NASHVILLE NOTES

Debt jubilees may not be fake news

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For whatever reason I have not gotten into watching movies like most people on planes; rather, I listen to podcasts when not reading or working. This week on a flight to Phoenix I stumbled onto a podcast David Rosenberg did with fixed income asset manager DoubleLine.

Rosenberg’s daily musings became a well-read staple around Wall Street when he was chief economist for North America at Merrill Lynch. He was bearish during 2002 through 2007 when the housing bubble helped fuel the economy and the market. Had he been the chief market strategist for Merrill Lynch he probably would have been fired because negativity does not generate retail commissions, but as a bearish economist he got to keep his job. He was nonetheless correct if somewhat early with his call.

Today, Rosenberg runs his own firm. After having turned bullish in 2012 he has turned bearish again. Among other things, he expects rates to trend lower given his view of a high probability of recession in the next 12-24 months.

Rosenberg notes that a key issue for the developed world is very high debt levels, much of which has been accumulated to finance consumption rather than investment. He sees the fourth asset bust occurring since 1990 due to an over-levered corporate sector. The other busts involved commercial real estate (1990), tech stocks (2000) and residential housing (2008).

There is nothing new about asset booms and busts. They have occurred, I think, since antiquity. Levered investors profit when asset values are rising, and can be wiped out when markets plunge and margin calls cannot be met. Lenders can be wiped out, too, if the collateral is insufficient. And asset busts are inherently deflationary, an outcome that seems to terrify central bankers.

Rosenberg is probably right — at least directionally — in my view of the implications of the rapid accumulation of debt; however, when and how bad a corporate debt-led bust could be are unknowable. Liquidity flows into corporate debt and risk assets more generally may push the next bust much further into the future than contemplated.

Rosenberg goes on to opine that the Fed inevitably will cut rates to the "lower bound" again and be especially aggressive with bond buying. I do not think anyone reading this is surprised by that view because it is part of the current playbook employed by the Fed. After each of the three asset busts since 1990 the Fed has cut short-term policy rates to a lower level than the prior bust and then hiked rates to a lower high in each subsequent recovery. In the vernacular of a market technician looking at a chart, this is known as "lower lows, and lower highs."

Maybe the more important question for investors is whether the Fed will adopt negative short-term policy rates even though the consensus seems to be they have been at best neutral for Europe and a disaster for its banking system. Rosenberg notes that Bernanke and some elements within the district banks that are part of the Federal Reserve are raising the potential for negative rates in the next downturn. My view, which is not worth much, is that negative rates may be too radical for the U.S. politically, and a nonstarter for the dollar as the world's reserve currency.

Negative rates aside, perhaps a more radical policy response would be a debt jubilee that Rosenberg sees governments potentially trying to implement. There is historical precedence from ancient civilizations when a new ruler ascended the throne and forgave debt. Exactly what that meant in Babylon or Israel of the Old Testament is not clear to me. Was it across-the-board forgiveness, or maybe an amount equal to a few days' labor and a vase of wine?

In this year's national election, what to do about student debt that is on pace to exceed $2 trillion within a few years is a contentious topic. Sens. Elizabeth Warren and Bernie Sanders are proposing policies that I would equate with a jubilee via forgiveness by the federal government.

Rosenberg suggests governments and their central banks could attempt a stealth jubilee, perhaps in the aftermath of a crisis or another recession in which government debt really explodes, as if that is not the case now. A stealth jubilee might involve some form of a bond swap of existing debt held by a central bank for new issues that stretches one's imagination of what it means to be a lender. My nomination would be a 100-year (or longer!) zero-coupon bond that from a cash flow perspective has a lot of positive attributes from the perspective of Treasury.

The Fed, Treasury and politicians could come up with a catchy name, but I think the appropriate term would be a troubled debt restructuring (TDR), even though the establishment probably would view the TDR moniker as an incendiary term.

The action Rosenberg speculates governments may attempt is absurd, but so too is the amount of debt that is accumulating in the developed world. To date, central banks have resorted to policies to suppress rates via setting short-term policy rates near or below zero while creating reserves to buy sovereign debt. It is a form of price control, but not a jubilee.

I do not know how the issues raised by Rosenberg will play out. One takeaway, however, as it relates to banks is that the directional pressure on rates is down rather than up and therefore net interest margin and bank earnings may face more long-term headwind than investors want to contemplate.

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