

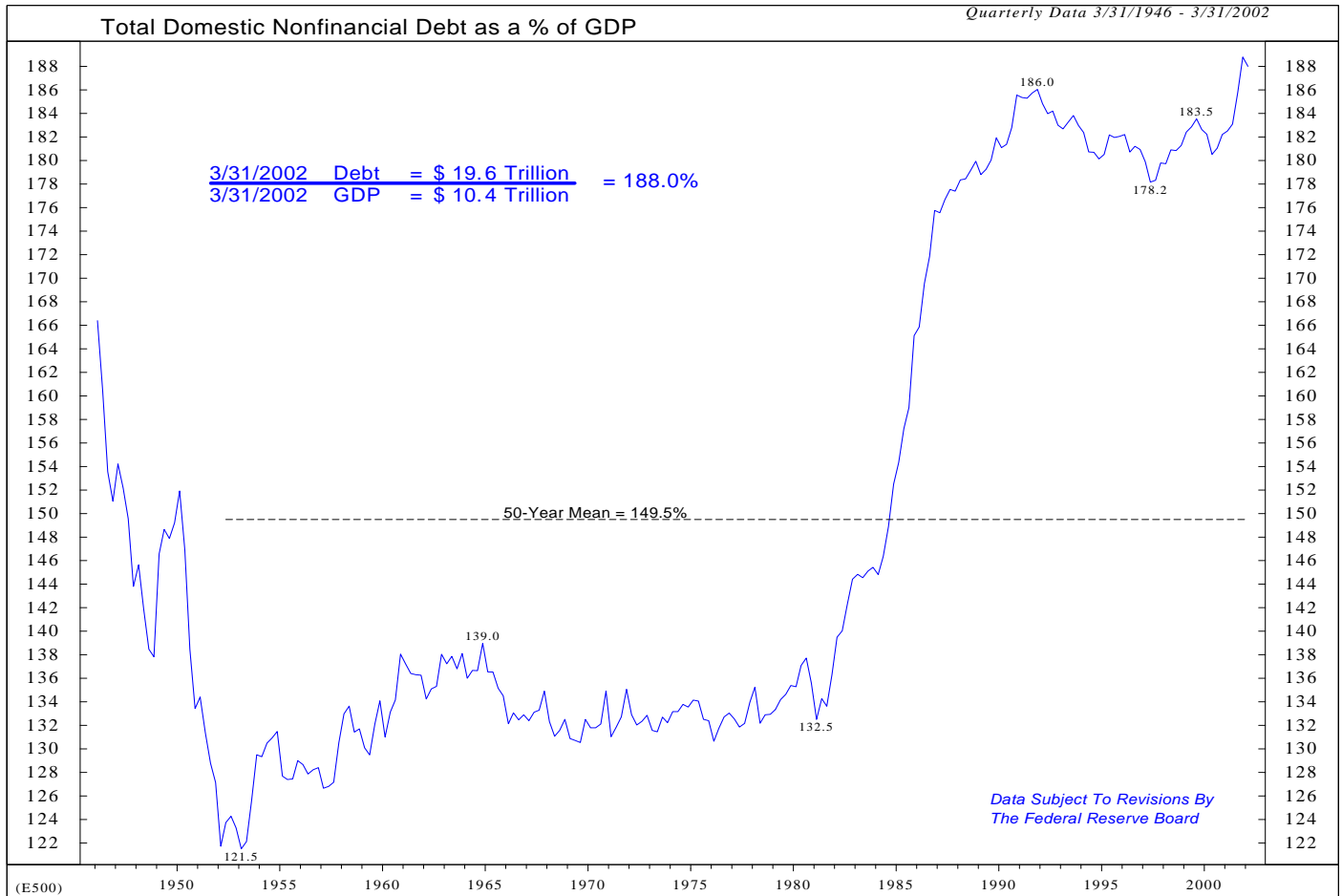
**DOUBLE COUNTING DEBT?**

**Question** -- I've seen you say that total credit market debt is 2.9 times GDP while Ed Hyman at *ISI* says it is 1.9 times. Who is correct?

**Answer** -- Knowing Ed Hyman and his expertise as an economist, he is probably right, but I am not inclined to change my favorite debt chart. I don't know exactly what Ed uses in his chart, but if it is really 1.9 times GDP, he is probably referring to Total **Non-financial** Debt like that featured on our chart E500 below. I have discussed this several times with Joe Kalish as well, and the point of **not** including financial debt is that it is like double counting the same loan. For example, if a company wants a big loan to buy a big piece of equipment, the company will go to a bank or insurance company and that financial institution will then go out and borrow the money and then turn around and make the loan. My ratio counts **both** loans, which is probably not right if the loan remains in good standing. But let us now say that it is US Airways who receives the loan and then they declare bankruptcy. Of course, the debt would be tragic for US Airways and its stockholders, but then wait about half a day and stories would start coming across the Dow Jones Newswire about all those who lent US Airways the money. So now you have **two** companies in trouble, and that is why I include financial debt when counting **total** credit market debt.

Regardless of whichever debt chart you feel is correct, they both still show a debt bubble. Debt is one of those weird balance sheet indicators that is really quite bullish in good times, and even normal times, as it helps the economy expand, and the leverage can **really** boost corporate earnings. I have been writing about this for years pointing out that borrowing money and buying back shares of company stock can magically "create" higher earnings per share. Debt is also the key in mergers and restructuring which can cut taxes, write off expenses and boost Wall Street's favorite of "operating" earnings. Way back on April 16, 1999 (before everybody knew there were a "few bad apples") I quoted Warren Buffett saying that CEOs "have come to believe it's okay to manipulate earnings by willful abuse of restructuring and merger accounting. All in the name of pleasing Wall Street." The latest great abuse of debt, in my opinion, is using home equity loans as ones personal ATM to borrow money. Home equity loans have soared an incredible 39.1% over the last year really helping keep the economy going but sucking billions in equity out of homes. So this may be the time when balance sheet debt shifts from a normally bullish factor to a bearish exception. And that is why we had a record 400,700 bankruptcies last quarter. It is not just the person, company, company employees or stockholders who are hurt, but also the entity that loaned the money.

Ten years from now I believe the U.S. will think very differently about debt, equating excessive debt to an addictive drug that can ruin lives and destroy companies. (continued on page 2)



FRIDAY, AUGUST 23, 2002

While on the subject of debt, I have seen a number of reports from experts recently about how the consumer has rebuilt their savings above 4%, and thus is in position to give the economy a strong boost. I have already shown how the consumer uses debt to continue to spend more than their income (actually negative savings) and the only reason the saving rate is up is due to the big tax cuts. Another way of looking at the same thing is featured on chart B680 (below) where the government is running ballooning budget deficits to shift their savings to the consumer. So, yes, the consumer is in better shape but any actual buildup in **overall** savings is small. By the way, the Senate Budget Committee has now completely retracted its predicted \$5.6 trillion 10-year surplus forecast made in January 2001. A trillion here, a trillion there, who says you can't forecast?

Due to the debt bubble, there is an **outside** chance that bearish secular pressures are so strong that they could overwhelm the cyclical positives. Thus, Tim Hayes, in Tuesday's *Chart of the Day*, while bullish, put in place a failsafe stop-loss for our current overweight position in stocks. --Ned

