Delta Paradigm......changing Visions, for changing Times!

November 18, 2011 — A personal opinion newsletter.

By Ernest 'Rus' Chisena

Is the rising tide of Debt morphing into a Tsunami?

"An economist's guess is liable to be as good as anybody else's."

William "Will" Penn Adair Rogers (November 4, 1879 – August 15, 1935) was an American cowboy, comedian, humorist, social commentator, vaudeville performer, film actor, and one of the world's best-known celebrities in the 1920s and 1930s.-Wikipedia

Let me share with you my "paradigm" or framework of looking at the economic situation that is ensnaring the world financial system. It may startle you; it may confirm what you already know; but most importantly, I hope it will challenge you to question explanations of events occurring around you today.

Since June of 2010, I have been focusing in on the size of the debt issued and outstanding in this country as well as around the world, warning of a critical mass being accumulated under which the burden of debt servicing would lead to loss of freedoms, loss of opportunity and prosperity, and eventually, if not checked, a complete restructuring of the world financial system. Since that time more debt and spending has been the only alternatives offered and since that time Greece has gone from a 19B euro bailout to over a 140 B euro quagmire.

Today, we see a scenario playing out across the European Union of too much debt feeding upon itself, forcing more deleveraging, higher interest rates, and further austerity measures "suggested" by financial entities such as the ECB, IMF, ESFS, FSB and others on democratically elected governments. Logically, the economies of these countries are slowing, less revenues and the cycle continues. Europe is an example of a debilitating tide of debt. This scenario is also playing out in other sovereigns, such as Japan, China and washing across our shores here in America.

- Cost of borrowing and debt service are rising

The Telegraph, November 15, 2011
http://www.telegraph.co.uk/finance/financialcrisis/8890107/Spain-and-Italys-borrowing-costs-soar-as-Angela-Merkel-remains-defiant-over-eurobonds.html

Spain and Italy's borrowing costs are "soaring" as bond yields exceed 6% in both countries. In addition to the rising burden of interest costs, the article goes on to state that "Eurozone industrial production fell 2% between August and September".

Germany, through the voice of Angela Merkel, would not support the sale of Eurobonds to solve the crisis. Thus, the supply of funds to further support more borrowing simply to service debt is starting to dry up, leading to higher interest rates over time and further deterioration in real GDP of the individual countries.

- More sources of funding for the Eurozone is evaporating

Reuters, November 3, 2011
http://www.cnbc.com/id/45149771

"Banks including BNP Paribas and ING are ditching billions of euros of euro zone government bonds, cutting their exposure to the region's trouble spots. More lenders are expected to retreat as the euro zone crisis deepens and leaders raise the possibility of the exit of Greece from the bloc, further damaging prices.
"The market value of the debt of the countries most under scrutiny is likely to decline further as banks unload sovereign bonds," Charles Dallara, managing director of the Institute of International Finance, warned on Wednesday."

Bloomberg, November 11, 2011
http://www.bloomberg.com/news/2011-11-11/blackrock-among-u-s-money-market-funds-cutting-deutsche-bank-investments.html

It is not just European banks pulling funding and not just limited to the PIIGS:

"The amount of Deutsche Bank short-term obligations held by the eight biggest U.S. funds eligible to purchase corporate debt, which included offerings from Fidelity Investments, JPMorgan Chase & Co. (JPM) and BlackRock Inc. (BLK), declined by 56 percent to $6.3 billion from Sept. 30 to Oct. 31, according to monthly portfolio updates compiled by Bloomberg and published in today's Bloomberg Risk newsletter"

"Among the French banks, commitments to Credit Agricole SA (ACA) saw the biggest decline, falling 66 percent in October to $1.3 billion. BNP Paribas (BNP) SA saw a decline of 10 percent, Societe Generale (GLE) SA lost 11 percent in funding and holdings in Natixis (KN) were cut to zero."

- Lack of confidence in the financial system

Bloomberg, September 14, 2011
http://www.bloomberg.com/news/2011-09-13/deposit-flight-from-european-banks-means-collateral-risk-piling-up-at-ecb.html

""All of this is symptomatic of a lot of fear in the European financial sector," said Kash Mansori, senior economist at Experis Finance in Charlotte, North Carolina, which advises U.S. and European companies. "It shows that even European banks don't trust each other anymore, so they're taking their money out of the EU system. It's similar to the distrust that happened worldwide in 2008."

The Telegraph, November 16, 2011
http://www.telegraph.co.uk/finance/financialcrisis/8854267/Europes-rescue-euphoria-threatened-as-Portugal-enters-Grecian-vortex.html

"Data released by the European Central Bank show that real M1 deposits in Portugal have fallen at an annualized rate of 21pc over the past six months, buckling violently in September.
"Portugal appears to have entered a Grecian vortex and monetary trends have deteriorated sharply in Spain, with a decline of 8.4pc," said Simon Ward, from Henderson Global Investors. Mr Ward said the ECB must cut interest rates "immediately" and launch a full-scale blitz of quantitative easing of up to 10pc of eurozone GDP."

Two things about this article.

Take time to look at the chart and see that all the PIIGS are experiencing a decline in their money supply as measured by M1. The Federal Reserve defines M1 as "demand and checkable deposits", i.e. bank accounts.

Second, the offered solution is to print money in the form of QE, up to 10% of Eurozone GDP, that is approximately $1.6 Trillion USD. As more of a currency is circulated, the higher the interest rates will be required to draw investors into their bonds. As an illustration, should there be 10% more Euro's in circulation, your holding of the currency depreciates by 10% in purchasing power over time. So one would conclude interest rates would necessarily increase to compensate for the expected loss of value. Higher interest rates, falling bond values, more losses and bank capitalization deteriorates. Leading to more equity infusion by government, to more quantitative easing to further depreciation, etc, etc, etc…..Until…?

What exactly will happen? Your guess is as good as mine! But the direction of the financial system is becoming clearer.

- What about the US?

Reuters, October 31, 2011
http://www.cnbc.com/id/45107925

"The U.S. Treasury Department said on Monday it will sharply increase its estimated borrowing over the next two quarters due to expected lower receipts and higher outlays.
Treasury said it expects to issue $305 billion in net marketable debt for the October-December quarter, an increase of about $21 billion from estimates issued on Aug. 1.
Treasury said it expected to issue $541 billion in net marketable debt securities in the

January-March 2012 quarter, marking the
second-highest quarter on record."

"Net marketable debt" means new debt, adding to our current obligations. The debt ceiling was raised in August by $1.7 trillion and the "super committee" has yet to even propose a solution, but the Treasury will spend over this quarter and next $845 billion of it. As of this writing, the http://www.usdebtclock.org/ shows US debt passing the $15 Trillion mark, plus another $800 billion in the next six months.

The Federal Reserve recently noted in their last FOMC statement that their expectation for GDP is to grow by 2.0-2.5% through 2012, or roughly equivalent to $3-400 billion in a year. Our Federal Government's borrowing is exceeding our GDP growth by a factor of 5X.

- Global Liquidity

Wall Street Journal, Online November 8, 2011 "Global Liquidity 'on the Cusp' of Drying Up"
By Nirmala Menon and Tom Fairless (subscription protected)

"Mr. Carney, who was appointed chairman of the Financial Stability Board at last week's G20 Summit, said….. the severity of the downturn will depend on how European banks deleverage. They are required to raise core Tier 1 capital to 9% by next June, which can be done through a combination of retained earnings, capital increases and asset sales. If only asset sales were used, up to €2.5 trillion of disposals would be required in coming months, Mr. Carney said. These sales will likely be concentrated in noncore businesses, notably in emerging markets and in U.S. dollars, he said."

The article goes on to state…

"Meanwhile, banks' use of the European Central Bank's deposit facility hit a new high for the year Monday for a third consecutive day, data released by the ECB showed Tuesday.
Banks parked €298.591 billion at the facility, the ECB said. These data represent the highest level since June 30, 2010, when banks parked €310.43 billion. Friday banks parked €288.429 billion at the ECB's deposit facility.
The amount of deposits has been elevated, around the €200 billion mark, since late October, indicating that banks prefer to park their money with the ECB instead of lending it to one another. Banks are afraid of lending because they don't know the extent of their counterparties' exposure to weak euro-zone sovereign debt.

To interpret this for you, several trillion dollars of assets have to be raised by European banks by next June in order to meet capital requirements set by the FSB. But if they are not lending the money (parking at ECB), or the economy is not growing (see first article of newsletter), there will be no retained earnings or capital increases to recapitalize the banks. What will they do next? Sell…"in emerging markets and in U.S. dollars".

- Fewer buyers for US bond sales?

Cnsnews.com, November 16, 2011
http://cnsnews.com/news/article/fed-now-largest-owner-us-gov-t-debt-surpassing-china

"In its latest monthly report, the Federal Reserve said that as of Sept. 28, it owned $1.665 trillion in U.S. Treasury securities. That was more than double the $812 billion in U.S. Treasury securities the Fed said it owned as of Sept. 29, 2010."

"Meanwhile, as of the end of this September, entities in mainland China owned $1.1483 trillion in U.S. Treasury securities, according to data published today by the U.S. Treasury Department. That was down slightly from the $1.1519 trillion in U.S. Treasury securities the Chinese owned as of the end of September 2010, according to the same Treasury Department report."

China's US debt holdings have slightly declined in the last 12 months, Europe has to worry about Europe, and Japan has more debt than anyone else and finances it all internally. The Federal Reserve has doubled their total holdings. I guess that will continue for a while.

- The slippery slope is coming upon us.

As posed in my last Newsletter of June 2011, the financial system is facing a double edged sword. The first cut is through the deflation of the money supply brought about by devaluation of financial and real assets from higher interest rates and defaults (i.e. declining real estate values, Greek Bonds- 50% haircut, Dexia Bank insolvency-Belgium, MF Global-futures trading). To remedy the situation, the sword swings back the other way and cuts deep with issuance of more debt, funded by quantitative easing (Inflation), contingent upon further austerity measures, which results in slowing economic growth.

At first, it may seem difficult to reason that the first swipe of the sword lowers asset values while the back slice of the sword will result in higher prices in "living essentials" such as food, energy, and water, as more paper money chases the same goods. But if you start to compartmentalize the "assets" debt deflation effects versus the effects of quantitative easing on prices of goods, you see there can be a bifurcation between the symptoms of the "illness" and the "side effects" of the "remedies". Similar to a 1970's style stagflation. Or, maybe one on steroids.

A case in point; the price of oil measured by WTI crossed $100/barrel today, second time this year. What is driving the price of oil up if not for the money supply? Demand for oil, if based upon World GDP growth, is weak around the developed globe, and supplies are restored from earlier issues and turmoil this past spring.

With the high correlation between real estate, stocks and bonds in the last "Liquidity Crisis", it is important to seek other investment classes that have a lower correlation with the type of assets that might suffer under the scenario of financial institutions or sovereign debt defaults, i.e., solvency issues.

Some recommendations would be:

Very short term bond funds:
- Will be less affected by raising interest rates than long term bonds
- Try to stay away from large exposure to US Gov't Agency "GSE's"
- Seek sovereign debt from better capitalized economies
- Currency diversification

Stay Global in perspective:
- Large multinational firms have assets in many different countries and use multiple currencies in operating their business
- Not all economies will be doing poorly at the same time, but the immediate to mid-term future looks bleak for heavily indebted countries.

Allocate weighting in sectors:
- Food, Agriculture, Energy, Water systems and supplies.
- People need the basics in life and will spend on "living Necessities"
- Raw materials and building equipment might work if less developed economies continue to grow and are not dragged down with "developed" debt.

Precious metals and mining stocks:
- Gold and silver have retained a store of value for thousands of years, most paper currencies last 80 years.
- As the "World Prints", assets of limited quantities will appreciate relative to paper currency. Gold has had a very consistent growth of supply of 1.5%/annum for the past 100 years. Not so with paper money, it grows on trees.
- Mining stocks provide an opportunity to invest in the precious metals and other mineral assets that only Mother Nature can make. Continue to think "Less is More".

Cash
- Depends greatly as to "Whose Cash", right now the USD is still the reserve currency, but diversification is your friend.
- Save your munitions for better buying opportunities. There are always ebbs and flows and once low tide is reached, the world will be your oyster of opportunities.

As a client of mine purchasing investments through my broker dealer affiliation, I would like to strongly suggest that we have an opportunity to discuss your current portfolio allocation and consider the issues discussed in this paper. Should there be a need for modifications in your portfolio, much of it can be accomplished within your existing family of funds.

Those of you who are advisory clients, (i.e. asset held at Fidelity and you receive their statements) you already have an allocation similar to the one discussed here, but I would still appreciate your feedback and thoughts on issued shared.

Either way, I am appreciative to hear from everyone. If you feel strongly that the *Paradigm* postulated here is of validity, feel free to pass this letter on to others whom you care about and feel it might be of value, or have them contact me directly.

Thank you.

Rus

Ernest (Rus) Chisena, III CFP(R)

LATITUDE FINANCIAL LLC

- Phone: 610-793-4430
- Fax: 610-793-4490