The End of the Credit Super Cycle

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When I was a student at Columbia Business School in 1979, I was struck by the pervasiveness of Milton Friedman's work in a variety of courses. The most notable was a paper he did with Anna Schwartz refuting the notion that low interest rates are inherently inflationary. If that were the case, he proposed, why do countries with high inflation have high interest rates and ones with low inflation have low interest rates? This paper introduced me to the importance of the real interest rate, the published or nominal rate minus the inflation rate. Friedman argued that responsible monetary policy is based on a real, after inflation, interest rate that is positive enough to discourage rampant borrowing when the economy overheats. Proper Fed policy controls growth in debt, inflation and economic activity by raising or lowering the real interest rate. With the prospect of potential global deflation, however, central banks are struggling to perform this function.

Originally, the United States was functioning on the gold standard. The banking system stood ready to accept or sell gold for dollars. As inflation rose, people went to the bank to exchange devaluing dollars for gold, decreasing the amount of outstanding dollars, choking off inflationary tendencies. Likewise, if deflation resulted, people would sell their gold for the appreciating dollar, increasing money supply and creating inflation. The system has a tendency to trend price changes to zero. The history of the United States under the gold standard shows 150 years of swinging from periods of inflation to deflation several times resulting in a constant value of the dollar over the long run. This all changed during the Depression when it became illegal to own gold. Although we were still on the gold standard, it was with other central banks. The Fed now solely controlled the inflation/deflation outcome. The United States officially ended the gold standard in the early 1970s.

Back in the late 1970s, the U.S. economy experienced accelerating inflation due to the fact that the Fed maintained interest rate levels that were far less than the inflation rate. At one point, the bank prime rate was 8 percent while the inflation rate was running at 12. After a while, investors and consumers realized that it made sense to borrow and buy goods and assets that were rising in price faster than the interest rate they paid on the debt. It all ended when Fed Chairman G. William Miller resigned abruptly and the new chairman, Paul Volcker, immediately raised the real interest rate from minus 4 to positive 6. Inflation was stopped in its tracks, although the cost was the 1980-1982 recession.

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Another monetary concept, which is relevant today, is the Liquidity Trap. Simply put, it is the idea that at some point lower interest rates do not incentivize borrowing. From 1981 to 2012, the U.S. economy went through a period of decreasing inflation rates until we actually had a brief period of deflation during the most recent recession. Lack of borrowing at current low interest rates is partially due to the fact that the real rate is still positive, although very low. If asset prices are steady, it discourages speculation. Another reason for low loan demand is that anyone needing cheap money has already borrowed. Not surprisingly, monetary policy therefore loses its stimulatory effect when lower rates no longer change borrowing behavior. The debt level in our economy as a percent of GDP has grown tremendously since 1980. The country has consumed and supplemented economic activity by increasing debt levels for four decades. This is truly “borrowing from the future” since the borrowers must dedicate more of their future disposable income to debt service. In spite of lower interest rates, debt service levels as a percent of income have been maintained by higher levels of principal being paid. Zero percent on a credit card still comes with a high monthly payment. The Liquidity Trap occurs at a point of overwhelming debt levels, leading to onerous debt service payments, even if they are largely principal payments. Economists have recently proposed that debt to GDP levels exceeding 250 percent slow an economy to a crawl. The United States is there.

Large amounts of debt in the system have another effect which is counter-intuitive. One associates rapid debt creation and money supply growth with inflation. Indeed, as an under-leveraged economy borrows to invest and consume, more money bids up the price of goods and services. Wages follow suit, reinforcing the inflationary effect. In contrast, the recent large amount of money creation has not gone to bidding up all goods and services. The financial drag of excess debt has kept inflation low, and because inflation is low, there is no penalty for holding cash. Instead, holders increase their wealth during deflationary periods by simply holding cash. Low inflation leads to a decrease in money turnover, offsetting the large growth in money supply. This is why we have not experienced a pickup in inflation, contrary to what all financial pundits were saying back in 2012 when the Fed embarked on quantitative easing. The counter-intuitive part is that large amounts of debt creation can have a strong deflationary effect on an economy in the long-run, as any modest increase in interest rates results in a crushing increase in debt service payments, preventing any borrowing and the ability to further bid up goods and services. The lack of further borrowing removes the inflationary bias. The overall effect is to create a deflationary bias in the system, which with all the debt overhang, is very dangerous.

With inflation running so low, not to mention the occasional deflation we have recently experienced, the Fed has realized that their policy options have become limited as inflation approaches zero. In early 2012, the Fed officially set an inflation target of 2 percent. This quiet sea change is in recognition that the idea of negative rates is not a smooth psychology transition for the average borrower or lender. In previous postwar recessions, the Fed has stimulated the economy by purposely creating negative real interest rates. At very low inflation rates, this only becomes possible by having negative nominal interest rates. In theory there can be a smooth symmetric transition from positive to negative nominal interest rates, maintaining proper policy of high or low real rates. In practice, however, it has many problems. Business prices and wages are historically sticky upwards. The idea that during deflationary periods employers would give workers a decrease in their wages, even though they may maintain or increase their purchasing power, is a stretch. Try telling that to an employee. However, there are negative wage “raises” in Japan, and there are reports of negative mortgage rates in Denmark. It is not impossible to break the psychological barrier to negative nominal rates, but it is difficult. If this isn’t enough, it has been mentioned that negative nominal interest rates by the Fed may have legal barriers to implementation.

Negative rates are now existing in one-third of all sovereign debt in the world. Japan has negative rates in their government paper out 15 years and their 30-year government recently yielded 0.29 percent. Japan has printed money and issued government debt at an unprecedented rate, and has the highest debt as a percent of GDP (350 percent) of any industrialized nation today. They would do anything for inflation. Recently the Japanese CPI was approaching zero, and the PPI (Producer Price Index) was down 3 percent year over year. By flooding the world with yen they hope to decrease its value, increasing their inflation rate. Recently their interest rates fell to new negative lows. The yen, in spite of lower interest rates, rose sharply. Why does the market bid up a currency where you must pay interest to own their paper? I fear it is the specter of deflation. In other words, this is a currency rising because the real interest rate in their bonds is potentially rising. Prices have not dropped sharply into a new lower deflationary level, but because Japan’s debt overhang is the worst, the capital markets might be predicting the inevitable deflationary spiral.

For any system with a large amount of debt, a deflationary spiral is the ultimate nightmare. As asset prices decline, collateral, such as homes, decline in price, wiping out the equity of the borrower. If the borrower defaults on the debt, the lender loses money as the sale of the collateral does not cover the debt to be repaid, resulting in a loss. Assets are sold in earnest to repay debt, further accelerating prices downward, resulting in larger losses to the lender, and ultimately threatening the lender and the banking system. The housing decline of 2008 precipitated the decline in mortgage prices, wiping out leveraged lenders. Recently, leveraged oil companies have gone bankrupt due to low oil prices. Their banks have been forced to write off a large amount of debt. In 1929, the leverage was in the stock market. Margin requirements were a mere 10 percent, wiping out some investors by a 10 percent decline in the market. The domino effect of the debt defaults contributed to the Great Depression. Imagine a debt problem on a pervasive scale over several asset classes.

The current bearishness on Wall Street is centered on this growing potential outcome. With debt levels so large around the world, one portfolio manager recently described central bank Quantitative Easing as pouring gasoline on a fire. It is not that he thought decreasing the real interest rate was not stimulatory, but more the idea that the attendant increase in debt and debt service puts more long-term deflationary pressure in the system.

The idea that world deflation will take hold is not a foregone outcome, but it is becoming an increasing possibility as the years progress with the debt to GDP ratio continuing to rise. If we are at the point where the propensity to borrow is near zero, then the postwar behavior of "borrowing from the future," stimulating the economy with debt creation, is over. This clearly indicates a more deflationary bias compared to the last 75 years. The Fed would like to slowly eliminate the debt overhang by raising interest rates to encourage debt repayment, but they are dealing with a fragile economy, especially to rate hikes. Shorter term, commodities have bounced, real estate prices are rising, and the tight labor market is creating growth in consumer income, giving inflation a tailwind. We are therefore currently in a period of reprieve, and this could continue for years. However, the recent pop in commodity prices may not last. The most appropriate concern is when the economy slips into the inevitable recession, putting maximum downward pressure again on asset prices. That is when the system strains will be the greatest.

The investment strategy is to move to cash if things progress in a deflationary direction. Liquid assets like securities are essential to being able to move quickly to a highly defensible position. A debt-free balance sheet is ideal. If deflation develops, illiquid investments like partnerships could be dangerous, and real estate sales could be difficult and clumsy. The good news is that recently debt has been decreasing and hopefully it can slowly be worked off without economic disruption. The need is for rising asset prices and rising consumer incomes while debt levels continue in a downward path. Unfortunately, this will take many years. That is the Fed's task, and one should consider Fed policy through the lens of that objective.