THOUGHT FOR THE WEEK
THE DEBT-FUELED RECOVERY

Global Financial Private Capital

SYNOPSIS

- The bears continue to believe that the current economic growth is nothing more than a debt-fueled ruse
- The first rule of debt analysis is to focus on the affordability of debt rather than the total amount
- The problem is not the debt itself but rather how it gets used

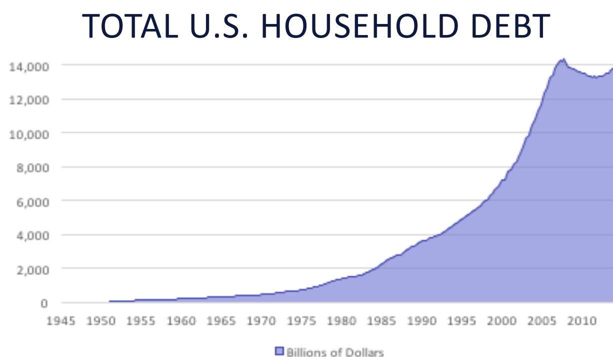
THE FIRST RULE

Benjamin Franklin famously said that he would "rather go to bed without dinner than to rise in debt." For many hard-working Americans who have spent their lives prudently saving for retirement, this sentiment reigns supreme.

For the bears, it is a reason to live in fear for the potential of another debt-fueled financial crisis. Even after eight years of continued economic growth, this small but vocal cohort continue to believe this recovery is a house of cards.

They claim that easy access to money has done nothing but create a situation where the economic gains and subsequent rise in equity prices are solely due to debt accumulation from governments, corporations, and most concerning, everyday citizens. When asked why they continue to remain on the sidelines, they refer to charts similar to the one below, which plots the total U.S. household debt since the 1940s.

TOTAL U.S. HOUSEHOLD DEBT



Source: Federal Reserve, 1/1/1945-4/1/2015

Upon first glance, this chart is rather frightening. Not only does the most recent data indicate that the U.S. is at an all-time high in total household debt accumulation, it's right back at the last peak which occurred just before the worst economic downturn since the Great Depression. Why believe in this debt-fueled recovery when history could so easily repeat itself again?

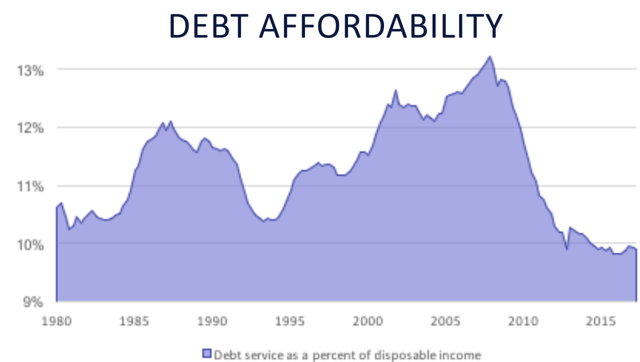
> **"…one person's debt is another's asset."**

The problem with charts like these is that it breaks the first rule of debt analysis - the total amount of debt on its own is meaningless. Some of the most successful companies in the world carry billions in debt, and they continue to operate for decades with little risk of default.

The key to proper debt analysis is to determine if the borrower can afford the debt. For example, if two neighbors have the same $1 million mortgage, but one makes $500,000 a year and the other $50,000, then the neighbor with the higher income should have an easier time making the mortgage payments.

The chart below puts the affordability of this debt into context by comparing the debt service payments as a percentage of disposable income.

DEBT AFFORDABILITY



Source: Federal Reserve, 1/1/1980-4/1/2017

This chart indicates that not only has the percentage of disposable income that goes to covering debt

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payments fallen since the financial crisis, it is currently at the lowest level since the early 1980s. Sure, there are pockets where debt is a concern for some Americans. Student loans and high credit card balances are obvious examples, but the current default rates on these are nowhere near levels that would indicate a looming crisis.

Simply put, debt accumulation is without question an important economic trend to monitor, but it must be done with a proper lens to prevent distortion to what is actually transpiring.

IMPLICATIONS FOR INVESTORS

Debt carries a negative connotation, but in the hands of disciplined borrowers, it presents more opportunity than it does danger. Healthy debt markets are vital to our economy because loans allow us to buy homes to raise families, cars to commute to higher paying jobs, and tuition to learn marketable skills.

In fact, the overwhelming majority of purchasing is done on credit, and since 70% of the U.S. economy is driven by consumer spending, access to cheap debt is not only important but also a necessity for any extended economic growth cycle.

Hence, in a way, the bears are right. This economic growth and the accompanying bull market has been debt fueled, but so has every other expansion in recent history. There is simply no way that our economy could grow at an observable rate without debt balances preceding this growth.

Furthermore, one person's debt is another's asset. Buying a house creates a liability for the homeowner, but it also creates a source of profit for the lender. Government and high-grade corporate bonds are purchased by those who need income in retirement and by insurance companies and pension funds in order to meet future liabilities.

The problem is not the debt itself but rather how it gets used, and this is where it could come back and bite us down the road. Gaining insight here is tough to acquire, but it's safe to say that not all of it is being used responsibly. However, until the cost of the debt becomes too much to bear, it should be of little concern.

THE BOTTOM LINE is that investors should be far less worried about the consumer debt situation today than in any other time in recent history.

SINCERELY,

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