A Scheme That Would Make Bernie Madoff Blush

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It’s all about debt. We spend on our credit cards, even when there’s enough money in the bank. Business finances inventories with credit and equipment with loans. Houses are purchased with mortgages and cars with car loans. Education with education loans from the government or banks. Governments maintain vast amounts of bonds, even on the rare occasion they run a surplus. Even the money we use is just an IOU if you read the fine print on the notes. And the money we keep in the bank is only owed to us, not stored for safekeeping.

This has all sorts of consequences. But it also makes my job easier. By focusing on debt, I can explain to you most of what’s going on in the world.

For example, Spain’s banks are in trouble again

Despite a, so far, successful rescue of Banco Popular, the bonds of two of Spain’s other lenders are sinking fast.

Liberbank’s junior bonds were trading above par before Banco Popular was rescued. They fell to 81 cents on the euro. Cajamar’s parent company’s bonds are close behind. Regulators imposed a short selling ban on Liberbank shares to try and stem the leak. But that never works.

There’s an important phenomenon at work here. Understanding it will improve your investment judgement vastly. It’s all about unintended consequences. They always pop up somewhere **when the government gets involved in the free market’s functioning**.

Under the Banco Popular rescue, junior bond holders were wiped out alongside shareholders. Junior bonds are not secured. Imagine a mortgage without the ability of the bank to repossess your home if you default. Junior bonds are the same – if the borrower defaults, investors don’t have a strong claim to get their money back. Senior bonds do have something similar to a repossession clause. They get paid back their money in full before anyone else gets anything. Junior bonds offer higher returns for the higher risk.

Well, the problem is that banks rely on the funding which flows from junior bonds to some extent. The Banco Popular rescue has highlighted just how risky those junior bonds are, making them suddenly less popular. This has put banks’ ability to raise funds in doubt, which heightens the risk of a bank crisis.

In short, the rescue of Banco Popular has put other banks at greater risk instead of calming things down. It’s a perfect example of how government policy always finds a way to fail. They tried to calm the markets and might’ve triggered a junior bond crash instead.

Always look for where the unintended consequences will pop up to identify investment opportunities and threats.

Using debt to predict the economy

Spain’s banking crisis is just one example of how you can u**se goings on in the world of debt to explain broader stories**.

Steen Jakobsen is an economist and chief investment officer from Saxo Bank. He’s a typically gloomy guy with a fantastic penchant for explaining remarkable ideas that other economists make boring.

Steen’s been focusing on the credit impulse, he told Chris Martenson on the podcast *Peak Prosperity*. This is a measure of net new credit as a per cent of GDP. Mathematicians would call it the second derivative, or the change in the change in the level of credit. Are people borrowing at a faster rate, the same rate, or at a slowing rate?

This is the bit you need to understand: the credit impulse measure for the world economy (about 77% of GDP is covered by it thanks to the world’s obsession with buying things on credit) has gone negative for the first time since the 2008 financial crisis.

By my analysis, which is to actually look at the chart, this is not true. It also went negative **during Europe’s sovereign debt crisis**. But that just reinforces the point.

If debt makes up most of the economy and the rate people are borrowing at is slowing, then the economy will slow too.

Jakobsen says there’s a 60% chance of a recession in the next 18 months, most likely this calendar year. And UBS, which puts out the credit impulse chart, has confirmed its coming release will only worsen the fall in the measure.

A recession with monetary policy as supportive as it is now would be a real shemozzle.

The next black swan?

On Thursday we took a look at the US' PIIGS. You saw what the original PIIGS did to Europe in 2012. Well many of the US states are in the same shambolic financial positions as Europe's southern states. And just like the PIIGS, they don't have their own **central banks** to bail themselves out. That makes things interesting.

A municipal bond crisis in the US is just the sort of black swan type crisis the world can't afford. And that's half the reason no sees it coming – the conclusion is just too gloomy. But as you're about to see, this story can make subprime look boring.

Harry Markopolos, the man who exposed Bernie Madoff's ponzi scheme, is on the case. He took a closer look at one of the pension funds in Boston and found a $500 million gap in the books. The Boston Transit Authority's pension fund was in bad shape to start with. But in a speech Markopolos gave on Friday, the details of something new emerged.

The big problem is a pair of hedge funds that managed the pension's investments. The first hedge fund lost $25 million, having promised returns of 12%, just as Madoff had. A local newspaper had to expose the mess before the pension fund admitted to it. It turned out the hedge fund was run by a former manager of the pension fund, and he used the money to invest in his brother's movie.

The second hedge fund is even funnier. It was run by the son of a famous ponzi scammer from the 1970s who ripped off Hollywood investors. Shortly before the Boston Transit Authority pension fund invested, the fund lost its auditor and made a large investment in Penthouse magazine using a forged signature on the paperwork.

This sort of thing is most likely rife in American state pension funds

For example, three other funds from Louisiana lost $100 million in the first hedge fund that the Boston pension fund fell victim to.

The end result is an unquantifiable problem because, as the Americans say, the books are cooked. And if anything goes wrong, it's the lawmakers that are in trouble politically. You can imagine their incentive is to keep the laws supporting the fraud.

The Boston Transit Authority pension fund has less than 30% of the assets it needs to meet its liabilities. That's according to the official figures. Markopolos thinks the situation is far worse, predicting the pensioners would have to live off cat food for the plan's promises to match its ability to deliver. And he's also suspicious of recent miraculous returns the fund claims to have.

"No good outcomes result when you mix politics and money," Markopolos reportedly told investment professionals at the conference where he laid out all this. There are many other pensions with similar problems, to his knowledge.

At some point, these funds will run out of assets to pay their pensioners. That will have enormous political and financial consequences. Which have already started…

Illinois, **which I focused on in Thursday's *Capital %26 Conflict***, is seeing its bonds steadily fall in the aftermath of a credit ratings agency downgrade. The state is trying to renegotiate deals with investment banks, which will cost vast fees. And another $2 billion in back payments was found to add to the existing $14 billion.

The world seems awash with potential crises. And debt markets are the warning system you need to keep your eye on.

Until next time,

Nick Hubble,
Capital %26 Conflict