

Debt Bubble Is Lost and Gone Forever

June 22, 2009

Ruby lips above the water,
Blowing bubbles, soft and fine,
But, alas, I was no swimmer,
So I lost my Clementine.

Oh my darling, oh my darling
Oh my darling, Clementine.
You are lost and gone forever
Dreadful sorry, Clementine.

– *Western folk ballad*

The stock market's rally off its March lows has sparked much talk of "recovery." The consensus seems to be that positive economic growth will resume sometime this year, and corporate earnings and the stock market inevitably will follow. Accordingly, current stock-market valuations reflect expectations for a return to peak-2007 earnings within approximately three to five years.

That simply is not going to happen. Certainly not in the near future, and perhaps not for decades. Despite frenzied government attempts to pump up the economy, the debt bubble has burst. And just as the 17th-century tulip bubble and the more-recent dot-com bubble did not re-inflate, neither will the debt bubble. The upshot is that the economy is not going to come roaring back as in a normal post-recession expansion.

When the dot-com bubble burst in 2000, the Greenspan Fed acted like the drowning Clementine and desperately began blowing more bubbles. Unfortunately, Fed policy was successful in engineering bubbles in real estate and debt-based consumption. Essentially, people borrowed money to build houses and then borrowed more money against increasing home equity to fill those houses with stuff from overseas. Foreigners amassed huge dollar currency reserves, which cycled back into U.S. debt securities. This self-reinforcing process sharply hastened a trend toward increasing household leverage that had begun in the 1960s.

Measured as a percentage of disposable income, U.S. household debt increased modestly from 55% in 1960 to 65% by the mid-1980s. By 2007, however, it had more than doubled to 133%. Debt had become the virtual lifeblood of the economy and, by extension, the stock market. As bubbles in housing and the stock market inflated, jubilation reigned and indebtedness accelerated unsustainably at every level: household, business and government.

We now are witnessing the unraveling of that economic paradigm in a vicious cycle of debt retirement helped along by defaults, bankruptcies and foreclosures. Such an unwinding of debt is euphemistically referred to as "deleveraging." One historical illustration of the deleveraging process at work is euphemistically referred to as "The Great Depression." From 1929 to 1933 nominal U.S. household debt declined by one-third. The rest of that story is fairly well known. A

more-recent example is Japan, where the stock-market bubble burst in 1989, and the real-estate bubble burst in 1991. Despite a myriad of government-stimulus programs, residential land prices remain more than 40% below their peak in real terms. Commercial real estate and the Japanese stock market, meanwhile, are still down over 70%.

Clementine Is Dead

Wealth destruction resulting from bursting asset bubbles in housing and the stock market will have lasting effects on the U.S. economy. For one thing, the collateral underlying U.S. household debt has become considerably impaired. That in and of itself will prevent the debt bubble from re-inflating anytime soon, especially amid tightened lending standards that include higher collateral requirements. Additionally, declining asset values have eliminated much of the speculation-driven borrowing that previously had supported prices. Moreover, households will need to rebuild their balance sheets through paying down debt and good old-fashioned saving. Simply put: saving is in, consumption is out, and debt-based consumption is out of the question.

Similarly, deleveraging at the corporate level will dampen any recovery in earnings. Unsustainably high profit margins at the 2007 peak were largely the result of excessive leverage throughout the system. That leverage-based earnings model is now dead.

In short, this debt bubble is lost and gone forever. As a result, the debt-fueled, consumption-based economic paradigm is no longer viable. A new one eventually will replace it, but that will take time. Meanwhile, the roadblocks to strong and lasting recovery will prove daunting.

The Picture

The first chart below shows the McClellan Summation Index along with the McClellan Oscillator and the corresponding stock-market index, the NYSE Composite. In terms of a single market-breadth indicator for judging overall market health, the McClellan Summation Index is the gold standard. It is derived from the McClellan Oscillator by tracking its daily accumulation or "summation."

Note that the oscillator broke below its zero line on May 13th. This caused the summation index to turn down from its May 12th peak. Notice also that the summation index failed to confirm the June highs in the NYSE Composite. It then headed lower and completed a negative divergence with the price chart last week. The implications are that market internals are not particularly robust here, and this rally may be starting to run out of steam. Also, with respect to its five-day exponential moving average the summation index is in its most bearish position since early March.



Next up is the S&P 500 Index in the daily time frame. The index currently is trapped between its 200-day and 20-day simple moving averages. The 50-day moving average also has come into play as it meets the 200-day moving average to provide support around the 900 level. The 20-day moving average near 925 now is providing valid resistance to the index for the first time in several months. The next important area of resistance is at 944-950. Key support is at 875-880, and then at 850.

For this index the May 8th momentum high at 930.17 appears to have been an exhaustion of some sort. Subsequent negative divergences by the McClellan Summation Index and other indicators now allows us to qualify that exhaustion as one of some significance.

\$SPX (S&P 500 Large Cap Index) INDX

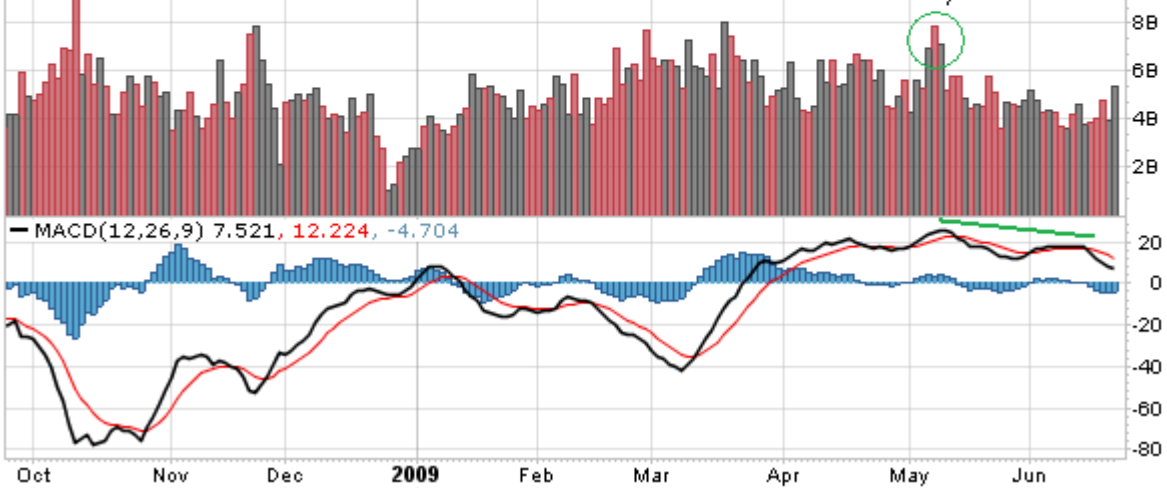
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19-Jun-2009 **Open** 919.96 **High** 927.09 **Low** 915.80 **Close** 921.23 **Volume** 5.3B **Chg** +2.86 (+0.31%) ▲

▲ RSI(14) 52.03



■ Volume 5,316,893,696



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In particular, RSI and MACD both generated negative divergences with the S&P 500 price chart last week. These are marked on the corresponding panels in green. While RSI traced out a failure-swing pattern, it now has cycled back to its failure-swing point just above the critical level of 50. Even so, momentum clearly is beginning to falter and price/volume behavior remains poor.

It is possible that investors are starting to wake up to the harsh realities inherent in a post-bubble economy. If so, we may see further sideways movement before the market finally begins to head down again in earnest. Although we continue to give this rally the benefit of the doubt by considering it a cyclical bull market within a secular bear trend, downside risk has become somewhat elevated over the short-to-intermediate term.

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