Economic & Market Update, November 2015

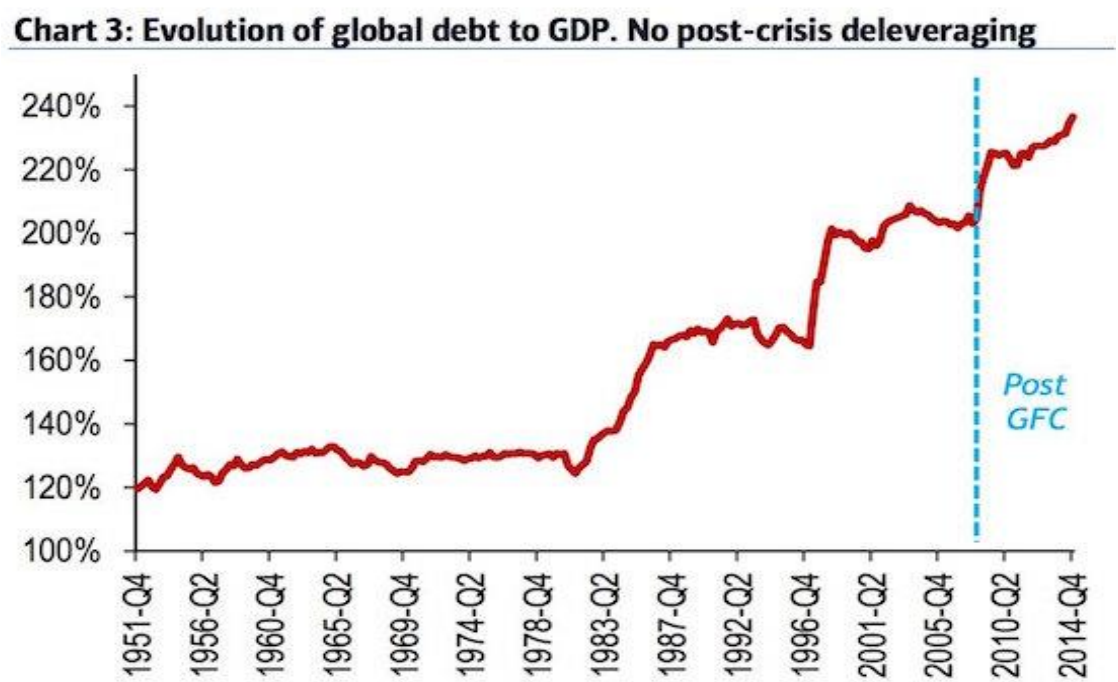
A Rolling Loan Gathers No Loss

By Richard Morey

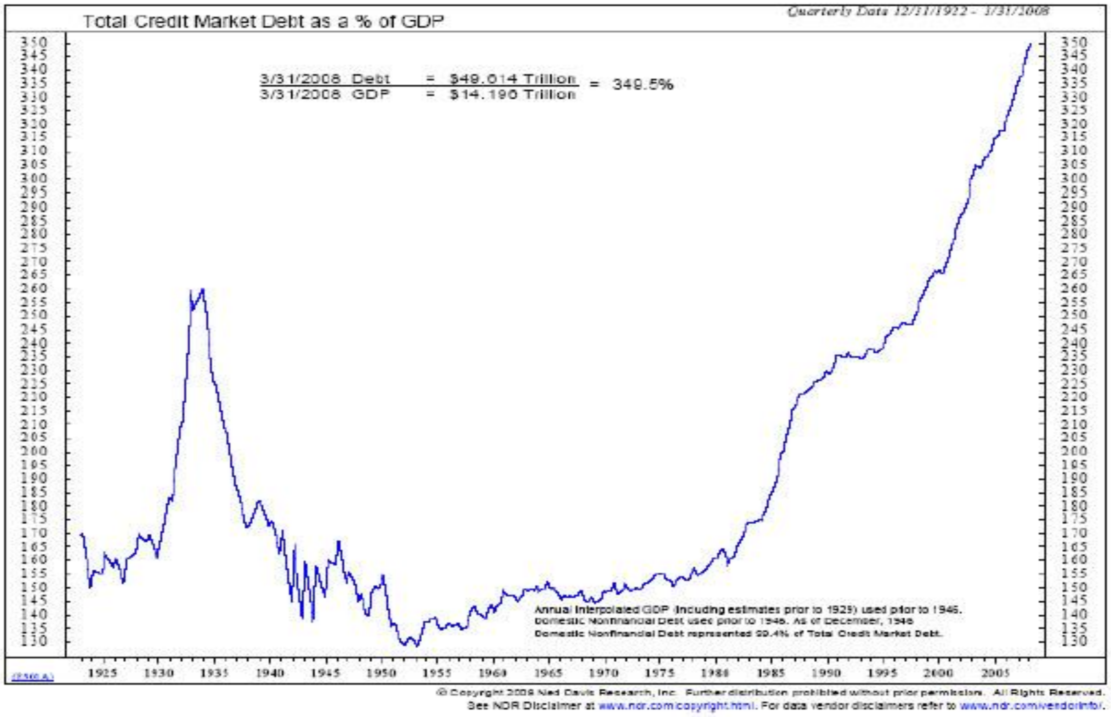
Throughout economic history, exactly one factor has led to "booms" followed by "busts." This is too much debt. As debt increases the economy expands, but after the debt level peaks the economy contracts. All debt-inspired booms lead to busts – every single one in the recorded history of the world.

Please note that debt in and of itself is not the problem. In particular, money borrowed and then spent on expanding business is "good debt." Expanding businesses lead to increased income that can then be used to make the interest payments and pay off the principal over time. It leads to increased employment in the private sector and growing tax revenues for the government.

Even then there are limits to the amount of debt an economy can carry. Studies have shown a healthy amount of debt for an entire economy is approximately 150% of Gross Domestic Product or GDP. This includes government debt, corporate debt, and individual household debt. According to a report issued last month by the Bank of International Settlements, total debt in the world compared to world GDP is now 265%. This means the world now has 75% more debt than is healthy for economic growth. The chart below shows the increase in worldwide debt from 1951 through 2014. As you can see, debt was at a modest level from 1951 until the early 1980's. It then shot up, with the result being the financial crisis in 2008-2009. The scary part of the chart is what has happened since 2009 (the blue line on the chart). Our response to the debt crisis was a huge spike in more new debt. And if we showed that chart including 2015 you would see it has continued to go straight up this year.

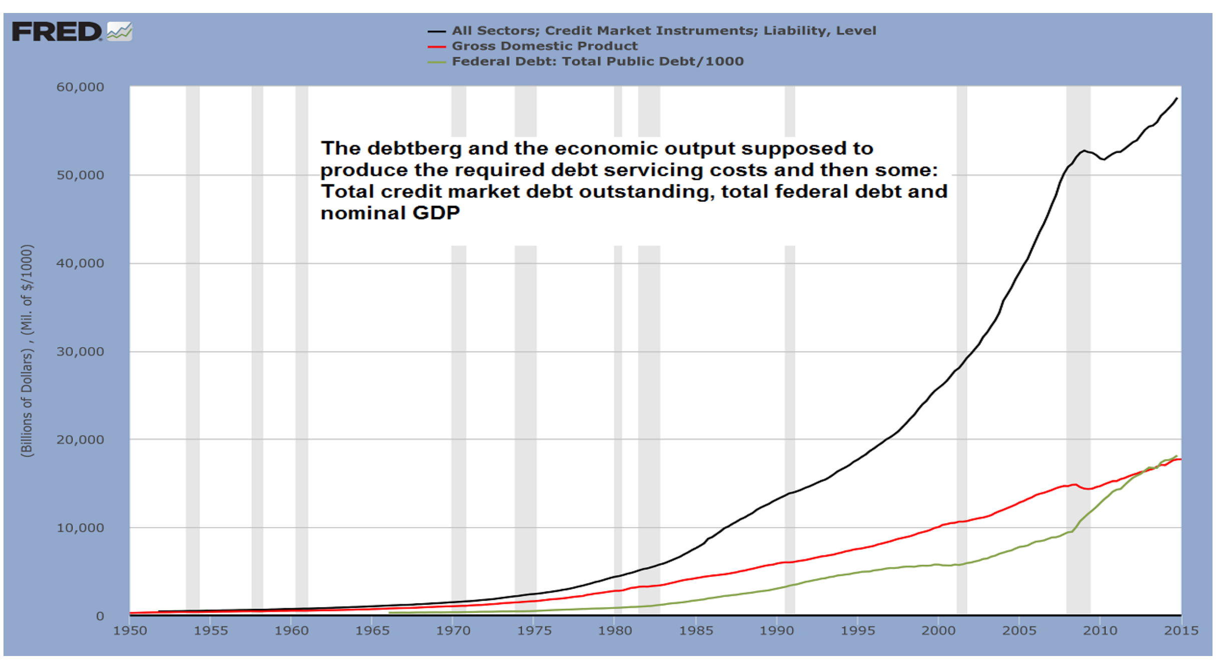


Now brace yourself before looking at the next chart which shows the total debt level here in the United States:

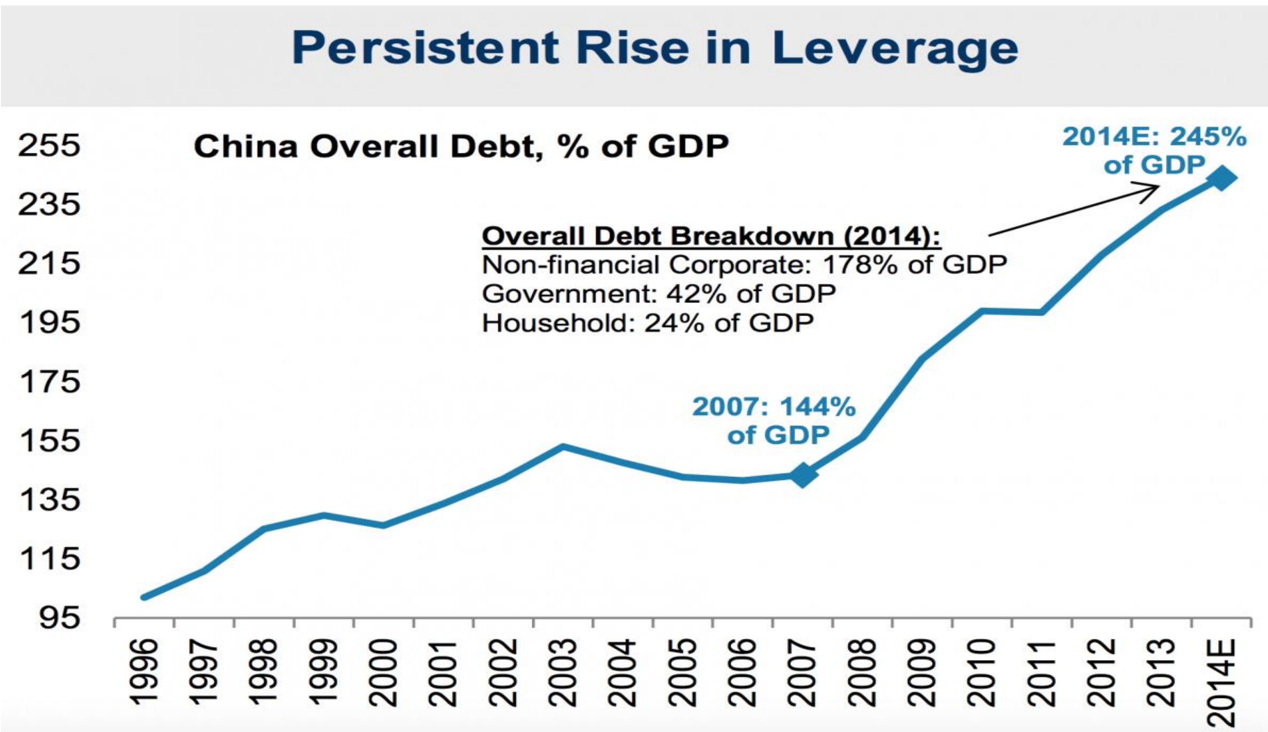


Total debt to GDP in the United States recently hit 350%, which is well more than double a healthy amount of debt. Again, all debt-induced booms end up with economic contraction, with the severity of the contraction directly linked to the extent of the over-indebtedness. This was the cause of the Great Depression, and in the chart above you can see debt had exploded by 1929. The sobering, if not downright scary, part of the chart is that our total debt level now far, far exceeds the debts we had accumulated right before that depression.

The next chart also shows the total debt in the United States, but this time it includes overall GDP or economic growth. When debt is productive, more debt leads directly to more economic growth. To be sustainable, the black "debt line" and the red "GDP line" should be fairly closely aligned. The difference is essentially "bad debt," meaning debt that did not expand the economy, including debt that the borrowers will never be able to repay:

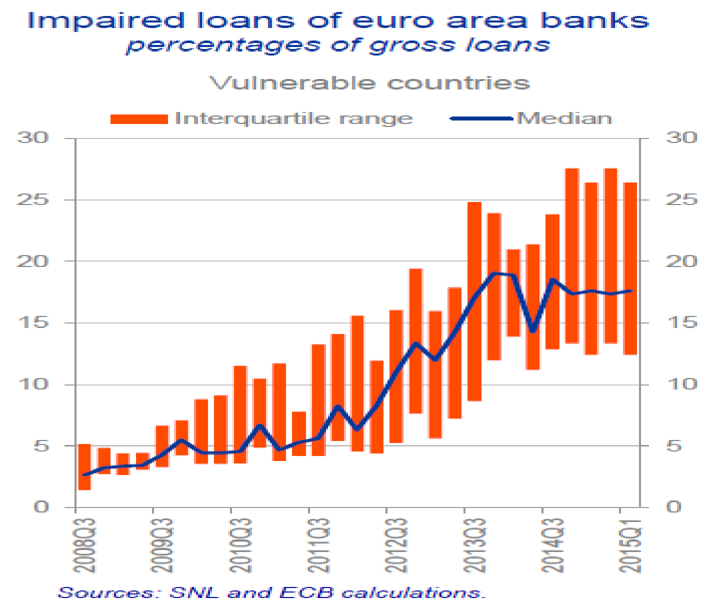


Unfortunately the United States is not alone in being over-indebted. The worst offender is Japan at a stunning 400% total debt to GDP. Then we have China which was the primary engine for global growth – until fairly recently. Most economists and so-called market experts do agree that a hard landing for the Chinese economy would put the entire world into, at least, a serious recession. Those who say China will not have a hard landing but only a modest slowing of their growth usually say China's problems are not actually that severe because their debt levels are manageable. This is absurd, as you can clearly see from the next chart:



China ended last year at 245% total debt to GDP, but as of last month this number had ballooned to nearly 300%. While it is true their government debt at 42% of GDP is quite manageable, their corporate debt is now over 160% of GDP, one of the highest in the world and double what we have in the United States. At the end of 2007 total debt in China was just over $7 trillion. It is now approximately $30 trillion! In the investment world we are never supposed to make guarantees, but I can safely make the following guarantee: China is going to have a massive debt crisis, bankrupting much of their financial system.

Europe is in the same troubled boat. These days we only hear about the Eurozone's problems when they are teetering on the edge of crisis. Then they manage to kick the can down the road for a while and most forget just how precarious their situation remains. Their government debts have not only not gone down but are now at an all-time high. But their biggest problems involve the massive amounts of private debt losses waiting to be realized. The following chart shows the percentage of all the loans Eurozone banks have made that are in jeopardy of defaulting.



That chart is shocking, as it shows approximately 18% of all the bank loans in the Eurozone are either currently in default, i.e. the lenders are no longer making payments, or in serious jeoopardy of going into default soon. This means that, as a whole, the Eurozone banking system is bankrupt right now, i.e. the total net worth of all Eurozone banks is far below $0. This is due to the leverage they currently have. For every $100 the average Eurozone bank has as an asset, it has borrowed over $96. This means their banks are bankrupt if the value of their loans go down by less than 4%. If they end up losing half of the principal from the 18% of their loans that are presently in danger, they will lose 9% of their total assets, i.e. over twice as much as they currently have in total value. Eurozone banks now have several trillion Euros worth of loans that will never be repaid. In other words, the entire Eurozone banking system is one misstep away from massive financial crisis.

A Rolling Loan Gathers No Loss

At Secure Retirement we always try to avoid two extremes related to what we can and cannot know. The stance of many investment professionals is that nobody can ever reallly know anything about the future of markets or economies. Whatever happens in the future is completely random. If this was true, I have always wondered why a person would hire someone to assist them with their investments? You might as well just throw darts to make investment decisions. On the other end of the spectrum we have a small group of investors who believe they know exactly what is going to happen in the future, and when.

Here at Secure Retirement we try to stay balanced between these extremes. We are confident we can accurately predict *what* will happen, but not *when*. The probability of accurately predicting what will occur goes up when the factors involved are large and there are many examples of the phenomenon throughout history. When it comes to economics you cannot find a larger factor than debt. We have dozens of examples in which countries had a huge increase in their debt level. Every single instance had the same outcome, which was a debt crisis and massive losses. We are therefore nearly certain this economic cycle will end in another "bust," meaning at least a severe recession and stock market losses of at least 40%.

Unfortunately, the "when" remains elusive! As an investor, the only way I can deal with the situation in which we know what is going to happen but not when is to have patience. So while we still do not know when our economy will go from the low level of growth we have been experiencing to recession – or worse – there are many indicators we follow that shed some light on this topic.

Since the problem is debt, one of the best places to look to try to determine when we will go from boom to bust is the debt or bond market itself. Unlike the stock market which moves on a short to intermediate-term time frame due primarily to investor psychology, the bond markets as a whole move based on economic performance.

As long as debt continues to increase in an economy, that economy will most likely continue to expand. Or to quote my favorite investment saying, “A rolling loan gathers no loss.” This means loan losses cannot appear as long as a troubled borrower can continue to pay off old loans with new ones. In recent years nearly every corporation has been able to borrow money to repay their old loans, as the banks were flooded with money to lend to corporations, and investors were desperate to get a higher interest rate or yield. The result was an explosion of high-yield or junk bonds. A large number of companies destined to go bankrupt in the next recession have managed to borrow huge amounts of money from unwary high-yield bond investors.

So what is the status of this market today? According to Moody’s Credit Markets Review and Outlook: “Cheap money is no longer readily available to riskier borrowers. In the third quarter, bond issuance by junk-rated companies plunged 38% from a year ago... But here is the thing: within 15 months of the three prior peaks of total high-yield borrowing – the all-too-familiar periods of Q3 2007, Q4 1999, and Q4 1989 – recessions occurred.”

What this means is that the trillions of dollars that have been loaned to companies with precarious finances are now in jeopardy of not being able to be rolled over. It’s like a huge game of musical chairs, and the music is ending. As companies find they can neither refinance their current loans nor pay them off, they go bankrupt. These losses will then cascade around the world, as the bankrupt companies lay off their employees who therefore cannot pay off their debts or make new purchases, etc. Given the interconnected nature of finance throughout the world and the previously unheard of levels of debt involved, the end result will be a “bust” such as we have never witnessed since the Great Depression.

But all the above is very positive for the highest-quality bonds, i.e. what we have purchased for our clients at Secure Retirement. The dark blue line in the following chart shows total debt in the U.S., while the light green line shows the yield or interest rate being paid on 10-Year U.S. Government Treasury Bonds. As total debt levels increase, bond yields go down, which means bond prices go up. This is just one of the key drivers of bond prices, but it is a very large force driving bond prices higher.

Summary

At the end of the day, nearly all financial crises are caused by too much debt, and every single time a country becomes severely over-indebted they have a financial meltdown. This is the situation confronting most of the countries in the world today.