A Personal Anecdote Which Highlights the Coming Debt Crisis

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To my recollection, this will be the first time in 20 years I have used a personal anecdote to "prove" a key market fact. This is the fact we are going to have another debt crisis here in the United States. No, we don't know when it will arrive, but knowledgeable credit strategists from Morgan Stanley now put the time frame between 6 and 12 months.

Now for the anecdote. I have a "nephew-in-law" named David who recently left his position as an attorney at a large Wall Street law firm focused on the airline industry. His job was to package groups of airline leases together and resell them to institutional investors. Lest you think the airline leasing industry is insignificant, there are currently over $260 billion worth of these leases.

I'm not going to go into details, as I have never dealt with an airline lease. But I do know it is one piece of the mammoth corporate debt pie, a piece that is reminiscent of the subprime mortgage market in 2008.

David told me that attorneys from his firm's "sales" department were regularly coming to him with leases that he knew, for certain, were going to result in massive losses. When he pointed this out to his bosses, they told him this made no difference. David's role was to take these individual leases and turn them into packages structured as CLOs or collateralized loan obligations. No matter how much he knew they would ultimately lose, his firm could sell them immediately (raking in huge fees in the process). Investors did not even look into the actual risks. These loan packages were paying 5-6% in annual interest. Until recently, interest rates were the lowest they have ever been. As a result, investors have been willing to lend money to companies paying a decent interest rate without even worrying about whether or not they would get their principal back! This does sound a lot like the subprime mortgage market in 2008.

The point is that this is a clear example of how easily bad corporate loans were made in recent years. Also, none of these packages of airline leases looks troubled today. But David who put them together knows for sure they will suffer huge losses the moment the industry has a downturn, i.e. we go into the next recession. Multiply this times thousands and thousands of similar examples and you begin to see how the debt markets will go from "nothing to see here" to a real crisis.

Since 2010, credit market debt consisting of corporate bonds, corporate bank loans, and all consumer debt minus mortgage debt, ***has grown by 118%.*** That qualifies as a bona fide explosion. Nearly all financial crises are caused by too much debt and we now have the most ever.

To put some numbers on it, "stressed" consumers, defined as those with low incomes and credit scores, have over $1.5 trillion of credit card, auto, and student loan debt. These individuals account for over 20% of all consumer spending. All three of these types of loans are at an all-time high.

Corporate debt from weak companies is significantly larger than low-quality consumer loans. In 2007, corporate bonds rated BBB totaled $700 billion. That number is now $2.5 trillion. The BBB-rated category is an important one, as this is the lowest level of corporate bonds that is still considered "investment-grade," which means it is *supposed to be safe*. But at this time, nearly half of all the higher-quality, supposedly safe corporate bonds are rated BBB. This type of debt

quickly turns into even lower-rated debt whenever we enter a recession. In other words, these companies may appear relatively stable today, but the moment the economy begins to contract, all their problems come to the surface. (Or as Warren Buffett once said, “When the tide goes out you see who was swimming naked.”) One of these problems is that banks and other investors become fearful of lending financially weak companies more money to remain in business whenever they begin to see a recession on the horizon. Without funds available to roll over their loans, they default and declare bankruptcy.

Then we have the largest and most glaring problem. Over $3.5 trillion of corporate debt is now rated below investment grade. This includes high-yield bonds, i.e. junk bonds, at $1.3 trillion, $1.3 trillion in bank loans to financially weak companies, and over $1 trillion in leveraged loans which are the riskiest type of debt. In addition, we have another $1-2 trillion, and possibly more, of risky corporate debt which doesn’t even show up in the totals because it is not rated.

Put together, this means there is around $9 trillion of debt in the U.S. which will be difficult to repay in the next recession. If this estimate turns out to be far off the mark, the reality will undoubtedly be this $9 trillion number understates the total. Much of this money will never be repaid. Conservatively, at least $3 trillion of this money will be lost in the next recession, and most likely much more.

To put these numbers in perspective, we had approximately $7 trillion of comparably endangered mortgages before that crisis began, versus over $9 trillion today, which means we now have approximately 30% more money at risk today than we did as the mortgage crisis began in earnest in 2008. The 2008 mortgage crisis led to the largest recession since the Great Depression. Expand the 2008 losses by 30% and pray the result is a recession and not a depression.

Unfortunately, this may be just the tip of the iceberg. In 2008, the problems originated here in the good ‘ole U.S.A. But this time around the total bad debt is definitely even worse in Europe and China. In a highly interconnected world economy, this next time around the worldwide losses will dwarf those of 2008, creating negative feedback loops which will scare nearly all investors, central bankers, and politicians. This is a perfect recipe for a worldwide financial panic. The ingredients are all in the pot just waiting for someone to light the match.