

## Cornerstone Commentary

### Highlights

- ◆ There is a downside to the upward spiral of debt
- ◆ Credit eventually dries up
- ◆ You don't solve a liquidity bubble with more liquidity



*As Seen in*

**Forbes**

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### Understanding a Credit Bubble (And it's brothers: Debt, Market and Economic Bubbles)

Originally written 1999

Let's suppose you are an average college student. Your eyes are much bigger than your wallet. But you are in luck. The credit gods have bestowed upon you a credit card, no - they have bestowed 3 credit cards. Your credit lines total \$10,000.

You are a smart college student. You buy only the best, a couple of grand on a computer, another couple on a stereo, some money on clothes and so on. You aren't just smart, you are wise. You don't run all your cards to the max. You leave a cushion, in case you see something else to buy.

But your little college job doesn't quite pay the minimum monthlies on your cards, after beer and pizza, that is. And Mom and Dad are paying your way, so you can't hit them up. So you use those checks that come with the cards, one to pay the other.

After a while though, you notice that the cushion you left is gone. You can't continue to have Peter pay Paul until... Poof! The credit gods bestow another credit card or two on you, and you are re-liquefied. You quickly scrawl out checks to pay your other cards off with the new cards. Then you use the old cards (now empty) to finance a spring-break trip. You run the old cards up to their old credit limits when... Poof! The credit gods smile again and increase your credit lines.

Now you are rolling into your junior year and you are about \$25,000 in debt. Your credit lines are maxed, again, and your job at the student union still only keeps you in hops and tomato sauce and cheese. Let's go with conventional wisdom and say the answer is more credit. So you go to the bank to see if they can help. (They aren't sending pre-approved cards any more.) They say "NO."

Now what? You can go bankrupt; you can quit school and get a better job; you can start to cut back on your expenses or you can... I guess that's it. You are stuck with a mountain of debt that will force you to do things you didn't want to do and will hurt your future growth (You could go to the guys with the crooked noses, but that's another story - see below).

The moral of the story: There is a downside to this ever upward credit cycle.

This is a microcosm of the U.S. economy. It's punch drunk on easy credit. The Fed re-liquefies the economy by lowering rates and unleashing a flood of new debt. But is it really helping, or making matters worse?

What should our college student have done? He should have stopped when he still could. He should never have paid one credit card with the other. He should have gotten a better job when he first got into trouble so he that didn't have to quit school. He should have cut his beer parties out. What are his options now? All bad, and painful.

At some point, the well runs dry. The Fed will have no choice but to stop increasing liquidity. If they don't, they run the risk of unleashing runaway inflation. What then? Or worse, what does the economy do when it bumps into its' credit limit and no one is there to increase the credit line?

Industries could go on a campaign of infrastructure investing to increase production and sell more goods. But the economy is slowing and then there would be that credit ceiling. Money would be tight, not loose. It won't be easy to get that loan to do the things you need to do to increase production. Besides, you couldn't justify the expense, even if you could get the money to do it.

Well, you could always increase current production without any capital investment. But you've been on a five-year campaign of closing plants, factories and offices, and consolidating operations, because of slower top-line sales. And your productivity rates are already at the highest they've been, in over two decades. And there's that sluggish demand problem, and those pesky cheap imports keeping prices down. The only way to increase sales is to cut prices, cutting into profits.

Of course, you could cut prices if you also cut expenses. But your company has been on a cost-cutting tear for the past decade. You have just-in-time inventory controls, your employees pay for their own benefits and you have changed management's compensation from salary to mostly stock options and performance bonuses. You've got nothing left to cut... except those annoying employees. A few thousand won't be missed and it shouldn't hurt productivity... that much.

Laying-off employees for the sake of profits tends to have a dampening effect on future sales of your product to those same employees. The "employees for profits" swap tends to slow an economy even further,

since those laid-off employees tend to participate less in the economy. This doesn't help an economy's debt problem.

So what is the solution? Increasing production to increase sales doesn't help since the economy is already slowing and sales are at best - flat. You will just be producing more stuff you can't sell.

Increasing sales only happens - in this environment - when you cut prices, which is not conducive to increasing profits.

You've already cut all the expenses you could, so the only thing left is to lay off employees. That puts further pressure on sales, further pressuring profits and necessitating more lay-offs.

None of these measures addresses the current credit/debt bubble in the economy. None of them showed how the economy would be healthier after, than before. The fact is, the economy, after an economic and market bubble, is not a pretty sight. The resolution of the bubble involves pain, pain eventually felt first by investors and then by all of us. The debt bubble is demanding more and more resources, and the economy is producing less and less.

The Fed's answer has been to throw more credit (debt) at the economy and hope some sticks. But most of the money gets spent on beer (stocks) and pizzas (mutual funds). The Fed has created the worlds first, financial "perpetual motion machine." As long as the Fed throws in money, the machine keeps going. But when they stop, or even slow down.... Watch out for that hang-over!

The only option we didn't explore was our college student declaring bankruptcy. Japan is faced with that right now. Their central bank did the same thing our Fed is doing - easing credit to keep the economy going. It didn't work, though.

Japanese interest rates were about 7% in 1989. Then their bubble burst. Their market dropped 66% in 3 years. Interest rates were continually cut until today; they stand at about 1 1/2%, with the short end at about 1/4%. They are giving money away, and it still isn't helping. Some estimate a trillion dollars of bad debt sits on their banks' balance sheets. Somebody is going to have to eat that. That somebody is going to be the Japanese people and Americans, to the extent they owe our banks. The Japanese have been suffering though their collective hang-over for the past 9 years, and it looks like they are about to take their medicine, painful as it may be.

The U.S. market is still acting like an irresponsible college student, though, and the Fed is serving the drinks. I don't know how the Fed will solve the current credit bubble without a lot of pain for everybody, especially the biggest frat house on earth - the stock market. You don't solve a liquidity bubble problem by adding more liquidity - It only makes the inevitable bursting of the bubble worse. Just ask the Japanese.

*"The guys with the crooked noses" are mobsters, wise guys, and loan sharks. NOT any particular nationality or religion. Everyone has their own mobsters - Irish, Italian, Russian, Brazilian, Japanese, Plutonian or whoever. I hear there is even a marauding group of bully penguins muscling in on the sea lions at the South Pole. So if you were offended, thinking the comment was about you or your group, don't be - unless you are a mobster*



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