



Peering through the Fog: Our Thoughts on the Current Credit Cycle

Now more than ever it is especially difficult to comprehend the bigger market picture. Increased announcements and responses coming from governments, central banks and the media cause many investors to jump from announcement to announcement without pausing to consider where current events fit in the global market cycle. This is our view of how we see the big picture and where the most recent events fit into this.

We think about the economic and market conditions in terms of cycles. These cycles take the form of long term credit cycles which last decades, short term business cycles lasting on average 5-7 years, and even shorter seasonal cycles which last 12-18 months. We would like to discuss the long term credit cycle and put into context where we believe we are in this cycle.

A short history of the current credit cycle

Credit cycles typically occur over 50-70 years and often recognizing the start and end of the cycle comes only in hindsight. Our current credit cycle began in 1939 during the early years of World War II when the United States began to finance our Allies. This new cycle marked the end of a decade of depression, recession, massive unemployment and deflation. An enormous amount of government debt was created in order to prepare our economy for war. This was a renewal of the “Guns or Butter” choice made by U.S. upon entering the First World War but on a much larger scale. Ironically, the beginning of this credit cycle also coincided with the United States exceeding its congressionally mandated debt ceiling of \$45 billion for the first time since its establishment in 1917. By the end of World War II the Federal debt ceiling stood at \$300 billion, an increase of 667% and this new limit remained in effect for the next 17 years.

In 1962 Federal debt resumed its upward move. Several factors contributed to the breach of the \$300 billion ceiling: the Cold War and spending on the Space Race, the Missile “Gap” and a new hot war in Vietnam along with a renewed focus on entitlement spending culminating in LBJ’s “Great Society” and “War on Poverty” programs. Now the focus was not on guns or butter but guns AND butter and the Federal deficit began to climb. Since 1962 the U.S. raised the debt ceiling 75 times (including the latest hike this past August) and today total gross Federal debt stands at \$14.86 Trillion -- an increase of 5000%.

Credit cycles don’t just refer to government debt creation, personal debt is also critical to long term credit cycles. Since January 1943 (when the Federal Reserve began tracking Consumer Credit outstanding), U.S. consumer credit increased from \$6.6 billion to a peak of \$2.58 trillion in July 2008. This was a 39000% increase in the amount of debt held by U.S. citizens. What is more remarkable, revolving debt – mainly credit card debt (which the Federal Reserve only began tracking in January 1968) increased from \$1.3 billion to a peak of \$972 billion in September of 2008 – a nearly 75000% increase in the amount of credit card debt in 40 years. This isn’t just a U.S. phenomenon; global credit has also grown exponentially at all levels.

Another recent engine of credit creation (since around 1990) is the Over-The-Counter (OTC) derivatives market. The OTC market has allowed banks and brokers to create credit in ways never before anticipated

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and in incredible amounts. In 1995 when the Bank for International Settlements (BIS) began keeping track of the global OTC derivatives market the size of outstanding derivatives contracts was already \$50 trillion. As of the end of 2009 that amount stood at \$604 trillion, a 1200% increase. As of end of 2010 the size of the market stood at \$601 trillion. This new method of creating credit made it incredibly difficult for regulators (like the Fed and FDIC) to keep track of the levels of debt and the collapse of this “shadow banking system” was at the epicenter of the 2008 market crash and ultimately marked the beginning of the end of this credit cycle.

The aftermath of excess debt

Since 2007 we have been fighting the effects of the conclusion of the credit cycle. Central banks around the world are trying to use standard monetary policy measures (via cutting interest rates) as well as non-standard measures (“quantitative easing”) in an effort to come to terms with this crisis. We saw this in the United States with the Federal Reserve’s Quantitative Easing (QE1 and QE2) programs as well as their Zero Interest Rate Programs (ZIRP). Governments have also instituted fiscal stimulus measures to blunt the effects of the economic contractions that inevitably occur during the end of a credit cycle. Here in the U.S., the American Recovery and Reinvestment Act of 2009 – or “The Stimulus” as it is better known – attempted to restart economic growth with \$787 billion in government spending projects.

Now the issue of excess debt and how to address it are affecting the European Union. This time the sovereign debts of Greece and to a lesser extent Italy and Spain now threaten to send Europe into the same tailspin as the U.S. Germany and France, the 2 largest members of the EU, are attempting to craft a deal to bail out Greece in order to prevent contagion from spreading to other weak EU members. A durable solution remains to be seen and if history is any indication, sovereign issues will remain problematic in the region for the foreseeable future.

History repeats itself

Looking back in time, previous credit cycles have similar characteristics: they begin with very low levels of debt, most likely due to the collapse and aftermath of the previous credit cycle, then a period of gradual “manageable” credit growth, culminating in a parabolic growth rate of conventional credit instruments along with new and novel means of credit creation and finally a sudden, sharp and painful collapse.

Debt created during the cycle ultimately needs to be paid off, forgiven or defaulted on. Paying off debt is a simple enough proposition but there is a problem – at the end of a long-term credit cycle there just isn’t enough money to pay back all of the creditors. So the creditors need to take a loss on their investment (a default), debt needs to be renegotiated to longer maturities and at lower interest rates or more money needs to be printed and creditors will receive debased currency to fulfill their contract. History shows that the solution usually involves all of these options.

Perhaps the best book on long term credit cycles was written by Carmen Reinhart and Kenneth Rogoff entitled, “This Time is Different: Eight Centuries of Financial Folly.” They assembled 800 years of economic data to construct a history of credit cycles along with their economic outcomes. The data is remarkable in its consistency; the average amount of time necessary to resolve a credit cycle collapse is 10 years and very little (if anything) can be done to alter this timetable, though governments throughout the ages have all tried. If our current credit cycle ended in mid 2007 this means that we still have another ~6 years to go before conditions improve and another credit cycle can begin.

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Investing after the end of a cycle peak

Does this mean that investors should shun the equity and debt markets while the excesses of the previous cycle are resolved? No, but it does mean that a different set of investing guidelines are necessary to avoid pitfalls. During the resolution phase of a debt cycle markets will generally trade with higher levels of volatility. This means that all asset classes will tend to exhibit bigger price swings than had normally been the case during the credit cycle and investors need to prepare themselves for choppy markets. Another focus should be on sources of return. Credit cycles tend to focus investor's attention on capital gains via price appreciation and minimize focus on dividend and interest as components to return. Now however every return component is critical to risk adjusted returns: dividends, interest and capital gains.

The sectors in which to invest also need to be defined. Financials, especially large cap banks and investment banks, remain burdened by toxic legacy assets. In addition, the Dodd-Frank legislation have forced banks and brokers to end many profitable (though risky) business practices – mainly proprietary trading – and this calls into question the future profitability of these firms. For these reasons it is best to look elsewhere for investing ideas.

Based on these guidelines our recommendation for investors would be to seek refuge in high quality dividend paying equities outside of the financial sector with a lower risk profile than the broader market. There is a saying on Wall Street that "Cash is King". We would like to modify this to "Cash Flow is King". Finding companies with the ability to consistently generate substantial levels of free cash flow – the amount of cash a company is able to distribute to shareholders after paying operating expenses – is essential for wealth preservation and income generation during the aftermath of this credit bubble. Identifying companies with substantial free cash flow as well as attractive growth prospects in this suboptimal economic environment is the cornerstone of our investing approach. The unwinding of the credit cycle will continue but we believe our process will best preserve as well as prudently grow capital.

As always we value the trust you have placed in us as we remain stewards of your wealth.

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