

A Night with the Bears

By: [Jeff Sanford](#)

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Some 1,500 curious Canadians packed the Elgin Theatre Tuesday for “A Night with the Bears,” a lavish and civilized affair sponsored by Spratt Asset Management that was a step-up from the typical event of this type. There were drinks at the press conference, a stage decked out as if it were the Oscars, and a well-known television personality as host. Best of all, a line-up of some of the most well-known, “now” names in business and finance.

Meredith Whitney, the securities analyst who was the first to call the severity of the banking crisis gave her take on what’s ahead for banks. Nouriel Roubini, the Stern School economist who has achieved a level of fame for both his dour economic predictions and his avant garde wall art, gave a general rundown on how down we’re going to get. And Ian Gordon, the Vancouver-based so-called Long Wave theorist, was there to put events into alarming order.

In a conversation backstage the genial and mannered Gordon mused about the speed of human cultural evolution and how particular human patterns can lead to predictable economic patterns.

A whole generation of Canadians suffered through the Depression and been exposed to the destructive role credit creation can play in an economy. But over the intervening years, the cultural attitudes shifted. Those with an immediate memory of that era died off. Lessons from that age were viewed as quaint. The culture moved on. Consumption moved back to the foreground. The dangers of unrestrained credit were downplayed. We rolled back the legislation that grew out of that era to avoid these events. And now we’re now back to where we were. We’ve increased the total amount of debt outstanding (measured as a percentage of GDP) to the point it was at just before the Great Depression.

The problem now, say the bears, is that this debt bubble (accumulating since the early ’80s) is imploding, and this is going to take down the global economy. Consumer spending, the biggest single driver of our economy, was pumped up as the personal savings rate dropped and central banks slashed interest rates lower and lower, which allowed all kinds of home refinancing. But that process is running in reverse now, and companies and individuals will have to readjust. People will lose their jobs. Consumer spending will fall further. Businesses will make less. The

debt payments won't be made. Stocks will suffer. People will feel poorer. More layoffs. Less spending. More declines in asset prices. According to Roubini, who was actually one of the optimistic voices this night, this debt deflation (not inflation) will be the dominant trend through to 2012. "The American consumer is tapped out," he said.

Meredith Whitney, the bank analyst, agreed. She began her presentation by reminiscing about her early days as a bank analyst who bought into the good story around securitization. By slicing and dicing bundles of loans into Triple AAA tranches and toxic waste tranches, we were able to offer more credit to more people, as well as to people who didn't qualify for credit before. And that was a good thing in the early days. It led to a cultural belief at the time in the "democratization of credit." "I believed in that idea, the idea that an immigrant with no banking background could come to North America and buy a house," says Whitney.

But as we let loose all kinds of new forms of debt (and therefore demand and liquidity) we created a whole new set of instabilities. The process of securitization, which allowed us to put off worries about "risk" and borrow lots more than we would have otherwise, is now the Achilles heel of the economy. The end of securitization will see less credit everywhere and at every level in the economy. We'll see lower credit card balances and a net decrease in total lending in the years ahead. Bank lending will go back to something more local and "monogamous" (more one-on-one, rather than bundled) "My deposits will be used for your mortgage," she says. But all of this will affect consumer spending in a negative way and will deepen the deflationary spiral.

The banks in the US have been dealing with this deflation by raising money in various ways. The first attempt to shore up what is effectively a bankrupt U.S. banking sector was through the big "vanity" buys by sovereign wealth funds, many of whom got burned by moving too quickly. Next it was the mergers. And then a bunch of preferred share issues. And then it was the governments stepping in to provide money to shore up the sector.

But that's not going to be enough said Whitney. Next will be big asset sales on the part of U.S. banks that will finally be forced to shed key assets they have so far been loath to part with. They won't have a choice. Credit card losses will mount. They'll have to deal with all the bad commercial mortgage loans outstanding. This will be good for the Canadian banks that could pick up some deals. But the

economy as a whole is likely to get worse yet as this debt and asset price deflation moves ahead.

To add one more layer of worry. In a Q&A with *Canadian Business* before the event, Eric Sprott was asked about the connection to energy issues in all of this. His shop is a believer in peak oil—the idea that we’re in for some large spikes in the price of energy in the years ahead as the rate of ongoing natural depletion of existing fields begins to run ahead of the rate of new oil production. Sprott agreed there could be a cap on any growth in the years ahead as oil prices rise with any attempted recovery. And so whatever recovery we get will be checked by rising energy prices.

There just doesn’t seem to be many reasons for optimism. As Ian Gordon put it, we’re moving into a stage of the economy akin to the winter season. The bounty of the now fading post-war U.S. consumption-led economy (now in collapse) will fall away, and the ground will go fallow for a period. And while this will eventually make way for the new green shoots of spring, the new less consumer-dependent economy that is going to grow out of what is now collapsing is far off yet.

This grey, cold no-growth season will be with us until 2020 says Gordon. It’ll take that long for the old order to break down, and for the new shoots lying underneath to come up. “That’s what I see as a financial historian,” says Gordon. Sprott agreed, suggesting it could be more than 10 years before the debt bubble that began forming in the early ’80s is wrung out of the system. So plan accordingly. There was, of course, a pitch in all of this. Sprott’s new gold bullion fund was mentioned. As was the wisdom of shorting the market.

But if there was one thing to take away from the event it is the notion that the fraction of total debt to GDP climbed to 200% in late ’20s, just before the Great Depression. And we’re back at that point again. “It’s amazing how one era is like another” say Gordon. Is it ever. It may be worrying. But it is amazing.