This is a *credit* cycle, not a *manufacturing* cycle: Part II – Evidence supporting this view

As we discussed in our previous commentary ("*This is a credit cycle, not a manufacturing cycle!"),* the 2008 – 2009 financial crisis was the culmination of a decades-long credit expansion. The crisis was not a result of a manufacturing slowdown, it was the result of assets prices declining, where borrowers were no longer able to support the *Ponzi* borrowing that financed those assets.

Remember: As defined by Professor Hyman Minsky, *Ponzi* borrowing occurs in the final phase of a credit expansion when borrowers invest 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 investments must be sold at a higher price than its cost. (Around this time you start to hear about *$0 down-payment* and *0% interest rate home mortgages,* or mortgages on raw land!)

Extraordinary measures taken to combat the credit cycle peak

In 2006 U.S. real estate prices stopped rising and by 2007 their prices actually began to fall. This forced borrowers to sell their assets in an effort to repay their loans. This selling caused real estate prices to decline further, which in turn caused additional selling. The deterioration in real estate prices soon led to large investment losses at financial institutions in the United States and around the world. In an effort to contain the accelerating deterioration in the banks' capital and to provide liquidity to the financial system, sovereign governments quickly stepped in with a combination of extraordinary measures. Some of these measures included the following:

a) Taking control of large banks and financial institutions
b) Guaranteeing corporate bond issues ensuring that bond investors could not lose any capital, (the guarantees covered existing bonds and future new bond issues)
c) Expanding guarantees on bank deposits
d) Altering the accounting rules to enable financial institutions to value their assets at prices above the fair market values, which artificially enhance their stated capital levels and financial statements
e) Establishing programs (Home Affordable Modification Program (HAMP), etc.) that enabled borrowers to walk away from their loan commitments without having the banks incur any losses. The taxpayers paid for the mortgage losses.
f) Intervening in capital markets via Quantitative Easing programs and restrictions on trading markets
g) Intervening in the negotiation and settlement of derivative contracts, artificially setting contract prices
h) Central banks providing corporations with trillions of dollars in loans at interest rates between 0% and 1.0% (basically free money)

Note: While the list above does not detail all of the interventions and extraordinary actions taken by governments around the world, it simply lends creed to the point that the policy responses to the financial crisis (by central banks and governments) are supportive of our view that the financial crisis was the result of a credit expansion cyclical peaking and not a typical manufacturing cycle.

Given this evidence listed above, the next question you have to ask yourself then is what evidence is there currently to support the view that a *new* credit *contraction* cycle has begun?

Evidence of new credit *contraction* cycle

All of the interventions undertaken by governments can create extreme distortions in economic data, business statistics, and capital flows. These distortions make it more difficult for investors and market strategists to clearly identify changing trends and cycle shifts in the short-term, but the evidence is beginning to appear in a number of areas of behavior on the part of consumers, financial institutions, and governments. These behavior changes clearly indicate that a reversal of the previous thirty-year credit expansion trend is underway. (Keep in mind that credit cycles are very long in duration and a change in trend does not happen over night.) While the change in direction evolves over years, the ways in which the trends appear to have shifted dramatically is outlined in the list below:

Note: These shifts are especially noteworthy when you compare the 2008 – 2009 period to previous economic recessions that are attributed to peaks in *manufacturing* cycles.

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

A number of the points above are already in place as evidenced by the data, namely:

- Interest rates are lower today than they were one, three, ten and thirty years ago.
- With the consistently high levels of unemployment, continuing decline in real estate prices and the sluggish economic growth, incomes have declined in the last three years. Some could

successfully argue the decline in incomes is a continuation of a ten-year trend.

- As a result of home foreclosures, increased bankruptcies and bank write-offs, debt levels have been declining.* This reversed the 30-year trend leading up to the financial crisis.
- Decreasing asset prices continue. Real estate prices continue to decline and even stock markets remain below their pre-crisis levels.*
- Negative inflation, or deflation, continues to be a major worry for central bankers, especially Dr. Bernanke. It is difficult to say whether the official government inflation data would actually be negative had central banks not injected trillions of dollars of liquidity into the financial system. The bond markets continue to indicate that inflation is not an issue of concern for them.
- The number of innovative credit products has declined dramatically. Their disappearance can be attributed to a combination of increased government regulation and oversight and the market's demand for these products that has simply evaporated.

**Canada appears to be an isolated exception as debt levels and real estate price continue to reach new highs, exceeding their pre-financial crisis levels.*

Other signs of a credit cycle shift to a contraction cycle

Indeed there are other significant signs in an economy that a contraction cycle shift has occurred, including the following items listed below (each of which is outlined in the following sections):

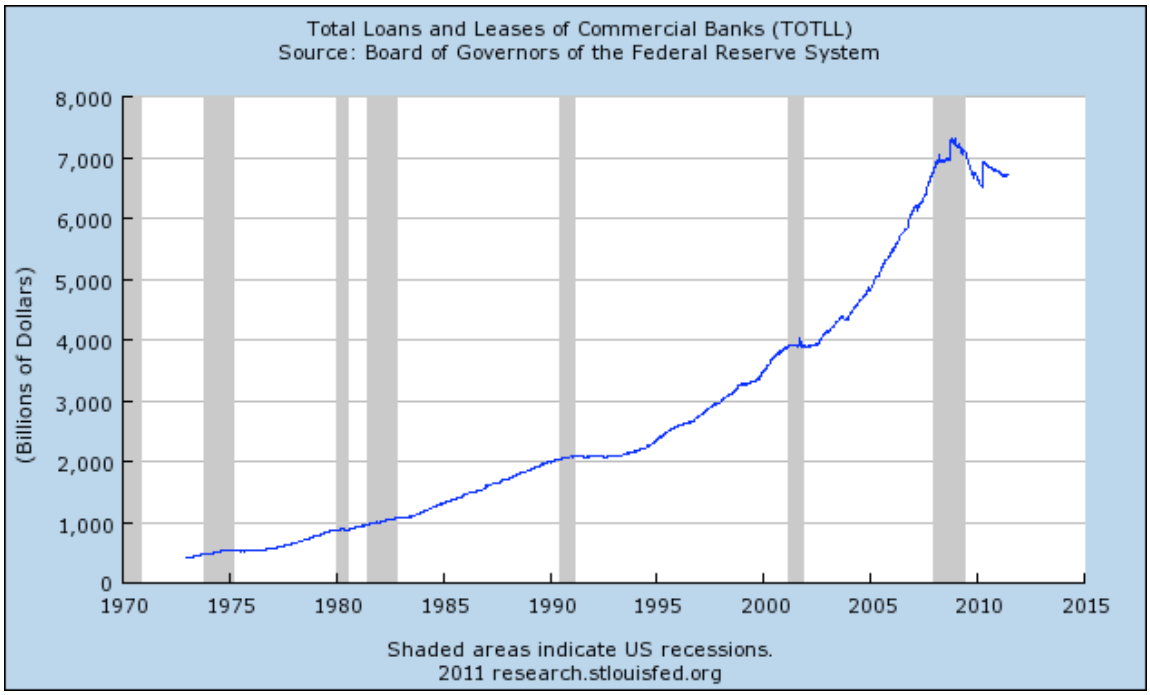
- decreased supply of credit
- decreased demand for credit
- shift in government policy away from *laissez-fair* market policies

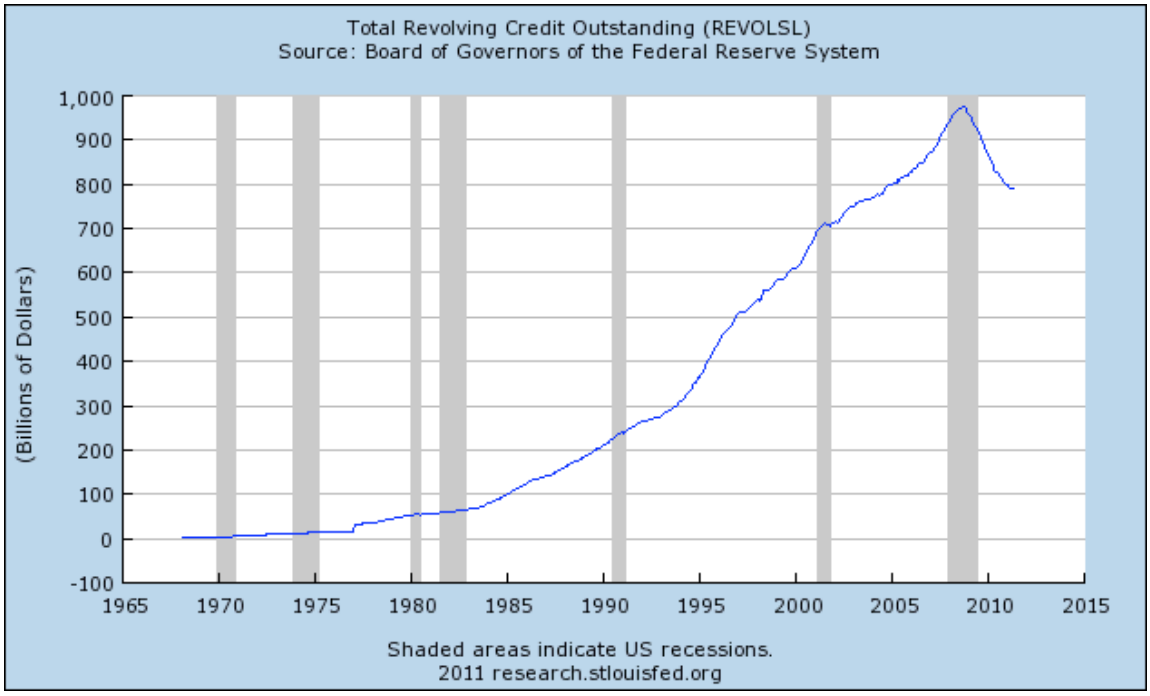
Decreased supply of credit

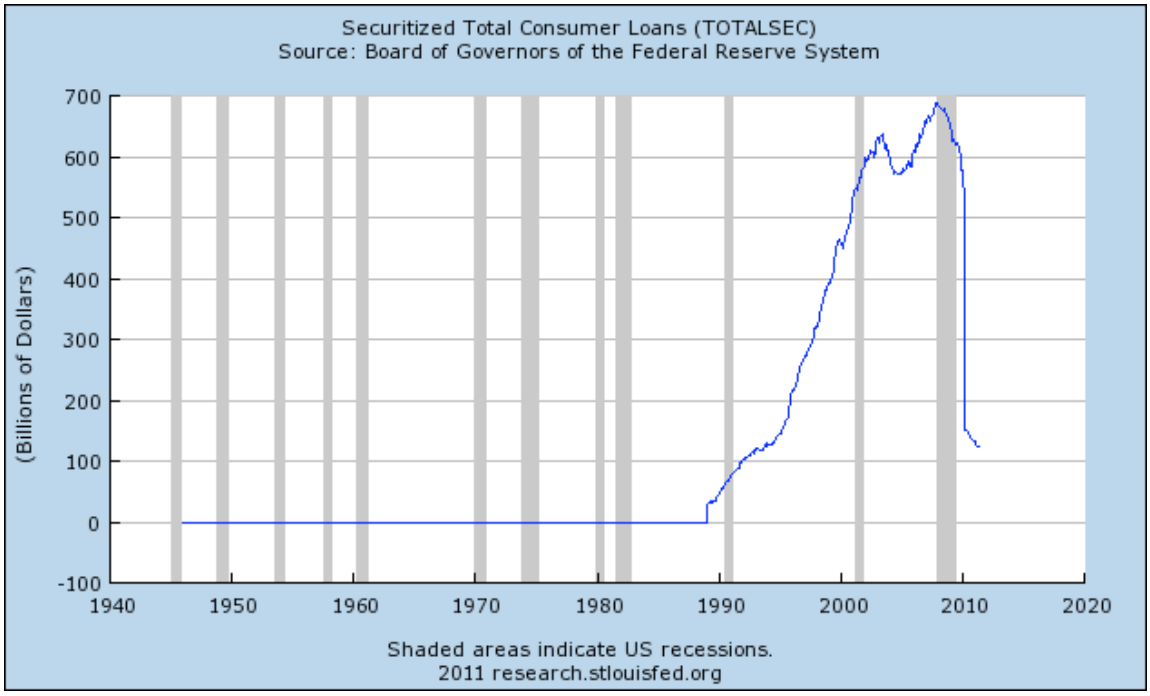
The expansion and contraction in the supply of credit to consumers, businesses, and governments is a direct function of the lender's confidence. In *good* economic times, lenders are confident in the current and future financial circumstances and they are comfortable expanding the supply of credit available to borrowers. In *good* economies, incomes and asset values are rising and these further support the increased supply of credit. The opposite is also true during *difficult* or *bad* economic times: asset prices and incomes decline and the confidence of lenders deteriorates. The decline in confidence is exacerbated by loan losses that result when borrowers are unable to repay their loans and the loan-securing asset values are insufficient to cover the loan principal.

Below are a couple of graphs from the St. Louis Federal Reserve Bank that indicate a meaningful decrease in the supply of credit. All of the graphs appear to

indicate a shift in the behavior of financial institutions away from expanding the supply of credit to actually decreasing the supply of credit. This shift, when compared with previous recessionary periods, is quite amazing. Compare the current trend (in blue) to those of previous economic recessions (as represented by the shaded areas):







Decreased demand for credit

In addition to the supply of credit shrinking, the actual demand for credit has also changed. Evidence of this shift in demand is outlined in a recent Bloomberg article *(Banks Holding $1.45 Trillion to Buy Treasuries as Savings Top Loans, June 20, 2011):*

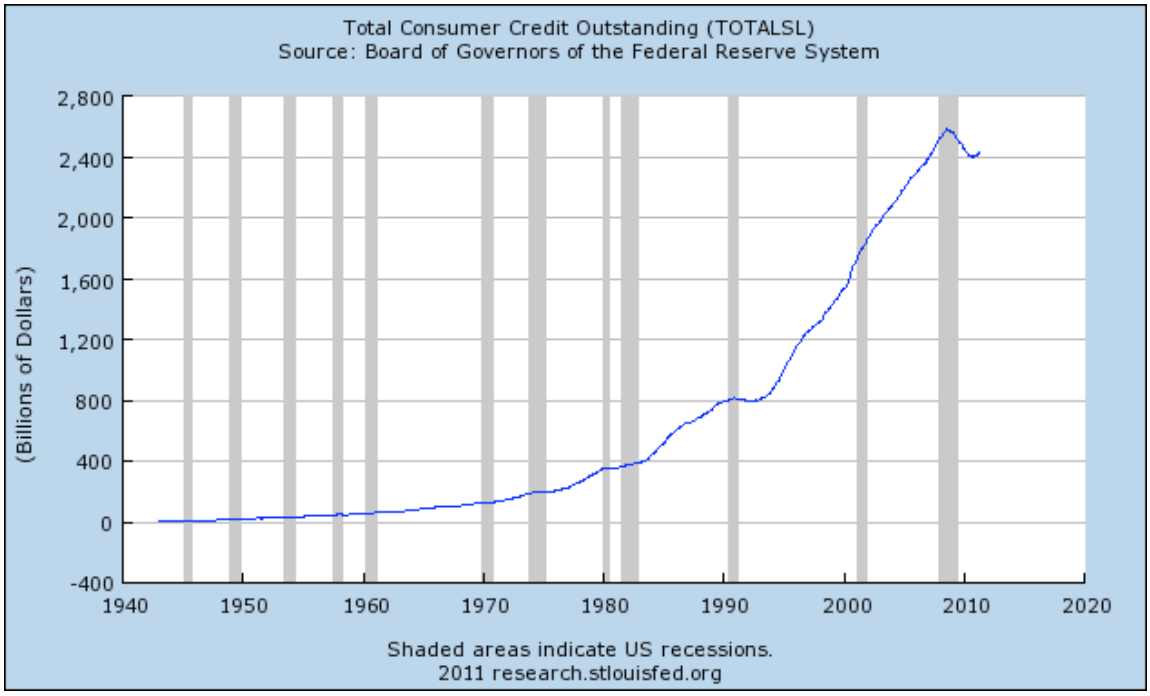
"Just as in Japan, deposits at U.S. Banks exceed loans, reaching a record $1.45 trillion last month, Federal Reserve data show. As recently as 2008, there were more loans than deposits."

The increase in deposits to levels that exceed bank loans by $1.45 trillion is the result of banks decreasing the supply of credit, and more importantly, the decline in demand from borrowers.

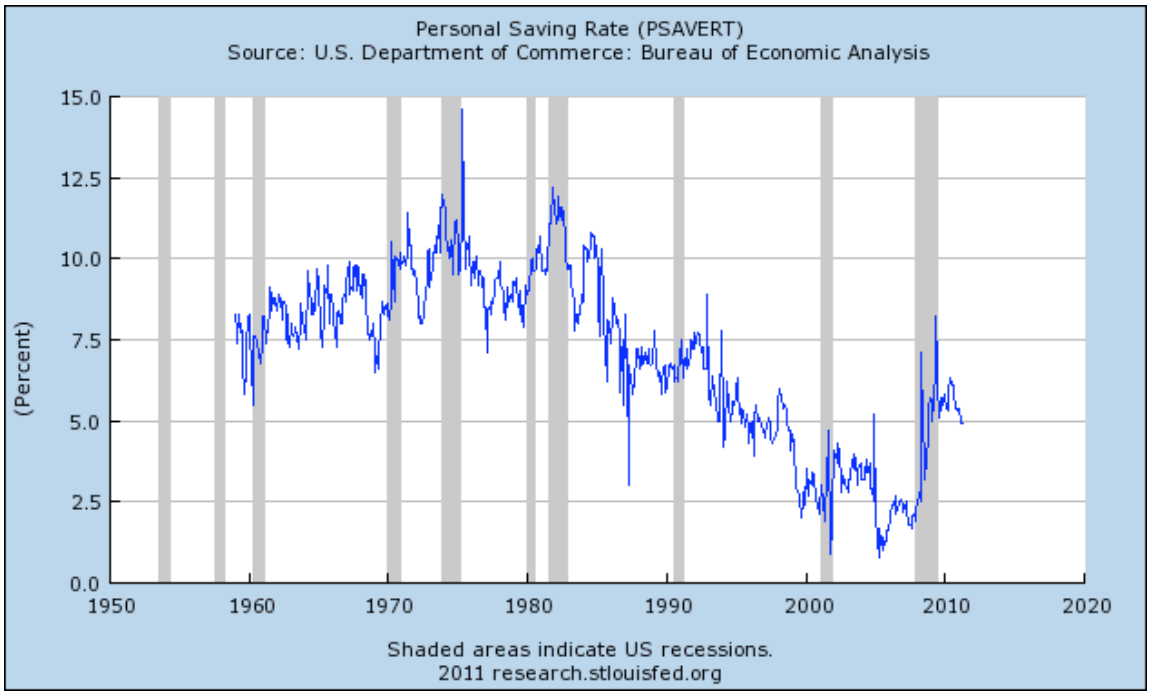
The shift in the Personal Savings Rate is a dramatic development when we compare this behavior with that of previous recessions.

The same Bloomberg article also notes: "The worst recession since the 1930s led consumers to trim household debt to $13.3 trillion from the peak of $13.9 trillion in 2008, and increase savings to 4.9% of incomes from 1.7% in 2007, Fed and government data show."

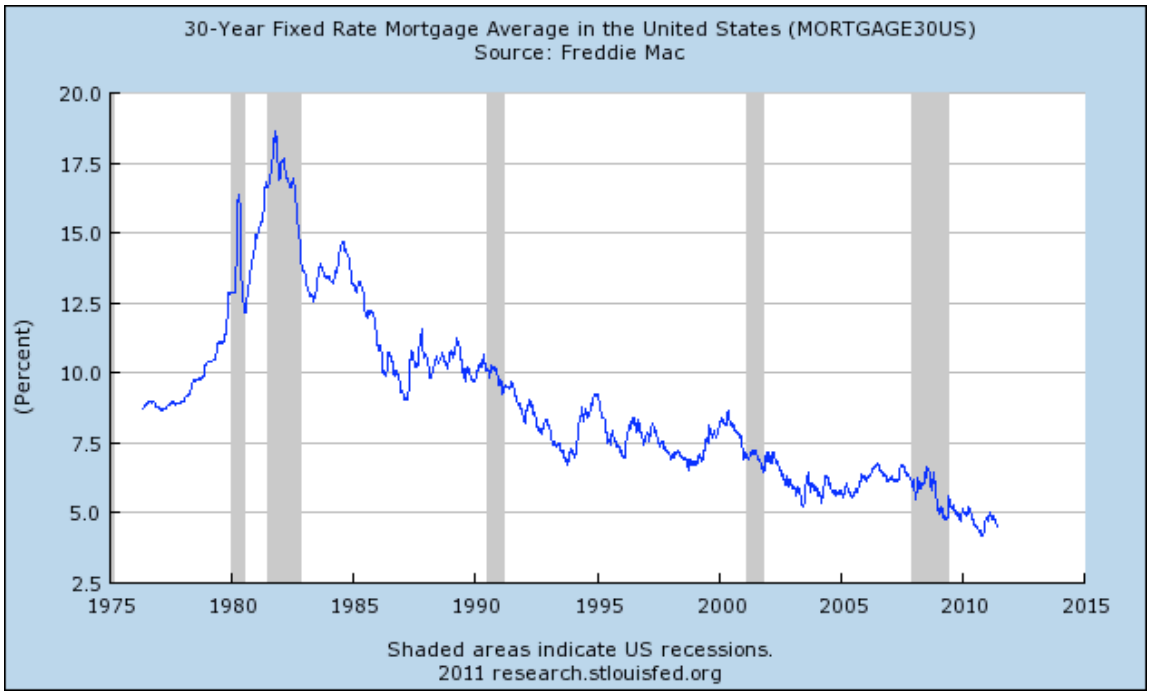
The St. Louis Federal Reserve Bank graphs below support the decline in consumer credit demands and the increased focus on creating savings. Again, compare the recent trend (in blue) with the trend during prior recessions (represented by the shaded areas).

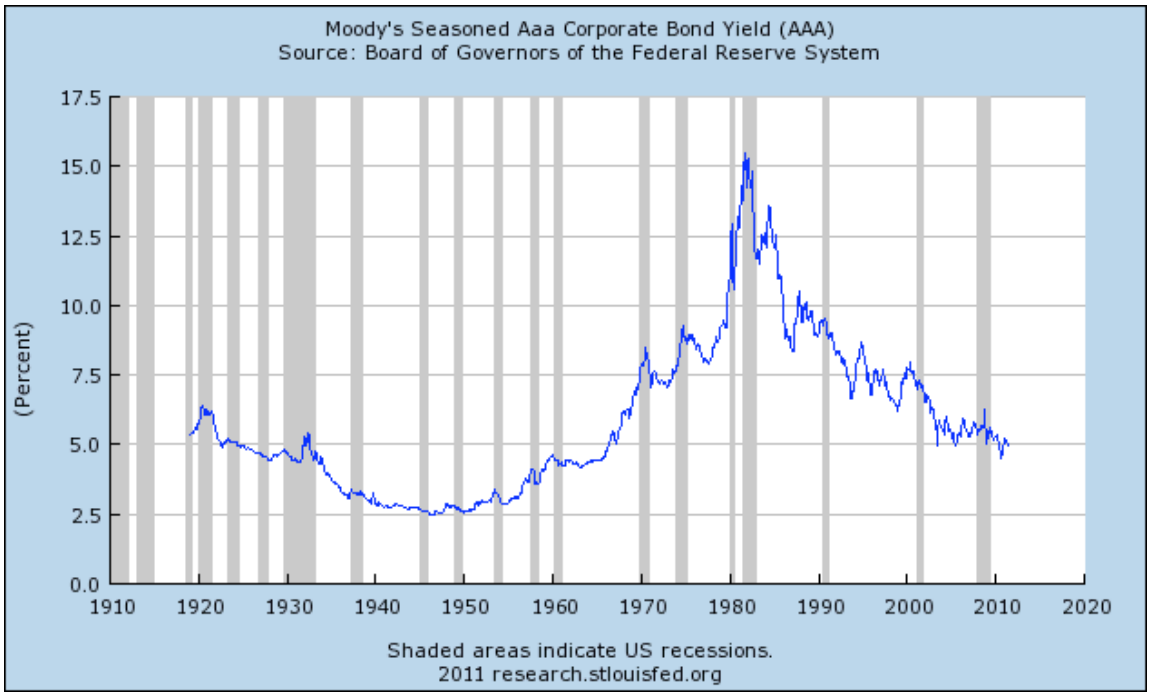


When we study the Personal Savings Rate data (see the chart below) provided by the U.S. Department of Commerce: Bureau of Economic Analysis, we see that the savings rate consistently grew from 8.3% in January 1959 to a high of 12.2% in November 1982. The savings rate then began a consistent decline until it reached an all-time low of 0.8% in April 2005. Note how from 2005 to 2010 the savings rate has increased to the current 4.9% rate.



We should also keep in mind that the decrease in demand for credit and the increase in the savings rates are taking place at a time when the interest rates to borrow money and the interest rate paid on savings have rarely been lower than it is today as illustrated in the St. Louis Federal Reserve Bank graphs below:





Note: Keep in mind that if the credit cycle has changed from *expansionary* to *contraction*, this shift will influence which investments will succeed and which will fail. It is widely accepted that developed economies rely upon individual consumers for approximately 65% of their economic growth. If this is true and consumers switch from borrowing and purchasing assets to behavior that emphasizes increasing their savings and paying down their debts, then developed economies will naturally evolve into lower economic growth patterns. This shift from borrowing to debt repayment will require households to reallocate their income away from consumption toward debt elimination. This shift will add to the downward pressure on the direction of economic growth, interest rates, asset prices and inflation making it difficult for investors to use the same investment strategies as they did in the past.

Shift away from *laissez-faire* market policies

One of the greatest changes that has signaled the end to the expansionary credit cycle is a fundamental shift (on the part of government policy makers and capital market regulators) away from a 30-year trend of de-regulation and decreased market restrictions and toward more government oversight and control.

The years leading to the 2008 – 2009 financial crisis witness a remarkable decline in capital market oversight, a shift toward *laissez-faire* market policies, and the creation of unregulated financial markets. A few examples of such policies in the U.S. include the 1999 repeal of the Glass-Steagall Act of 1933; the growth in financial derivative products and their opaque, unregulated trading that resulted from the passage of the Commodity Futures Modernization Act in 2000; and continuing growth in the use of *Dark Pools* or alternative trading platforms that enable trading to operate outside of the regulated capital exchanges. These are examples of a deteriorating regulatory environment that resulted from the policy makers' growing belief that markets were better at regulating their activities than governments.

In studying the factors that led to the recent financial crisis, the National Commission on the Causes of the Financial and Economic Crisis in the United States came to the following nine conclusions:

Note: We have copied the first paragraph only from each of their conclusions. Notice their first conclusion! This view that the crisis was avoidable sets the stage for governments to begin drafting and implementing new policy initiatives that will lead to increased government regulation and oversight and marks the shift towards a credit contracting cycle.

1) **"We conclude this financial crisis was avoidable.** The crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire. The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well being of the American public. Theirs was a big miss, not a stumble. While the

business cycle cannot be repealed, a crisis of this magnitude need not have occurred."

2) **"We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets.** The sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves. More than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe. This approach had opened up gaps in oversight of critical areas with trillions of dollars at risk, such as the shadow banking system and over-the-counter derivatives markets. In addition, the government permitted financial firms to pick their preferred regulators in what became a race to the weakest supervisor."

3) **"We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.** There was a view that instincts for self-preservation inside major financial firms would shield them from fatal risk-taking without the need for a steady regulatory hand, which, the firms argued, would stifle innovation. Too many of these institutions acted recklessly, taking on too much risk, with too little capital, and with too much dependence on short-term funding. In many respects, this reflected a fundamental change in these institutions, particularly the large investment banks and bank holding companies, which focused their activities increasingly on risky trading activities that produced hefty profits. They took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products."

4) **"We conclude a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis.** Clearly, this vulnerability was related to failures of corporate governance and regulation, but it is significant enough by itself to warrant our attention here."

5) **"We conclude the government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets.** As part of our charge, it was appropriate to review government actions taken in response to the developing crisis, not just those policies or actions that preceded it, to determine if any of those responses contributed to or exacerbated the crisis."

6) "We conclude there was a systemic breakdown in accountability and ethics."

7) **"We conclude collapsing mortgage-lending standards and the**

mortgage securitization pipeline lit and spread the flame of contagion and crisis. When housing prices fell and mortgage borrowers defaulted, the lights began to dim on Wall Street. This report catalogues the corrosion of mortgage-lending standards and the securitization pipeline that transported toxic mortgages from neighborhoods across America to investors around the globe.

8) **"We conclude over-the-counter derivatives contributed significantly to this crisis.** The enactment of legislation in 2000 to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis."

9) **"We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction.** The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval."

Conclusion

In addition to their conclusion that the crisis was man-made and preventable, the National Commission on the Causes of the Financial and Economic Crisis in the United States) also state that the governments' interventions have placed taxpayers at risk of incurring substantial investment losses and this new exposure provides policy makers with the motivation to implement greater regulations and oversight on financial markets in an attempt to minimize those losses. Because governments view the crisis as "preventable," it would appear the tide has changed for policy makers and market regulators *("Regaining Control? Controls and the Global Financial Crisis", Kevin Gallagher, MA, PhD, Tufts University)*. For the first time in over 30 years, we are beginning to witness increasing regulations and restrictions placed on capital markets. Policy makers are moving away from *lasses-faire* market attitudes and toward greater government regulation and oversight of financial markets and market participants. This evolution will be slow and gradual, but if it continues investors must adapt their investment approaches and strategies going forward from here.

A number of new policy initiatives from around the world that highlight this move toward greater government regulation and oversight of financial markets include:

- the Dodd–Frank Wall Street Reform and Consumer Protection Act signed in 2010
- the European Union's proposed legislation imposing a financial transaction tax
- the planned Systemically Important Financial Institutions Fees (SIFI) imposed on banks deemed too-big-to-fail by the Basel Committee on Banking Supervision
- the capital restrictions imposed by sovereign nations such as China, India, Brazil, Indonesia and Taiwan.

In addition to a shift in the attitudes of policy makers and market regulators, world agencies are now advocating the benefits of capital controls in stabilizing capital markets. For example, in February 2010 the International Monetary Fund's (IMF) senior staff declared that capital controls are now justified as part of a country's policy toolkit. (Prior to the financial crisis, such a view from the IMF senior staff would have been seen as heresy!)

Although the financial crisis began three years ago, the shift from a credit *expansion* cycle to a credit *contraction* cycle is becoming evident. Even with the distortions created by the extreme government interventions, the trends associated with a credit contraction cycle are beginning to take shape. While these trends can take years to become established in financial markets, government policy, and societal attitudes, investors need to be aware of these long-term shifts in established trends if they are going to be successful with their investment decisions.