BUBBLES

Kids love bubbles. Even at an early age there is some sort of joy in seeing bubbles and trying to catch one.

Investors seem to love investment bubbles too – until they pop. The difference from soap bubbles is that investment bubbles don't appear to most people to be one except in hindsight.

Nearly all bubbles i.e. investment manias, begin with the promise of better times via some new thing. Consider the infamous bubble that began in Holland in 1593 with the importing of a new flower from Turkey called the tulip. It was new, rare and beautiful. It had no practical utility at all other than being nice to look at. Yet, in the stampede to buy these rare beauties, the price ramped up to an amount equal to the average annual income of a Dutch citizen. Then, tulip prices crashed. Today, you can buy them in many places, costing most Americans for a fraction of an hour's minimum wage similar to the price of a box of oatmeal.

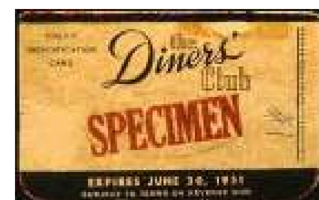
We had similar bubbles with the 1) tremendous expansion of the railroad across our country, 2) the invention of electricity, 3) the somewhat affordable automobile, 4) the good times of the 1950s and early 1960s when the end of WWII was fresh in the minds of Americans, plastics were invented along with instant photos, photocopiers, consumer air travel and the interstate highway system. Then we saw the promise of the 5) internet around the same time that as 6) mass market personal computers.

With the exception of the tulip, all these did in fact produce tremendous change in our standards of living but in each case stocks ran far ahead of the real-life schedule of actual gain in productivity. These produced the investment crashes of 1872, 1909, 1929, 1967 and 2000. The last two took the longest to build to a crescendo.

THE DEBT BUBBLE

We are now in the time of a bubble in debt, probably the biggest economic bubble in recorded history. It built up over several decades and touched every corner of the economy. It involves consumers and governments as well as banks, the major funding mechanism for the economy. No corner of the economy was left untouched except for the bare necessities. And, this bubble is global, not just the U.S. The years from 1933 until the present and still continuing will eventually be known as the Debt Era.

CREDIT CARD DEBT



Let's start with the introduction of the credit card. According to MasterCard, the first bank card, named "Charg-It," was introduced in 1946 by John Biggins, a banker in Brooklyn. It was really a debit card and both the merchant and customer had to have an account at Biggins' bank. In 1952

American Express introduced a card on which people could carry a balance and pay interest, the first true credit card. www.creditcards.com/credit-card-news/credit-cards-history-1264.php

According to a study by the Federal Reserve Bank of New York lenders report an average credit card balance per household of $7,134. http://economix.blogs.nytimes.com/2011/10/20/how-much-do-you-owe-guess-again But since many households do not use credit cards, it is worthwhile to note that the average balance for households who do carry a balance is just under $16,000 http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php Chase Bank actually has a card called the freedom card. I call it a Go to Jail card.

MORTGAGES

One could mark its beginning with the introduction of the thirty-year mortgage. According to www.TheHistoryOf.net

> The beginnings of a mortgage system have been found . . . as early as 1190. English common law included a law that would protect a creditor by giving him an interest in his debtor's property . . .
>
> As pioneers moved from Europe to settle in America, they brought their systems with them. As land ownership increased, so did the need for mortgages; so much so that by the early 1900s, they were already widespread and readily attainable. However, not everybody could get a mortgage. In those days, those seeking to buy property were often required to pay a *50% down payment on a 5-year mortgage* [emphasis added].

Then along came the Great Depression. As part of President Roosevelt's New Deal, The Federal Housing Administration was created to insure mortgages. That assurance of repayment to the creditor lowered the risk of lending and in turn interest rates on mortgages dropped. The main benefit though was the ability to get a mortgage for thirty years, six times the previous length. That made payments small and of course when times improved after WWII people built homes like crazy.

Of course, if you look at homes built in the 1950s you'll see that they are often something between 800 and 1200 square feet. In 1960, the average new home size was 1,200 square feet.

Even though family sizes had dropped, by 2004 the average home size had doubled to 2,330 square feet and was far nicer in most every way and the cost reflected it. McMansions popped up seemingly everywhere.

Look at average home sizes (in square meters) around the world. http://greenlivingpedia.org/House_size_comparisons

In 2008 the average home size in the US was almost twice the average size of homes in Europe, Australia and New Zealand. The latter two are probably included because they are unusual in their size, about the same as in the US. Home sizes in Asia are also smaller than the US.

Of course, this does not include the average lot size, which is getting smaller in the US but is still much larger than in most of the world.

Country	House size (m^2)	Relative to US
Australia	214.6	1.07
United States	**201.5**	**1.00**
New Zealand	196.2	0.97
Denmark	137	0.68
Greece	126.4	0.63
Belgium	119	0.59
Netherlands	115.5	0.57
France	112.5	0.56
Germany	109.2	0.54
Luxembourg	104.1	0.52
Spain	96.6	0.48
Austria	96	0.48
Ireland	87.7	0.44
Finland	87.1	0.43
Sweden	83	0.41
Portugal	82.2	0.41
Italy	81.5	0.40
United Kingdom	76	0.38
Non-US Average	**113.21**	**0.56**

HOME EQUITY LOANS

Somewhere in there borrowing not just for the cost of the home but borrowing against the appreciation in the price of the home became possible and borrowers spent the proceeds on everything from building or remodeling new rooms to embarking on vacations in Europe. They also borrowed to pay off their credit cards or their car loans. Others started or expanded businesses with the money or sent their kids to college, not bad things of course but costly.

BANKS

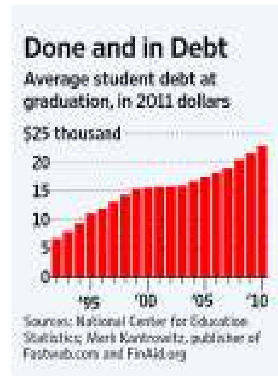
And, you know the blow-off. Banks started loaning at zero interest or loans where the borrower could just pick their payment. Loans without documentation of the borrowers' credit or income became an actual product, sold to millions. All the while, politicians stood by and applauded as the parade of homeowners swelled to overflowing and the effect of their borrowing rippled through the economy.

If no-doc loans were not enough, big banks ignored financial good sense by borrowing massive amounts themselves so they could have others borrow from them. It made for great profits until somebody somewhere with enough market sense and influence began to sell in earnest. Quickly, the fragile superstructure began to totter and lean.

Since most of the modern, developed world runs on credit, including individuals, governments and companies, when banks and credit markets for all kinds of debt are afraid to lend or when demand for loans drops an economy will obviously slow down.

It seems likely that **the magnitude of the slowdown will be proportionate to how much of the previous growth in the economy was built on borrowing.** For the US and Europe, that's quite a lot by long-term historical standards.

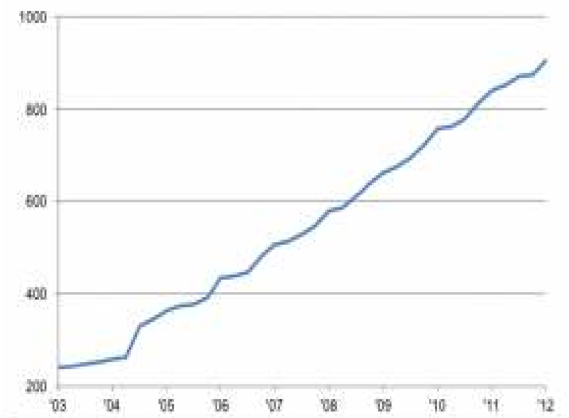
STUDENT LOANS



Student loan growth has been in the news quite a bit lately as these debtors have joined the line asking for the government to bail them out of the consequences of their bad decisions. You can see the growth in the average student loan debt at graduation that I have inserted here.
http://blogs.wsj.com/economics/2011/05/07/number-of-the-week-class-of-2011-most-indebted-ever

Student loans at graduation have quadrupled over the last twenty years. What in the world is behind this enormous growth?

Take a look at the two charts below. As always, you can drag a corner to stretch the chart.



As you can see if you take the same time frame for both graphs, the rise in student debt is about 3X since 2003 while the growth in tuition is about 2X. Probably, the rest of the growth has come from more people going to college or going back to college because they couldn't find a job. It could also be that young people today, having been raised in an era of debt are more willing to borrow and less willing to save for college or work during college.

Why is tuition going up so fast? My guess is that colleges mainly differentiate themselves from the other thousands of colleges by trying to be more prestigious. This college arms race is seen in the expansion of research and research staff, the expensive recruiting of star professors, building new buildings (including stadiums) and other efforts to be increase prestige. Now, in most cases when prices increase demand falls but for some reasons colleges seem largely immune.

GOVERNMENT DEBT

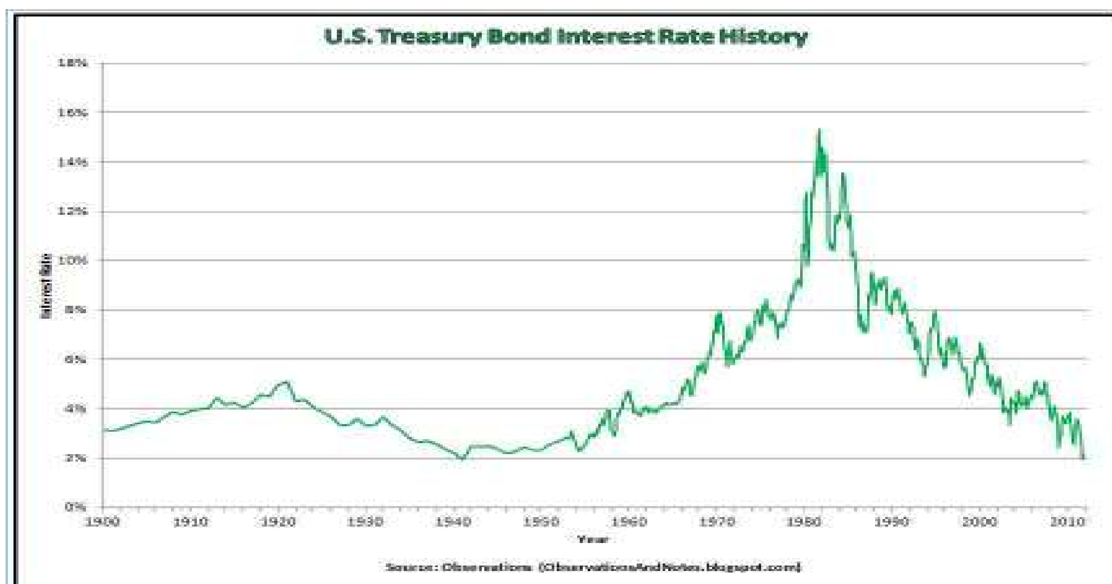
In late September 2008 “just in time” some of the leaders of the cheering political crowd had their faces slapped by the realization, delivered mainly by Federal Reserve Chairman Ben Bernanke and US Treasury Secretary Hank Paulson that the whole financial system was perilously close to a collapse similar to the start of the 1930s Depression.

Their dual answer was to 1) pump massive amounts of money into the economy through Central Bank lending, big government spending programs and 2) to boost confidence in the banks through delaying recognition of market losses, a government guarantee of the survival of the largely ruined big banks, government guarantees of bank accounts up to a much larger limit. Both of these avenues led to a renewed confidence in the stock market, helped by a 50% drop in stock prices that made them appear to be great deals.

In my view, the main contribution was from the second route – restoring a good bit of consumer and investor confidence. One could make a good argument that the groups also believed that route #1 would also make a big change and in part did, because the Federal Reserve’s massive printing of money lowered interest rates and the value of the dollar, making exports more competitive.

In actuality, the spending by politicians did little or nothing to actually grow the economy while the massive borrowing by the Fed in order to give money to the big banks did little to actually stimulate the economy.

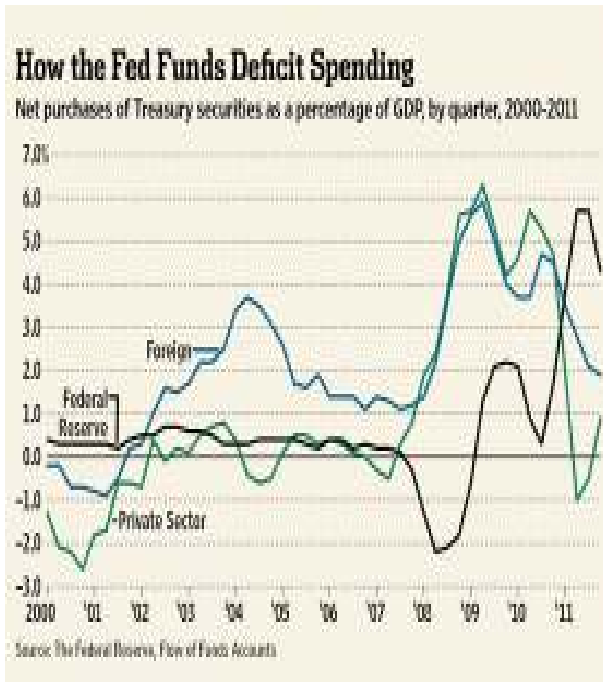
Fed borrowing did have a much more important effect that is not much reported upon which has allowed the federal government to borrow unprecedented amounts of money at extremely low rates. Looking at the chart below, does anyone want to seriously argue that the rates on US federal debt will stay down at this level for a long time? The chart is the interest rate on the 10-year Treasury bond, currently at a bit under 2%, less than the long-term average inflation rate.

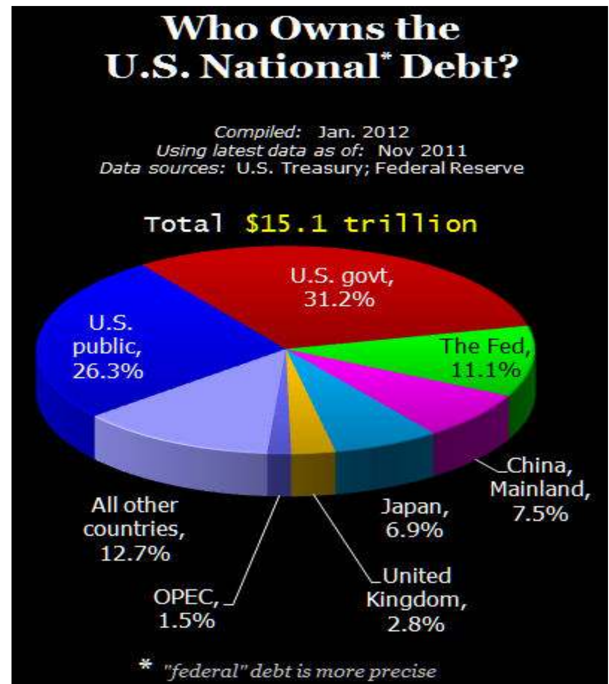


FEDERAL DEFICIT

Where does the federal government find lenders with enormously deep pockets so that the government can spend more than it raises in taxes? Look at the left chart below. The blue line shows foreign buying of government securities used to finance the deficit. You can see a huge increase in foreign buying in 2008 and early 2009 whence it dropped off sharply. Now look at the black line, representing net Federal Reserve purchases of US Treasury debt. It was a little positive for several years, dropped in 2008 and shot up since in two legs, referred to as QE 1 and II. Due to the weak economy and the limited effect of government spending the Fed is considering QE III.

Now look at the right chart. The Fed, having bought 60% of all new Treasury debt in 2011, according to The Wall St. Journal, has in 4 years jumped up to an 11% stake in federal debt. QE III if it is ever announced would have the Federal Reserve owning more US Treasury debt than China and Japan together, currently the two largest foreign holders of our debt.

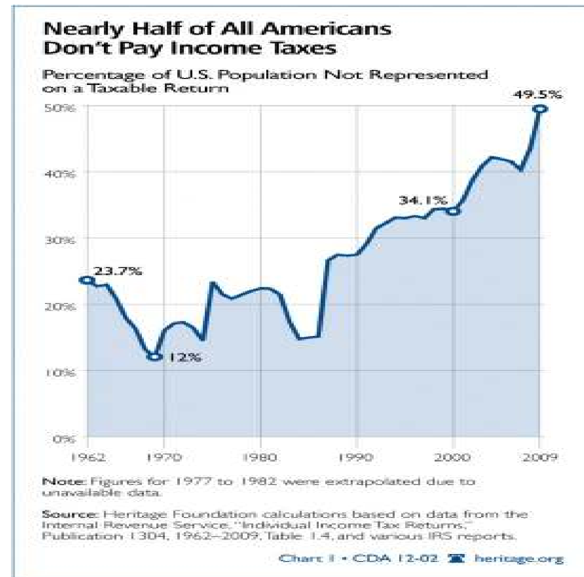


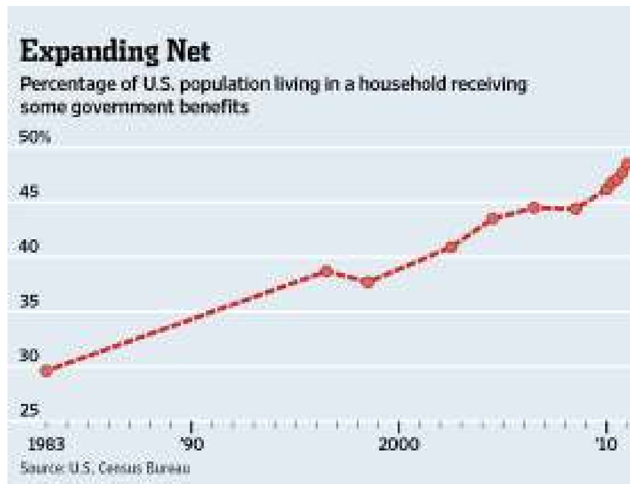


How big should government be, especially when it is borrowing much of what it spends? In FY 2011 the federal government deficit was $1.3 trillion versus spending of $3.6 trillion http://cbo.gov/publication/42573 . That means 36% of what the federal government spent in fiscal year 2011 was borrowed.

The gross federal debt is now larger than the entire US economy. And the federal debt is growing at the rate of 7% per year the last four years. Using the rule of 72 that means the national debt will double in the next 10 years.

The gross US federal debt is now larger than the value of the entire US economy. It is now over $50,000 per citizen and $134,000 per taxpayer. See www.usdebtclock.org. Didn't know that many citizens were not taxpayers, did you? Rarely are the missing in the richest 1% of Americans. In fact, 50% of all Americans do not pay federal income taxes. See chart at right.





The other side of the coin is that roughly 50% of Americans receive government benefits. Who would like to guess whether it is the half paying taxes or the half not paying taxes? My guess is that there is some overlap, though I don't have a study to back that up.

INVESTMENT IMPLICATIONS

We have not even talked about European debt and the question of whether the number of nations sharing a common currency will drop from 17 to a lesser number, nor have we talked about the slowing US economy, confirmed again today by a sixth consecutive monthly drop in retail sales. Both of these argue for caution in **stocks** and **commodities**. I do recommend **natural gas** now and while **oil** is down this year its price will be constrained by low global economic growth.

With **cash** paying essentially nothing and real estate difficult to buy in an IRA or other retirement account, that pretty much leaves bonds. That is where most individual investors have shifted to, though stocks have had the best outcome in 2009, 2010 and so far in 2012. Also, election years tend to be good years for stocks with most of the gains coming in the second half.

Long term, it will take a long time for American and European consumers to get the debt monkey off their backs. Since 2007, Americans have reduced credit card balances and left behind a number of huge mortgages, though not as many mortgages as the news would suggest. In the last five years, 4 million homes have been foreclosed but that is only 3% of a total of 131 million households (US Census 2006).

For US and European governments, debt continues to escalate. They are not yet close to the paying down debt stage.

I think that makes a pretty good case for **gold** as a store of value. Don't buy **silver**; it is much too volatile for most investors and over time has had a similar return to gold.

I think investors should still keep a stake in stocks because most corporations do usually find a way to grow and as their profits grow so too do share prices, with periodic exceptions with which most investors are pretty familiar now. The market is priced less than its historical average and as I mentioned earlier, the second half of election years tends to be good for stocks.

Bonds deserve a spot in most portfolios. It will be different when rates begin to rise but rates in general typically rise with inflation or if there is a downturn in the creditworthiness of the borrower. The latter is being seen now in Europe and at some later point may affect the US. Rates also go up with strength in the economy, something I do not foresee for a while. Slipping back into recession would argue against holding high yield bonds and bank loan funds, both sensitive to economic downturns.

On **alternatives** funds, it is hard to find one with a consistently good return or a long-term track record.

The US continues to be the best place for stocks but largely as "the cleanest dirty shirt." As usual, I strongly recommend letting the best mutual fund managers make your stock picks. With good diversification, they also lower your risk in stock investing over owning individual stocks.

The most important thing to take home from this discussion of the debt bubble that has not yet meaningfully deflated and government debt is still growing rapidly. The process of paying down consumer debt will take years, though significant progress should be rewarded by the stock market. Overall deleveraging will entail a generational shift in attitudes toward debt and the best size and role of government.

In the meantime, investing is much more complicated than it was in the 1950s – 1990s. Use a professional advisor with a lot of experience. I have been managing investments since 1984 and since 1995 as owner of this firm.

But, don't put your money in the back yard. Yes, the interest rate is about the same as the bank, but I have generally provided positive returns for my clients over the years, even during most of these tough years that started in 2000. And, I don't think you will find somebody with as good a grasp of what is going on in the world. Hopefully, that is evidenced by my newsletters and investment blog.

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