

CREDIT MARKET CYCLES

WEB BUZZ 2007.11.26

There have been three great credit cycles in modern U.S. history with the following ratios of credit growth to GDP:

1. 1890's 25% to 75%
2. 1920's 25% to 50%
3. 1960's to 2007 25% to 135%

Never has the world seen such an explosion in debt. For example, in Australia, the ratio is currently 150% of GDP. This has had a profound effect on the value of various assets: commodities, common stocks, housing, commercial real estate, and—last but not least—bonds and mortgages. This is where the inflation [?] has occurred, as opposed to the cost of living.

We believe this inflation of asset values is coming to a close. Many have termed it a slow train wreck. We agree, but it seems likely that the final phase is nearing, and it may look like falling off a cliff. The major difference in this current cycle is that it has been the consumer that has become the most indebted. Please note the following quote from Stephen Roach, Chairman of Morgan Stanley, Asia:

“After nearly five fat years, the global economy is headed for trouble...the subprime fiasco is the tip of a much larger iceberg...an asset-dependent American consumer who has gone on the biggest spending binge in the modern history of the global economy...post-bubble adjustments seem likely to hit U.S. consumption, which at 72% of GDP, is more than five times the share the capital spending sector was seven years ago...a capitulation of the American consumer spells considerable difficulty for the global economy...In an increasingly globalized world...Asia will be hit hard...As always, the cycle of risk and greed went to excess.”

Again, please be careful with your investments. There is big trouble out there. Direct obligations of the U.S. government are the safest investments right now.