



## In the middle of an extraordinary credit contraction

As 2009 concludes, it is clear that the debate between inflation and deflation will have to move into this new year for resolution. The data will soon confirm or deny the merits of a tremendous amount of speculation reflected in the stock market, commodities, and the yield curve. Securities markets have long-since left behind valuations that are consistent with today's economy, and made their intentions clear that a V-shaped recovery is ahead; modeled in the likeness of the familiar sequence of post-war recessions with shallow troughs and powerful recoveries.

We take a different stance that this recession will follow the path of the more severe, and longer credit cycle contraction recession<sup>1</sup> pushing inflation and government bond yields much lower as a result. This recession's framework lies in only two Twentieth century examples; Japan through the 90's and 00's, and the United States in the 30's and early 40's. The rich history left behind from these episodes show that the current experience shares more than a passing resemblance.

### Long expansions of credit are followed by long contractions of credit

Credit cycles span decades and encompass several of the familiar 5-year business cycles. Credit expands as long as asset prices do not meaningfully break the chain of favorable expectations. Demand for credit increases as asset price gains eclipse the price to borrow and supply increases with creditors having a comfortable history of being paid back regularly; having ample liquidity to lend. This establishes a positive feedback loop of ever more liquidity that reinforces higher prices which feeds more liquidity, etc.

In turn, the break in the cycle comes only when asset prices fall meaningfully enough to force a secular change in behavior in both the supply and demand side of credit. Once creditors are reminded of the possibility of default, new loans become much more scarce. Likewise, borrowers, not seeing opportunities for asset price increases, become more interested in paying for what has *already been purchased* rather than buying anew.

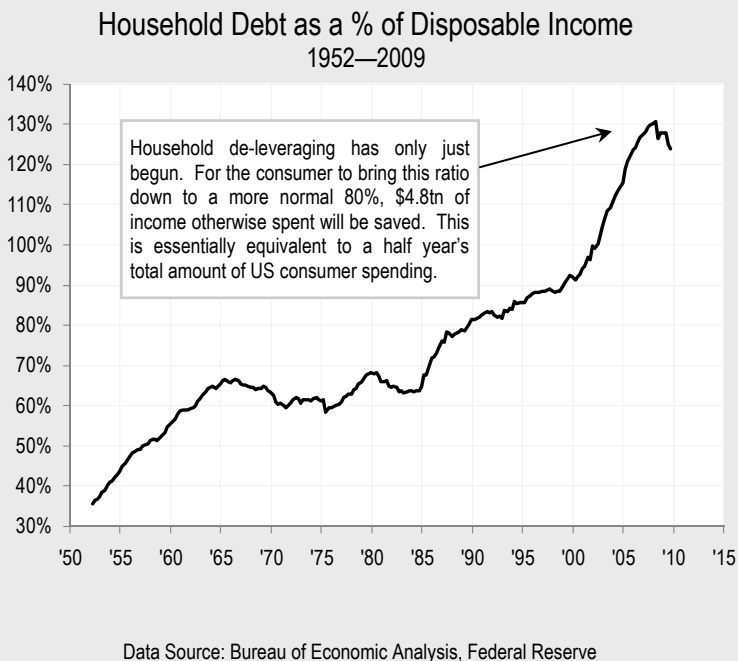
The consequences to the contraction side of a credit cycle are enormous; requiring monetary and fiscal policy responses far more unusual than in shallow recessions. When households become more interested in de-leveraging and saving than borrowing, the economy grinds to a halt. The positive feedback loop supporting the expansion side, becomes just as forceful in

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<sup>1</sup> Similar concepts have been coined the "Debt Super-Cycle" by Martin Barnes of the Bank Credit Analyst and the "Balance Sheet Recession" by Richard Koo, chief economist of the Nomura Research Institute

reverse on the contraction side. Less spending and more saving impacts asset prices which begets more saving. This eventually finds its way to lower consumer prices and lower government bond yields.

fig. 1 Household credit has expanded un-impeded from 1985 until 2007.



In ordinary recessions, monetary policy is sufficient because private demand is willing to spend at a lower price of credit, and inventory re-building is all that is required to kick-start economic growth. However, when the consumer makes a more drastic change from spending to saving, the government must use fiscal spending beyond the monetary tools at their disposal.<sup>2</sup> The government must be more vigilant with stimulus than the former Federal Reserve Governor, William McChesney Martin Jr.'s famous proposal that the job of the Federal reserve is "to take away the punch bowl just as the party gets going."

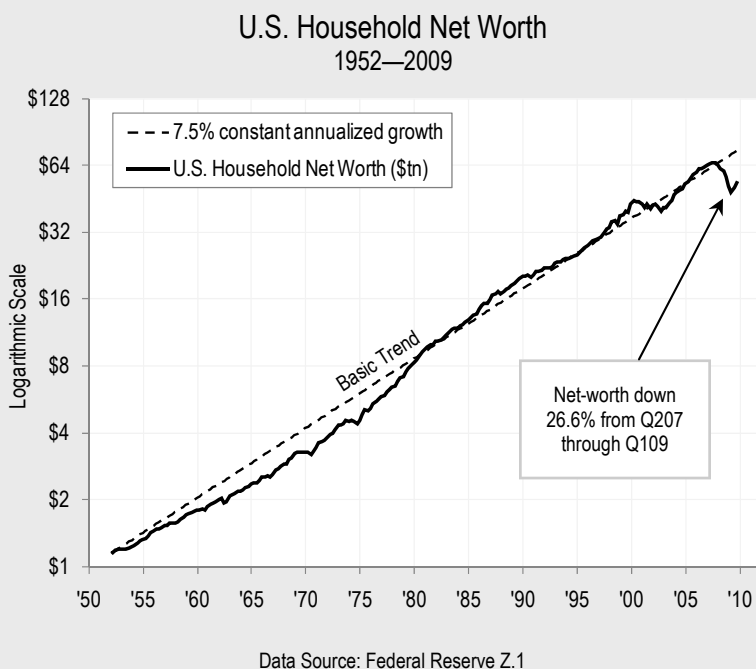
To use another metaphor, shallow recessions require small doses of stimulus, which can be imagined as the first draw of breath in a siphon hose to get the liquid to the point where the fluid flows from one container to another effortlessly. When the private sector is de-leveraging, it is as if

<sup>2</sup>Richard Koo, Chief Economist of the Nomura Research Institute spoke about this in an interview with Bernard Lo on Bloomberg TV on December 17th, 2009,

"And when you are in that kind of situation, monetary policy is the first casualty because for monetary policy to work, there have to be borrowers willing to lend and then people who are willing to borrow. But that fundamental framework is no longer at work in...to a large part in the United States and parts of Europe as well. And that's why you bring interest rates down to zero and very little happens. I mean, commercial real estate prices in the United States are still falling, economic...economy's still very weak even with these very low interest rates because a large portion of private sector is minimizing debt instead of maximizing profits. And when you have that situation, you have to use fiscal stimulus because the government cannot tell the people, 'Please don't repair your balance sheets' because private sector has to repair the balance sheets. Then the government has to do the opposite of the private sector: borrow and spend the money that private sector used to pay down debt and put them back into the income stream."

each flow of fluid is commensurate to the amount of breath pulling on it; there isn't a natural flow in-waiting.

fig. 2 Household Net Worth has decreased by more (%) from June of '07 than anytime since 1952.



*This is the framework of the current recession in the United States.* Credit has expanded virtually unimpeded since 1985 (see fig. 1) to unsustainable levels and U.S. household net worth has contracted by about one-quarter (see fig. 2), decisively breaking the chain of favorable expectations. Both fiscal and monetary government stimulus have been effective in preventing the wholesale collapse of the economy, however stimulus is not a full or permanent solution. Fiscal spending of \$1 or \$2tn pales against the \$12.5tn loss of net worth, or the approximate \$5tn we estimate the consumer needs to deleverage.

We see clear evidence of the contraction of credit. Monthly consumer credit published by the Federal Reserve has now contracted for its ninth straight month, the longest streak of declines in the data history from 1943. The Federal Reserve, having flooded the system with liquidity not being lent or borrowed, is not working as it has in the past to spur economic activity (i.e. no velocity). Ben Bernanke, in Essays on The Great Depression makes reference to this phenomenon during the Great Depression,

“The growing level of bank liquidity created an illusion (as Friedman and Schwartz pointed out) of easy money; however, the combination of lender reluctance and continued debtor insolvency interfered with credit flows for several years after 1933.”<sup>3</sup>

We don't know how much more fiscal spending will be needed to supplement private demand, but we do know it took 15 years from the stock

<sup>3</sup>Ben S. Bernake. Essays on the Great Depression. New Jersey: Princeton University Press, 2000

market peak in Great Depression before WWII provided the final exit. We also know that in Japan, after 135% of GDP in fiscal spending and 20 years, deflation continues. In the United States, *it has just been 2 years and yet virtually all economists are already preparing for a strong recovery.*

Financial markets are misunderstanding the effect of governmental stimulus as if it were applied to familiar recession periods

The government is meeting an extraordinary problem with extraordinary stimulus, however, markets are mistaking upward trajectories in asset prices and economic indicators with self-sustaining growth. A quick analysis of the 2010 year-end projections of the 2yr and 10yr UST yields by the 18 government securities primary dealers, shows an adherence to familiar models of recession recoveries, or even boom times. Whether their yield model looks like 1993, 1994, 2003, or 2004, none of them consider that this recession is the first in the U.S. since the 1930's to face a broad and likely continuing contraction of credit.

The United States also faces an inescapable, and not talked about nearly enough, spending slowdown from an aging population. From the 1950's, the United States has enjoyed the benefits of an expanding population pyramid, with more young than old. Younger people invest, spend, and borrow as related to incomes and habits, and have contributed to the economic miracle of the last thirty years. Now, the bulge in the population distribution is between ages 50 and 55. As the baby-boomers get older, they will naturally save more and spend less.

A lesson from Japan and the Great Depression is that sentiment will continuously be overly-optimistic, and fearful of strong inflation throughout the de-leveraging period, even though there is no record of it.

Everything that has happened in the last two years since the stock market peak is consistent with patterns in the two examples of extraordinary credit contraction we have to study; Japan recently and the U.S. in the 30's and 40's.

Both have long rallies in the stock market before turning around and reaching new lows, both have widespread sentiment that the cycle is over, and both have continual worries about inflation in regards to fiscal deficits and monetary stimulus. Despite all of this, the U.S. 10yr yield fell from November 1932 through November 1945, reaching a low of 1.55%. Likewise, the Japanese 10yr hasn't closed over 2% in the last 10 years. The clear lesson from these periods, is to not mistake the dynamics of recent inventory-cycle recessions with the current situation.

In a book we highly recommend, The Great Depression: A Diary by Benjamin Roth, a middle-class professional man documents the economic sentiment and events through the 1930's and 40's from an employed middle-class perspective. The Great Depression is often reduced to photographs of weary men and women in black-and-white which can make it seem irrelevant to today, however this diary re-creates what the depression *felt* like in real-time with a saturation of mis-placed inflation worries throughout. *The sentiment Roth describes is often indistinguishable from now.*<sup>4</sup>

The pervasive bullish expectations and inflation fears today are *no stronger* than they were in the middle of these past credit contractions. Markets trade with a short memory and when this type of de-leveraging cycle begins

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<sup>4</sup>Some illustrative quotes from: Benjamin Roth. The Great Depression: A Diary. New York: PublicAffairs, 2009

"April 18, 1933

Business is still in the dumps altho optimism comes back with the nice spring weather. Steel production jumps from 13% to 30%. Inflation talk grows stronger..the stock market jerks up and down with each new threat of inflation. Most people believe that if inflation comes, they should sell bonds and buy common stocks."

"January 2, 1936

When I started these notes it never occurred to me that the depression would last more than two years. We are now in the beginning of the seventh year and the road is not yet clear—with the possibility of inflation ahead. We seem to be emerging from the panic, industry is picking up, etc.—but so much of it has been created by artificial spending that it is difficult to know just where we stand. Industrial production is only 10% below normal and the steel mills are operating at about 54%.

8/12/46 *\*\*in-line note by Roth in the diary to comment on past entries*

We had very little inflation during the past ten years although it has been widely discussed. Prices are now pretty high because of post-war inflation but are being held down—especially rents—by the OPA [wartime office of Price Administration]. Nothing very severe has happened yet government debt is now close to \$300 billion and still going up."

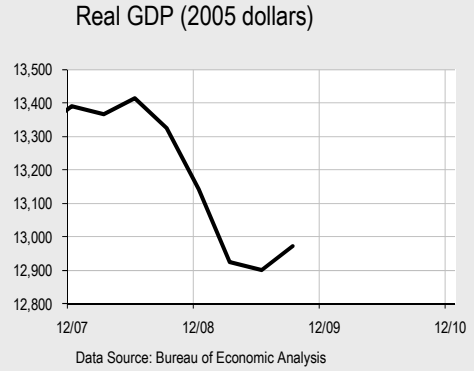
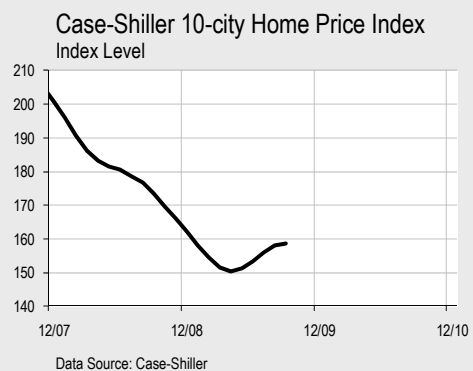
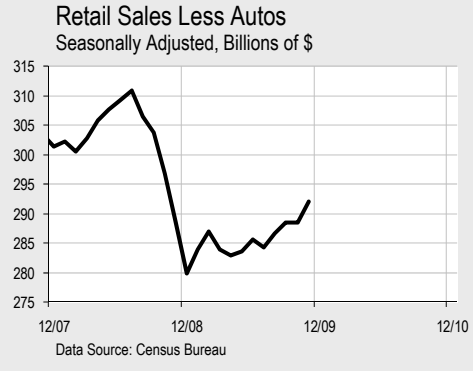
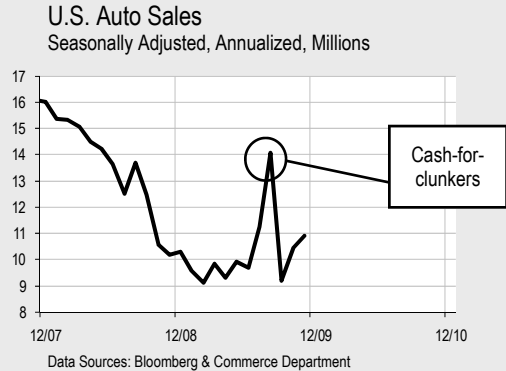
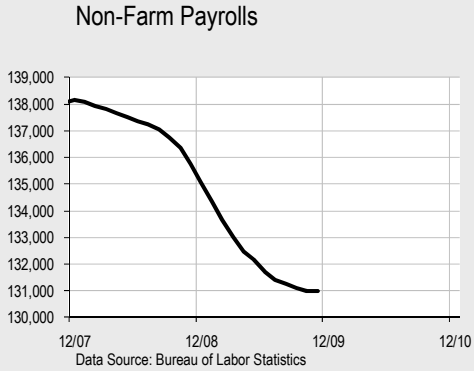
"February 21, 1936

Bonds pay only about 3% and because of this low return and because of fear of inflation much money has been switched to equities" *\*\*Note: The US consumer price index finished the decade of the 30's 18.6% below where it started and inflation grew at an average 1.59% annualized pace through the 30's and 40's. Inflation worries were mis-placed in this era as they are now.*

"September 12, 1939

Our banks are loaded to the gills with government bonds paying 1 1/2% interest. Last week these bonds broke badly because there is a chance to use the money to better advantage. Will depreciation of US. Bonds affect our banking situation?" *\*\*Note: 10yr yields fell by more than 1% from this point*

fig. 3 Viewing economic indicators in nominal terms (rather than by a % change over a period) tell a different story than how financial markets have been trading.



All are much lower than where they came from. A return to original levels and beyond is the goal, not just positive growth.

(once every several decades), market participants draw from the framework of what they know which is almost certainly not of a recession with contracting credit, given their sparse frequency. Economists and analysts working today have no experience with this type of recession.

## Implications for investment

No matter what the media makes it sound like, the state of macro-economics is very weak. Positive gains in various indicators during 2009 look more like bouncing around on the bottom, than they do meaningful recovery progress (see fig 3).

Several pundits have come out recently calling for the Fed to raise rates (James Grant, Andrew Bary, David Malpass, and Brian Wesbury). We find this to be a complete mis-understanding of the cycle. The ultimate problem is a glut of debt, not savings. Raising rates to slow things down when we have seen no evidence of speeding up, would be catastrophic to the economy. If borrowing isn't taking place at 0%, then how would 3% help? *It seems to us that many commentators have not consulted history, and use their large platforms to promote what they want to happen rather than what makes logical sense.*

The gap between current inflation and future inflation expectations has widened precipitously in December with the bond market forced into a higher rate concession response to the stock market proving the durability of its rally. This is the latest iteration of the *fear of inflation*, rather than any evidence of it. It will not last. The bond market is now priced to imply 3% annual average inflation over the next 20 years. This may not sound high, but core inflation is currently running at 1.4%<sup>5</sup> and has never exceeded 2.7% in the last 15 years.<sup>6</sup> Japan's average annual CPI growth since their stock market bubble (20 years ago) is 0.4%/yr, and the US CPI grew at an average of 1.5%/yr from the stock market peak in 11/1929 through the end of the 40's (about 20 years).

Outside of macro-economics, the question we hear the most is a version of "how can the U.S. continue finance the deficit?" We think an amalgamation of factors including a historically big deficit, 50% foreign ownership share of Treasuries, and historically low rates lead many

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<sup>5</sup>Personal Consumption Expenditures Deflator, less food and energy "core", rate from November 2008 through November 2009.

<sup>6</sup>Considering all monthly year over year rates for the core Personal Consumption Expenditures Deflator, less food and energy

<sup>7</sup>All household ownership statistics taken from the Federal Reserve Z.1 release, updated through Q309

commentators to conclude that rates will *absolutely* rise. *This is imagined cause and effect, not from a study of the relevant figures.* The answer is that the deficit will be funded by Americans, as it always has been before. Firstly, the savings rate has increased to the point now that households are saving approximately \$500bn/yr. A large portion of this flows into Treasuries. Over the last two years, households have purchased approximately \$500bn more of Treasuries, or about 5% of the total outstanding Treasury debt.

An even bigger source of funding comes from slight re-allocations in household financial assets. Treasuries make up just 1.8% of household financial assets, having risen from as low as a 0.5% at the end of 2007. As recently as 1994, this allocation was 4.5% and in the early 50's, the allocation to Treasuries was 8%; with the 10yr yield averaging just 2.5% during that period. A return to the 1994 levels of 4.5% would imply a net purchase of \$1.1tn by households, and a return to early 1950's levels of 8% allocation would imply a net purchase of \$2.7tn, or 36% of all outstanding. US households could buy all Treasuries outstanding with just a 17% allocation of their financial assets<sup>6</sup>. We know from Japan and the Great Depression that the expectation of investors to make big returns, prevalent in boom times, are replaced with the tendency to be content with preservation of capital in deleveraging periods. We see clear evidence of this happening today.

We expect inflation rates to go substantially lower from here and that the 10yr UST yield will eventually come down to 2% and below before the conclusion of this cycle. The entire U.S. Treasury yield curve will continue to offer large amounts of carry and opportunity.

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