

The Debt Bubble is Gaining Momentum

I have had many clients wonder why all of the caution. Why so bearish? Years ago, I saw it coming. We were building one of the greatest debt bubbles in the history of this country. I have written about it ad-nauseum. There is no question that this great bursting of the debt bubble is occurring right before our very eyes. The question is, "How bad will this get?"

We can all speculate. I have always felt that this was going to have a very bad ending. I derived that by assessing the outcomes of similar examples that history affords us. We saw a debt bubble in the 20's, which created the greatest stock market crash the world would ever see.

So what is different today than the 20's? One of the main sources of the debt bubble in the 20's was stock market debt. The stock market had major amounts of debt. Investors of all levels of society were betting the farm (literally) on the stock market going to the moon. Back then, there was very little regulation as compared to today.

So all of that debt came due and the stock market crashed. Margin calls beget margin calls, creating a domino effect of selling that tanked the stock market.

Today, this debt bubble is all about the mortgage market and loans going bad. It is a slower process that can develop over a period of years. The real estate markets don't just come crashing down. In the 20's, the debt bubble was a little more isolated. Today, debt is the fabric of our economy and that fabric is unraveling.

The 20's ended badly. You can also look at the debt bubble created in Japan that started to come apart in 1989. That ended very badly too, with a deflationary environment that was in effect for thirteen to fourteen years. They are still suffering to some degree from that time period. The Nikkei (Japanese stock market) dropped from 38,000 to below 10,000 (don't know the exact number). This occurred over ten plus years.

So, we have two debt bubbles to draw upon. They both ended in long periods of deep economic deflationary contraction. They both ended with a huge decline in the stock market. Government intervention in both situations just made things worse.

All of these debt bubbles have identical characteristics. I think that this has the potential to be historic. Am I being dramatic? I am just looking at what is happening and reporting the events that are taking place.

Over the past few weeks, the stock market has started to acknowledge what we have been discussing in these pages for a while now. This isn't about people with bad credit who signed up for horrible mortgages and are now losing their homes. In a recent Wall Street Journal article, it was written for the first time in a major news source that this is also affecting people with great credit. Unfortunately, it was people with great credit that took out bad loans.

The markets are finally acknowledging the fact that this really is an adjustable rate mortgage problem, as well as the fact that we are in the early innings of this problem.

The markets are finally acknowledging that it is the adjustable rate mortgages that are the leading cause of the extremely high rate of foreclosure that is causing the problems with these mortgages and the credit markets.

Finally, Wall Street is slowly acknowledging the pain the real estate markets have yet to see.

It is the classic bursting of a debt bubble. Debt bubbles burst in stages. First, it is the real estate markets. Next, I think that we are going to see credit card companies experience a world of pain when millions of credit card holders default on their debt. They are about the only source of credit right now.

The Federal Reserve is making this money available, which forces the credit card companies to lend it. Unfortunately, they are about the only part of the industry still giving credit.

There is one thing that Wall Street is not acknowledging. Wall Street just thinks that this problem is ultimately going to go away without much pain to the economy. This monster is too big and too interconnected into every part of the economy for it not to be a problem. Debt is deceiving. It slowly becomes a problem, creating a huge overnight problem down the road. We are in that process.

Government Bail-Out

So Treasury Secretary Paulson can fix the problem by freezing interest rates on mortgages, right? The Federal Reserve Board can just lower rates until the credit markets stabilize, right?

Let's start with the Federal Reserve Board first. Earlier this year, I wrote that there would come a day when the Federal Reserve Board and their policies of lowering interest rates would cease to be effective. We are seeing that now. The money supply is growing at a fast rate due to Fed policy decisions. However, banks are not lending money. *The debt markets are contracting*. This is what happens when a debt bubble explodes.

The banking community has become risk averse and they are not lending money. There is nothing the Fed can do to fix that problem. The banking system is in a tough spot right now.

Then there is Treasury Secretary Hank Paulson. His first idea of creating this big super fund that is going to save the universe cannot even get off of the ground. His current idea of freezing the interest rates of homeowners who face crisis because of their adjustable rate mortgages is not even realistic. If he were able to even remotely get all of the parties to agree to some type of program, it would only push the problem out to the future, making it even worse.

Then there are the unintended consequences of such a program. History has shown that government bail-outs of this proportion turn out to be disastrous. Someone takes the hit and there are many more entities involved beyond the home owners. However, this is President Bush's legacy and he at least wants the appearance that he is solving the problem.

I have made a list of data points that are occurring right now. You will see how this debt bubble has a far-reaching effect.

Data Points and Statistics

- *US Corporate Profits*

US corporate profits are in what looks like a recession. During the third quarter, profits fell 25% over the previous twelve months. At some point, this credit crunch starts to affect corporate profits.

- *Debt is being used to pay the bills*

There are some very fascinating things occurring in the consumer debt markets. There is a site where you can actually see consumer debt on a daily basis. My analysis, derived from this information, is as follows:

The creation of consumer debt is drastically slowing from year to year. That is credit contraction. Debt is still climbing to record levels. However, it is doing so at a very slow rate. The interesting thing is that consumer spending isn't increasing as much. If you look at all of the economic statistics together, they point to the consumer using credit cards just to pay the bills.

As of December 4, 2007, we are also sitting at a new record debt level.

- *Credit Contraction*

LIBOR rates are watched very closely. This is the interest rate that banks charge each other when money is loaned between banks. The LIBOR rate has shot up over the past few months. This indicates that banks do not want to lend money, which is a major concern for the market. This introduces a "shock" to the system if this rate does not go back down. This type of credit contraction has not been seen in the thirty-four years that the Federal Reserve has been tracking this data.

- *State investment funds are in trouble*

In **Florida**, the investment funds for schools and local government were hit by a 44% loss due to losses from these investments that hold sub-prime mortgage debt. Many of these huge investment funds are being affected. That equates to \$700 million in losses. There is a rumor that the fund might have to file bankruptcy.

In **Montana**, the investment pool for school districts, cities, and counties investment pool is also at risk. Thirty-six percent of the fund is affected by these bad mortgage based investments.

The same thing is happening in **California**. Keep in mind that this pool of investments went bankrupt in 1994 because of the same type of investment. Well, they did it again. They have a 20% or \$460 million exposure to these mortgage-based investments.

Here is what happens. A rating agency will inform the investment pools that their mortgage-backed securities are not worth what they have them priced as on their books. In other words, they say these investments are worth a certain dollar amount. However, if sold on the open market, they might only get two-thirds of that investment value. For example, a \$100,000 investment could suddenly be worth \$66,000 (imagine that on a much bigger scale). As a result of these dramatic drops in value, investors start withdrawing money, which makes the situation worse. In the above cases, these public investment pools had to suspend withdrawals to prevent a possible "run on the bank."

- *The Real Estate Markets*

The real estate markets continue to worsen. I have a list of stats that back up this claim. However, at this point, I think that you get the picture.

As far as the investment management goes, we had a real good month in November. I did decrease the bearish positions in the strategy because the decline felt like it was at a short-term stopping place. I might end up decreasing them some more. We are at year end and the market has a tendency to end on a positive note. So I

will keep an eye on it. This is only in the short-term. I am always looking for the opportunity to increase the bearish positions.

I just think that next year is going to be very interesting and full of opportunities. I have received many comments regarding '08 being an election year and that the market should do just fine.

Remember that 2000 was an election year and the S&P started a bear market that year and lost -10%.

The problem with this debt bubble is that the train has left the station and there is no turning back. Although the government will try to intervene, this detox process will still occur.

Keep the Faith,

Bob