Commentary
by Steve Henningsen
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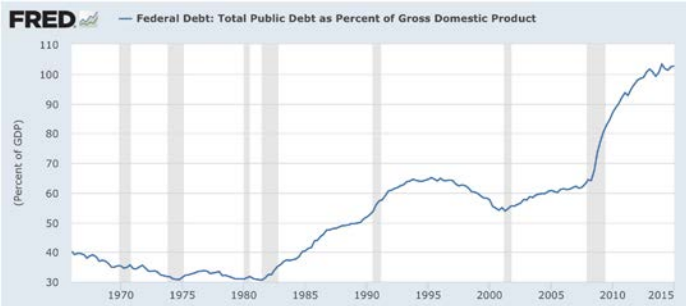
Debt Denouement?

"The correct way to think about deflation in today's debt-engorged world is in terms of the inability of asset prices to keep up with the growth of the debt used to inflate their values. When that relationship breaks down, the world will again experience the type of deflation described by Irving Fisher in his seminal 1933 essay The Debt-Deflation Theory of Great Depressions. That was what happened in 2008 until central banks came to the rescue. But they have used up all of their ammunition. Having tried to solve a debt problem by printing tens of trillions of dollars of additional debt, the world's debt-fueled expansion reached its limits in 2014."
–Michael Lewitt, *The Credit Strategist* October 2015

"Seven years after 2008, global leverage is higher than ever, and aggregate global demand is still insufficient to drive robust growth. More radical policies – such as major debt write-downs or increased fiscal deficits financed by permanent monetization – will be required to increase global demand, rather than simply shift it around."
–Adair Turner, *Debt Déjà Vu*, 10-6-15

To pump, or not to pump, that is the question…

I'm certainly no Shakespeare, so it's always easier to steal a little Hamlet than to write your own. Regarding "pumping," I'm referring to some market participants' request for the Fed to step in with QE4 in hopes of inflating the recently deflated stock markets. I'll follow up with my "pumping" metaphor in a moment, but first let's discuss why some investors are calling for more stimulus. It may have to do with the fact that this past quarter was one of the worst stock market performances in years, with the emerging and commodities markets hit hardest. Only bonds (with the exception of junk bonds) were able to post positive numbers. While many possible reasons were given (slowing Chinese economy, poor global economic figures, commodities downturn, uncertainty with The Fed, etc.) the bottom line was that many investors sold off stocks and now go into the last quarter with negative returns for the year. Whether or not the Fed comes to the markets' rescue before year end is uncertain. What seems to me is that an overleveraged global economy is hitting its limits. Paul Brodsky, from Macro Allocation Inc., put it succinctly in September by stating; *the nominal scale of global GDP is too large relative to its real productive value. As a result, the natural tendency of the global economy is to contract, and the natural tendency of global asset values is to fall*.

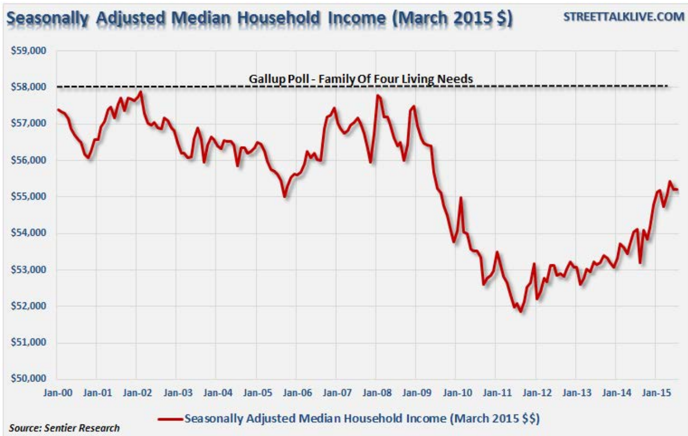


In my last commentary, *How Much Further*, I discussed how the high global debt levels were slowing the growth potential of many countries, and that I doubted we could grow our way out of the problem without devaluation. The United States has been growing its debt since the 1980s and now has a debt to GDP ratio above 100%. (See chart.) The U.S. isn't alone in borrowing to sustain its unnatural rate of growth. Much of the developed world has endured years of deficit spending to keep up with increasing government budgets. Now all that is left are the large pools of debt with their required interest payments. It is no wonder to me that interest rates need to be kept at record lows.

Economy is Deflating

I believe this concept is extremely important to understand the investment environment that lies ahead of us. Therefore, let me expand on the points Mr. Brodsky, Lewitt and Turner were describing in their previous quotes. Working in Boulder, one of the most bicycle-friendly cities around, I figured I would use an easy-to-understand bicycle analogy to explain the problem. Imagine that your bicycle tire represents the economy and that the manufacturer states it functions best at a PSI (Pounds per Square Inch) of 80, which reflects our economy's real productive value. Now capitalism is naturally deflationary due to innovation and competition, which work to drive prices downward - a good thing! (Think of it as a slow leak in the tire.) The tire is kept inflated via GDP, which adds credit to the system. However, over the past several decades, our government has been boosting our GDP above its *natural rate* via increased credit. Unfortunately, as seen in the chart above, they spent the past 30 years overinflating the tire (increasing debt and leverage through lower interest rates) which at first lead to better performance (higher asset prices), as one can go faster on a 180 PSI tire. However, the long-term effects are an overinflated, warped tire, or in our economy's case, an overleveraged system of misallocated/unproductive capital. This level of debt also makes it more difficult for the Fed to stimulate real growth, because it needs to pump faster in order to compensate for the increased debt, which is ironically slowing growth. (Debt compounds due to interest.)

In 2008, we blew a tire. The PSI began dropping and the Fed stepped in with its air pump (first QE program) to begin reflating the financial system. They claimed that they couldn't allow the PSI to drop back to its normal state of 80 PSI as the financial system was now geared up for 180 PSI. In other words, the overvalued asset prices (stocks, houses, etc.) used as collateral in our banking system needed to stay high to support the financial systems' foundation. (If the air pressure dropped back to 80 PSI in the tire, the bike would fall over.) As seen in this chart, the Fed used its own balance sheet to help pump the stock and real estate markets back up over the past several years. Frustratingly for them, every time the air pump was removed (the QE program ended), the tire (represented by the stock market in the chart) began deflating again, and they would need to put the pump back on. In November 2014 the Fed ended QE3 and once again the markets have begun to deflate.



The United States is not alone in this situation, as most of the developed world is trying to prevent their own bicycles from toppling over by taking turns with the air pump. (They have their own QE programs.) As seen in the previous chart, the Fed now has over $4 trillion in assets on its balance sheet and we have added approximately $9 trillion to our public debt. Add to that $1.2 trillion in student debt, another trillion in auto loans, stagnant incomes (see chart) and one doesn't need an economics degree to figure out why our economy can't grow more than 2%. Sadly, unlike the cartoon from the first page, air is not free and debt comes with a cost. With U.S. families struggling to make ends meet, a global overcapacity of "stuff," and continued deflationary forces resulting from poor demographics and robotics, where is the global growth going to come from?

"Coming events cast their shadows before them." (山雨欲来风满楼)
— Chinese proverb

Now the actual inner workings of the financial system are obviously more complex than my simple bicycle analogy, as it involves currency devaluation and effects from nominal vs. real growth that were omitted. Nonetheless, with the global economies deflating once again, even after $54 trillion in new debt has been pumped into the financial system over the past seven years, the question now is what's next? Another QE program, a Congressional stimulus program (helicopter money) via tax rebates or infrastructure building, a negative interest-rate policy to force consumers to spend, a combination or maybe, as I've discussed previously, a global reset of the whole financial system via the IMF and their SDR currency? One can only guess at this point, but I think the central banks can't let asset prices fall too far again, as the system would likely collapse. While my personal opinion is that the system can't be sustained in its current state, their only short-term choice is inflation via currency devaluation, which would allow them to pay back debt with cheaper money. This would put us on the path of a type of "stagflation" where we get low growth and higher goods and service prices for a period of time.

"The Fed's balance sheet is a pile of tinder, but it hasn't been lit … inflation will eventually have to rise."
- Alan Greenspan, October 2014, New Orleans Investment Conference

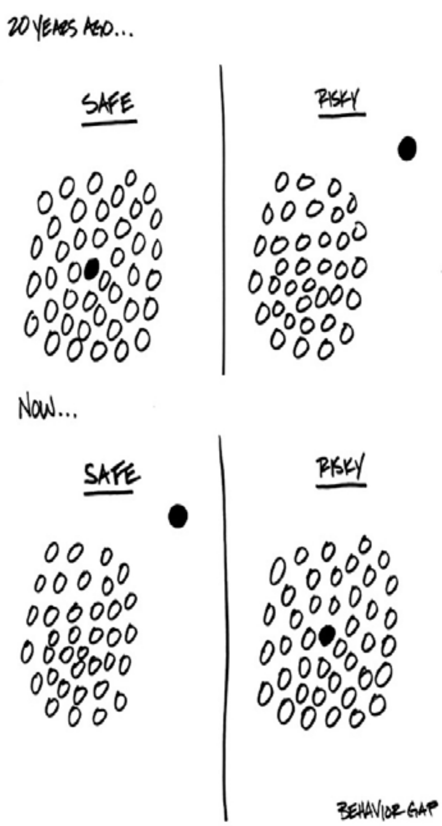
This type of environment will lead to a loss of purchasing power as the "nominal" value of things may stay level, but the "real" value will decrease due to inflation. The more interesting pondering is how far the Fed allows deflationary forces to proceed before lighting an inflationary fire?

Portfolio Ponderings

"Uncertainty should not bother you. We may not be able to forecast when a bridge will break, but we can identify which ones are faulty and poorly built. We can assess vulnerability. And today the financial bridges across the world are very vulnerable. Politicians prescribe ever larger doses of pain killer in the form of financial bailouts, which consists in curing debt with debt, like curing an addiction with an addiction, that is to say it is not a cure. This cycle will end, like it always does, spectacularly."

–Nassim Taleb via [Absolute Return]() 8-11-15,

I like Mr. Taleb's analogy, and as you may know, I also believe the foundations of our financial system are faulty and destined for failure. While my timing has been poor and frustrating, (I never imagined the extent that central banks would go to prop up the financial system) cracks now are beginning to appear. A major understructure of our portfolios has been gold for over a decade, and even though it has wobbled over the past few years, I continue to hold it for its historical stability and value.



I love this Carl Richards cartoon because it encapsulates how I believe we are positioned – outside the box and in the "safer" direction. It's true, my philosophical approach is not aligned with the conventional wisdom of Wall Street. For all the reasons stated above, I believe our current allocation will protect us in the coming quarters. Of course, time will tell, and there are no guarantees, but signs of change are beginning to appear.

Company profit margins are beginning to contract, which means that one of the main drivers of stock performance over the past few years, stock buybacks, won't be as widely used because corporations won't have adequate cash flow to continue this financial engineering feat. This means that stocks will need to be revalued to reflect their true earnings potential, as opposed to their leveraged-up balance sheets and overhyped investor expectations that have pushed many of them passed their intrinsic value.

I know this isn't supposed to be possible, according to efficient market theorists, but as James Grant (one of my favorite market historians) once said; *To suppose that the value of a stock is determined purely by earnings is to forget that people have burned witches.*

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