Rude Awakening

June 14, 2004

Our Web Buzz of May 3rd talked of nine triggers that might puncture the enormous bubbles that have been created by the most expansive monetary and fiscal policies the world has ever seen. Although nothing is ever clear in love, war, and economies, it does seem that the on going "spike" in interest rates is clearing the deck for many of the other triggers to come into play. As a reminder, the following are the possible triggers:

1. **Sudden Interest Rate Rise** – subject of Web Buzz 4/26/04
2. **Real Estate Bust** – Low interest rates have force fed this area, creating a bubble
3. **Debt Saturation** – Consumers have little money to spend due to payments
4. **Tighter Credit Standards** – Lenders become worried about bad loans
5. **Supply Shock** – A shortage, contrived or otherwise, which acts as a tax increase because of its "must buy" status.
6. **Derivative Meltdown** – There are at least $150T in derivatives slouching around out there that are interest rate sensitive. It's a prime speculative vehicle and is fraught with default possibilities.
7. **Contingent Debt** – In the fine print of many loan agreements are collateral value provisions. If broken on the downside they become callable (Enron problem).
8. **Terrorism Incident** – Enough said
9. **Asset market Correction** – This might occur before any of the above possibilities. This would signal problems to come.

Our first guess was that number three, debt saturation, would come into play first but the financial community is absolutely in love with the consumer. No amount of credit seems too large to be offered and spent by the "shop till they drop" generation. The Fed just released their Flow of Funds report for the 1st Quarter of 2004. The household sector increased debt at a record annualized $1.008 trillion. During the decade of the 90s, the average annual rate was $307 billion. By the way, total mortgage debt increased at an annualized rate of $1.01 trillion. Of that amount, household mortgage debt was $819 billion annualized. It just seems as if the financial institutions are not going to tighten their lending standards come hell or high water. That will surely be tested when higher interest rates hit the consumer's pocket book.

If the die has been cast (higher interest rates) then we say "bring it on." The road to our promise land of 3% long-term government yields will just come all the sooner. The slow Chinese torture of a small decline then a somewhat higher increase in interest rates day after day preys on one's patience. Unfortunately in doing it this way (bringing it on), those invested in common stocks, real estate, and low-grade corporate bonds are in for a rude awakening. Really Rude!