

The Supercycle of Debt - America's Growing Burden

John Mauldin

Debt and the dollar, employment and interest rates, the U.S. economy and world trade, money supply and inflation/deflation, taxes, deficits, commodity prices, politics, war, regulation plus a host of other variables. They are all related in a very complex and dynamic fashion. Changing one of them may change each of the others in often unpredictable ways, which in turn affect all the others.

We are in a stimulus driven recovery. I think it will last for most of this year, if not the entire year. Yet, easy money and stimulus are not without a price. Messing with a free market is a perilous task. On the other hand, to have not acted would have insured a double-dip recession of what I think would have been of serious proportions. Will the stimulus be enough to start a self-reinforcing growth cycle? Perhaps... perhaps not. But it is still useful to understand what the effects of current trends and policies are likely to be. The Butterfly Effect is the theory that the flitting of a butterfly in Costa Rica can change the weather patterns for the world. Everything is connected to everything else. It makes for an interesting New Age proposition or a late night philosophical conversation.

But the items mentioned in the first paragraph above are not butterflies. They are not even whales. They are volcanoes and earthquakes and ocean currents. They are the fuel and engine and tires and transmission of the world economy, not the fine Corinthian leather or color of the paint.

Let's look at two quotes. The first is from the respected (and currently quite bullish) Bank Credit Analyst. As part and parcel of their views, they have an over-riding theme on what they call the Supercycle of Debt. This view is widely held by many market observers, including me, but their explanation is far simpler than most. Let me quote from their recent January issue (www.bcainvest.com):

"The Supercycle is a description of the long-term decline in balance sheet liquidity and rise in indebtedness during the post-WWII period. Economic expansions have always been associated with a build-up of leverage. However, prior to the introduction of automatic stabilizers such as the welfare state and deposit insurance, balance sheet excesses tended to be fully unwound during economic downturns, albeit at the cost of severe declines in activity.

"Government policies to smooth out the business cycle were successful in preventing the frequent depressions that plagued the pre-WWII economy, but the downside was that the balance sheet imbalances and financial excesses built up during each expansion phase were never fully unwound.

"Periodic 'cyclical' corrections to the trend occurred during recessions, but these were not enough to reverse the long-run trend. Each time that liquidity was rebuilt during a recession, it failed to bring the level back to the previous recovery high. Meanwhile, the liquidity rundown during the next expansion phase established new lows.

"These trends led to growing illiquidity, vulnerability and volatility in the financial markets. The greater the degree of illiquidity in the economy, the greater the threat of deflation. Thus, the bigger that balance sheet excesses become, the more painful the corrective process would be. So, the stakes have become higher in each cycle, putting ever-increasing pressure on the authorities to reflate demand, by whatever means are available.

The Supercycle process is driven over time by the building tension between rising underlying deflationary risks in the economy, and the ability of policymakers to create inflation."

From there let us go a quote brought to my attention by Michael Lewitt in the HCM Market Letter by economist Joseph Schumpeter. As you read the following, think about the nature of our current recovery. Is the stimulus for the current recovery real or is it artificial?

"Our analysis leads us to believe that recovery is only sound if it does come from itself. For any revival which is merely due to artificial stimulus leaves part of the work of depression undone and adds, to an undigested remnant of maladjustments, new maladjustments of its own." - Joseph Schumpeter

Liquidity, as used by BCA, refers to the ability of businesses and consumers to put their hands on cash, either for purposes of investing or consumption. The appearance of home equity loans and mortgage refinancing has the effect of increasing liquidity. It clearly created a great deal of consumption in the late 90's and more recently, in the massive wave of re-financing last year.

But once debt is used, that source of liquidity is no longer available until the debt is repaid. As noted last week, predicting the demise of the American consumer has been a losing bet, but that does not mean that all is well. Much of the available liquidity in the form of debt has been used. How much more is available? No one knows. But let's look at some numbers from Applied Income Sciences in San Francisco:

"U.S. consumer debt is at a historic high. Excluding mortgages, the average personal consumer debt is about \$18,654 per person. This is up more than 41% from 1998. The cost of servicing consumer debt is also at record levels: the average American now spends 18.1% of their disposable income servicing personal debt."

U.S. household debt as a percentage of GDP has risen from below 50% in 1984 to almost 90% today, almost doubling in the process. That is in just 20 years. From 1964 to 1984, debt as a percentage of GDP was essentially flat, rising only a few percentage points.

Clearly debt has played a large part of the growth of the last two decades, and is equally important in the sustained consumer spending of the recent recession. The recent ability of consumers to access debt in the midst of a recession was unprecedented in world economic history, and along with the housing boom was responsible for a very mild recession. The U.S. government and the Fed applied a very powerful cocktail of stimulus from low interest rates, tax cuts and deficit spending. The rest of the world obliged by buying our national debt in massive amounts. Combined with consumer debt, it worked to produce a recovery, and recently a most powerful one.

Will the Fed's cocktail be enough to induce a self-perpetuating recovery? The answer remains to be seen... when the effects of the U.S.'s credit intoxication eventually wear off.

[\[Top\]](#)