"Long Term Parking"

Anthony 'Tony' Soprano:	**And I don't want to hear about the freaking economy, either! Sil, break it down for 'em. What two businesses have traditionally been recession-proof since time immemorial?**
Silvio Dante:	**Certain aspects of show business … and our thing.**

– The Sopranos, "For All Debts Public and Private" (Season 4, Episode 1, 2002)

There's a great scene in the 4th season of The Sopranos where Tony is upbraiding his crew for their lack of "production", particularly in the traditionally lucrative field of loan sharking. The recession is no excuse, says Tony, for failing to make money from "our thing" – organized crime. It's a great scene because of the language, the routinization of a decidedly non-routine business. You can easily imagine Tony and Silvio as the CEO and CFO of a regional bank in 2002, exhorting their loan officers to get out there and drum up some business.

Like the Soprano Family in 2002, the problem with the US economy in 2014 is not that there is too much private debt being created, but too little. The danger for US markets is not that there is some private debt bubble about to burst, but that markets have become disconnected from the natural cycle of debt and growth, a cycle which remains decidedly anemic.

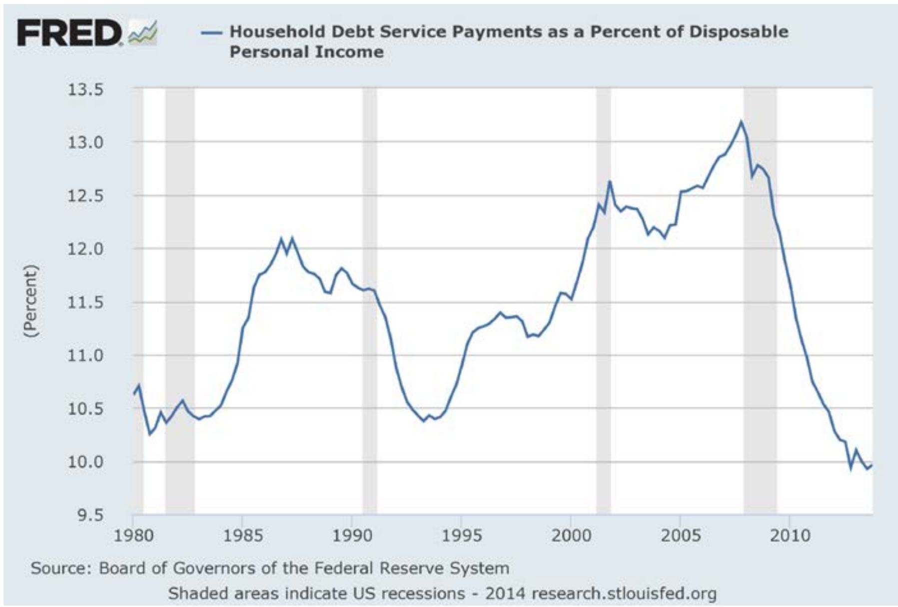
I think it's this disconnectedness that fundamental investors feel about this market – the "alienation", as Marx would put it – that pushes otherwise sober market observers to wring their hands about this debt bubble and that debt bubble, this looming apocalypse and that looming apocalypse. Most recently, the media alarm bells have been about a "complacency bubble", where low implied volatility levels for the market in and of themselves somehow create the potential for a big market drop. Even the occasional Fed governor has gotten into the act, claiming in their best Capt. Renault voice that they are shocked … shocked! … that markets are so blasé about world events. Please. This was the plan all along, explicitly laid out by Bernanke et al, that monetary policy would force everyone to buy riskier assets than they would otherwise prefer, inflating all financial asset prices and bridging the gap between the market everyone wanted and the real economy we actually had. **This is not market complacency born of animal spirits and a "what, me worry?" attitude. This is market complacency born of an intentional (and incredibly successful) government plan to mold investor behavior.** As a result, the current market complacency does not *mean* the same thing as prior periods of market complacency. And that makes all the difference in the world.

I've written here, here and here about why the whole "Minsky Moment" notion – which has come to be something of a rallying cry for those pointing to the dangers supposedly inherent in this market – is entirely misplaced. The Minsky-lite idea that "stability creates instability" may be in vogue, but really it's just a vague tautology. Yes, I will stipulate that stability does not last forever. Thanks. Terribly keen insight. No, if you take Minsky's ideas seriously you have to focus on private debt bubbles, and right now there are none in the US. Maybe there are in China, and I'm particularly interested in learning how far down the rabbit hole this commodity rehypothecation story goes. But in the US? Nope.

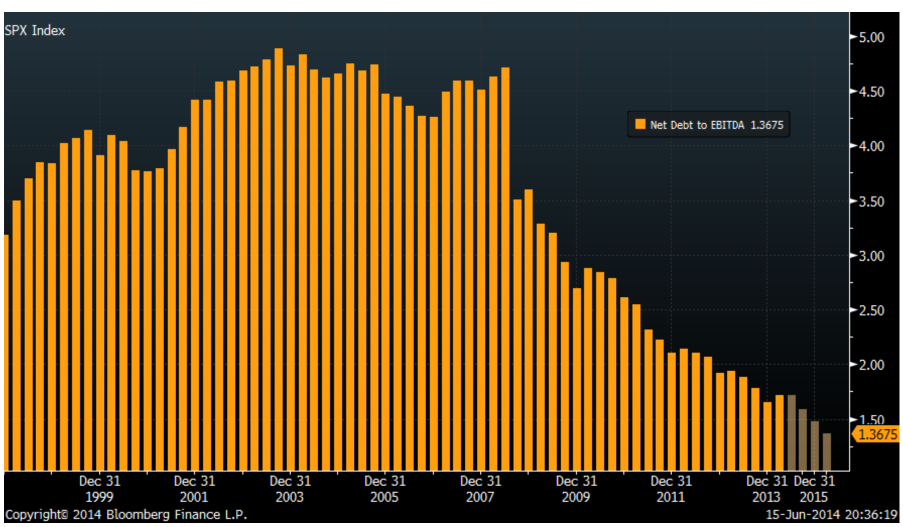
But what about the $1 trillion student debt burden, Ben? What about the historically high levels of auto loan debt and corporate debt? Here's the answer: **a high *level* of private debt does not necessarily create a debt *bubble*.**

First, debt in an absolute sense is never a problem. The problem, as Tony Soprano would be happy to explain to you as he cracks a baseball bat across your knees, arises when your debt obligation outstrips your ability to pay it back. **This problem does not exist for households or corporations in the US.**

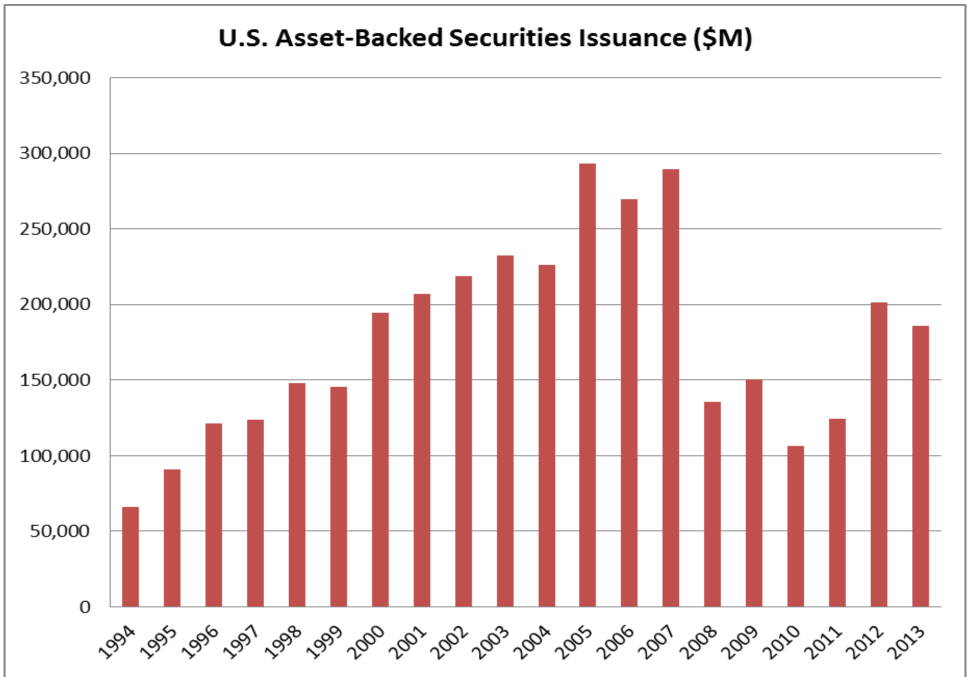
Here's a chart from [Fed data](#) showing household debt service obligations as a percentage of disposable income. Debt servicing has not been this easy for American households since the Fed started compiling the data in 1980.



For corporations, here's a chart from Bloomberg data showing the ratio of net debt (debt minus cash) to EBITDA (earnings before interest, taxes, depreciation, and amortization) for the S&P 500. This is a very standard measure of liquidity and leverage, and today's ratio of 1.37 is less than one-third what it was before the Great Recession. The cold hard fact is that US corporate balance sheets have not been this strong or less levered in more than 20 years.



Second, a market bubble can only exist in the form of market securities. If debt is not securitized it never reaches the public market and does not create a bubble. Here's a chart from [SIFMA data] showing asset-backed securitization issuance (auto loans, student loans, credit cards, equipment loans, etc.) for the past 20 years through 2013. ABS issuance last year was not even equal to what it was in 2000, and is more than $100 billion below its peaks in the go-go years of 2005-2007. Sorry, no bubble here.



Source: Securities Industry and Financial Markets Association (SIFMA)

Third, even if a high level of poorly underwritten private debt manages to find a high degree of securitization – I'm looking at you, student debt – a bubble can't exist if the private debts are backstopped by public debt. This was the magic of the Temporary Liquidity Guarantee Program (TLGP), which for my money was the single most important program – far more than QE 1 – in preventing the world from imploding after Lehman's bankruptcy. If the FDIC had not placed the full faith and credit of the United States behind the future issuance of private unsecured debt of FDIC-insured bank holding companies in November 2008, I have no doubt that the entire financial system would have collapsed for lack of liquidity. I mean, why do you think Goldman Sachs and Morgan Stanley became ordinary banks? Do you think they *wanted* to come under the thumb of Sheila Bair? No, the TLGP was the difference between life and death for Goldman Sachs and Morgan Stanley, as there is no way on God's green earth that they would have been able to fund themselves given their highly levered balance sheet without a US government guarantee on their unsecured debt. So they chose life, which for Goldman Sachs amounted to about $30 billion in new funding. For GE Capital it was about $90 billion. How nice it must be to be too big to fail, and how infuriating it is to hear Lloyd Blankfein and crew claim today that Goldman Sachs was just fine all along and they never wanted to accept TARP money in the first place. Well, no kidding, Lloyd. TARP was a sideshow in many respects, a way to recapitalize all the banks choked by bad RMBS. It's debt guarantee programs like the TLGP and the Fed's Commercial Paper Funding Facility that the big boys like Goldman Sachs needed to keep their private debt bubbles from bursting (a true Minsky Moment!) and that's what they got. Today, of course, owners of student debt receive the same protection. It was politically impossible to see the shadow banking system collapse in 2008, and it is politically impossible to see the student lending system collapse in 2014.

Okay, so maybe there are no private debt bubbles lurking around, and maybe Minsky-esque bubble-bursting isn't the danger. But isn't there some sort of danger associated with the $5 trillion dollars in public debt on the Fed's balance sheet? Isn't this a dangerous bubble? Yes and yes! But it's an entirely different (and counter-intuitive) sort of danger than what everyone is shouting about.

First the punch line. **The Fed's public debt bubble can only burst if private debt growth takes off, and the bursting of the Fed's bubble leads to rampant inflation, not rampant defaults.**

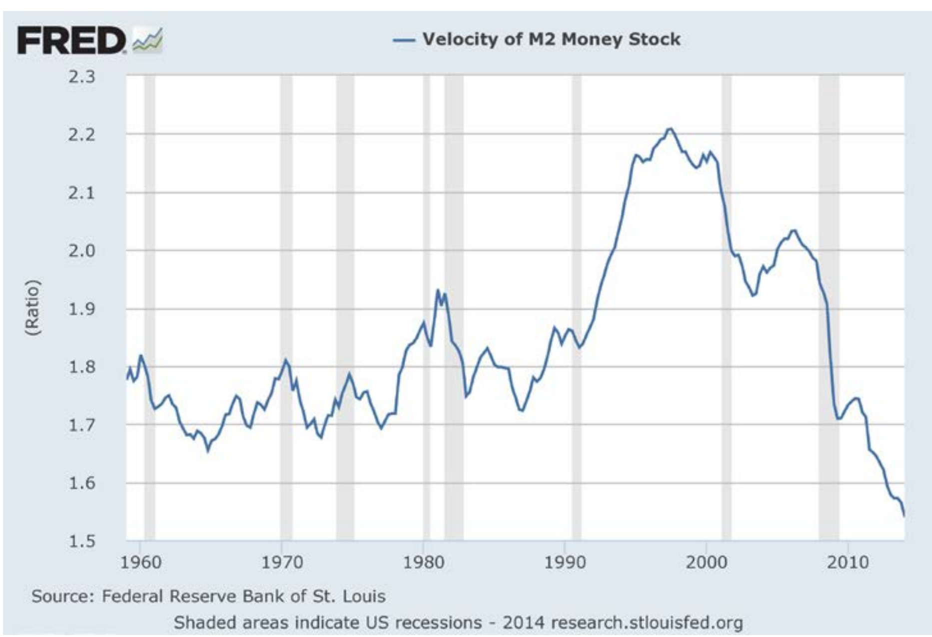
Why? Because the massive debt racked up by the Fed in its QE purchases of US sovereign debt and mortgage-backed securities doesn't work like household or corporate debt. The money for this buying spree never actually enters the real economy, but instead sits in the reserve accounts of the big banks. And that's where it sits, and sits, and sits … until the big banks use those reserves to make private loans to households or corporations that want to use that money for some sort of real-world economic activity. This private lending activity is what turns reserves into money, and the cascading usage of that money – where it flows through multiple hands making real economic purchases – is what turns money into inflationary pressures and expectations.

I've referred in prior notes to the nitroglycerin-like nature of $5 trillion in bank reserves, and this is what I meant: if these massive reserves were ever to start getting into the real economy through private debt growth, the Fed debt bubble begins to explode in a rolling series of inflationary expectation blasts. What does the Fed do then? It either lets the inflationary blasts roll through the world economy and hope for the best, or it "drains" the reserves by QT – quantitative tightening.

Either result is a nightmare for markets. In the former, the Fed is saying that it has lost control. In the latter, the Fed is saying that it's still in control, but it's going to embark on a massive and experimental tightening regime, the mirror image of its market-supportive policies of the past five years. Pick your poison.

I remember a 2011 dinner with a chief economist for a bulge bracket bank, both of whom shall remain nameless (I'd drop a hint like "he's been consistently wrong on the US economy for the past 5 years", but that really wouldn't help you identify him in this crowd). Usually I feel bad for these guys at events like this, as the nature of their position forces them to make predictions that they really don't want to make, but this guy couldn't wait to make his bold forecast for the US economy: another quarter or two of 1-2% growth, and then off to the races with 4%+ growth as far as they eye can see. My response: God help us if you're right. Debt is the oxygen for the flame of economic growth. You cannot have strong economic growth in the modern US economy without strong private debt growth, and if you have strong private debt growth it means that the Fed genie is getting out of the bottle. This was in 2011. The Fed genie is twice as powerful today.

But here's the thing. **Precisely because the bursting of the Fed's public debt bubble through private debt acceleration would be a disaster of unimaginable proportions, I don't think it will ever happen.** So far it certainly hasn't. Here's a chart of the velocity of money since 1960.



But if the velocity of money never picks up, that means that private debt growth never takes off. **And if private debt growth never takes off, the real economy remains stuck in this mediocre, constantly disappointing growth malaise.**

It's what I call the Entropic Ending, a long slog of a gray winding-down, neither fire nor ice, neither Happy nor Shocking, where the transformation of emergency monetary policy into permanent government program creates a low growth, low inflation *political* equilibrium that can last for decades. Stocks will go up and stocks will go down, but not by much either way. Perpetually disappointing growth translates into persistently dashed expectations of corporate earnings growth, but the programmatic Fed backstop of financial asset prices essentially outlaws a significant price decline. **There are neither secular bull markets nor secular bear markets in an Entropic Ending, just an ossification of an increasingly mediocre status quo.**

The Fed's bubble is currently parked in the banking reserve system, and I think that's where it's going to stay for a really long time. I titled this note "Long Term Parking" because it's the title of my favorite Sopranos episode, where Christopher's girlfriend gets whacked out in the New Jersey woods and they park her car in the long-term parking lot of Newark airport to create a narrative that she is just away on a trip, not dead. Similarly, the Fed has whacked the prospects for robust economic growth with its QE policies. Similarly, the Fed has created a narrative that strong growth is just temporarily and oddly missing, not permanently depressed by its policy decisions. Keep hope alive, the Powers That Be say, a vibrant real economy will return from this unplanned vacation any day now. Yeah, right. My guess is this happens about the same time that Adriana picks up her car from the Newark parking lot.

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