This is a *credit* cycle, not a *manufacturing* cycle!

Most of us are familiar with the economic boom and bust cycles that result from a manufacturing cycle, but not so familiar with the booms and busts from a credit cycle.

Manufacturing cycles

Often referred to as *business* cycles, manufacturing cycles embody characteristics such as

a) Expansion (Boom), including:
   - rising consumer confidence
   - increasing demand for products and services
   - falling unemployment
   - rising job creation
   - increasing Manufacturing Capacity Utilization
   - increasing consumer prices
   - rising employee earnings
   - economic growth
   - rising demand and supply of credit
   - increasing asset prices (Real Estate, Financial, etc.)

b) Contraction (Bust), including:
   - declining asset prices
   - declining supply of available credit
   - slowing and declining economic growth
   - declining employee earnings
   - declining consumer prices
   - declining Manufacturing Capacity Utilization
   - declining number of available jobs
   - rising unemployment
   - decreasing demand for products and services
   - declining consumer confidence

A complete manufacturing cycle can average somewhere between four to six years and, for the past 30 years, the manufacturing cycles have occurred within a framework of declining interest rates and rising debt levels. This experience has preconditioned most investors to view the 2008 – 2009 financial crisis with the same set of expectations as they held for the previous 30 years of manufacturing cycles. However, the 2008 – 2009 financial crisis was *not* part of a *manufacturing* cycle; it is actually part of a *credit* cycle. This distinction is *critical* for investors to understand because selecting successful investments in a *credit* cycle is different from that that of a manufacturing cycle.

Credit cycles

Credit cycles are comprised of two phases:

- an expansion phase, and
- a contraction phase

Complete credit cycles are much longer in duration, happening once in a generation, and can fundamentally alter society's financial structures and attitudes toward finance (including debt levels and investments). And it's important to note that *manufacturing* cycles are not independent and exclusive of *credit* cycles, and that the shorter manufacturing cycles continue to operate within the framework of much longer credit cycles.

Because the phases of a credit cycles evolve slowly over decades, they can be difficult to identify and their slow evolution enables society's attitudes to change in support of each phase of the cycle. For example, our parents and grandparents viewed borrowing money as a *necessary evil* and the debt was to be paid off as soon as possible. Our generation, on the other hand, does *not* view debt as *bad*. In fact, many in our generation view debt as a tremendous *asset*, a good thing, and they view having a cash balance in a savings account as old-fashioned and unprofitable. This change in society's attitude has evolved over decades.

Minsky's 3 phases of a credit *expansion* cycle

Most of the published academic work concerning credit cycles has its roots in the writings of the late post-Keynesian economist, Hyman Minsky (1916 – 1996). Professor Minsky was the first to define the credit expansion cycle as three separate phases – *Hedge* financing, which leads to *Speculative* financing, which finally ends with *Ponzi* financing. A brief description of the three phases is provided below.

Note: As you read each description, remember the past 30 years of declining interest rates, the increasing consumer and government debt levels, and the creative finance vehicles leading up to the 2008 – 2009 financial crisis.

1. **Hedge finance**: In the earliest stage of the credit expansion cycle, the borrower invests the loan proceeds and the investment will generate sufficient cash flow to pay the contractual interest charges and repay the borrowed sum over time. (Think of the conventional prime home mortgages!)
2. **Speculative finance**: In this next phase of credit expansion, the borrower invests the loan proceeds and the investment will generate cash flow only sufficient to pay the contractual interest charges. Repayment of the original loan principal can only be accomplished if the asset is sold for the same value as the loan or

higher. (Think of the *Interest-Only* and *Adjustable-Rate Home Mortgages*!)

3. **Ponzi finance**: In this final phase of a credit expansion, where the borrower invests the loan proceeds and the investment's cash flow is insufficient to repay the loan principal and the contractual interest charges. To make the interest payments and repay the loan, the investment must be sold at a higher price than its cost. (Think of the *$0 Down Payment* and *0% Interest Rate Home Mortgages* or mortgages on raw land!)

Note: Leading up to the 2008 – 2009 financial crisis, the *Ponzi phase* was enhanced by new distribution channels and investment products such as Mortgage Brokers and Mortgage-Backed Securities (MBS). (An MBS is created when a large number of mortgages are bundled together and sold by bankers to investors.) By securitizing large pools of mortgages, banks no longer cared if the borrowers could make their interest and principal payments because the banks knew they would sell those mortgages to someone else or they could buy default insurance from a dozen or so mortgage insurance companies.

When does a credit expansion cycle end?

The credit expansion cycle takes decades to complete because it requires structural changes that transform business institutions, business conventions, regulatory bodies and societal attitudes toward less regulation and decreased government oversight. Institutions and conventions that are in place to help stabilize capitalist economies take time to dismantle and replace with more market friendly structures. Prosperity and success leads society to question the need and value of institutions that regulate and might discourage innovation. Therefore, the credit expansion can only be completed if and when restrictive regulations are eliminated and governing bodies are made ineffectual. This transformation was completed in the ten years leading up to the 2008 – 2009 financial crisis.

In theory, the peak or end of the credit expansion cycle is thought to coincide with a plateau and eventual decline in asset prices. This shift in asset prices forces *Ponzi* financed investments to be sold, which further accelerates asset price declines.

When does a credit contraction cycle begin?

Following the expansion's peak, a credit contraction phase begins, which often brings renewed efforts to enhance regulations through the rebuilding of old regulatory institutions, the establishment of new regulatory structures and by instituting new restrictive legislation.

A credit contraction cycle is characterized by both a decline in the supply of credit and the demand for credit. As financial institutions and investors struggle with failing loans, institutions become reluctant to supply new credit to potential borrowers. At the same time, borrowers become less optimistic about their

financial futures and allocate a greater portion of their incomes to the repayment of their loans.

Opportunities and risks: expansion vs. contraction credit cycles

For investors, the investment opportunities and risks present in a credit *expansion* cycle are considerably different than those during a credit *contraction* cycle.

Credit expansion cycle

During a credit expansion cycle some or all of the following economic conditions may be present:

- declining interest rates
- rising incomes
- rising debt levels
- increasing asset prices
- easy and abundant credit
- positive inflation
- increasing number of innovative credit products
- decreasing government regulation and market oversight
- a prolonged shift by economists and policy makers toward *laissez-faire* market philosophies

During these periods, when the supply of credit is increasing, interest rates are declining and the demand for credit is rising, certain investment categories benefit and certain types of investment behavior are rewarded, including the following:

a) Borrowers benefit and savers are disadvantaged as the interest rates on loans and the interest earned on savings decline.
b) Investors that buy real estate, common shares and commodities typically do well during credit expansion cycles. As credit becomes cheaper and more readily available, investors can borrow more and pay higher prices for these asset categories. As the asset prices rise, this success fuels additional borrowing and buying, further fueling rising asset prices.
c) Investors that purchase fixed income assets (such as bonds, guaranteed investment certificates and possibly preferred shares) initially see an increase in the market price of their investments, as interest rates decline, but ultimately they benefit less as their maturing investments must be reinvested in lower and lower interest rate options.

Credit contraction cycle

During credit *contraction* cycles, the social and investing dynamics are altered and investments that were profitable during a credit expansion may (suddenly?) become unprofitable.

For example, during a credit *contraction* cycle some or all of the following economic conditions may be present:

- declining interest rates
- declining incomes
- declining debt levels
- decreasing asset prices
- decreasing supply of credit
- decreasing demand for credit
- negative inflation
- decreasing number of innovative credit products
- increasing government regulation and market oversight
- a shift away from *laissez-faire* market philosophies by economists and policy makers

During these periods, when the supply of credit is shrinking and, more importantly, the demand for credit is declining, certain investment categories benefit and certain types of investor behavior is rewarded, including the following:

a) Borrowers are disadvantaged as asset prices decline and available credit shrinks making it difficult to repay borrowed funds.
b) Investors that buy real estate, common shares and commodities typically do not fare well. As the demand for credit declines and individuals focus on debt reduction, asset prices and consumption declines as household monies are shifted toward debt repayment. This shift in consumer patterns can lead the economy and business sectors into a slower growth cycle, which in turn, makes it difficult for corporations to increase revenue and profit for shareholders.
c) Investors that purchase fixed income assets (such as bonds, guaranteed investment certificates and preferred shares) continue to benefit as their invested capital is not at risk, but they are still faced with the reinvestment of their capital in a decreasing interest rate environment.

During a credit *contraction* cycle a number of society's attitudes about finance and investing evolve away from those held during the previous credit expansion cycle, namely:

a) Society slowly alters it view of borrowing and carrying a high level of debt. Individuals begin to fear that incomes and the asset values will be insufficient to support the repayment of their loans. This fear leads to a fundamental shift in psychology of *savings are good and debt is bad*.

b) Financial institutions are reluctant to make additional loans as they continue to wrestle with unwinding years and years of innovative loans, often with losses. In addition, financial institutions must also adhere to new restrictive regulations as they are subjected to increased government oversight. This can lead them into a slowing growth cycle for their revenues and profits.
c) The criteria for making investment decisions are altered. Investment *rules of thumb* based upon the prior decades of investment outcomes may become meaningless. Investment theories and strategies that made sense in prior *Bull and Bear* cycles may no longer be valid and accepted views of certain investment categories may become void.

Conclusion

The financial crisis of 2008 – 2009 was not the result of a manufacturing cycle. This is confirmed by the crisis' origins within the global financial system, the balance sheets of banks, and by the policy actions adopted by central banks around the world. Programs like the U.S. TARP, Quantitative Easing, and the ongoing sovereign country bailouts (Greece, Ireland, Portugal, etc.) are all responses to a peak in the credit *expansion* cycle.

The crisis came about as a result of the credit cycle peaking and shifting from *expansion* to *contraction*. Evidence of the contraction cycle has been increasing over the past couple of years and investors should understand how credit cycles function and how they impact their investment decisions, as an inflection point in a cycle is always more difficult to work with than when a cyclical trend has been identified and is fully entrenched. This difficulty is further compounded by all of the government's policy decisions that have created tremendous distortions in the business and economic data. These distortions hinder an investor's ability to clearly identify the investment characteristics of the new trend making it more difficult to develop long-term investment strategies.

In next week's commentary, we will discuss the recent developments in consumer, borrower, bank, and government actions that support the view that a credit contraction cycle has begun.

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