Economic & Market Update, January 2019

What's Really Going On?

by Richard Morey

I know it can sometimes be hard to believe I know what I'm talking about when the mainstream financial media is acting as if what I'm always writing about doesn't even exist!

Unfortunately for the mainstream view, I'm pretty sure reality doesn't change just because the clan decides to ignore it. I know my views are different from nearly all the ones you hear on television, and their constant repetition can make it hard to keep what I'm calling reality in mind. So, here's a refresher course in reality-based economics and market analysis.

While my views are far from the mainstream, I can find 20 of the best economists in the world right now who are seeing the same dire economic picture developing that I see. Last week even the current and past Fed Chairs Powell, Yellen, and Bernanke warned about the debt discussed in this article.

Debt

At this time there is exactly one topic which will determine the course of events and markets. That word is 'debt.' I believe we will be well-served to focus our attention on the exact place where the biggest losses will be coming from, which is low-quality corporate debt. Until those losses begin in earnest, I'm not actually overly concerned about large losses hitting anywhere in the U.S. – though of course negative forces from China or Europe could tip us into the negative quickly.

In order to fully understand my current economic perspective, the only thing you need is a summary of debt and financial crises throughout history. Let's get this straight. In the last 700 years, pretty much every single country whose debt level exceeded a certain amount ended up in a severe financial crisis. We now have a worldwide, and U.S., corporate debt level that exceeds the previous high in history. We also have total worldwide debt, including government, corporate, and consumer debt, approximately 50% above the level beyond which countries have ***always*** had a financial crisis at the end.

The entire world is more over-indebted than at any time in history. All previous examples of severe over-indebtedness ended in financial crisis and bone-crushing asset losses. Basically, without fail, for 700 years. Do we really believe, once again, "this time is different"?

Here are four huge, and I mean all-time monstrously large, debt bubbles in the world today:

1. U.S. Corporate Bonds. We have approximately $2.7 trillion of junk bonds and leveraged loans. These are all loans made to companies with poor finances. When recession hits, these corporate borrowers tend to default on their debts, i.e. they don't pay some, or any, of the money back.

   In addition, we have the highest percentage of "investment grade" corporate bonds rated BBB or the equivalent, which is the step just above junk status, in history. This means we'll have another $3 trillion of junk bonds flooding that market in the next recession.

   To put this in perspective, the subprime mortgage market in 2007 was $1.3 trillion.

   This means our troubled corporate debt is over two times larger than the subprime mortgage market was at its peak. Nobody could convince me the riskiest low-quality corporate debt, the $1.4 trillion in leveraged loans, won't have losses equal to or greater than the subprime mortgage losses. Then we have another $1.3 trillion in junk bonds which won't be far behind in losses. Is there any reason we should not therefore expect overall losses in the economy of approximately double that of 2008-2009? I have thought a lot about this, and I cannot think of a rational reason.

The world has never had a debt bubble as large as the U.S. corporate debt market is today without ending in severe financial crisis. Never. And I just described the smallest of the four debt bubbles engulfing the world today.

2. European Government & Corporate Debt. Europe's coming bloodbath is going to make our corporate debt losses look like a walk in the park. Throughout Europe, there are multi-trillion Euros in losses that haven't been recognized but have in fact already occurred. European banks are stuffed with massive piles of corporate loans in which the companies won't be paying back the money. In fact, this is also the likely outcome for several entire European counties, who will default on some or all of their government debt. They will have a corporate debt crisis *and* a government debt crisis at the same time. This will probably start in earnest once we're all clearly in recession. Look out in Europe.

3. Japanese Government Debt. This clearly should be number one, as their government debt levels are probably around 250% higher than the second highest in the history of the world. All the previous times when debt levels rose anywhere near Japan's, they crashed very hard. Of course, Japan has not really grown for 27 years. Their challenges remain rather daunting.

4. In China, we have seen the largest explosion of debt in the last 700 years – hands down. Take the previous high and double it, and the result is China today.

The moment one of these bubbles pops, they all will (pretty much guaranteed). This will coincide with the largest worldwide economic downturn since the 1930s (pretty much guaranteed).

Every single debt bubble in 700 years has led to financial crisis. We have four of the largest bubbles ever, and by far the largest worldwide debt bubble ever. Yet nobody on television ever mentions these provable facts. Isn't that rather bizarre?

It appears to me as if the mainstream media listens to the Fed and Wall Street. The Fed basically can't admit the facts about our corporate debt levels, though they have started to warn they could bring us down. Still, the Fed can't paint the real debt picture, as markets would crash and we'd be headed into a depression before they got done with their presentation!

Then we have Wall Street. That group has never seen a stock market you shouldn't buy into today. Debt, what debt?

In other words, what I'm describing does sound extreme and unlikely, but severe economic losses always follow from creating far too much debt (much of which will never be repaid). When asset prices have gone up in the process, like stock prices have risen since 2012, but the losses due to too much debt continue to grow, at the end the debt suffers massive losses while the stock market suffers even greater losses.

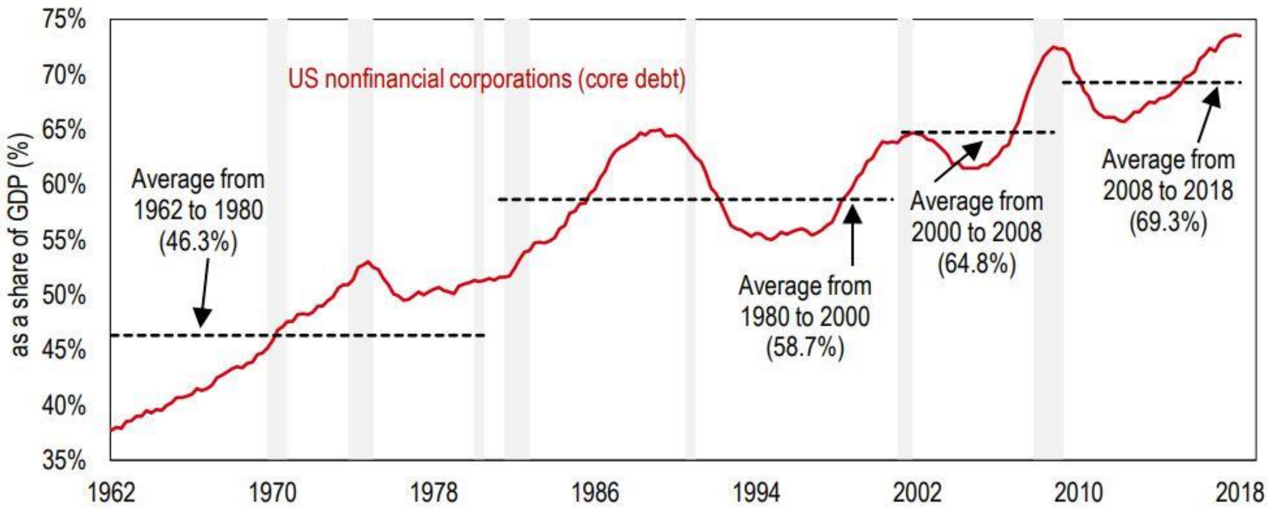
Right now, this debt situation is my entire case. If I'm correct about debt, I'm correct about the entire picture – that's how big a part of this coming recession debt will play. Dramatically elevated debt levels have never ended up misleading us. When they occur, we *know* what followed, every single time in the last 700 years.

Whenever time is involved, your guess is as good as mine. Bad debt, however, doesn't really care about time. Not only does time not diminish it, but the longer time that passes, the larger it grows. Near the end of a true "debt bubble," you would expect it to begin to grow, practically exponentially. Of course, this is exactly what has happened in the U.S. The chart below shows the growth of our corporate debt.

When looking at this chart, keep in mind we haven't had a complete "clearing" of our bad debt since at least the year 2000, and none at all since 2009. This means more companies than normal will default in this coming credit cycle. We see this clearly reflected in data from the credit rating agencies showing we now have a higher percentage of our corporate debt rated as junk or just one step above junk than ever before.

When looking at the chart also keep in mind the previous all-time high, since at least 1948, was in 2007. We have been in a cycle of increasing over-indebtedness. Unfortunately, the losses in 2009 were essentially artificially halted by Congress and the Fed. This led to an even bigger bubble, and one packed more tightly with companies likely to default than ever before.

In other words, this means we have both the largest amount of corporate debt ever ***and*** the riskiest total corporate debt ever!!! I certainly haven't heard anyone dispute this, yet the financial media and investment public have decided this little fact isn't newsworthy?



Source: HSBC, BIS total credit statistics

The Immediate Future

Our coming recession and accompanying debt crisis will be centered on corporate debt. When those debts or bonds begin to crash down in price, this means the companies whose bonds are collapsing will soon be going bankrupt.

This coming debt crisis is similar in some ways to the mortgage crisis, and different in others. This relatively new corporate debt bubble is undeniably much larger than the subprime mortgage market was, at $2.7 trillion versus $1.3 trillion. Another difference between 2008 and today's impending storm is that when a homeowner defaults on their loan it is bad for their family, and the bank who had lent the money. Yes, the entire local economy suffers, but the big losses are to the banks and homeowners.

In contrast, when a corporation defaults on their loans they usually lay off most or all their workers. This is not a very pleasant distinction. When we add in our huge government deficits and our consumers already as indebted as they have ever been, we start painting a very ugly economic picture.

Most of the low-quality corporate debt is owned in mutual funds and related investment funds. At some point we are highly likely to see the prices of junk bonds and leveraged loan funds begin to crash – going down over 10%, and probably closer to 20%, in consecutive days. The first day that occurs, I guarantee you we will be in recession. Of course, the recession will have begun earlier, with October of 2018 being a good guess, and December of 2018 probably at the latest. But we still don't know that for sure. The day low-quality corporate bonds plummet in price, we will know.

Very shortly thereafter the first wave of corporate bankruptcies will begin to wash across the economy. That will, I am afraid, probably be one of the first of several debt explosions as tens of trillions of bad loans come due throughout the world.

Those of you who have known me for 20 years know I am not by nature a person who likes anything sensationalistic, in any way. In this case, my hand is forced. All debt bubbles end in a spectacular crash. If that sounds sensationalistic, so be it. I'm just describing what I see coming to our corporate bond market. The eventual losses will almost certainly be stunning in size.

Of course, the other countries could beat us to the punch and have their debt bubbles crash down before ours does. I can't predict the order or timing of what's coming – only the potential size of the eventual losses and what that means for the economy and markets. What's coming is going to be very difficult for most people.