SCHWARTZ *Report*

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Turn Off the Bubble Machine

I read Andy Kessler's Inside View column a while back with a bit of a nostalgic chuckle. He starts out with a rewind of the "Champagne Music Makers" and the Lawrence Welk Show which had a 30 year run on network television, noting that it was famous for its "schmaltzy champagne music" and its ever present impresario. It occurred to me that reruns of the Welk show continued on the local PBS channel for at least a decade after it went off the national TV in 1982. They were a fixture of our Friday nights during weekend visits to Rehoboth. The boys even asked their grandfather at one point if he had any Lawrence Welk action videos.

Andy's focus was not, however, on Mr. Welk or his music. It was on the bubbles which filled the television screen to overflowing at the opening and closing of each show. There must have been, he reasoned, a powerful machine to churn out those bubbles. He broadens this observation into a monetary analogy. For most of the past quarter century or so our own band of champagne music makers at the Federal Reserve, have "accommodated bubbles, bubbles everywhere," he says. Perhaps it was Ben Bernanke and his fear of another Great Depression spawning from the Great Recession of 2008 or previous Fed Chairman, Alan Greenspan's tolerance of what he termed "irrational exuberance" in the stock markets prior to that but the Fed has been maintaining low, sometimes unprecedentedly low, real interest rates for two dozen years or more. For long periods during that time, the real federal funds rate has been negative. Interest rates have been below the rate of inflation. More recently, the Fed continued to accommodate, all the while preaching that inflation was transitory, which it turned out not to be.

Whether our fiscal engineers have been asleep at the switch or not, they certainly were not following the mantra of former Federal Reserve Chairman William McChesney Martin when he said that the Fed's role should be "to take away the punch bowl just as the party gets going." This is a hard lesson to absorb when, like most debtors, our policy makers are haunted by the specter of deflation which, of course, means that real indebtedness needs to be repaid with real money. This is the fear that produces the knee jerk reaction to pump air into the bubble machine. But productivity gains over time also reduce costs and prices along with them. Increased productivity delivers the much better variety of deflationary trends, the earned kind.

Present Federal Reserve Chairman, Jerome Powell has admitted that the Fed's tools "work principally on aggregate demand." Dampening demand is a round-about and painful way of reducing prices to acceptable levels of inflation. However, it is also considered damaging to full employment which is another of the Fed's charges from Congress. Our Federal Reserve seems more inclined to fight inflation rather than forestall its appearance in the first place. They seem content to bludgeon aggregate demand into submission by sharply increasing interest rates. This happens principally through the removal of the interest rate subsidies that contribute to lower borrowing costs. Subsidies, however, create market distortions, such as the 2004 to 2008 housing bubble, which invariably lead to more subsidies, more regulations and more distortions. The impression is of a dog chasing its tail.

Better to foster productivity gains which will also reduce costs and prices in the long term. Innovation flourishes when the supply side is given its due. This may seem deflationary but it is not. It is merely following Jean-Baptiste Say's Law of Markets which says that "the ability to buy something comes from income earned from supplying something else first."

Recent trends in our local real estate markets provide a tutorial on why more housing supply might help to dampen demand in a more positive and less draconian way. The first quarter of 2023's market pended sales

Cont. from pg. 1

results (25% to 30% below the same period of 2022) would seem, at first glance, to be a product of the doubling of mortgage rates during that time. From a national perspective, borrowing costs on the median priced home have risen nearly $600 per month in principal and interest costs alone. One might infer from this that the buyers whose purchasing power has been depressed and those potential move up sellers who are sitting on 3 percent fixed rate mortgages or all those folks who renovated their properties during the pandemic should want to stay on the sidelines.

Locally, at least for the would be buyers, this has not been the case as testified by the continued incidences of multiple offer situations and the fact that even though the number of transactions is down the median sales price has not followed as precipitously as it did in previous market adjustments. Sellers who need to sell and buyers who need to buy will still benefit if offered more suitable alternatives. The market is not so much depressed as it is stuck owing to lack of opportunities and inventory. Those multiple offer buyers are testifying through their determination that a 6% mortgage on the right home, if they can find it, is just fine and no deterrent at all. So let's think supply first. As Mr. Welk would say: It's "Wunnaful ah Wunnaful!"

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