Weekly Relative Value

What Would Minsky Say Today?

"Success breeds a disregard of the possibility of failure." – Hyman Minsky

The late economist Hyman Minsky spent most of his academic career studying financial crises. He wanted to know what caused them and what triggered them. He thought crises had a lot to do with debt. His research led up to his publication of The Financial Instability Hypothesis. His theory came back into fashion after the global financial crisis, which neatly fit his description of "Ponzi" finance.

Here is Minsky's hypothesis:

"The first theorem of the financial instability hypothesis is that the economy has financing regimes under which it is stable, and financing regimes in which it is unstable. The second theorem of the financial instability hypothesis is that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system. In particular, over a protracted period of good times, capitalist economies tend to move from a financial structure dominated by hedge finance units to a structure in which there is large weight to units engaged in speculative and Ponzi finance."

"MINSKY MOMENT"

A so-called "Minsky moment" follows a long period of stability and complacency, which eventually leads to the build-up of excess debt and overleveraging. The more comfortable we get with a given trend, the longer it will persist. Thus, says Minsky, the longer the

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PORTFOLIO STRATEGY

period of stability, the higher the potential risk for even greater instability when market participants must change their behavior. In other words, at some point, gravity takes over. It can happen quickly.

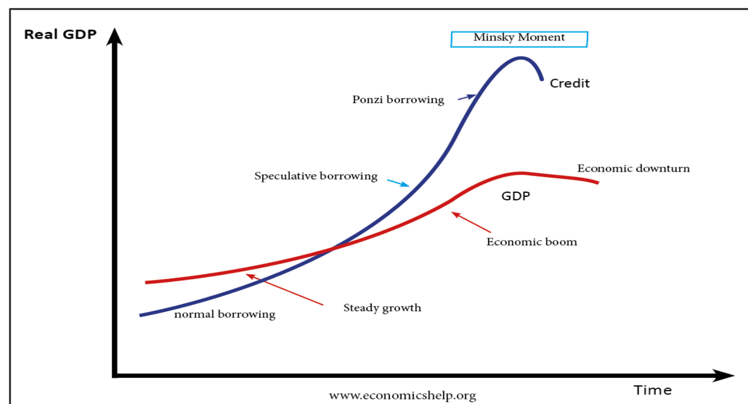
Ten years ago, a long period of growth led to complacency. Everyone was willing to borrow, and banks were only too willing to lend, creating a virtuous cycle of rising asset prices and a stronger economy. When it went into reverse, the need to repay debts smashed asset prices and threw the economy into a deep recession. During the height of the financial crisis, a wide range of markets reached all-time lows which caused margin calls, a sell-off in assets to cover debts and higher default rates.

Minsky was most concerned about “speculative” and “Ponzi” debt:

“Hedge financing units are those which can fulfill all of their contractual payment obligations by their cash flows… Speculative finance units are units that can meet their payment commitments on ‘income account’ on their liabilities, even as they cannot repay the principle out of income cash flows…

For Ponzi units, the cash flows from operations are not sufficient to fulfill either the repayment of principle or the interest due on outstanding debts by their cash flows from operations.”

A Minsky Moment



Ponzi debt is the most dangerous type of debt. This debt can have a systemic impact on the economy and markets. At the peak of the 2007 cycle, Ponzi debt was widespread in debt-financed takeovers, hedge-fund leverage, property speculation and highly geared investment structures, among other places.

A “Minsky moment” crisis follows a prolonged period of bullish speculation, which is also associated with high amounts of debt taken on by both retail and institutional investors. That said, Ponzi finance can work for a while. Sometimes people have good timing (or just plain good luck) and buy a leveraged asset before it tops out. The housing bull market of 2003-2007 – when people with no income, no job (NINJA) and almost no credit were buying and flipping houses and making money – attracted more and more people and created a soaring market. The phenomenon fed on itself. Undoubtedly, bull markets in housing, stocks or anything else can go higher and persist longer than we skeptics think is possible. That said, gravity always wins eventually. That is, what makes bubbles so dangerous.

THE ZOMBIE ARMY

"As a protection against financial illusion or insanity, memory is far better than law. When the memory of the 1929 disaster failed, law and regulation no longer sufficed." – J.K. Galbraith, "The Great Crash 1929"

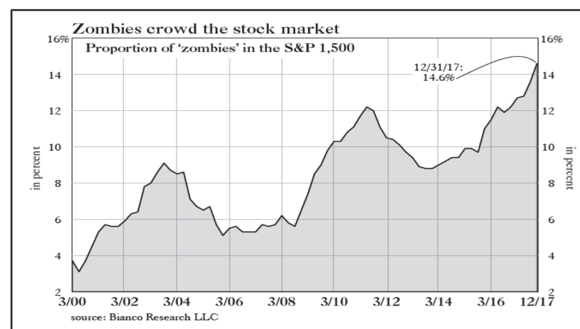
The good news is that the more investors focus on the last crisis, the less likely they are to take the sort of excessive risks that could lead to the next one. In other words, the more investors keep harking back to 2007-2008, the less chance there is of a repeat.

My worry is that memories are fading. Minsky's theorem appears to have been forgotten.

The graph below shows the percent of companies in the S&P 500 that would fall into Minsky's "Ponzi unit" category. Specifically, Bianco Research defines these "zombies" as companies whose interest expense is greater than their three-year average EBIT (earnings before interest and taxes). As of year-end 2017, we now have the greatest percentage of "Ponzi units" in at least 20 years.

So long as interest rates remain low and investor risk appetites remain strong, zombies will survive. However, interest rates have been rising for nearly two years now. It's not hard to imagine just how vulnerable these zombies might be to rising interest rates and waning risk appetites. Should they be forced into liquidation, a resulting collapse in asset values could present a major problem for the economy, as there are plenty of reasons to believe the wealth effect may be even more powerful to the downside than it is to the upside. Either way, the threat to the economy posed by the greatest corporate zombie army in history is surely enough to make Minsky roll over in his grave.

The Zombie Army

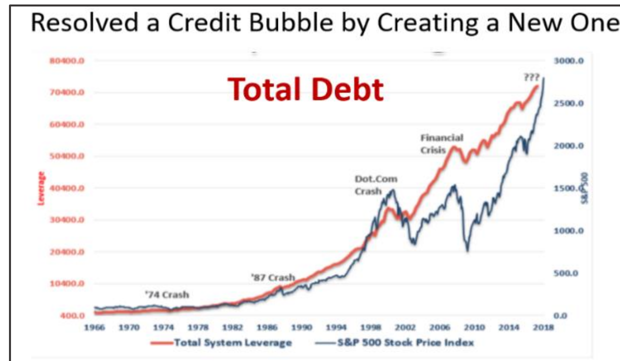


DEBT AND BUBBLES

"There are no new eras – excesses are never permanent." – Bob Farrell's Third Rule for Investing

Now, 10 years after the collapse of Lehman Brothers, we're seeing the results of the grandest central bank experiment in history. On the surface, it looks like mission accomplished. In the U.S., the unemployment rate is near a 48-year low, the S&P 500 Index recently reached another all-time high and consumers are about as confident as they've been this millennium. But dig a little deeper, and you'll find that this road has been paved with debt, debt and more debt – and that it's a one-way street.

Remember, Lehman was not the cause of the financial crisis. It was a symptom of a more significant disease. In 2008 we had a problem because of too much debt. Today, a crisis created by excess risk and high debt has been "solved" by adding even more debt and incentivizing greater risk.



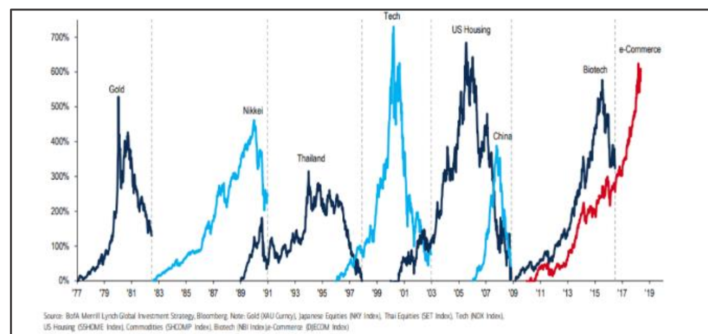
The level of outstanding debt at all levels of society – household, business and government – is approaching $70 trillion versus $50 trillion at the great financial crisis. So, the U.S. has merely added more debt to an existing debt bubble. If we add the $40-$50 trillion of unfunded liabilities, we're in excess of $120 trillion of total debt outstanding relative to an economy that's growing at $20 trillion. How can a $20 trillion economy support over $120 trillion in debt? It can't. At some point there will be a massive reset. The issue is when.

Thanks to the central banks' monetary laughing gas, all asset classes have been covered with a fake blanket of security, disguising risk with ultra-low rates.

Consider the following amazing stats:

- **Dow Jones Internet Commerce Index (Amazon, Netflix, Google and Facebook) up 617%, largest bubble of past 40 years**
- **U.S. tech market cap ($6 trillion) exceeds that of all companies in the eurozone**
- **Facebook (25,000 employees) market cap > MSCI India (1.3 billion people)**

Equity Bubbles



As the debt throughout the economy rises, the risks of instability within the total credit system are seemingly growing. While there are many domestic issues that could act as a trigger, the next Minsky moment may come from China, Russia or Italy. But it does not matter. All the necessary excesses are in place. The hard part, of course, is the timing; the happy daze can linger far longer than any of us anticipate. Then again, some seemingly insignificant event – like an Austrian

Archduke's assassination, or what have you – can cause the world to unravel. In other words, the world changes, but danger remains.

While equity markets may, in fact, continue to rise to still-higher levels, it is quite dangerous to one's financial health to believe the current fantasy that bubbles will never "pop" and recessions are "a thing of the past" or that financial engineering can maintain bubbles and "growth forever."

BUFFETT AND BUBBLES

Warren Buffett was asked by CNBC's Andrew Ross Sorkin "**if he is worried another crisis will happen again.**"

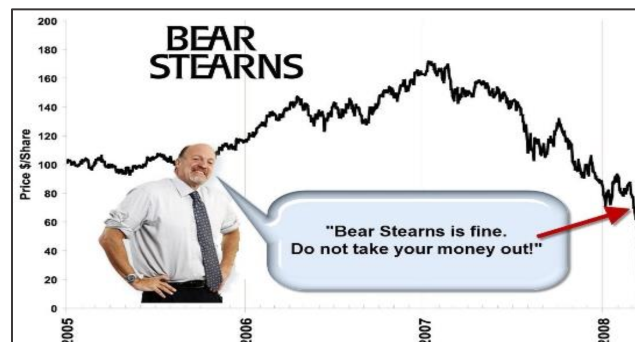
"Well there will be one sometime," he said. "*People start being interested in something because it's going up, not because they understand it or anything else. But the guy next door, who they know is dumber than they are, is getting rich and they aren't…* ***And their spouse is saying can't you figure it out, too? It is so contagious. So that's a permanent part of the system."***

That said, he does NOT see a bubble in stocks, bonds or real estate. Party on!

David A. Grogan | CNBC

REMEMBER WHEN?

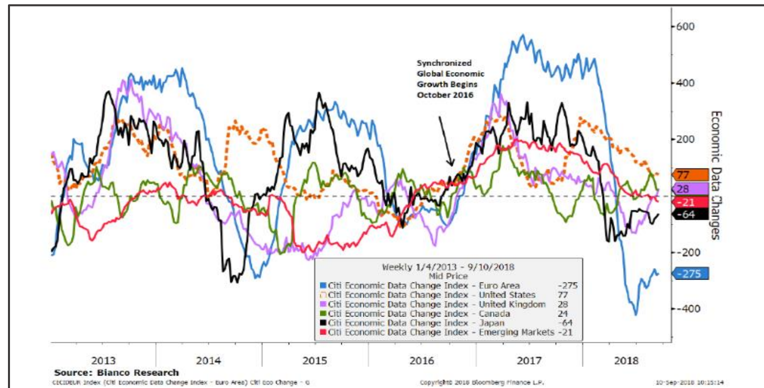
On March 11, 2008**,** Mad Money host Jim Cramer told a viewer who wrote into his show, "Bear Stearns is fine!" right before the stock absolutely collapsed. The stock was trading at $62 per share. Just five days later, the firm was mercy-folded into JPMorgan Chase (aka bailed out) at $2 per share. This undoubtedly caused considerable pain for CNBC viewers who followed Cramer's advice.



DEFICITS EXPLODE

While there is no doubt that the U.S. economy, on a relative global basis, is the best-looking horse in the glue factory, keep in mind that no other country in the world is blowing its brains out as much on government stimulus. And it's not just tax cuts, either. With the Tea Party conservatives seemingly on sabbatical, U.S. government spending has ballooned 30% over the year (the highest government monthly outlay of any month on record).

Global Growth is Slowing

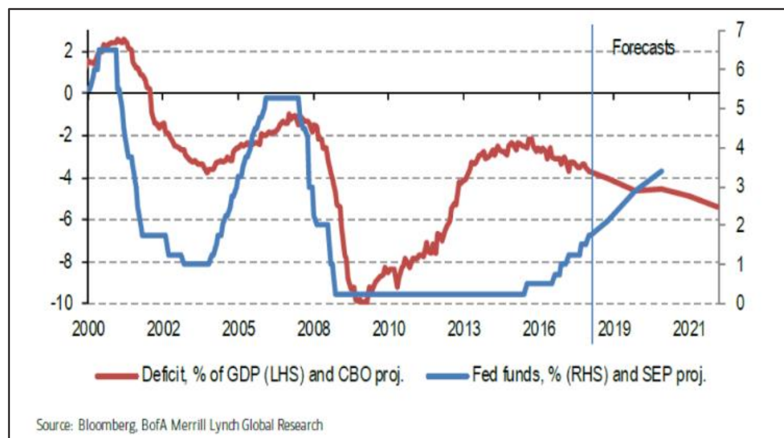


That, alongside the tax cuts (which only a fool would believe could pay for themselves), has taken the fiscal deficit up more than 33% to $895 billion in the first eleven months of the fiscal year ending September 30. The Congressional Budget Office now sees trillion-dollar deficits stretching into the indefinite future. Wall Street analysts reckon that by the end of 2019 the monthly issuance of Treasury bonds will have roughly doubled since the beginning of the Trump administration.

This is the key point: After a 10-year economic recovery, debt/deficits should be small and declining. Instead we find that debt and deficits are high and rising.

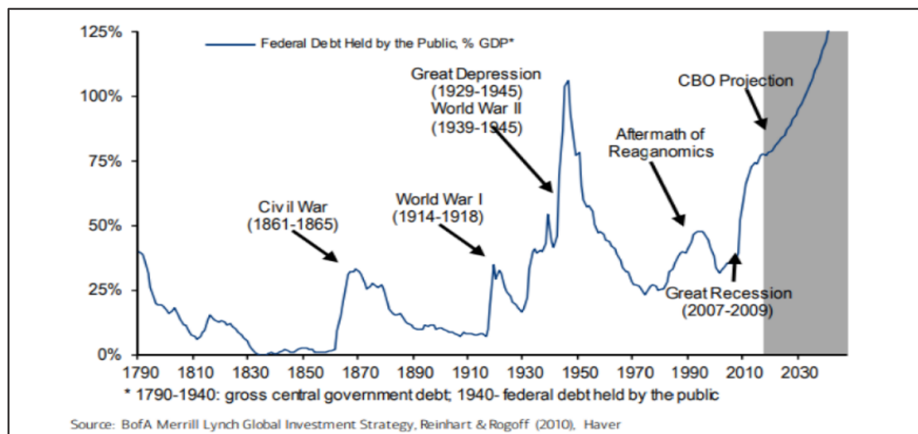
It's bad enough that deficits are increasing this late in the cycle, but interest rates are rising. This will put further pressure on the deficit and create a self-reinforcing cycle of higher debt and higher rates.

Rising Debt and Rising Rates



Relative to GDP, the U.S. budget deficit now stands at 4.4%, which is a level that would make even a classic socialist blush. After all, Sweden (the posterchild of socialism) has a surplus-to-GDP ratio at 2.0%. For some perspective, the last time the U.S. ran such a shortfall was in the spring of 2013, when the unemployment rate was 7.5%, not 3.9%. Scary numbers indeed! While the soaring debt is providing a sugar-high to the economy for now, the question is: what happens after the next downturn when the deficit – which is already exploding higher – will be off the charts? It may not be apparent today, but there will be a price to be paid for this government sponsored largesse at some point down the road. Enjoy the sugar-high while it lasts.

Debt to Explode Higher

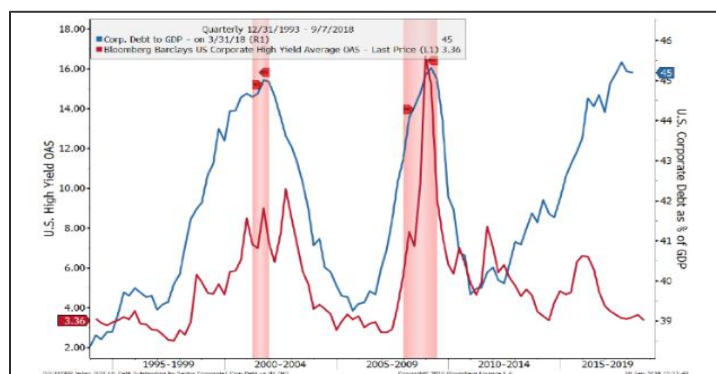


WILL CORPORATE DEBT BE THE FIRST DOMINO TO FALL?

"Rising risks are notable in the corporate sector, where low spreads and loosening credit terms are mirrored by rising indebtedness among corporations that could be vulnerable to downgrades in the event of unexpected adverse developments." – Fed Governor Lael Brainard

As Uncle Sam continues to flood the market with Treasury notes and bonds at a time when the Fed will be providing increasingly less support, this will crowd out demand for lesser-grade corporate credit and force spreads higher from their current unjustifiable levels.

Corporate Debt Levels Inconsistent with Yields



As shown in the previous graph, corporate debt to GDP has risen to 45% of GDP. Meanwhile, corporate yields have declined to close to record-low levels.

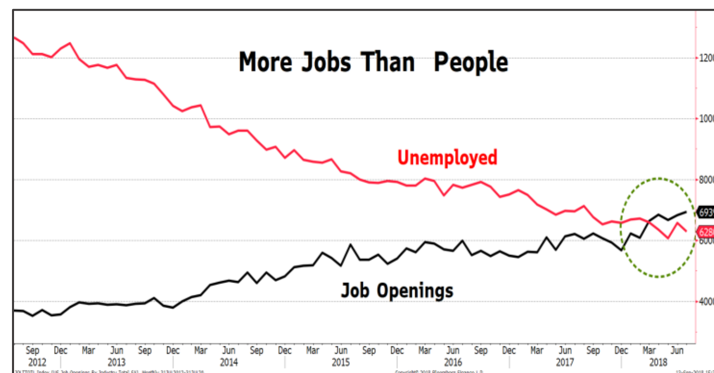
And, as supply has increased, corporate balance sheets have deteriorated. Currently, more than 50% share of the corporate bond market is BBB (versus 30% a decade ago). **In other words, the bubble is now on corporate balance sheets. It is so big that we have an estimated $4.3 trillion in outstanding lower-quality corporate loans and high yield bonds, which is almost double the existing liabilities eight years ago.** According to McKinsey & Company, two-thirds of U.S. corporate debt are from corporations that pose a high default risk. The average interest rate on leveraged loans has risen a full percentage point in the past year to 5.5% and is likely heading ever higher. As rates move higher along with quantitative tightening (QT), a lot of interesting things could happen as all that debt needs to be re-floated.

From my perch, a cycle of rising defaults for lesser-quality credit is a matter of when, not if. Remember, the corporate debt market is triple that of the subprime mortgage space at the 2007 peak. As such, it makes the outlook for risk assets and the overall economy that much murkier. A Minsky moment fast approaches.

MORE JOBS THAN PEOPLE

Job openings from the Job Openings and Labor Turnover Survey (JOLTS) soared to a record-high 6.9 million in July. Obviously, labor demands remain very firm. At the same time, since October, new hiring has flat-lined while job openings have soared 880 thousand – underscoring the chronic constraint of a lack of skilled workers for the positions that need to get filled.

The ratio of the unemployed-to-job openings dropped further to a record low of 0.90x. At the peak just as the recession was ending, this ratio stood at 6.64x. Think of what that means: there is more than one job available for each job seeker. The ranks of the unemployed have nobody competing for them, yet it does beg the question as to why new hires aren't rising at all, let alone keeping in lockstep.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

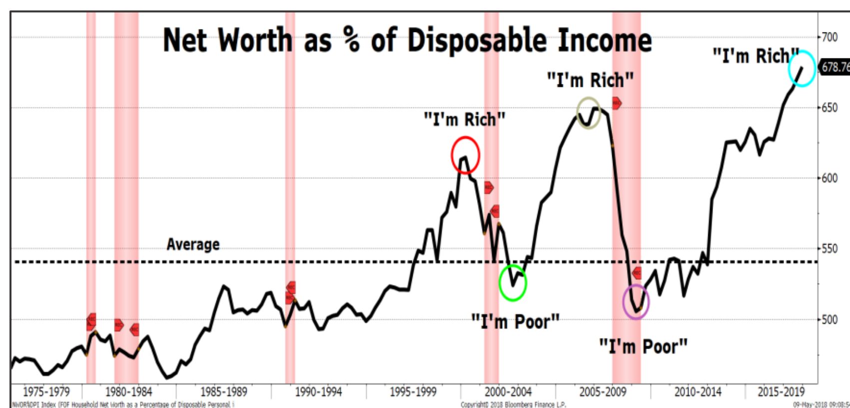
Mr. Greenspan preferred to ignore bubbles – believing they couldn't be identified as they were occurring – and only moved to clean them up after the fact. That said, Fed Chair Jerome Powell is increasingly focused on the role of the Fed's policies in inflating financial bubbles. He has noted that the past two recessions have followed financial excesses: the housing bubble that led to the financial crisis of 2008, and the tech-stock bubble that burst in 2000.

"Inflation may no longer be the first or best indicator of a tight labor market… In the run-up to the past two recessions, destabilizing excesses appeared mainly in financial markets rather than inflation. Thus, risk management suggests looking beyond inflation for signs of excesses." – Fed Chair Jerome Powell

While inflation has reached the Fed's target of 2%, the Fed should be concerned about the asset inflation that its policies have created. This is the fourth asset inflation cycle in a row. We had the commercial real estate and leveraged buyout bubble of the late 1980s, the dot-com bubble of the late 1990s, the housing and mortgage bubble of the mid-to-late 2000s, and now a bubble in growth stocks and investment grade corporate bonds (and collateralized loan obligations and leveraged loans and the like – the so-called 'shadow banking system').

As shown in the following graph, asset bubbles make us feel "rich" and we may in fact consume more to boost the economy. However, when the bubble breaks (they always do) the impact on the real economy can be quite severe.

At Alloya's 2018 Credit Union Executive Leadership Symposium in Chicago, I debated CUNA Economist Steve Rick. Steve predicted that the next recession will occur in 2020 and be caused by an inventory correction. This is classic economic theory. On the other hand, I believe that the next recession will rear its ugly head in late 2019. The cause will be the bursting of the Fed's most recent "everything bubble."



Since 2015, the Fed has raised rates seven times, and the markets no longer have any doubts that the Fed will raise its target range for the federal funds rate by 25 basis points at its September 25-26 meeting to a range between 2.0% and 2.25%. This will be the third hike in 2018.

Thus, while the markets lurch up and down on the latest tariff headlines, the key is and has always been monetary policy and the fact that the exceptional monetary accommodation is being unwound. Remember, the Fed has had its finger prints on every recovery, recession and bubble that the world has ever seen.

And what seemed like a thin chance of four rate hikes in early 2018 is now getting closer to becoming reality for the markets. The possibility of a fourth rate hike in 2018 has taken hold, and the Federal Open Market Committee meeting on December 18-19 is the likely occasion. This hike would raise the target to a range between 2.25% and 2.50%. The chance of an additional quarter-point move on December 19 has risen to 79.2% from around 10% at the beginning of this year.

As I end, the question, of course, is how high will rates have to go before something breaks?

In terms of portfolio strategy, we continue to advocate a fully invested, risk appropriate diversified ladder strategy.

MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@balancesheetsolutions.org or (800) 782-2431, ext. 2753.

Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI, has more than 30 years of fixed income portfolio management experience. He has developed and successfully managed various high profile domestic and global fixed income mutual funds. Tom has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

At Balance Sheet Solutions, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the goal of optimizing investment portfolio performance at the credit union level.

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