

The Debt Time Bomb

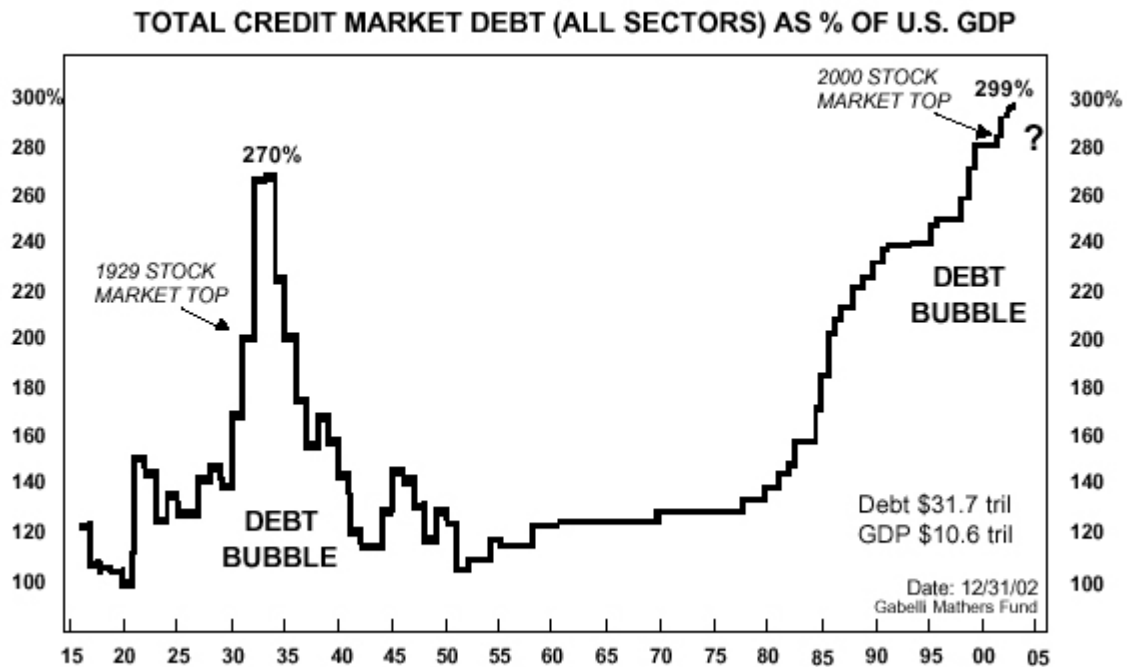
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Put simply, I believe that we are in a unique investment climate. As mentioned in many of my previous literature, I feel that there are major structural imbalances within the global economy that pose systemic risks to those investors who do not recognize the magnitude of these imbalances. Such imbalances stem from the gargantuan debt and leverage levels that need to be perpetuated in order to keep our economy afloat. Unfortunately, free markets always correct such imbalances, although the timing is very difficult to gauge.

The following pages will describe how credit expansion and leverage relating to large debt levels may affect the economy going forward, and why the reliance upon foreigners to facilitate this credit expansion makes for a very tenuous situation.

Debt

The following chart shows total U.S. credit market debt relative to U.S. GDP. The current figure is well in excess of 300% of GDP, a figure never before seen for *any* economy of recorded history.



While debt and leverage can be quite beneficial in aiding economic expansion, they are also double-edged swords. Debt and leverage eventually need to be worked off. When this happens, it acts as a major headwind to any economy at best, and outright disaster at worst.

Credit Creation

To illustrate this point, let us first imagine an economy without the availability of debt or leverage. In such a scenario, the economy can only grow as fast as earnings less expenses, or disposable income. As a consumer, you are able to spend the amount you earn less any expenses you have. Those expenses become earnings to the company you pay them to, who also has expenses that become earnings to other entities. But in an economy without credit, one can easily envision how an economy cannot mathematically grow any faster than the growth in disposable income. Without the availability of credit, one cannot make a purchase unless they have the savings to pay for the product. Therefore, one could not contribute more than their disposable income to the economy.

However, for the sake of illustration, let us now introduce credit provided to one individual. Perhaps an auto dealer has produced one too many cars, and now wants to get rid of it as it is taking up space on the lot. This dealer can agree to give the car away to this individual in exchange for payments over time. In this scenario, one who does not have the savings for a large purchase in cash can purchase that item on credit, which helps to expand the economy by the price of the car. This one time expansion is simply offset by the extra monthly expenses the consumer now has to pay for the automobile over time. For example, the economy grows by \$30,000 today (the price of the car), but will be offset by the \$500 per month that the consumer has in extra expenses over the next five years.

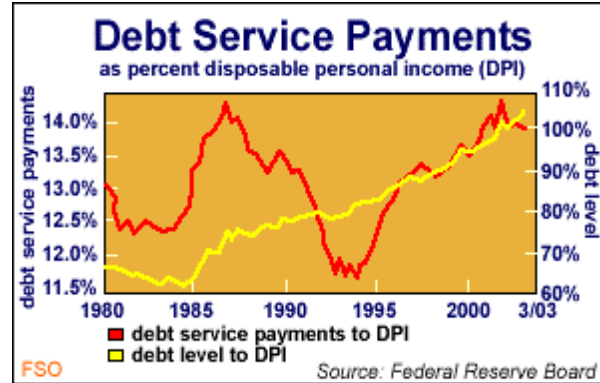
Now, obviously, this is just one simple example, but we can see how rapidly the economy can grow simply by the creation of credit (in this case, by \$30k more today than would be possible without credit). In fact, this is in part the reason for the strong economic growth seen in the last couple decades. Credit has exploded higher, which perpetuated the explosive growth in the U.S. economy. The cost to this growth is the future interest payments that will act as a headwind to the economy as the credit needs to be paid back.

In many cases, this credit expansion is beneficial. If someone can purchase an automobile on credit, as in the above example, which can help increase their earnings by more than the interest payments, such credit actually creates value. Let's now assume that the car is worth \$15,000 five years later. The individual who bought the automobile on credit had a real cost of \$250 per month ($\$30k \text{ cost} - \$15k \text{ value}$, divided by 60 month term of payments). If in fact that automobile helped the consumer earn more than \$250 more per month than otherwise possible (without the car), such a purchase on credit added value to the economy. Conversely, anything less than an extra \$250 per month in extra earnings would actually decrease value to the economy, as there would be a stronger headwind of repayments than was able to be generated by taking on the debt.

Suffice to say that this is an oversimplified example, and we cannot determine whether credit creation is good or bad unless we know the circumstances under which such credit is used. But like anything else, too much of a good thing usually results in a bad thing.

How Credit Creation Relates to us Today

This example leads us back to the debt levels as indicated in the chart above. Credit, while exploding, is no longer contributing much to the economy. The additional credit is primarily being used to simply service that debt. Despite a continued rapid increase in credit, the economy is reasonably stagnant. The debt levels have reached a point of saturation, whereby ever-increasing amounts of credit are needed just to keep the economy stable. For you statisticians, the figure is about \$6 dollars of debt necessary to grow the economy by \$1, and the ratio keeps expanding. Effectively, so much debt is in the system that additional debt is necessary just to pay the debt service on the original debt. This new debt does not perpetuate value in the economy, but instead merely perpetuates more debt service. It is likened to being maxed out on all your credit cards with no means to pay them, so you need to get a new credit card to get a cash advance in order to pay the minimum payments on the others. (The chart above was obtained at financialsense.com.)



Many pundits claim that because this has gone on for so long, it will simply continue. However, history tells us otherwise. In every case in history, debt levels have reached a point of saturation and the credit cycle reverses. The more egregious the debt levels, the more violent the correction of the imbalance. Most notably in recent history, Japan topped out at about 268% of GDP after their boom in the 1980's, and the U.S. reached a saturation point around 270% of GDP after the boom in the 1920's. When those cycles reversed, they were devastating. With current debt levels in the U.S. at more than 300% of GDP (and up to 350% by some estimates), we face massive potential risks should the process reverse.

This is the fear of those of us in the bearish camp. Not only do we have a perpetual debt machine building in the system, but also we simultaneously have no control over it. We are completely dependent on foreigners helping us to perpetuate this cycle, as they act as our "Visa." The fear is that they will cease to do so much longer as our nation's balance sheet is so poor, with Japan as the most likely candidate to stop flooding us with additional credit in the near future.

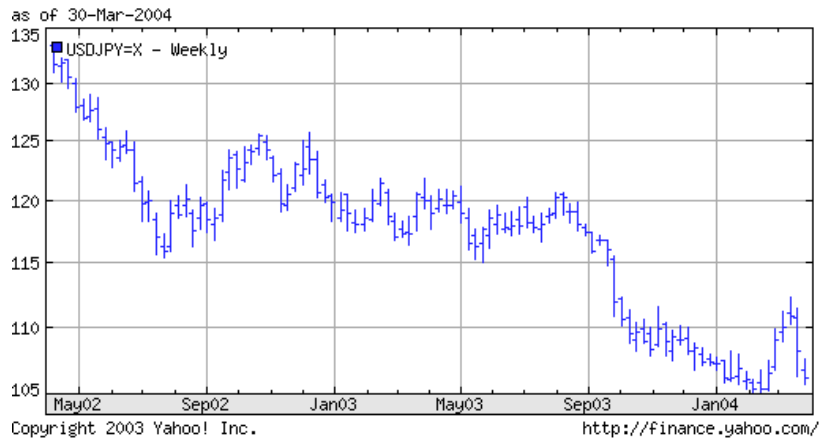
Our Federal Reserve members continue to tell us that there is nothing to worry about as we continue to have these foreigners help aid the process. This has in fact been true, but recent statements from Japan indicate that they may no longer be willing to throw good money after bad. Parenthetically, Japan's fiscal year end of March 31st may be just the time for them to stop doing so. How long is Japan (or any other nation for that matter)

likely to continue to perpetuate lending to us should the dollar continue to decline, as those loans will be repaid in U.S. dollars.

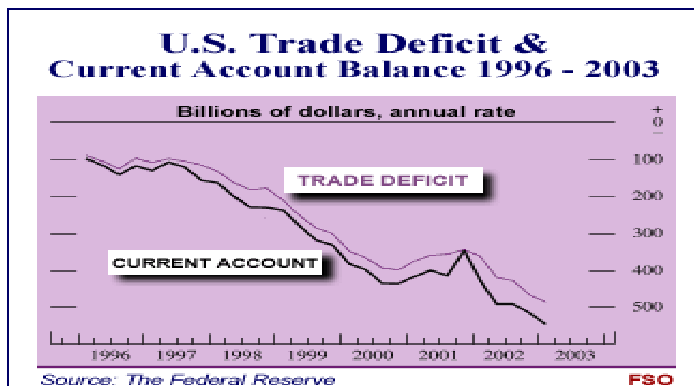
Understand the nature of this cycle is due to the global economic ties we currently face, with the U.S. consumer as the economic buyer of last resort. This perpetual debt machine is permeated, as every major economy is very weak, with any strength coming from the consumption habits of the U.S. consumer. As a result, most major countries are trying to devalue their currency in an effort to make their goods remain attractively priced. To use Japan as an example, they literally print as much yen as they can in order to sell their yen in the open market (thus weakening the yen) and buy U.S. dollars in the form of treasuries (which strengthens dollars). By doing so, American's are better able to afford Japan's products.

And herein lies the dilemma: at what point does the process end? How long will foreign countries print their paper currency to sell in the forex markets and buy U.S. dollars, so that our currency is strong enough to buy their goods and keep them from running into a renewed recession? I suspect that the answer is somewhere from which foreign currency declines begin to outweigh their cost of avoiding a recession. The chart below shows the effective "investment" of

Japan in the U.S. for the last two years. Japan has invested more than \$500 billion (in U.S. prices) by funding our consumption and purchasing U.S. debt. As the chart shows, Japan is clearly underwater in these transactions, as the meager interest rates provided on those purchases is far less than



the currency conversion losses. Should the losses on these transactions begin to outweigh the benefit to their economy, they will likely slow their funding of our consumption, not to mention the possibility that they *could* in fact begin selling their U.S. dollar denominated assets. The ramifications of merely slowing their funding is staggering, as they have contributed over half a trillion dollars over the time frame of this chart (which shows the relative loss in value of the dollar relative to the yen).



This is all fine and good theoretically, but we need to look at the actual figures for a sense of the magnitude of this process. First, understand that the U.S. economy is a \$10 trillion economy, as measured by GDP.

Because we spend a lot more in this country than we earn (hence the continual need for lending from foreigners), we are running current trade imbalances of about \$500 billion per year, or 5% of our GDP, for both the current account deficit and the trade deficit. (The chart above obtained from financialsense.com.) This is similar to a person making \$100,000 per year, but rather than saving some, going into more and more debt by \$5000 per year. And this is exactly what is happening. We have no savings in this country, and are borrowing massive amounts from foreigners. This has caused the U.S. dollar to decline by about 25% in the last couple years as U.S. dollars are sold in order to buy foreign goods. The decline in the dollar would likely be greater if these foreign governments were not simultaneously trying to weaken their own currencies.

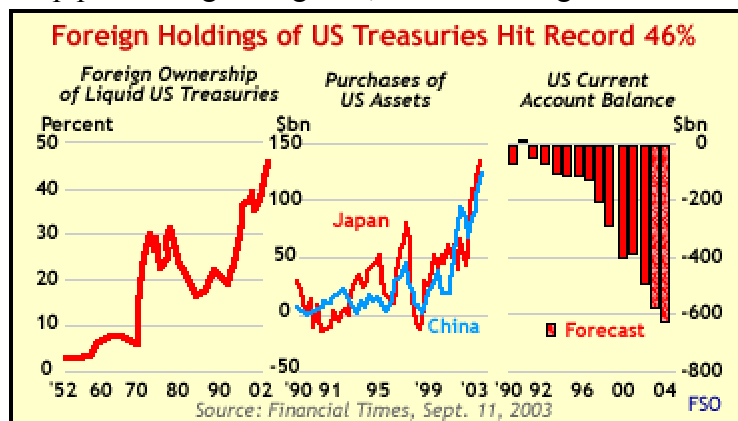
The weaker the U.S. dollar gets, the less competitive foreign pricing becomes. As the dollar declines, it takes more of them to purchase foreign goods. To stem this, foreign governments print more dollars of their own, sell them in the open market, and purchase U.S. treasuries in an attempt to further weaken their currencies and keep the U.S. dollar higher so that U.S. consumers can continue to purchase their goods. This is the process of competitive devaluations of currencies. In fact, Japan has done this to the tune of more than \$350 billion in the last 12 months alone.

These are staggering statistics. Should foreigners decide that they will no longer send good money after bad, these flows will slow, which will result in an even weaker dollar, higher interest rates, or both. Neither of which will be good for a debt-laden economy like ours.

So we, as a country, continue to spend more than we earn, and foreign countries are more than happy to sell their goods and services to us as it helps propel their economies. Unfortunately, as the imbalances get ever larger as this process continues, it is becoming more and more difficult for them to stem the decline in asset prices of the U.S. treasuries they buy, due to the declining dollar.

Effectively, foreign governments sell more goods to us than we sell to them. The difference is the aforementioned trade imbalance, running at a rate of a half trillion dollars per year. We do not pay for this out of savings, but rather more debt, perpetuated by the easy money and credit policies of our Federal Reserve. By issuing more debt, we can buy their goods. We sell our dollars to buy foreign currencies in order to pay for their goods. This weakens the U.S. dollar and strengthens their currencies.

Normally, a currency decline would lead to a point where we could no longer afford to keep purchasing their goods, thus stemming the decline and keeping everything in



balance. But as we are now a global economy, foreign countries cannot allow that to happen, as their economies are not strong enough to sustain themselves without

additional and continued purchasing of their goods by U.S. consumers. So they purchase the debt issued by us so that we have the money to buy more of their products. They lend, and we buy. We go more into debt, and they become ever-greater owners of that debt. In our \$10 trillion economy, we owe about \$500 billion more to them each year as a result of this process. (The chart above obtained at financialsense.com.)

These imbalances are keeping our currency weak. By issuing this level of debt, we are literally printing more and more dollars. Naturally, as more dollars are produced at virtually zero cost, each of those dollars will become worth less. The dangers arise, as foreign central banks cannot afford to let the dollar decline any further, as it would make their products less affordable to us. To combat this problem, they no longer lend to us from savings, but rather print their own currencies at a pace similar to ours. In Japan's case, they simply print yen, sell them to buy dollars, use those dollars to buy our treasury obligations, which we have issued to provide credit in order to buy their products.

This process of competitive currency devaluation has become a perpetual cycle. When the saturation point is reached, further currency declines are necessary to keep it going.

Understandably, this inevitable process has been sold to us as a good thing. Presumably under the premise that if you owe the bank \$100 dollars and cannot repay it, *you* have a problem. But if instead you owe them hundreds of billions of dollars and cannot repay it, *they* have a problem.

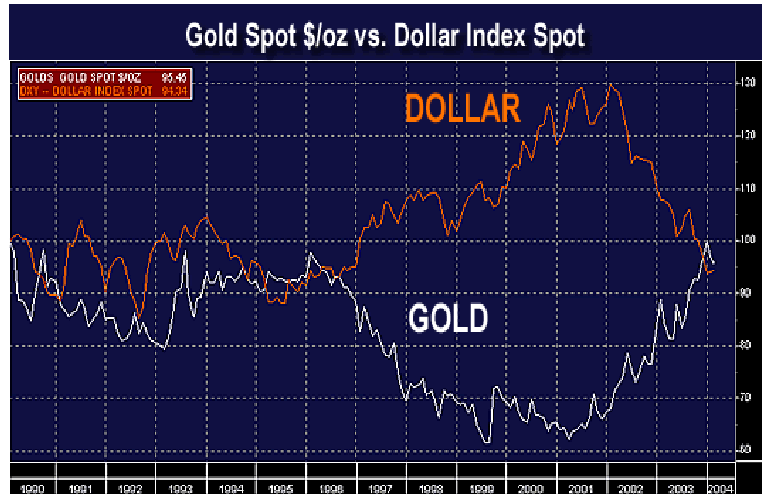
To date, these foreign central banks have not deemed this to be a problem (at least not so much of a problem that they choose to change their actions). However, as these imbalances grow, there becomes an ever-increasing risk that the debt they are purchasing will either decline in value (as the U.S. dollar declines) or we will simply be unable to pay it back. Being unable to pay it back is not deemed by many as a possibility, as our government has the right to simply print more money to pay it back. But by doing so, we cause the currency to decline, perpetuating the loss in their asset value once they try to convert it back into their own currency.

Therein lies the virtuous cycle of our global economy. The risk to this process lies within a debt pyramid supported merely by more and more debt and leverage. Should foreign central banks deem this process no longer beneficial to their own interests, the cycle will reverse, sending our economy in a tailspin as we no longer are able to borrow money to keep the process going. Without this foreign lending, more dollars will need to be printed to perpetuate asset prices higher, but even doing this will come at the expense of a lower value of those assets due to a declining value of the currency as we just print more of it.

Due to the debt and leverage in our system, I believe our economy faces severe headwinds for growth. Should these headwinds be overcome through a continued dollar devaluation process, I do not believe that people will remain supportive of dollar-based paper assets as the dollar continues to decline. Those countries that act to constrict their money supply, or simply treat their currencies less like confetti than we do, should do

well relative to the dollar. Furthermore, time tested currencies (i.e. precious metals) that cannot be simply manufactured (at a fraction of their stated value like paper currencies) should also perform well. Whether these investments do well as a function of the reflation (show nominal price increases) the Fed is trying to manufacture, or do well as a result of a flight to a “real” store of value remains to be seen. However, the recent rise has likely been a combination of both.

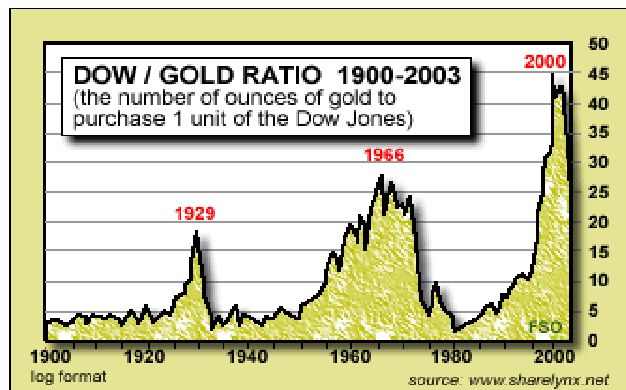
You can see in the chart below, that gold has performed inversely to the dollar, as it is a U.S. dollar denominated commodity. As the dollar declines, it simply costs more dollars to purchase an ounce of gold. Should the dollar keep declining, this relationship is likely to continue. All U.S. dollar denominated assets have been rising over the past 18 months or so.



Everything from gold and silver, oil and natural gas, soybeans to cocoa has all been rising in price due to this process. Our Federal Reserve, in an attempt to keep all assets rising in nominal price (i.e. stocks), is perpetuating this effect, which equates to rising costs in commodities. However, we are told that this is not inflationary as the statistics on such measures are smoothed and massaged. (Please see my piece on statistical adjustments for more detail.)

It is also possible, and quite probable in my opinion, that should paper currencies and paper assets (stocks and bonds) lose their appeal due to the aforementioned currency devaluations, the time-tested store of value of precious metals may become the likely asset of choice to preserve wealth. This statement often receives criticism as it is rarely, if ever, mentioned in the mainstream press. However, consider that as stocks are at near record high valuations, and gold is just emerging from a multi-decade long bear market, the difference in valuation is also at historic levels.

For these reasons, I am more optimistic toward those investments which are not dependent on this process of continuing debt and additional leverage. Investments in currencies of foreign countries who act to constrict their money supply relative to the U.S. should do well relative to the U.S. dollar. Simple supply and demand, Economics 101, whereby less supply of their currencies versus more and more supply of our currency, will



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increase in relative value all else being equal. Many such currencies also offer interest rates which are significantly higher than that in the U.S. Likewise, precious metals should continue to perform well should the dollar continue to decline, with the possibility of significant gains should confidence in paper assets begin to erode due to the continual printing of paper dollars. Furthermore, the chart above (obtained at financialsense.com) shows just how undervalued gold is relative to stocks. There is plenty of room for the yellow metal to run.

Markets are inherently cyclical, yet market participants, being human, continually make linear projections. While the timing is always elusive, I remain steadfast in the belief that should the abovementioned process be allowed to continue indefinitely, a major currency crisis could evolve. Conversely, should the credit cycle reverse course, the credit contraction and de-leveraging of financial assets will act (at best) as a substantial headwind to the U.S. economy. In either scenario, I believe that precious metals and some foreign currencies will substantially outperform the U.S. stock and bond markets in the years ahead.

As always, your feedback is appreciated. Should you have any questions or concerns regarding financial topics, please feel free to contact me.

Sincerely,

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Charts and graphs in this article, along with other valuable financial information, were obtained and can be found at the following websites:

www.comstockfunds.com with charts developed by the Gabelli Mathers Fund
www.financialsense.com
<http://finance.yahoo.com/?u>