

INTEREST RATE TELEGRAPH

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The Ticking Time Bomb

This Issue's Highlights

Increased debt fueled a mighty tailwind for economic growth this decade. Starting in 2007, debt will move to a strong headwind for the economy.

Odds of a recession have increased substantially. The Fed will walk a tightrope between inflation and deflation fears in 2008.

The banking system faces its own headwinds. Capital is a concern for money-center banks. Credit standards are tightening.

The long secular decline of inflation has ended. Look for inflation to regain a foothold in our economic system.

" Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pound ought and six, result misery."

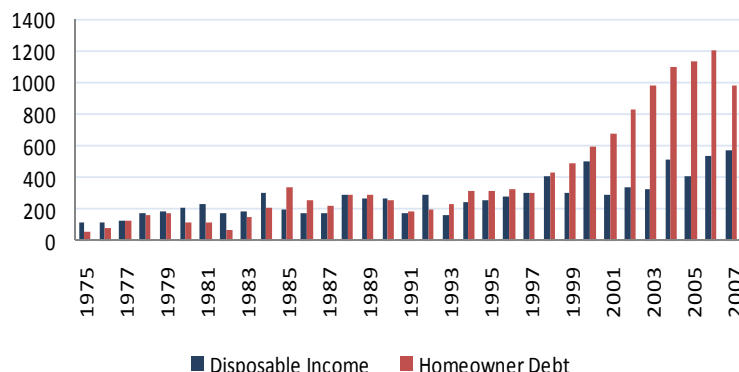
Charles Dickens, *David Copperfield*, 1849

The inspiration for this quote purportedly came to Dickens from his father's lament while in debtor's prison. As recently as the Great Depression, debt was a four-letter word. I still remember my grandmother determinedly telling me to avoid indebtedness at all costs. Debt would lead to ruin. The day she bought a new car was the day she began saving for her next car. Obviously, her excessively cautious view formed from witnessing the damage debt caused so many families during the Depression. But last year witnessed the opposite arc of the pendulum's swing. With the advent of NINJA (no income no job or asset) loans, debt was extended to even the credit unworthy. We went from debt destroys wealth to debt creates wealth. This year, I strongly believe that the

pendulum started the long swing back toward a more tepid approach to debt. Though in its infancy, this swing will prove to be secular, not cyclical, over the coming decades.

I've written extensively that leverage fueled growth over the last five years. Mortgage equity withdrawals, lax credit standards and large government spending propelled this decade's growth: more so than traditional wages. The chart clearly shows the torrid debt growth this decade compared to income. Since 2000, homeowners' increased their debt loads by \$7.5 trillion while disposable income grew a modest \$3.5 trillion. It was like the US economy took medical advice from golfer John Daly, "nicotine plus caffeine equals protein". Now however, past excesses appear almost daily as financial institutions take billion dollar losses, the housing market woes are compared to the Depression, and talks of Government bailouts permeate the political landscape.

Growth in Income vs. Debt



It is true that debt is only critical to the financial system under three conditions. 1) Debt burdens can no longer be serviced. 2) Assets underlying the debt have declined in value. And 3) the total loss is significant to the capital health of the financial system. (I will discuss this topic in the next section.) However, for economic growth, any need for consumers to increase savings or

Ticking Time Bomb Continued

retire debt hurts. And what gives me concern is the likelihood that U.S. consumers will reach the tipping point in mid-January. I expect Christmas to be merry as consumers use their plastic one last time. But then in January, it's not just a hang-over, it's time for consumers to admit they have a debt problem and enter rehab.

"We don't think that the United States is going to see an economic meltdown, but we don't think there is going to be strong growth in the U.S. economy, and that's what our forecast is built around."

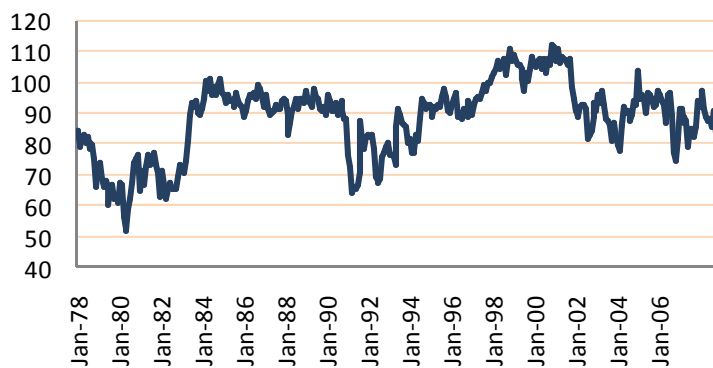
*Fred Smith, FedEx
Chairman and CEO*

12/20/2007

Over the coming years, consumers will inevitably slow their consumption at the margin. From 1952 – 1990, Americans saved on average 10.8% of their disposable income. During the 90's, the rate declined to 6.7%. This decade, the rate fell to 0.2%. Last year it was -3.2%. Consumers simply drank from the punch bowl of easy money. The result has been a sharp acceleration in mortgage delinquencies. Today, total delinquencies run at 5.59%, the highest rate since June 1986. Credit card and automobile loan delinquencies are also rising, but at a slower rate. The net effect is shown by the toll on consumer confidence, which has fallen to a level not seen since the early 1990's recession.

The Fed simply proved to be a hospitable host, taking the punch bowl away much too late as partygoers drank and drank and drank. Now that partygoers are aware of their foolhardy behavior and nursing crushing hangovers, they hope the Fed gives a little "hair-of-the-dog-that-bit-you" by lowering rates. And the Fed will grant their wish and lower rates significantly over the next year. However, the problem with the debt crisis is that it acts like a street drug. The more you take, the more you need: or rather the economic law of diminishing returns. So the Fed will push on the proverbial string and the result will be much lower rates than

Consumer Confidence



most investors expect.

Why am I confident the Fed will cut rates aggressively? Because Chairman Bernanke's greatest fear is deflation. He spoke on the dangers of deflation often during 2002 and 2003. In a 2004 interview with the Federal Reserve Bank of Minneapolis, Bernanke said, "In short, my principal reason for avoiding deflation is that you need to keep short-term nominal interest rates sufficiently above zero to have some room to respond in the case that aggregate demand falls short. There are other reasons as well; for example, deflation can be very hard on the financial system by increasing the real burden of debts." Given that our current problem is the burden of debt, I expect the Fed to administer generous doses of easier credit. But what about this month's inflation scare? First a quick lesson from the Great Depression.

Economists place the severity of the U.S. Depression at the Federal Reserve's doorstep. But few appreciate the difficulties facing the Depression-Era Fed. Most investors do not realize the Fed slashed interest rates by half after October's 1929 market decline. They did exactly what today's Fed has begun. And monetary policy positively impacted the economy with markets improving by 1931. But then investors began to

Ticking Time Bomb Continued

demand repayment in gold. The Fed had to make a choice: abandon the structural gold standard or lift rates incrementally to support the dollar. The Fed chose the latter. Why does this matter today? In a question regarding the Depression's cause, Bernanke said, "The collapse of the money supply that was engendered by the combination of mistaken monetary policies in the United States and a few other countries, and the transmission of those policies throughout the world by a gold standard that in many ways had a bias toward deflation built into it, seems clearly to have been the major single cause of the Depression. The evidence for this view—for example, the fact that whether a country adhered to the gold standard after 1931 or not explains much of the difference in cross-country experience is very strong." Bernanke clearly believes the Fed should have abandoned the gold standard and let the dollar fall to whatever market determined level. So on this month's inflation scare, ignore it will be Bernanke's policy response. Fear of a debt deflation will outweigh any concern over inflation. Thus the Fed will cut rates and inject liquidity into the system to prevent debt liquidation. One note about Bernanke's Depression cause: he rightly remarks the gold standard in many ways had a

bias toward deflation. Does he equally realize that today's dollar standard is in every way biased toward inflation? If investors start to shift from a dollar standard to a Euro or gold standard, will he abandon the dollar to increase money supply? Given his past statements, the answer is an unequivocal yes!

As a result, 2008 will likely experience anemic growth or a modest recession. The Fed Funds rate may drop to 3% before year-end. With liquidity flooding the market, long-term inflation expectations begin to rise. The yield curve steepens and the dollar continues its descent lower. The Fed and the Treasury publically state they stand for a strong dollar and low inflation. The markets wise-up. They realize the Fed wants modestly higher inflation to alleviate debt burdens and the Treasury wants a lower dollar to revive exports to aid the economy. Market volatility increases as fears over debt-induced deflation compete with currency induced inflation. The Fed faces a very difficult year! I have no doubt Chairman Bernanke favors inflation over any deflation. Thus, I see a much lower Fed Funds rate and a skittish investing market. Caveat Emptor! Buyer Beware!

FDIC Quarterly Notes

The FDIC recently released its Quarterly Banking Profile. Its headline bullets read as follows:

Credit Quality Problems Drag Down Earnings

Industry Net Income Falls to Four Year Low

Asset Growth Sets New Quarterly Record

Net Interest Margins Register Slight Improvement

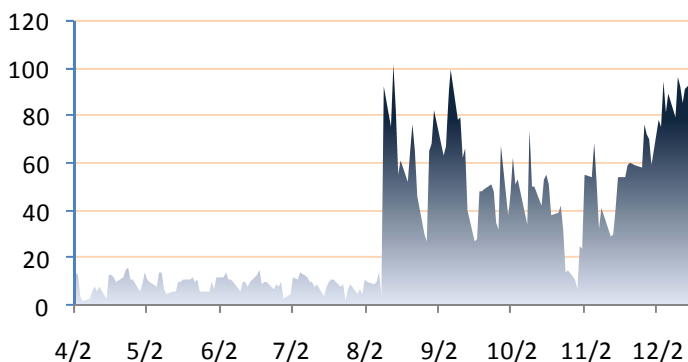
I guess the editor decided to give the bad news first and good news last. The best news is that in total, our banking system appears to have solid capital. I say appears to have solid capital

because no one really knows the true level of off-balance sheet assets. For example, we have learned recently that Citicorp held at least \$50 billion in subprime assets off-balance sheet. Even if the assets are good quality, placing them on the balance sheet will erode capital levels. But for now, the capital ratio is a strong 10.44%. However, after deducting goodwill the capital ratio falls noticeably to 6.82%. And let's face facts, goodwill is an asset during good times but you can't tap it during bad times. Currently loans 30 days past due and noncurrent rose 51%

"As a result, the industry's "coverage ratio" declined from \$1.21 in reserves for every \$1.00 of non-current loans to \$1.05 during the quarter—the lowest level for the coverage ratio since the third quarter of 1993." *FDIC Quarterly Banking Profile—Third Quarter, 2007*

FDIC Continued

3 Month LIBOR - Fed Funds



But fears persist because credit losses continue to mount. As of late December, credit write-offs exceeded \$80 billion. And yet, most investors believe that amount will double and perhaps reach \$200 billion. \$200 billion exceeds 15% of total capital. For the moment let's just assume total losses reach \$100 billion. What does this mean for banks and the econ-

American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage. To the degree that households are driven by fears of payment shocks but are willing to manage their own interest rate risks, the traditional fixed-rate mortgage may be an expensive method of financing a home.

*Alan Greenspan,
Chairman Federal Reserve
February 2004*

from last year and represent 1.41% of total assets. So overall, banks appear to be in reasonable shape.

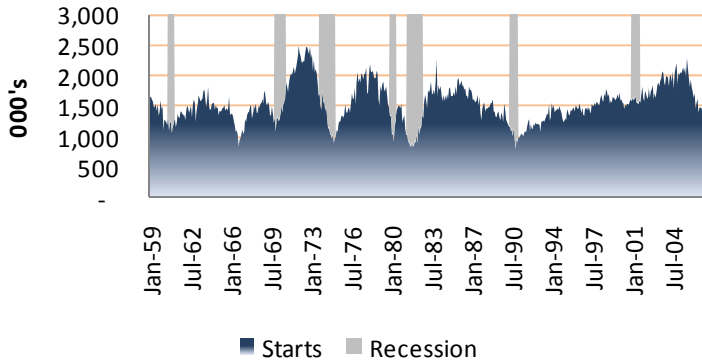
So why is there so much fear in the financial system? And why do I think there is fear in the system? Fear can be gauged by the willingness of banks to extend short-term loans to one another. If Bank A worries Bank B may fail, Bank A will not extend a term loan or will want higher yield compensation for the risk. In normal operating environments, LIBOR (London Inter-Bank Offering Rate) trades in virtual lock-step with Fed Funds. And LIBOR is the global bank lending rate. The chart shows that since the subprime crisis happened this summer, banks have been demanding significantly higher rates to lend to one another. Another indicator of fear was December 18th's action by the European Central Bank. Frustrated that all their previous liquidity injections failed to return LIBOR to normalized levels, the Bank offered a two-week loan at below market levels with no caps on amounts. The result was stunning and unprecedented borrowing: over \$500 billion! To put that in perspective, that's 4% of total assets in the U.S. banking system. Even more surprising, LIBOR remained 72 basis points above Fed Funds. So the central banks are flooding the system with temporary liquidity to ease credit fears.

omy? If the losses were spread throughout the total banking system, the loss would be an unpleasant load. But since evidence suggests these losses penetrate only a handful of banks (the FDIC reports that, "ten institutions accounted for more than half of the decline in industry earnings), the risks increase. For these large money center banks at the storm's epicenter, this loss results in a heavy toll on capital ratios. Restoring the balance sheet is today's priority. That means both raising capital and selling assets. So let's assume banks split the difference, raising \$50 billion in new capital. Because these banks have on average 7% capital, they would have to sell over \$700 billion of assets to preserve their capital ratios. That's asset liquidation the Fed will work overtime to avoid! And that is why fear grips the banking system. Money center banks loath funding new loans today and the credit crunch will persist into the New Year.

Even if consumers did not face debt induced headwinds, accessing credit would still prove difficult. The aggregate banking system is downsizing and credit standards are tightening. The days of easy money, even with a 3% Fed Funds rate, are dead. Risks of a recession led by consumers and financials dominate market thinking for much of 2008.

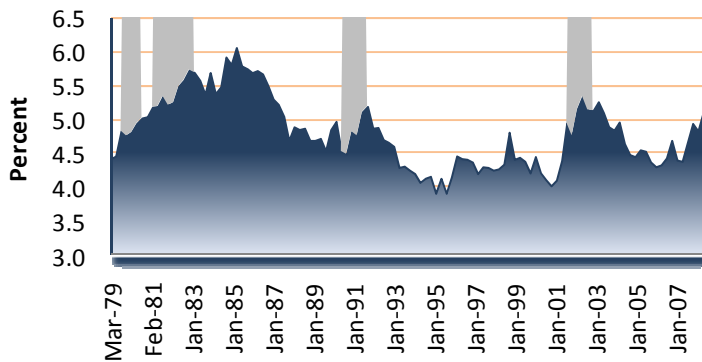
Charts For Consideration

Housing Starts



Housing Starts are a leading indicator for economic growth. The chart clearly shows recessions follow major downturns in housing, such as we are experiencing now. Only in 1966 did the economy prove resilient to housing.

Home Delinquency Rate

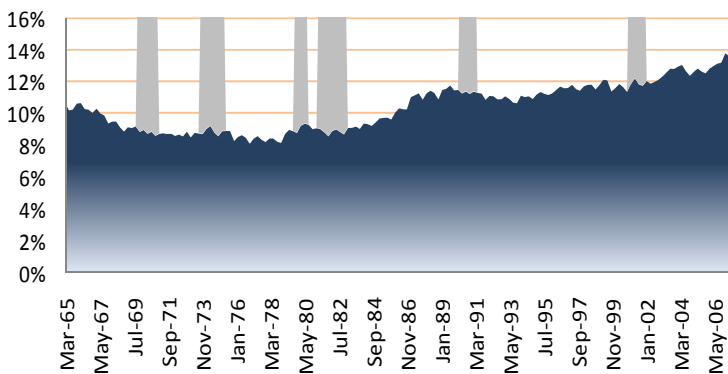


Delinquencies tend to rise significantly as the economy enters a recessionary period. My fear is that the economy may already be in a recession.

“From now until the end of next year, monthly payments for an average of roughly 450,000 subprime mortgages per quarter are scheduled to undergo their first rate reset.”

*Randall Kroszner
Federal Reserve
Governor
November 30, 2007*

Percent of Homes Vacant



While not a recession indicator, I was surprised at the number of homes vacant. Clearly many are second homes. But I can't help but wonder if the 2% increase since the last recession is the result of speculative home-flipping.

Best Question and Answer Regarding Bubbles

Q: How confident can we be in identifying...bubbles, and if we can't be confident, what's the role of the central bank in dealing with these events?

First, I think that many distortions in asset prices have arisen historically because of various kinds of structural regulatory problems in the underlying markets. For example, research on historical episodes suggests that large asset price increases are sometimes preceded by credit booms. In many cases this pattern results from the fact that the country in question deregulated its banking system, giving banks extra powers, but did not enhance the supervisory structure adequately at the same time. The result is that institutions have an incentive to make economically bad investments, to take advantage of the "put" provided by the government safety net.

So you could have a situation where a badly managed deregulation of some financial market, such as in the case of our own savings and loan crisis or in episodes during the 1980s in Japan and Scandinavia, has the potential to create a one-way bet that generates a destabilizing move in asset prices. It's extremely important for central banks, or for financial supervisory agencies in those countries that have them, to ensure that the underlying microeconomic regula-

tory structure is such that moral hazard and misalignment of incentives are not pervasive in the system. More often than not, such moral hazard problems are the source of asset prices becoming disconnected from fundamentals. So good oversight of the banking system and of the broader financial system is one very important way in which central banks or other agencies can prevent these kinds of problems.

Federal Reserve Chairman Bernanke in an Interview with the Federal Reserve Bank of Minneapolis in June 2004

[Click here for Interview](#)

Maybe it's just me, but doesn't his description fit the sub-prime crisis to a tee? As lending decisions moved away from regulated banks and credit unions to mortgage underwriters, credit standards evaporated. And now many are trying to take advantage of a government "put" via direct government mandates or lower interest rates. Clearly our Federal Reserve Chairman understands bubbles and markets. My only question is why did he fail to increase regulation on the shadow banking system created by mortgage underwriters and Wall Street?

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