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Topical Study #22

APOCALYPSE NOW! (NOT!)

May 8, 1992



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I. THE HIGH PRIESTS OF THE TEMPLE OF DOOM

Rebuttal. This Topical Study is our rebuttal to the bearish scenario outlined by Michael Aronstein in a recent *Barron's* interview (April 27, 1992). The article is titled "Apocalypse Soon" and updates a lengthier interview with Mr. Aronstein and his two associates at Comstock Partners, Stanley D. Salvigsen and Charles L. Minter, in the June 10, 1991 issue of *Barron's* titled "Apocalyptic Vision".

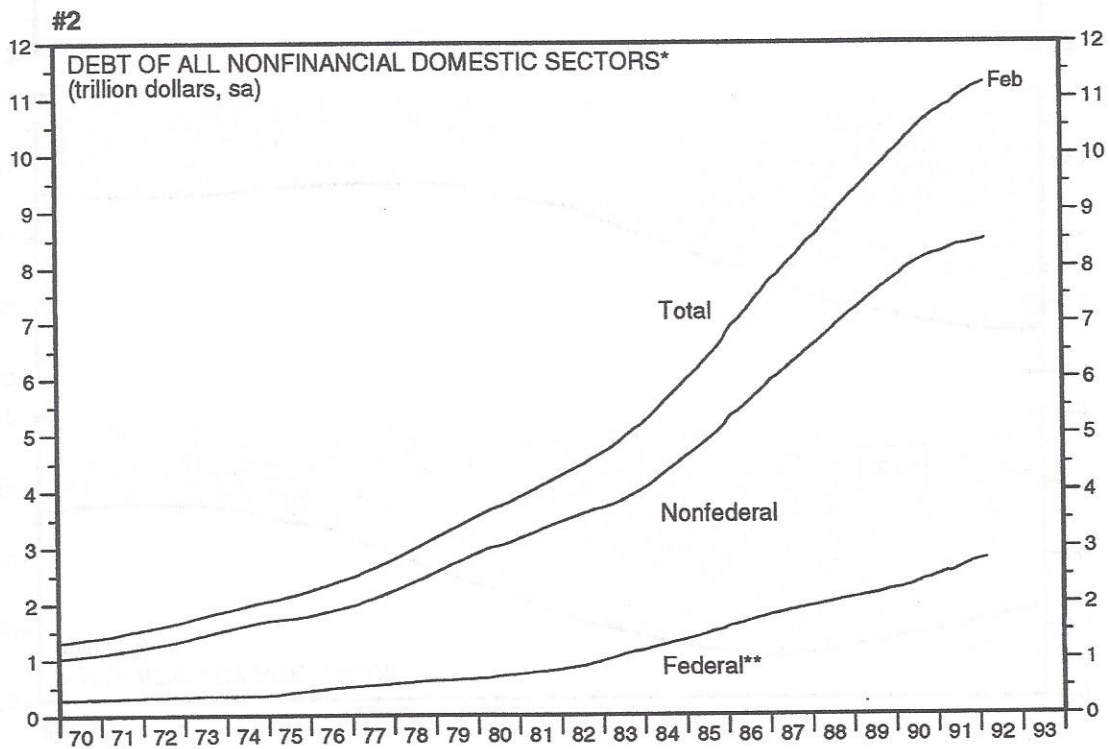
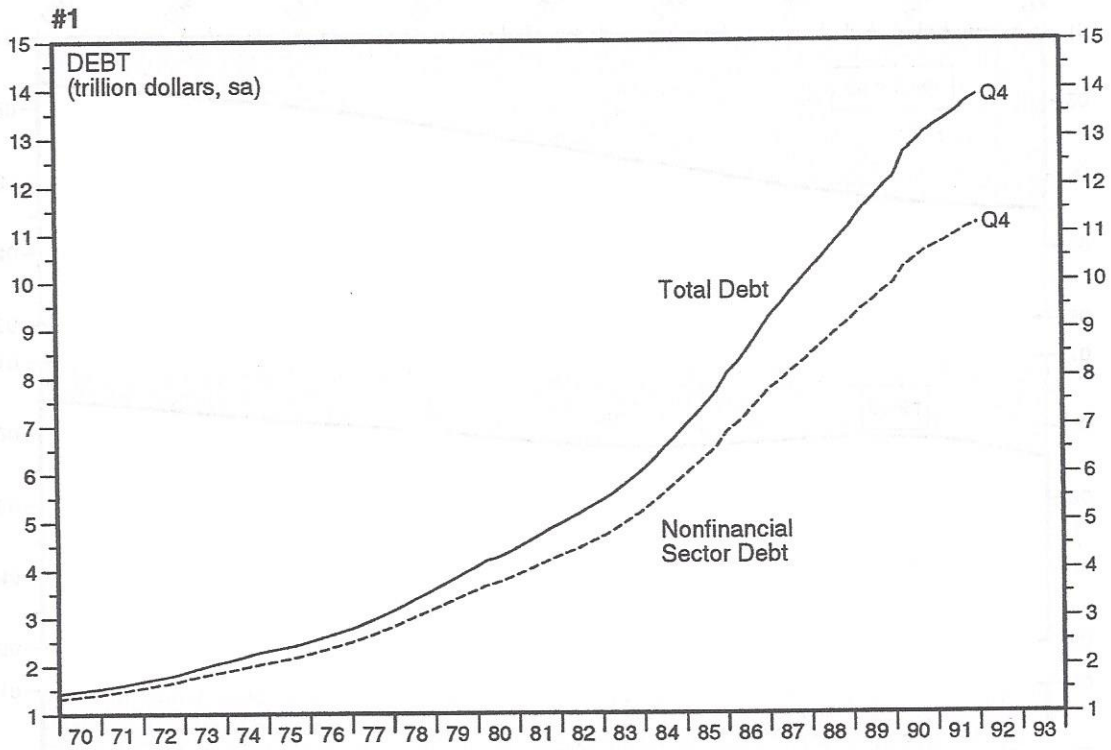
The partners are convinced that the overuse and abuse of credit during the 1980s will have increasingly dire consequences for the economy in the 1990s. They see deflation and hint that even a depression is likely. They observe that debt grew much faster than GDP during the 1980s and that the cost of money, as measured by the corporate bond yield, has exceeded nominal GDP growth since 1980. They conclude that the economy can't generate enough income to service the debts of the previous decade. They see widespread defaults as the only way to reverse the debt excesses of the 1980s.

During March of last year, we first referred to this trio and other well-known pessimists as the High Priests of the Temple of Doom. Don't get us wrong: We think the Comstock investment strategists are among the most thoughtful and thought-provoking on Wall Street. Their grim scenario is internally logical and several of their dire predictions have come to pass. The collapse of the junk bond market, the debacle in the savings and loan industry, and the drop in home prices in several regional markets are events that confirm their apocalyptic views.

But for quite some time, we've noted one major flaw in their depressing logic: *We think the doom-and-gloom crowd has failed to appreciate the power that falling short-term interest rates have to offset the forces of deflation and to revive economic growth.*

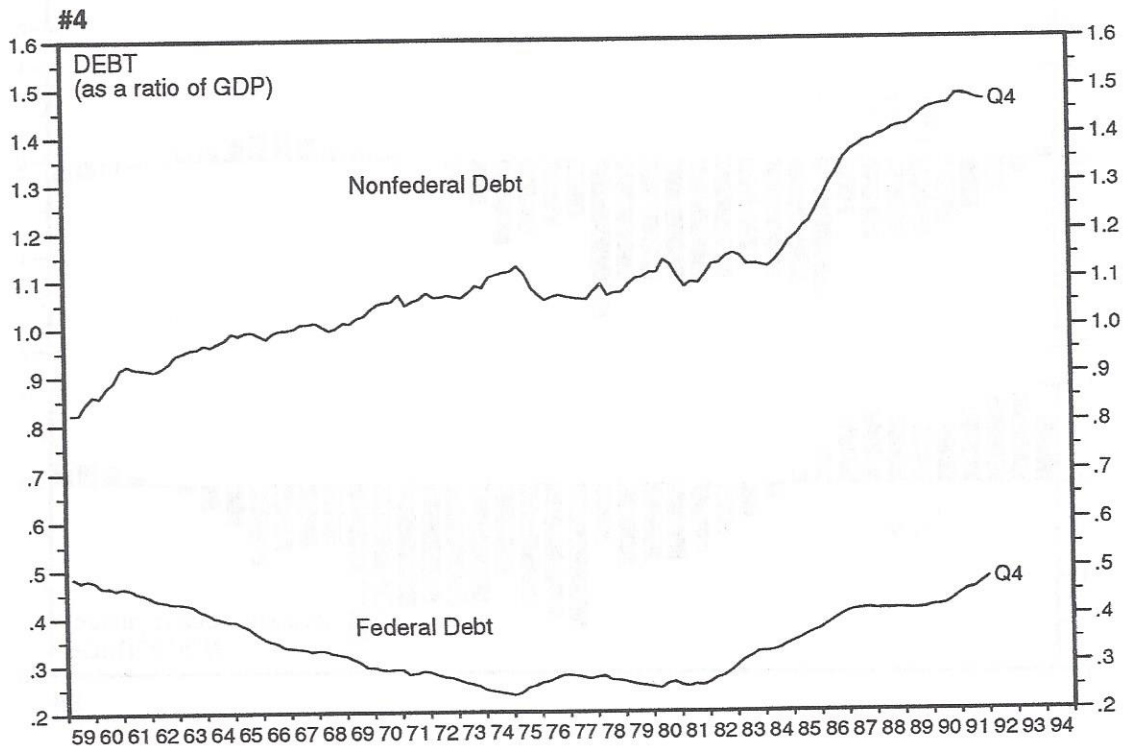
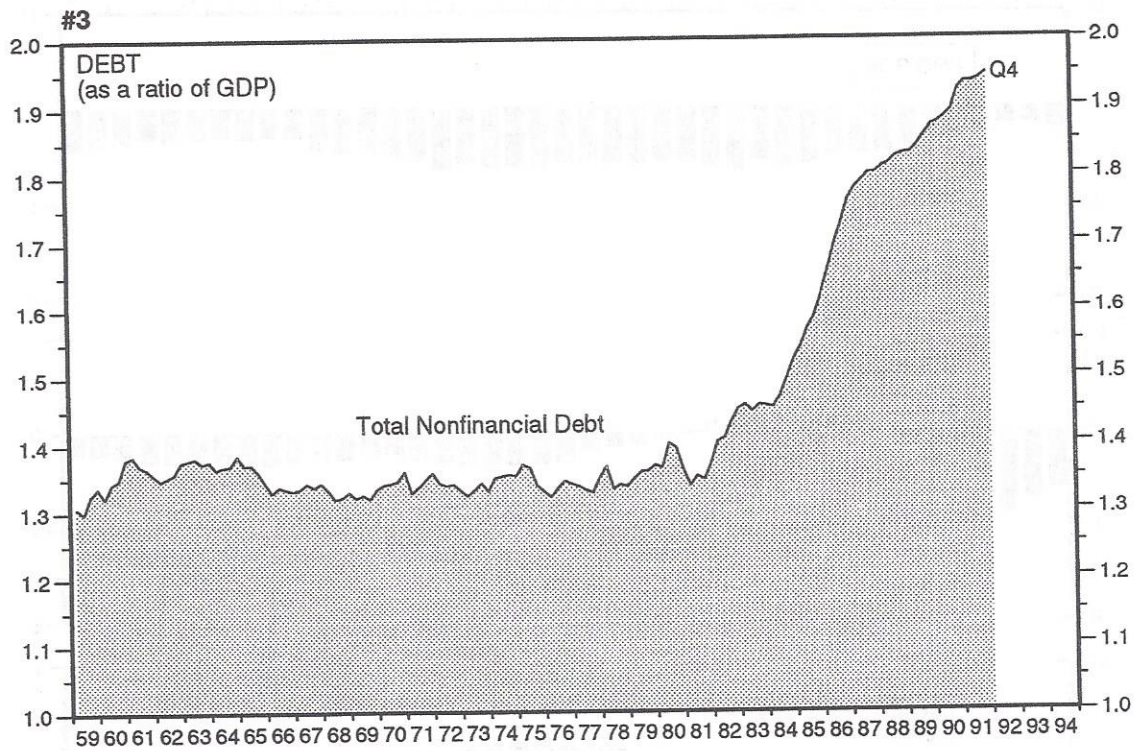
This is the main thrust of our rebuttal; it's really that simple. The debt excesses of the 1980s can be resolved through widespread defaults—as the pessimists expect—or through a big drop in interest rates. The debt-to-GDP ratio rose dramatically during the 1980s and so did the burden of servicing all that debt. But lower rates are the least painful way to relieve that burden and the most likely way to avoid the Default-Deflation-Depression Death Spiral that is the main theme of all the sermons offered by the High Priests of the Temple of Doom.

Excessive Debt. Over the past 10 years through year-end 1991, total debt soared 181%, to \$13.8 trillion. The debt of all domestic, nonfinancial borrowers jumped 160% over this period (Exhibits 1 and 2). By comparison, nominal GDP increased 85% over the past 10 years. The ratio of nonfinancial debt to nominal GDP was remarkably steady around 1.4 during the 1950s, 1960s, and 1970s. But it shot up to 1.95 last year (Exhibits 3 and 4). GDP is currently about \$5.7 trillion. If the ratio had remained flat at 1.4 during the 1980s, then nonfinancial debt would be \$3 trillion less than it is today. The economy clearly has accumulated a huge debt burden.



*Mortgage, consumer, business, and government.

**Includes Treasury and agency issues.



Let's assume that this \$3 trillion is a good estimate of the excessive amount of debt created during the previous decade. That is a lot of debt. It also represents a lot of assets. One person's debt is another's asset. The 1980s was a decade of excessive debt creation. But assets also expanded dramatically. A significant fraction of those debts could turn into bad loans. This means that some of the assets accumulated during the previous decade will be worth much less than the owner ever expected. But the economy has very "deep pockets." The resources are there to absorb the losses caused by bad debts.

Let's assume that, at the worst, 15% of the excess debt of the 1980s eventually goes bad. That amounts to \$450 billion. That is a huge hit to the financial system and the economy. However, it isn't big enough to cause the kind of apocalypse predicted by the High Priests of the Temple of Doom. Remember, nominal GDP is approaching \$6 trillion. Also, keep in mind that some of the losses will be incurred by individuals and institutions that made a fortune in the 1980s. They will give some of it back in the 1990s. That's not so tragic.

And, of course, not all of the bad loans will go bad in one year. More likely, most of the problem loans will be worked out over several years. The pessimists don't appreciate the resourcefulness of the accounting profession.

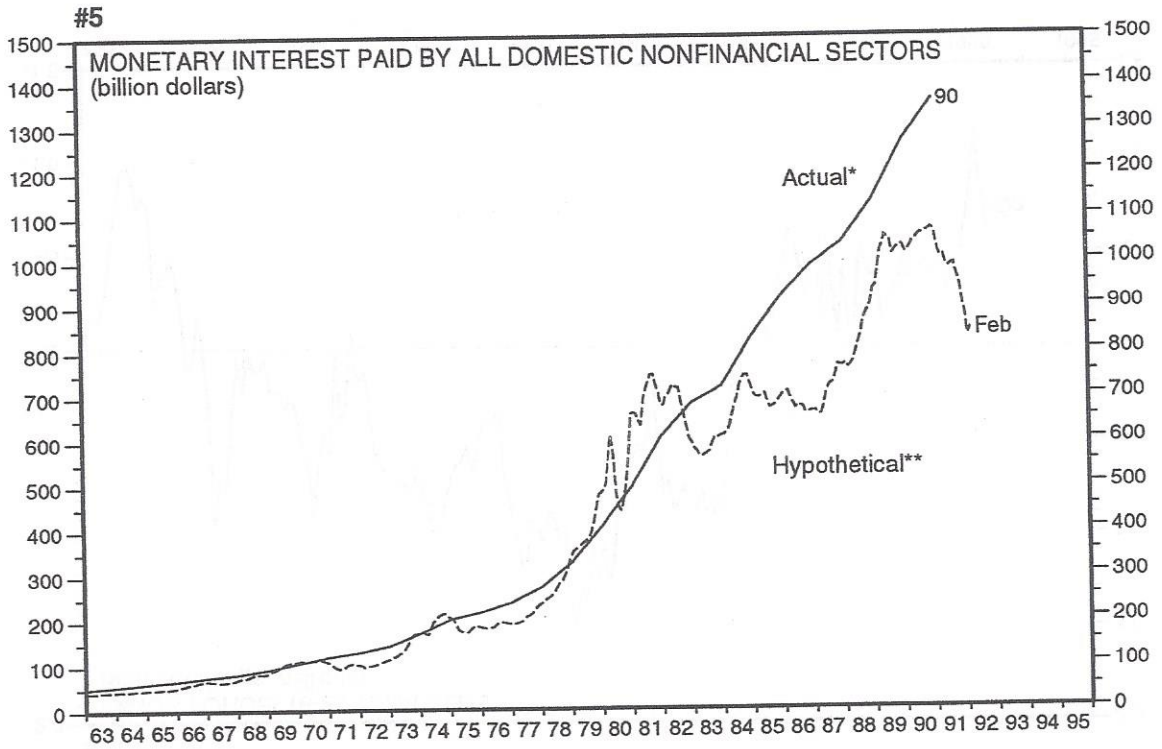
The pessimists say that we are in a "balance sheet recession." Yet, they seem totally fixated on the bad loans on the liability side of the balance sheet. They don't acknowledge that the resources on the asset side of the balance sheet might absorb the losses without crippling the economy.

Double Counting. The most strident Cassandras like to include the credit market debts of financial institutions when they calculate the debt-to-GDP ratio. This broader ratio jumped to 2.3 in the 1980s from about 1.5 during the previous three decades.

But isn't that double counting since the funds raised by financial intermediaries are used to make loans to nonfinancial borrowers? For example, at the end of 1991, home mortgages outstanding totaled \$2,904 billion. This figure is included in total nonfinancial debt. At the same time, mortgage pools held \$1,168 billion of those mortgages and issued the equivalent amount of mortgage-backed securities, which are in the financial debt category. Mortgage pools now hold nearly 40% of all outstanding home mortgages and account for more than one-third of all financial sector debt. Adding the two numbers together would grossly exaggerate the amount of debt the economy must carry.

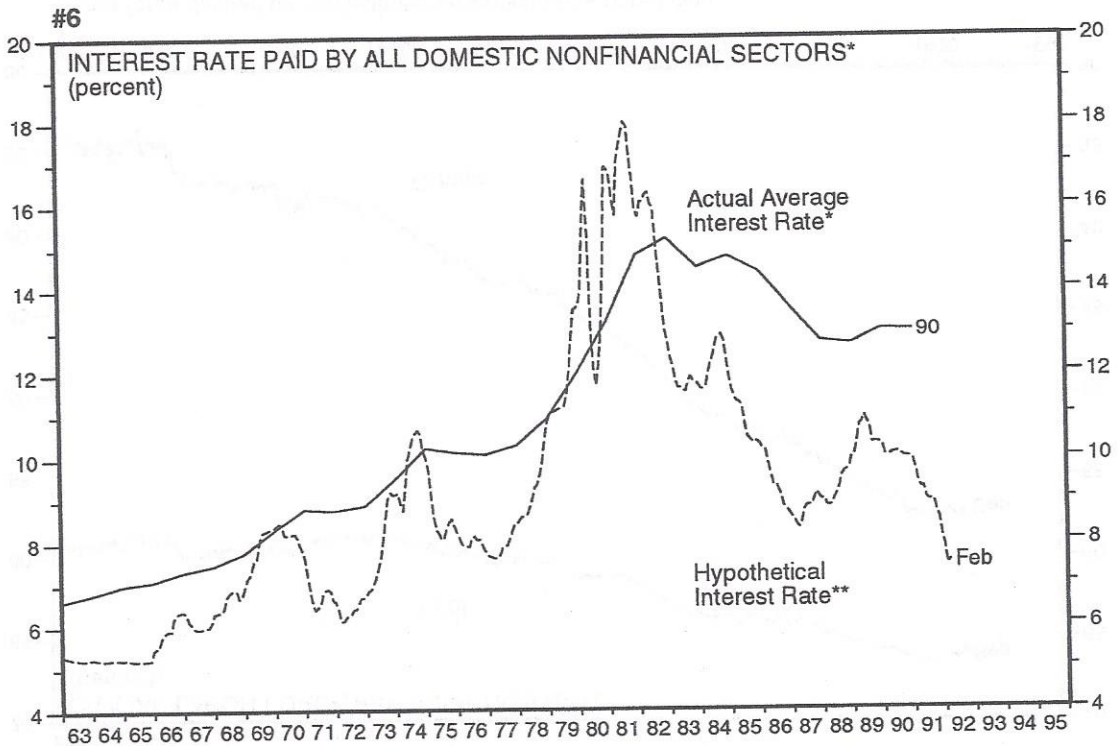
II. LET THE FORCE BE WITH YOU

Decompounding. According to the latest available annual data (which we found buried in a very obscure table of the *Survey Of Current Business*), monetary interest paid by all domestic nonfinancial sectors totaled \$1,357 billion during 1990 (Exhibit 5). We know that these payments were made on nonfinancial debt totaling \$10,731 billion at the end of 1990 (Exhibit 1). These numbers imply that the average interest rate paid during 1990 was about 13% (Exhibit 6).



* Includes net interest in owner-occupied "space rent."

** Nonfinancial debt outstanding times average of prime rate and fixed-rate mortgage yield.



* Actual monetary interest paid (including net interest in owner-occupied "space rent") as percent of total nonfinancial debt.

** The average of the prime rate and the fixed-rate mortgage yield.

During 1990, monetary interest payments as a percent of nominal GDP rose to 25%, the highest on record and well above the 18.3% reading during 1980 (Exhibit 7). These figures tend to support the gloomy view that the burden of servicing debt has risen alarmingly in recent years. *Borrowers must earn enough to transfer one-quarter of GDP to lenders every year!*

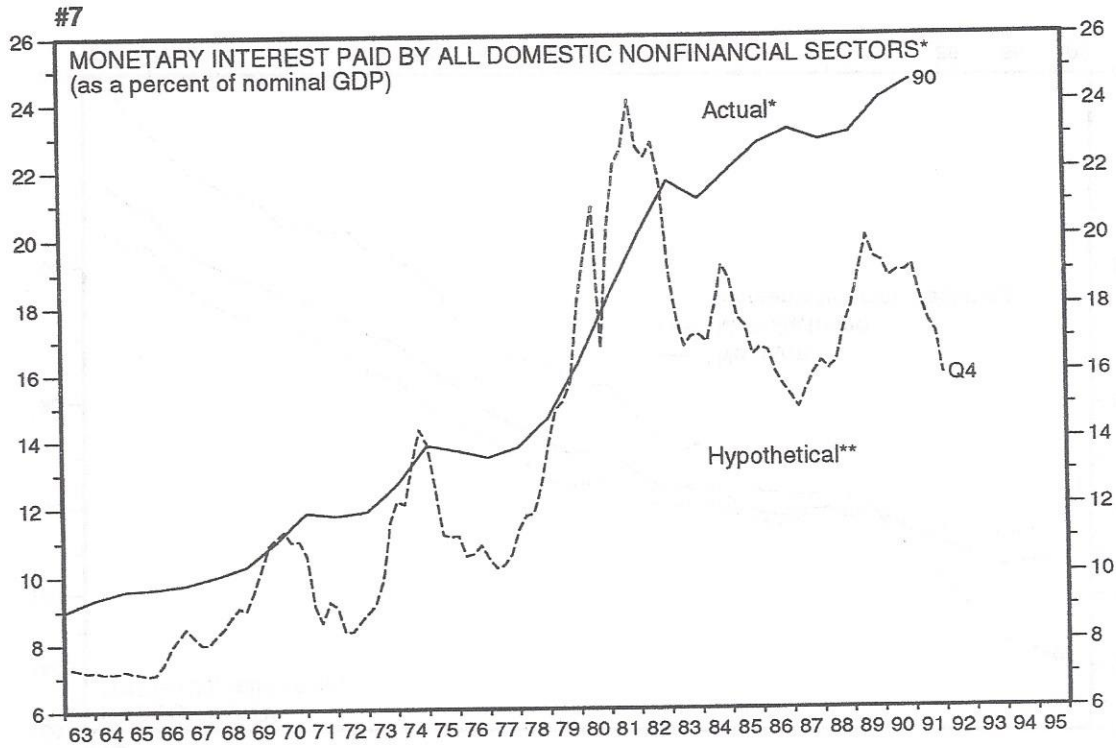
That's staggering. The doomsayers believe that the debt burden is now so great that it is depressing economic growth. Since the borrowers must spend such a large fraction of their incomes on interest payments, they must cut back their spending on goods and services. This development can easily turn into a deflationary debt spiral. As the debt burden depresses economic activity, the burden increases. Borrowers must reduce their spending even more. Lenders become less willing to lend the money the borrowers need to conduct their economic transactions. In the extreme, the debtors are forced to default as their incomes collapse along with overall economic activity.

But as we noted above, there is another, more civilized way to reduce the debt burden. The sharp drop in interest rates over the past two years is providing a big relief to borrowers. If the deflationary forces unleashed by the debt excesses of the 1980s continue to depress economic activity, then interest rates will fall even closer to zero. (Of course, at a zero interest rate, the cost of financing \$11 trillion in debt is zero.) Low interest rates reduce interest payments and stimulate economic growth.

[In Exhibits 5, 6, and 7, we compared actual monetary interest paid by all domestic nonfinancial sectors to a "hypothetical" series we created by multiplying nonfinancial debt by a hypothetical interest rate; i.e., the average of the prime rate and the fixed-rate mortgage yield. The hypothetical series tracked the actual data very closely in the 1960s and 1970s. But during the 1980s, they diverged as actual interest costs rose faster than the hypothetical ones. A significant increase in high-yield borrowing could explain this divergence. We expect that over the next few years, the two series will converge again, with the actual interest costs falling toward the hypothetical ones.]

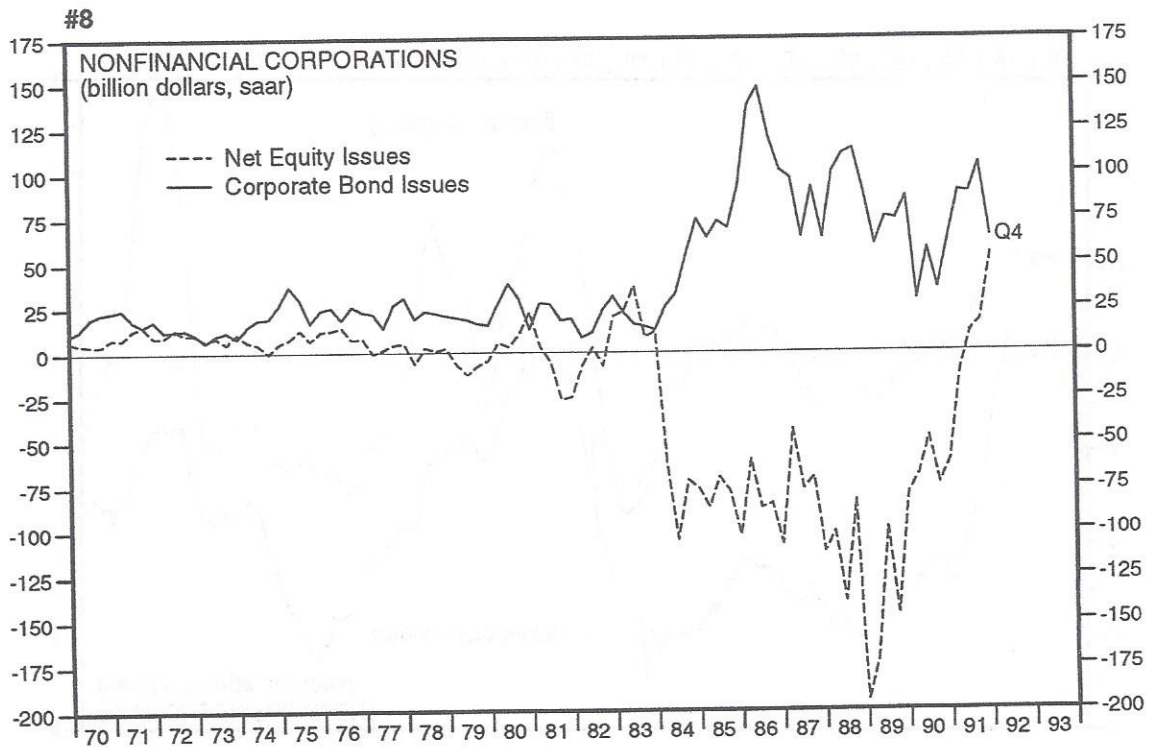
Deleveraging. Falling interest rates have unleashed other "forces of light" which are also offsetting the "forces of darkness." The pessimists predicted that highly leveraged companies, particularly those that had issued junk bonds during the 1980s, would fail as soon as a recession hit the economy. During the 1980s, the supply of equities shrank as many companies bought back their shares and issued lots of debt. According to flow of funds data collected by the Federal Reserve Board, "net new equity issues" by nonfinancial corporations fell by a staggering total of \$641 billion from 1984 through 1990. Over the same period, these corporations raised a grand total of \$549 billion in the corporate bond market (Exhibit 8).

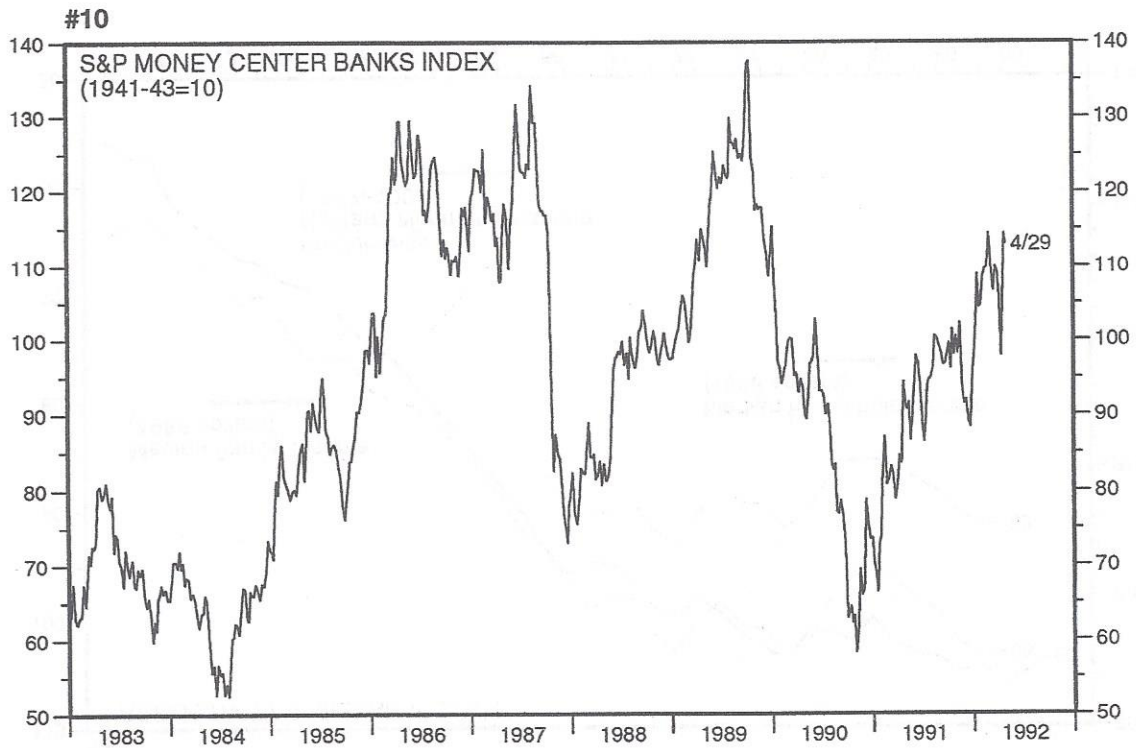
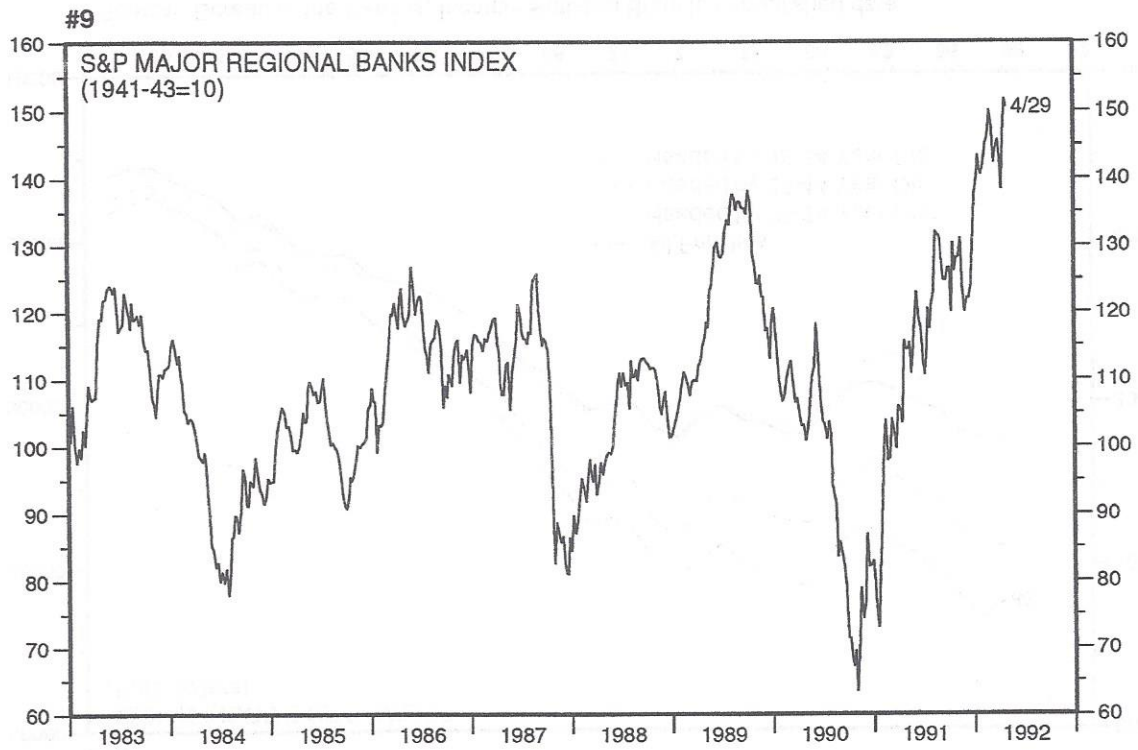
The pessimists warned that the recession could turn into a depression if enough highly leveraged companies collapsed at the same time. Instead, the sharp drop in short-term interest rates led to a dramatic rally in stock prices as well as in junk bond prices. Since early this year, the stock market is performing as a true capital market—where companies can raise money for expansion as well as to pay down their debts. The big rally in bank stocks came just in time for many banks to relieve their capital adequacy problems by issuing more equity (Exhibits 9 and 10).



* Includes net interest in owner-occupied "space rent."

** Nonfinancial debt outstanding times average of prime rate and fixed rate mortgage yield.





Some observers said that the stock market had become nothing more than a casino for leveraged-buyout pros, arbitrageurs, and program traders. Maybe so. But in the 1990s, it has already become a major source of capital for American companies.

III. OTHER NIGHTMARES ON WALL STREET

The Corporate Debt Burden Isn't So Burdensome. Just how burdensome is corporate debt? Many pessimists compare corporate net interest expense to after-tax profits. This ratio is currently around 81%, and it exaggerates the problem because after-tax profits already exclude interest expense (Exhibit 11). If we add back both taxes and interest expense, then the ratio has been remarkably steady around 35% since the start of the 1980s. During the 1970s, the ratio was also relatively stable around 20%.

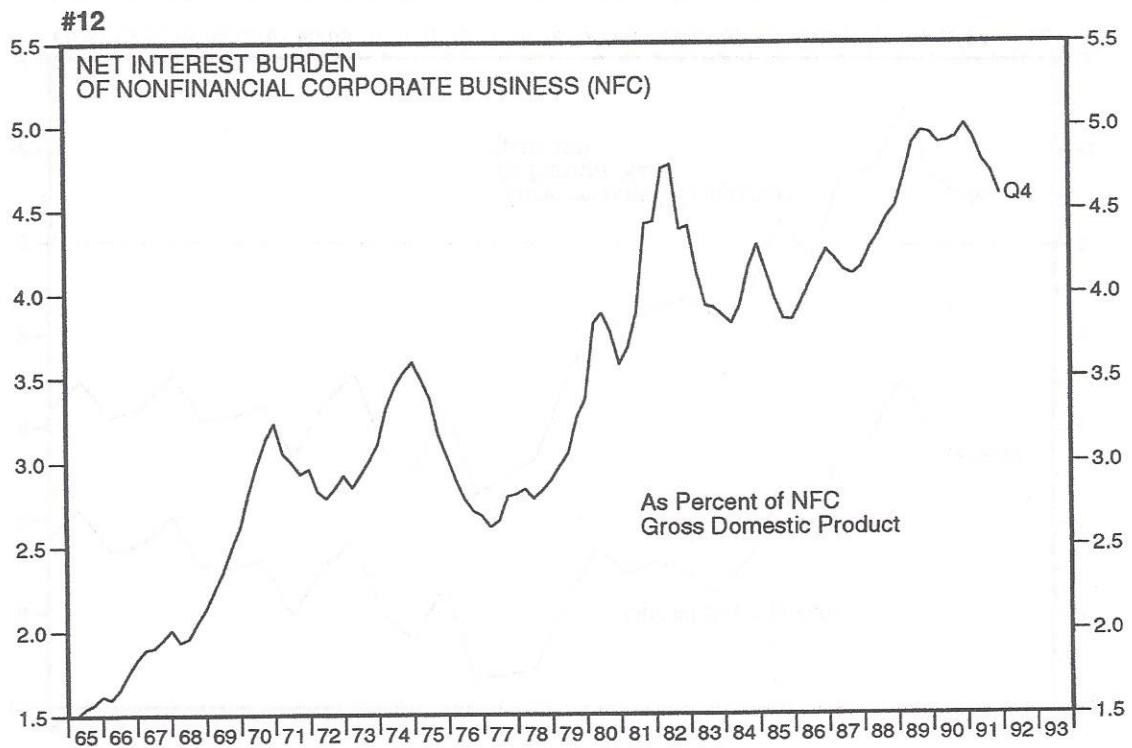
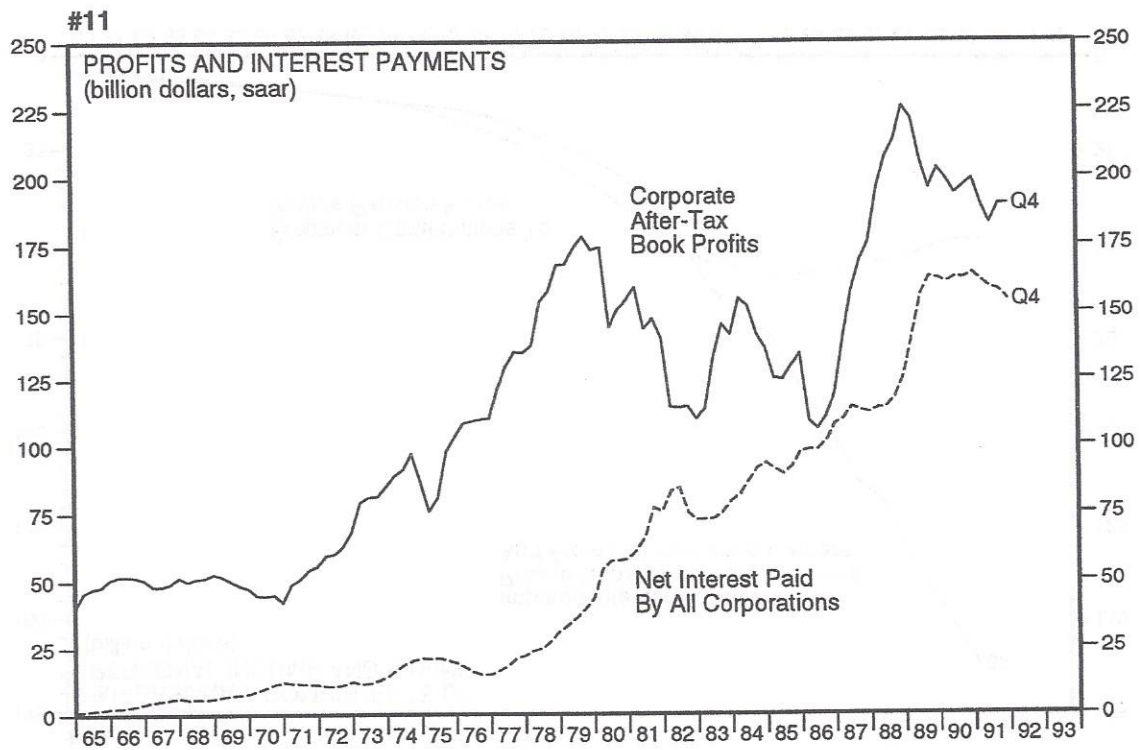
The interest burden ratio is smaller if we use cash flow before interest expense as the denominator rather than earnings before interest and taxes, EBIT. This measure has risen from about 17% during 1985 to 25% last year, but it is probably peaking. Relative to total revenues, as measured by the gross domestic product of nonfinancial corporations, the net interest burden ratio is only 4.6% (Exhibit 12)!

The corporate sector is likely to be the most immediate beneficiary of lower interest rates. Many corporate treasurers are refinancing their bond obligations at lower rates. They can also roll over their commercial paper debt at interest rates that are at least three percentage points below a year ago.

During the fourth quarter, the net interest expense of all U.S. corporations was roughly \$150 billion at a seasonally adjusted annual rate (Exhibit 11). Let's assume that the net interest expense was based on an average borrowing rate of 10%. This implies that total net corporate debt amounts to about \$1.5 trillion. So a one-percentage-point cut in the average borrowing rate should save corporate America \$15 billion. A two-percentage-point cut would save \$30 billion.

Let's go with the bigger number. Of course, not all of the \$30 billion would be added to profits. That's because interest costs are tax deductible corporate expenses. In other words, the \$30 billion saving could boost *before-tax* profits by the full amount. But after taxes, the boost might be closer to \$18 billion, assuming an average tax rate of 40%. If these assumptions are close to the mark, then corporate after-tax profits—which were about \$190 billion at the end of last year—could increase by 10% from current levels just as a result of the drop in interest expense.

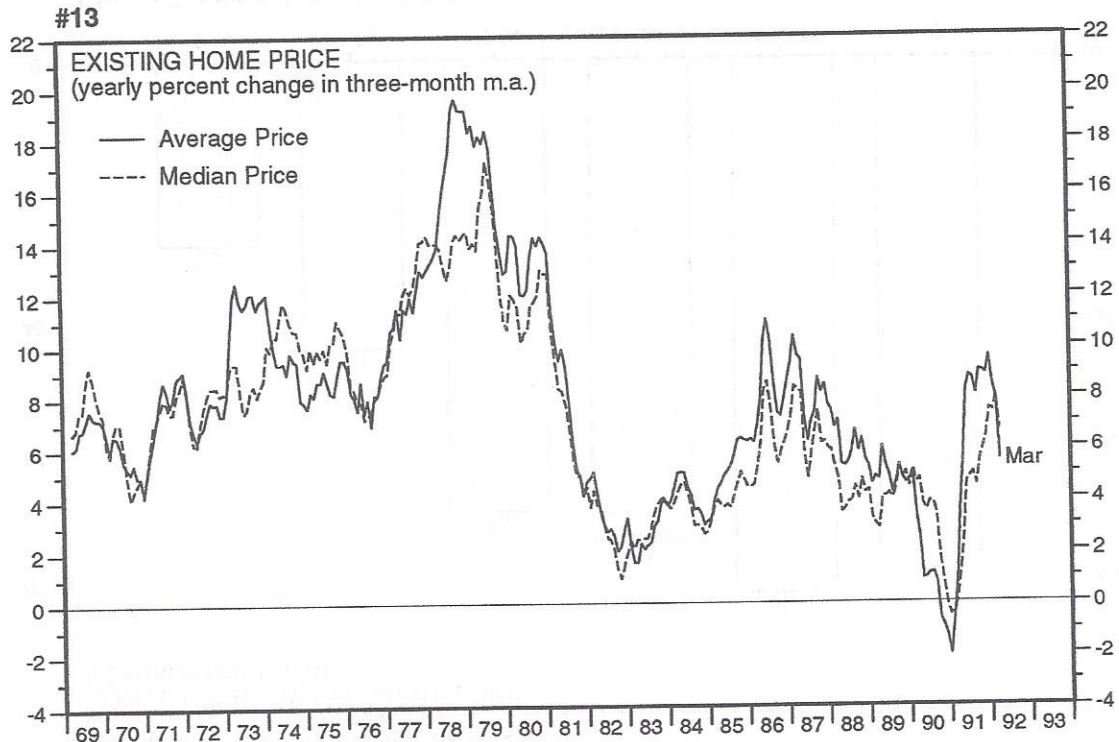
The Great Crash In Home Prices Wasn't So Great. One super-bearish scenario anticipated a crash in home prices, which in turn would send the recession into a depression. Again, this grim outlook seemed plausible during 1990 and 1991 as home prices did fall by 20% to 50% in some of the most speculative and overpriced neighborhoods in the country.



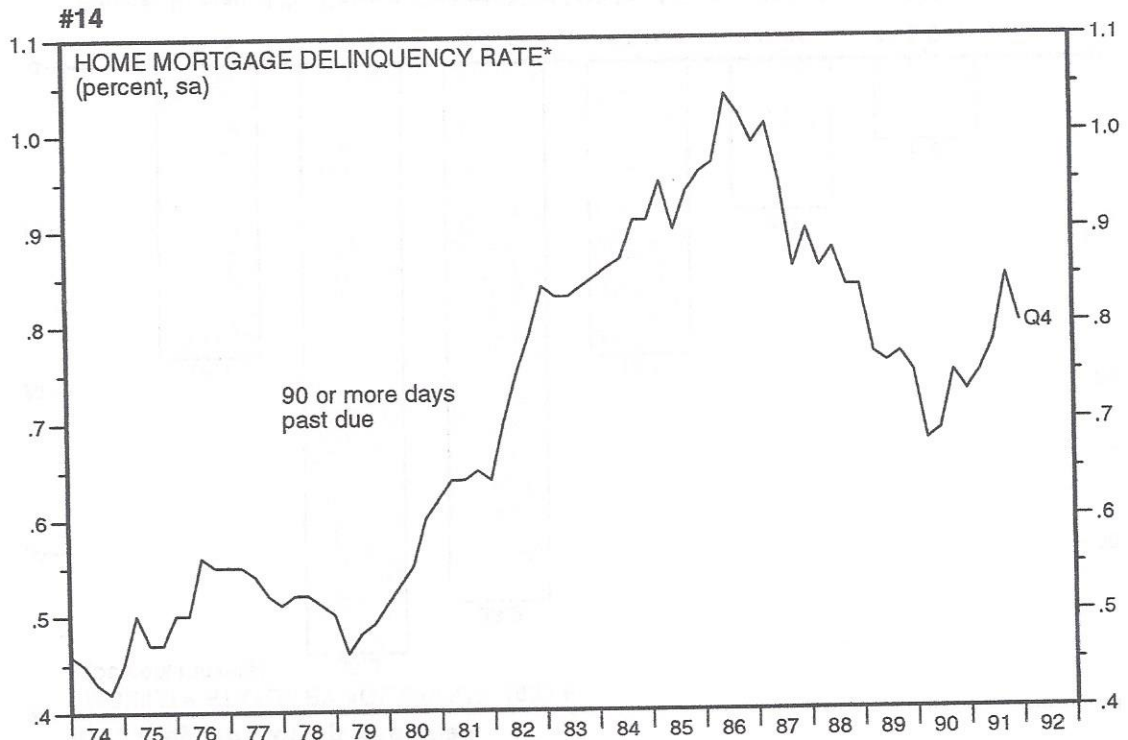
However, data collected by the National Association of Realtors show that the national average existing home price fell by not much more than 2% at the end of 1990, compared with a year earlier (Exhibit 13). Again, the sharp drop in adjustable mortgage rates, which are tied to short-term interest rates, averted the calamity that the High Priests had been predicting.

Today, home prices are rebounding along with housing activity. In March, the average price of an existing home was 5.5% above last year. The median price—which isn't as influenced by the moves in high-priced homes—was up 6.7% in March, but it never fell by more than 1% during the recession (Exhibit 13).

The apparent collapse in real estate prices was limited mostly to high-priced neighborhoods. And the collapse was from lofty levels that represented excessive speculation rather than fundamental value. The percent of home mortgages that are 90 or more days past due peaked during the third quarter of last year at .85%. That's well below the last peak of 1.04% recorded during the second quarter of 1986 (Exhibit 14).



Source: National Association of Realtors.



*Beginning with 1989 Q2, sample was expanded from 260 to 380 respondents.

TOPICAL STUDIES

- #1 Dr. Edward Yardeni, *Exports Should Weaken U.S. Recovery*, March 22, 1983 *
- #2 Dr. Edward Yardeni, *The Ten Pillars Of Faith*, April 6, 1984 *
- #3 Deborah Johnson, *Behind The Corporate Borrowing Binge*, June 13, 1984 *
- #4 Dr. Edward Yardeni, *Why Has The Leading Index Of Inflation Failed So Badly?*, October 24, 1984 *
- #5 Dr. Edward Yardeni, *The Case For Lower Oil Prices*, December 12, 1984 *
- #6 Dr. Edward Yardeni, *The True Story Behind The Mighty Dollar*, January 9, 1985 *
- #7 Dr. Edward Yardeni, *Plenty Of Cash Around To Fuel Additional Stock And Bond Gains*, January 30, 1985 *
- #8 Dr. Edward Yardeni, *No Shortage Of Gluts*, July 10, 1985 *
- #9 Dr. Edward Yardeni, *The Protectionist Road To Depression*, September 9, 1985
- #10 Dr. Edward Yardeni, *The U.S. Becomes The World's Largest Debtor, So What?*, July 14, 1987
- #11 Dr. Edward Yardeni and Deborah Johnson, *The Restructuring Of Corporate America Is Bullish*, December 9, 1987
- #12 Dr. Edward Yardeni, *How The Baby Boomers Are Changing The Economy*, April 6, 1988
- #13 Dr. Edward Yardeni, *The Coming Shortage Of Bonds*, June 20, 1988
- #14 Dr. Edward Yardeni, *Could Real Estate Prices Fall? And What If They Do?* August 24, 1988
- #15 Dr. Edward Yardeni and David Moss, *The New Wave Manifesto*, October 5, 1988
- #16 Dr. Edward Yardeni with Amalia Quintana, *The Baby Boom Chart Book*, January 25, 1989
- #17 Dr. Edward Yardeni, *The Triumph Of Capitalism*, August 1, 1989
- #18 Dr. Edward Yardeni and Deborah Johnson, *Dow 5000*, May 9, 1990
- #19 Dr. Edward Yardeni and David Moss, *The Triumph Of Adam Smith*, July 17, 1990
- #20 Dr. Edward Yardeni, *The Collapse Of Communism Is Bullish*, September 4, 1991
- #21 Dr. Edward Yardeni with Amalia Quintana, *The Baby Boom Chart Book 1991*, October 9, 1991

* Out of print.