupled with face-recognition software, detailed 'public persona' profiles now become available online about almost anybody. Customized advertising, marketing, pricing, and email/ social media promotions become the norm. Your non-public data is now precious.

Now what? Are do-not-tap-data registries (akin to do-not-call) established? Do the HUD and LIHTC privacy requirements disappear? Is income certification automated, with rent/ pricing adjustments occurring automatically?

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[1] After being forced into conservatorship because they absorbed $180 billion in losses (mostly writedowns, not cash), the GSEs stabilized and rode their dominant market share to large annual profits. As of today, Fannie/ Freddie have cost taxpayers *zero*, and are still returning big dividends back to Treasury.

5. Single-family foreclosure epidemic

The meteor. A combination of interest rate jumps (resets of introductory teaser rates), economic slowdown, and a credit crunch on real estate collateral leads to massive nationwide homeownership defaults and foreclosures.

The immediate shocks. Several million single-family homes are foreclosed, leading to price shrinkages in many metropolitan areas; a noticeable decline in total US households (as people move home or double up); an increase in renters; and upward pressure on renting in job-creating markets (mainly coastal cities with development restrictions).

Now what? Hey, wait a minute! Didn't that happen already? Half a decade later, we are still picking up the pieces. What will we do with the 1.3 million or so homes still not reoccupied? How will the households who aspire to homeownership be re-formed? Will the trillion dollars of student debt permanently impair America's new homeownership-household formation? Will there emerge new forms of tenure used widely in the UK, such as rent-to-own or shared ownership?

6. Major municipal bankruptcies remake city contracts

The meteor. Like a meteor shower, multi-billion dollar bankruptcies keep hitting cities, counties, and possibly even states throughout the country. Experience in Central Falls RI; Harrisburg PA; Jefferson County AL; Stockton CA; San Bernardino; Vallejo; and Detroit demonstrates that a city going through bankruptcy can reboot itself by clearing away unserviceable debts and unsustainable pension obligations. Bankruptcy becomes the new black: the trendy way to reboot a city's finances and economy.

The immediate shocks. Previously sacrosanct public-employee pensions become subject to bankruptcy restructuring, leading to major overhaul of municipal budgeting, including previously unthinkable privatization of city services. Spreads on new municipal issues widen dramatically as the market re-evaluates bankruptcy risk. Some cities lose the ability to tap capital markets and file bankruptcy abruptly.

Now what? Do cities un-grow? Do some of them (e.g. Detroit, Cleveland) physically shrink, with sections returned to greenfield? Can states with unsustainable financial situations (e.g. Rhode Island, Illinois, California) file bankruptcy? Does the Federal government become the unwilling emergency liquidity provider and de facto receiver? What does that do to existing revenues and policy obligations? Is public housing privatized or entirely deregulated?

7. LIHTC repealed

The meteor. In a grand-bargain compromise, Congress and the President agree on the Fairness And True Consistency in American Taxation (FATCAT) Act, a comprehensive tax code rewrite that lowers brackets "on hard-working middle-class Americans" and "broadens the base" by (a) slashing, then phasing out the mortgage interest deductions, (b) canceling high-profile 'loopholes' (like tax inversions and overseas corporate earnings), and eliminating all the tax preferences (including zeroing all tax credits) so that the widely popular middle-class tax reductions under FATCAT are revenue neutral.

The immediate shocks. It's 1986 all over again. Affordable housing advocates are drowned out by the primal screams of the homeownership lobby (builders, realtors, mortgage bankers). Every-constituency-for-itself becomes the game as each group tries to eke out transition relief. Beltway analysts and trade associations get rich.

Now what? Will Congress toss the affordable housing arena a bone via a new program? Will it

instead force the mandate down to states (via some new block-granted or revenue-shared model)? Might that program focus exclusively on non-profit entities? What happens to properties caught in the maelstrom?

8. 2016, and it's President *Who?*

The meteor. "Hello, good evening and welcome to Election Night Special – everything is up for grabs. Here's our first Congressional result: what do you make of it, Norman?"

"This is largely as I predicted … except that the other candidate won."

"I see. How did this happen?"

"Actually, Brian, according to our computerized analysis and exit polling, it's largely the result of the number of *votes* cast. The winner simply got more of them, and as we explained earlier in the evening, the candidate with the most votes wins *nearly all the time*."

"Amazing, Norman. Now, who is our new president is going to be?"

"Someone nobody saw coming 18 months ago!"

The immediate shocks. Housing policy goes shooting off in random new directions.

Now what? How much does the new president make housing a priority? Is he or she an urbanist or a suburbanist? Does the president have freedom of action or a honeymoon period where broad new legislation can be proposed and enacted? Will there be a sense of urgency that sweeps all before it, or will partisan trench warfare continue?

Summing up …

If you see ten troubles coming down the road, you can be sure that nine will run into the ditch before they reach you. – Calvin Coolidge

Most of what we fear will never come to pass – and even if it happens, it'll differ from our scenarios. Why bludgeon one's brain scenario-planning and war-gaming one's responses? There are at least three reasons:

- ***Common themes***. When a potential effect (say, higher deficits, higher interest rates, inflation) can have multiple causes, it becomes likely, and you can be more robust in strategy planning.
- ***Alertness to the omens***. Denial is not just a river in Egypt, it's a too-common state of emotional complacency. Far better to be awake to the danger than asleep at the switch.
- ***Faster action***. In chaos, faster movers don't just survive, they prosper. As the camping joke punch line goes, *I don't have to outrun the bear, I just have to outrun you.*