

MARATHON

IS THEIR LIFE AFTER DEBT?

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When we perform an act that leads to a successful or pleasurable conclusion, we tend to repeat the act. When continued repetition leads to greater success or greater pleasure, we become conditioned to continue the act. American consumers, corporations and government have all found debt seductive. The act of borrowing has been followed respectively in these three categories by the pleasure of more consumption, growth and political largess to distribute to constituents.

Because we remain in this century's longest peacetime business expansion, few corrective forces have imposed themselves upon borrowers. As with a reveller at a party, the consequences to the borrower typically are not felt until after the good times end. If you haven't felt those consequences in nearly a decade, it's easy to believe that you've found a way to imbibe without suffering from hangovers. Have we really found a way to avoid the pain, or have we drunk so long and deep from the cup of debt that we will inescapably rue our actions in the morning?

The average consumer's cumulative household debt, now exceeds 90% of his disposable personal income. The interest paid on that debt exceeds 7% of disposable personal income. These figures have risen more or less steadily over the past four decades from 30% and 2% respectively. Collectively, we have never before been so leveraged, and we are arguably near full employment. Saddled with this unprecedented debt

load, the composite consumer has begun to exercise some restraint or has had it imposed upon him. The year-to-year change in consumer installment debt has been declining substantially for more than a year. In the real estate area some confluence of slackening demand, tighter credit standards and declining borrower creditworthiness has resulted in a decline in the growth of mortgage debt.

The corporate borrower has gone on a well publicized binge that accelerated dramatically in the second half of the 1980's. Corporate interest payments rocketed upward by 140% in just the past three years. In conjunction with sagging corporate profits, corporate interest payments now come to nearly 60% of pretax corporate profits. And this without benefit of a recession!

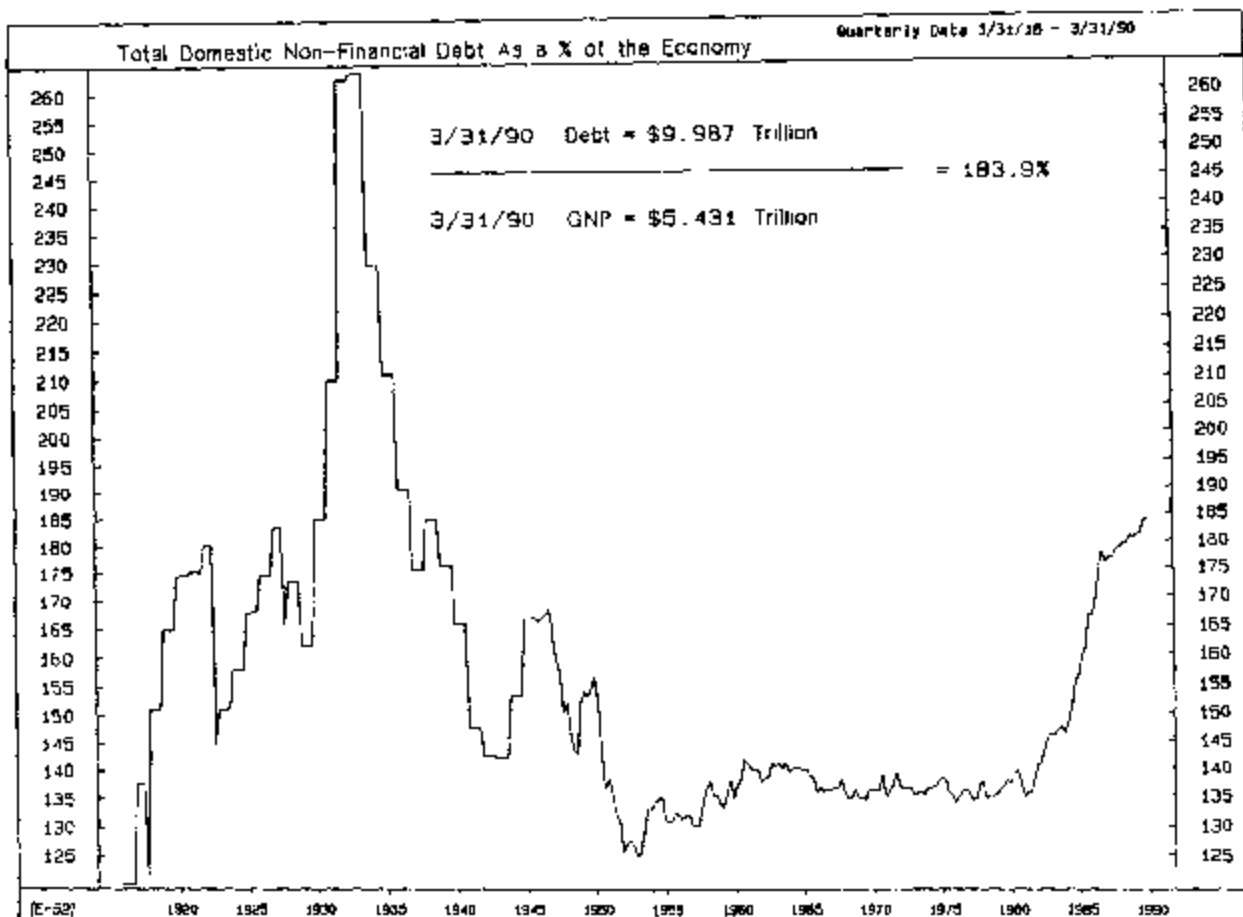
The most overleveraged corporate borrowers have captured our financial headlines for a year or more, with an increasing number mentioned as rescue candidates. Although many of these are in desperate need of new loans for survival, the consequences faced by previously burned lenders have led to many more "closed" signs on the loan windows.

The federal government's insatiable appetite for debt has grown so large that we are no longer shocked by even the most egregious additions to its mountain of debt. We can now modify the old Everett Dirksen line to "A hundred billion here and a hundred billion there and pretty soon it adds up to real money." When we look at a cumulative federal government debt of about \$3.1 trillion, we're looking at real money, whether in absolute terms or as percentage of our giant economy. Net interest payments on this federal debt eat up nearly 17 cents of

every tax dollar. Without some drastic change in federal spending and/or tax policy, negative compounding will lead inexorably to an ever increasing percentage of every tax dollar going toward interest in the years to come. The posturing that we hear annually both from Congress and the Administration is merely about the deficit, this year's addition to the already huge debt. We hear arguments only about how to decrease the amounts we are going to add to the debt, not about how we are going to diminish the debt monster itself. What could these numbers look like when the next recession hits?

Total domestic non-financial debt at the end of this year's first quarter totaled nearly \$10 trillion. It represented about

184% of the GNP figure of \$5.4 trillion. (See the adjacent graph.) The U.S. economy has never been able to sustain such a burden before. In the period from 1950 to 1982 that ratio never exceeded 142%. Except during the Depression of the 1930's, that ratio has not exceeded its current height in the past 75 years. The thirties saw the ratio skyrocket over 260%, not because of rising debt, but because the GNP denominator of the equation collapsed. The ratio plummeted into the early 1940's, in large measure because much of the debt was written off. Ominously, the ratio's only other foray to its current level occurred in the late 1920's. In other words, over the past three-quarters of a century, in the only other instance in which the components of our economy assumed so crushing a



Courtesy: Ned Davis Research

debt load, the economy crumbled under its weight, and we descended into the depths of the Great Depression, with long lists of corporate bankruptcies, massive unemployment and bread lines.

Clearly the logic is less than compelling to conclude that since the economy collapsed the only other time we assumed this level of debt, we must endure the same dire consequences now that we have grown our debt burden back to the same relative level. At the very least we can observe, however, that we have never before been able to bear this heavy a debt load and remain economically upright.

Who can blame the skeptic who says: "Sure, I see the mountains of debt, but they aren't new, and we haven't collapsed yet. Besides, why worry about something you can't control?" That, of course, is a defensible argument up to the point at which it fails.

Responsible economic commentators have suggested that the government will not permit the natural consequences of excessive debt to play themselves out because the results at this stage would be too calamitous. Such reasoning is based on the presumption that ultimate control is within the government's capacity. While it may well have been for decades, we must today seriously question whether the government's unprecedented debt load and the intricate economic interrelationships among nations preclude such control.

Loss of governmental control is obvious in the severity of the S&L debacle. The viability of the guarantees underlying the government's agencies is entirely dependent upon no major decline in asset values. If we experience appreciable declines in asset values, such as have

occurred in prior recessions, those agencies will have to be bailed out, just like the S&L's. We may have just started down the rescue road.

Remember well the facile explanation of the stock market crash of 1929 -- 10% margins. Have we not leveraged ourselves into the same box today but on a much broader scale? Is not Donald Trump effectively getting a margin call? And is he not, perhaps, a proxy for the rest of our system?

We might aptly depict ourselves in a boat that we have so loaded with debt that the water is almost up to the gunwales. The government is attempting to steer the boat without leaning, lest water come over the sides. So far the boat is moving slowly ahead, but the debt load inside is still growing. The biggest fear is a wave, almost any wave, that could swamp the boat. The captain and crew still show no inclination to lighten the load; they persist only in arguing about the amount they will add to the load this year.

With consumers, corporations and government all up to their eyeballs in debt, can we simply grow our way out of it? That would certainly be the painless path. And while anything is possible, we lack precedent to demonstrate our ability to accomplish such a desirable outcome. To accomplish that feat, we would have to reverse the declining trends of productivity and profitability and sustain those reversals for a considerable period of time. Perhaps one could make a case for such a scenario if we were emerging from a recession that had purged the excesses from the system. While we have experienced some sector and geographical recessions, we find ourselves in this debt induced imbroglio at the long end of the longest peacetime business expansion in

this century. This is hardly the wrung-out base from which major expansions are typically launched.

All that notwithstanding, the stock market is within the shadow of its alltime high. If economic conditions are still relevant to stock market performance, do these debt burdens not place investors in a precarious position?

By virtually no measures of observed data is this market cheap. By many measures it ranges from fairly expensive to extremely overvalued. And with the rate of debt growth falling dramatically, we have lost the engine that has fueled the post-1974 stock market boom.

The most attractive lure to currently underinvested managers and plan sponsors has been the action of the market itself. They have heard a compelling call to participate as prices have moved higher. Having been spared a traditional long-term bear market since 1973-74, our market is now populated with more than half its plan administrators, consultants and investment managers who have never had their current responsibilities through even one historically normal bear market. Theirs has been a bull market education, and their expectations are, logically enough, bull market expectations. While that conditioning may influence investing patterns and may promote a positive outlook longer than might fundamentally be justified, it does not change the underlying economic reality. Either the king is wearing clothes or he is not. If he is not, all the enthusiasm in the world will not hide that fact forever. In the long term, markets eventually reflect their fundamental underpinnings.

To bet on the launching of a sustainable bull market from here demands the

occurrence of the unprecedented on several fronts. We must be able to manage a debt load at the consumer, corporate and government levels that we have never been able to handle before. We must sustain a peacetime business expansion longer than ever before. The stock market must continue to rise for its ninth consecutive year and beyond, a feat it has never been able to accomplish.

Investing 101 says to "buy low and sell high", paraphrased to "buy cheap and sell dear". Buying dear and selling dearer can also be profitable but goes by a name other than investment. Its successful long-term proponents are not numerous. There are many more, however, in that camp before bear markets than after. If our markets can defer a major bear phase for another year or two, there is money still to be made. Save for the advantages to be gained from successful market timing (a perilous proposition at best), there will, however, be no net benefit from heavier equity participation now unless the markets launch a rally from here that never retraces to these levels or below. If we ever come back, the investor would have been better served waiting in higher yielding fixed income securities until some excesses are wrung out. Of course, that is more easily said than done in light of the microscopes that plan sponsors and consultants train on investment managers quarterly.

If the unprecedented is a longshot, we would logically accord past precedent at least a reasonable probability in the current environment. Excessive debt could again lead to the negative consequences that we have experienced before. And the potential consequences of a recession at these debt and market levels are frightening indeed.