The Market School

Scit Uti Foro

Matthew Piepenburg, 10/15

The Character of Debt, A Debt of Character

History's Lens.

History is an exceptional teacher of psychology, philosophy and alas: economics. Indeed, the areas overlap wonderfully. Great leaders—be they of countries, armies or industries—understand this. They understand that the lessons of the past serve as sources of perspective for the present and foresight into the future. In particular, yesterday's lessons train the eye to look more clearly at tomorrow. History shapes our lens with the necessary skepticism, courage and individuality that comes only from taking the time to hear her lessons. Lessons, of course, nourish knowledge, and knowledge, in turn, creates confidence. Lastly, and most importantly, from confidence comes character. *Character*. It's an evasive, opaque term today. Almost an abstraction. Like so many of the words tossed around by advertising drivel or media spin (i.e. "freedom," "ethics," "guidance," or "national security"), character's very meaning is often lost, distorted, or co-opted for immediate sales and propaganda rather than long-term applicability. Far worse (and we all *feel* this), the knowledge and confidence that precedes character is increasingly lacking upon the once sacred fields of American society—from Donald Trump politics to Larry Summers education, Gordon Gecko finance to Daniel Steel fiction, or Paris

Hilton Hollywood to Bill O'Reilly journalism. Mediocrity (even stupidity) and fame have supplanted maturity and greatness. We live, as the poet Octavio Paz remarked, in an age of mud.

The financial industry, which increasingly promotes sales and self-interest over education and candor, is no exception to this mediocrity. Having spent over 25 years navigating its highest circles (from Ivy League diplomas and Goldman Sachs credentials to conversations with countless hedge fund *wunderkinder*), my own conclusion is that most of Wall Street's so-called experts have very little knowledge, and by extension, very little, well… character. This lack of character, of course, is admittedly easy to overlook when one is otherwise seduced by the Faustian calls of an industry synonymous with easy fortunes. I certainly was not immune to the promised dollar signs. Wall Street is a siren for armies of young, bright minds looking to find the fastest route to a beach house in the Hamptons, a third car for the weekends and that special Christmas bonus from bank X, Y or Z. Cadres of well-armed MBA's, JD's and BA's from the best schools look to the markets and their gatekeepers as a kind of supernal space where the American Dream lies just within one's grasp. But here's the rub: there can be no American Dream without character, and in the long term, the very industry that promises this dream is the same industry that is slowly destroying it—for it is an industry that lacks the very character needed to save it.

The evidence of America's sad economic decline is all around us, yet because of this collective lack of knowledge—of history—we are missing the parallels, the lessons, the signs and *hence the warnings*. For those still curious enough to look beyond Cramer TV or the Ken and Barbie economists at CNN, however, these signs are painfully obvious and worth repeating, especially in the face of the historically overwhelming distortion of truth and facts that so characterize the modern financial environment.

In order to illustrate this distortion of financial risk, I sometimes turn to military headlines to drive the point home. Recently I visited the battlefields of Gettysburg with my son. I go there often, as the ground is a reminder of so many insights, so many lessons—including the notion that pride cometh before the fall. Fought in July of 1863, this battle effectively ended the war for an over-confident Confederacy as the army of Northern Virginia lay bleeding on the hayfields of Pennsylvania. General Lee –like Longstreet—had to have known that very day that the American Civil War was over. Nevertheless pride, stubborn bravery and an admirable Johnny-Reb loyalty pushed the war deeper for two more years and countless more had to die unnecessarily in the name of false hope and an inability to accept the unthinkable. The same was true of the German army in the winter of 1943 at Stalingrad. Their defeat there sealed Germany's fate, yet lunacy, supported by propaganda, false reporting and unwillingness to accept the unacceptable similarly drove that horrific war on for another 2 years and another unnecessary death toll.

The same is true for America's economy and stock market. That is, the signs of our inevitable defeat are already past. Our economic and stock market Gettysburg and Stalingrad have already been lost. What is left now is the stoic anticipation of economic surrender. The astounding levels of debt, money printing, zero-bound interest rate promiscuity and derivatives market leverage have already killed fair market price discovery or any hint of sober risk analysis and common sense. Yet the same pride, lunacy, false reporting/hope and dishonesty which kept proud yet doomed armies marching past their expiration date is keeping our tired economy and markets temporarily lulled into accepting fiction and battle cries over reality and the honor to admit a well-deserved defeat.

Well-deserved? Defeat? Is it not un-American to harbor such pessimism about our economic "recovery"? Is it not uncouth to predict an end before the white flag becomes official? Seemingly, yes. But let's clarify, brush aside the emotion and --like honest, tired generals in the smoke of battle—call it like it is. And here are the cold facts: We did this to ourselves. The numbers are beyond sustainable. We must accept the coming collapse because our debt is too high, money supply too inflated, and productivity and employment too low to ever turn the tide and avoid a catastrophic recession.

It's About Debt.

I have unpacked each of the foregoing elements in greater detail in other papers. Here, the topic is simple. It's about debt, and frankly, that's about all one really needs to know, for behind every market crisis is a debt crisis with a guilty smile.

So the hard-nose fact is this: our country has passed its debt point of no-return. Let's abstain from all the complex, sordid and highly relevant details about yield curves, credit spreads, PE ratios, junk bond risk, CPI fictions etc. and repeat this very simple fact: debt tells the entire story. We can pretend, extend and declare victory (as Obama did in the recent State of the Union Address with as much fated hubris as Bush did from an aircraft carrier in 2003), but we can't escape raw math, common sense and the law of markets any more than a weatherman in a dingy can escape the law of nature as a tidal wave forms. What *is* un-American, however, is for government officials and agencies (such as the Bureau of Labor Statistics), elite banks, and market pundits to distort truth, lie and promulgate false hope to gather assets and sustain fiction rather than take brave responsibility for self-inflicted wounds.

Some of these wounds we know well, from the repeal of Bretton Woods in 71 (nod to Nixon) to the repeal of Glass Steagall in 99 and the deregulation of derivatives in 2000 (nod to Larry Summers, of which I've written extensively). *We* created the fiat currency; *we* printed 3.5 trillion dollars in a blink (thus destroying our currency *long-term*); we accumulated an additional 8 trillion of new debt (more in seven years than in the prior 219 combined); *we* kept interest rates at 0 for 81 months and counting (thereby harboring the oldest sin in Wall St: the fast money "carry trade"); *our* government declares unemployment at 5.2% when the reality is closer to 20%; *our* government places inflation at less than 2% when the truth is far, far worse. The foregoing numbers, by the way are staggering, but like the death count of the Holocaust or the battle of Verdun, they slowly become just an abstraction, a figure too large to grasp and hence almost too big to matter. Pause to re-read them. These facts and figures cannot be un-done. In short, a country, like a family, a marriage, a business or an individual is not immune from this simple truth: if you live only on debt and produce next to nothing in income, eventually the game ends. The battle is lost. America—like Germany, France, Russia, Argentina, or even Zimbabwe before it—is no exception to such self-inflicted economic wounds no matter how unthinkable the pain or how "elite" or backwards the nation. History and markets confirm this over, and over, and over…

And so again, let's just look at one simple indicator in this otherwise layered tornado of confusing and complex indicators of economic Gettysburgs—let's just look at debt. Privately, and despite a few kids driving undeserved Teslas in Silicon Valley, the real American citizen is hardly thriving. Instead, the average Joe is living on debt, just like his Uncle Sam. Specifically, Americans are sitting on $13.5T in mortgage debt, $1T in credit card debt, and $1.1T in auto loan debt (much of it sub-prime) and $1.3T of student loan debt. These trillions matter. Trillions. These debt levels are extraordinary. Add on top of that 46 million Americans are on food stamps (the invisible food lines) and notwithstanding the 5% unemployment creative writing given to us daily by the BLS (whose job reports are mostly about low wage, part-time jobs), full-time employment among those aged 24-54 *is the lowest in history*. In short, we are broke, unemployed and in debt. And that's just the private sector. Since 08, the private debt crisis in America became a public debt crisis when we handed the multi-trillion-dollar unresolved sub-prime hot potato to our national balance sheet rather than actually solve anything. Growing at a rate of $1.6B a day, we have an $18.3T national debt and 200T in unfunded liabilities. Again, pause to re-read those numbers. They are immoral. They are completely unsustainable, more so than the Confederacy after Gettysburg or the Third Reich after Stalingrad.

But like any dying army, they march on lies and false hope. The easiest and perhaps most important lie in today's market is the fantasy that the Fed has your back. Really? The same Fed that declares we are in a "recovery" but is terrified to raise the Fed Funds Rate a measly 25 basis points above zero (when the historical average is 5.7%?) Why the fear? To those who understand markets rather than TV anchorpersons, the answer is obvious: because the market is too weak, the economy and government are too broke and the Fed fears a rate hike—even a minuscule one—is enough to send the bond market into a substantive and figurative nosedive, creating a contagion effect into a stock market that is already at bubble levels 35% higher than the S&P of 2008. The Fed then tells the public they simply want to hit "target inflation" of 2% before they raise rates. That inflation target is even more of a lie than our so-called "unemployment target" of less than 6%. But I find the inflation lie the most disturbing of all—and the most symbolic for a very simple reason, and one which I hope readers take way from these pages and remember at the next water-cooler debate on America. That is, the real veterans of Wall Street know that inflation is far higher than the fiction of 1.9% reported by the BLS. But even the average American feels this inflation at the tuition bill or the grocery store or the dentist, doctor or pharmacy. It's obvious that inflation is falsely reported. And it's equally obvious why. Because if the BLS/FED were honest about inflation (and let's be conservative and call it 5%), that would mean our sacred Treasuries (the means by which the US debt economy survives), which yield about 2% in nominal dollars, would yield at least a *negative* 3% in real, *inflation-adjusted dollars*. In short, because the truth about inflation is so bad, the reaction from the top is to just, well: lie. It's that simple. And a negative US Treasury would be the pin in the proverbial bubble of the debt-soaked "recovery" that has artificially inflated US stock and bond markets to nose-bleed levels. It's that simple. Inflation is a lie, the recovery is a lie, the employment numbers are a lie and the valuation of our markets is a lie.

Why is this so hard to see? Why aren't the cheerleaders at Barron's or the WSJ digging deeper? This isn't rocket science. If we could silence all the quacking experts talking past each other and pose a few simple questions, the bluff would end. Again, take the FED, for example. Yellen and Co has maintained over and over that once our economy hits full employment and 2% inflation, they will raise rates. OK, fine. According to their own (fictitious) reports, we are in fact at full-employment (unemployment at 5.1%) and remarkably close to 2% inflation at 1.9% today. So why not raise rates? Why the emergency level 0% going into its 81st month? As noted above, the FED is trapped. Their reports and promises mean nothing, because behind the press meetings, lies a deeper fear—the debt fear. The FED's addiction to so many years of low rate-induced debt creation have created a perfect storm. First, low rates incentivize risky borrowing (look how the junk bond market has grown from $1.3T to $2.5T since the 2007 peak. It's revolting). Higher borrowing levels, in turn, steal from future growth, for as debt levels increase, more and more debt is needed to service the original debt. This is a death spiral scenario and explains why in the 1980's $4 dollars of debt was needed to generate $1 dollar of GDP; by 2000 it took $10 dollars, and today it takes an unconscionable $20 dollars of debt to create a single buck of real GDP. Again, re-read that…

Debt does other very bad things. In particular, it impacts the behavior of herds, and we are definitely seeing a herd mentality (or lack of mentality) at full force today in what is a grotesquely misunderstood stock, bond and real estate market (don't think the housing industry will save America when mortgage rates rise). Hyman Minsky warned of these distortions when describing the three stages of financial system behavior in a rising debt context—namely the "hedge stage", the "speculative stage" and finally the "Ponzi stage." The fun part of the "speculative" stage is quenched by a debt punch-bowl mania of easy credit which always creates an illusion of wealth and productivity (think of a teenager with dad's gold card, or the recent $67B purchase of EMC by Dell at 17X earnings for a company that free cash flows at 1%), but slowly devolves into stress when the bill arrives and the stupid spending spree feels, well….stupid. If and when rates rise, this of course makes repaying the debt a lot less fun then spending it. In short: this is when panic sets in. The party ends as borrowers worry about their ability to pay principal and interest—which leads to the proverbial "Oh-Shit" moment that folks like Bernie Madoff and Alan Greenspan or Ben Bernanke know oh so well. Solution? Default or Ponzi Finance. Needless to say, we already know the option the US FED (and central banks around the world) have chosen: print money—and this is nothing more that state fraud (Ponzi) hidden behind Keynesian rhetoric and euphemistic labels that rhyme with "Quantitative Easing."

So what's a central bank to do if it's caught in the Minsky Cycle of issuing more and more debt to pay for old debt? If it raises rates, it immediately breaks the cycle and defaults increase, bonds tank and panic spreads. If it doesn't raise rates (as brave Mr. Volker did in the 1980's), the FED merely increases the size and consequence of the debt nuclear bubble it has already created. What to do?! What to do?! One can only imagine the fear rising in Yellen's throat (explaining her sad nervous breakdown recently at U-Mass Amherst). She must know the policies of her predecessors (Bernanke and Greenspan, one of whom is currently on a book tour congratulating himself for saving the world…) have created the ultimate "damned-if-I-do, damned-if-I-don't" trap. Meanwhile the Fed has also created a classic Minsky Moment—that is, their easy money debt policies (low rates) have created a class of investors lulled into an artificial warm and fuzzy feeling that the FED will save them. Retail and institutional investors remain over-loaded in appallingly risky equity and fixed income markets whose price and risk levels are *totally* ignored. In sum: they sit upon bubbles without historical precedent that are going to pop the instant the jig is up. The results will be historic. I actually feel sorry for Yellen. She inherited an impossible task while her predecessors hit the book and party circuit, tail between their academic legs and wallowing in their momentary and undeserved glory.

As I've said, it's too late to turn back. The debt is too high. Gettysburg is lost. The only way for an economy to extricate itself from this fiasco is to accept economic Karma and massive debt defaults. Again, the debt is just too high in the US to solve the problem through "growth." Even more alarming, however, is the equally obvious reality that this debt spiral is not merely a US problem, but a global one. Nowhere is this more obvious than in the case of China. About 25 years ago China put down the rifle which Chairman Mao attributed to power and replaced it with Mr. Deng's—"it's glories to be rich"-- money printer. Two decades and 28T dollars later, this country has turned itself into an open-air construction site with a stock market out of control, a busted housing bubble, 65 million empty and massively over-priced apartments and a phonebook of unused and equally empty airports, towns, bridges and trains. Eh ehm…Despite import declines of 23% this year (and we wonder why oil prices are down?) and a globally recognized casino of corrupt stock pricing, the Chinese Ministry of Truth advertises 7% GDP to the decimal point quarter, after quarter after quarter….Indeed the very consistency of these numbers is grounds enough to see how cooked they are—and yet the cheerleaders at the WSJ and CNN keep applauding "Chinese growth" with the same poker face they declare our own economy in "recovery" despite painfully blunt evidence to the contrary. My grandchildren will look back at this media-led hype and herd-like audience with the same awe we looked at McCarthyism or Watergate—that is, wondering how it ever was allowed to happen. Yet it's happening right before our blind eyes as the investor sheep (and the economy) walk toward the cliff's edge.

So when will the white flag go up? When will the bubbles pop? The moment we gain a little character as a nation, accept reality and stop believing the lie.