

## Thought for the Week: Monday, August 9<sup>th</sup>, 2010

### How Deep does the Hole Go?

If you ever have the grave misfortune to fall down a big dark hole, a hole so deep there is no obvious way out, **figuring out the depth of the hole might be a useful start in estimating how long it will take to escape**. Can you reach up and pull yourself out; should you start to build something to effect egress; or do you just wait around until someone or something comes along to rescue you?

And so it is with the current recession. More than two years into the Credit Crisis many people are still trying to figure out how deep is the hole into which the economy has fallen.

A definitive answer is beyond anyone at this time; however, this week we will look at one way of estimating the depth of the U.S. Government's fiscal shortfall and the amount of time it will take for recovery.

#### **The Shadow Financial System (How the hole was dug and why it appeared so suddenly)**

We know the credit crisis happened mainly because America and the developed World borrowed too much without traditional collateral backing. This happened because financial institutions were able to trade, transform and leverage many different forms of derivative investments without traditional financial or regulatory constraints. We also know this created asset price bubbles, most obviously in housing and many securities, particularly alternative 'derivative' securities.

Many retail investors believe the lax mortgage lending standards caused the housing bubble; however, mortgages were just the starting point of lengthy, vertically integrated chains which brokered credit through a wide range of securitization and secured funding techniques such as ABCP (Asset Backed Commercial Paper), asset-backed securities, collateralized debt obligations, and repurchase notes (Repos).

This was made possible by financial institutions creating a shadow financial system through which they could alter, trade and issue credit to a wide range of beneficiaries (at its simplest: loan money and transform the resulting money into a form that could be sold or loaned to others).

We call this the 'Shadow Financial System' because it could do all of the above without access to such traditional sources of security and liquidity (places to quickly and cheaply borrow money) as the Federal Reserve and Federal Deposit Insurance. Moreover, this system was lightly regulated.

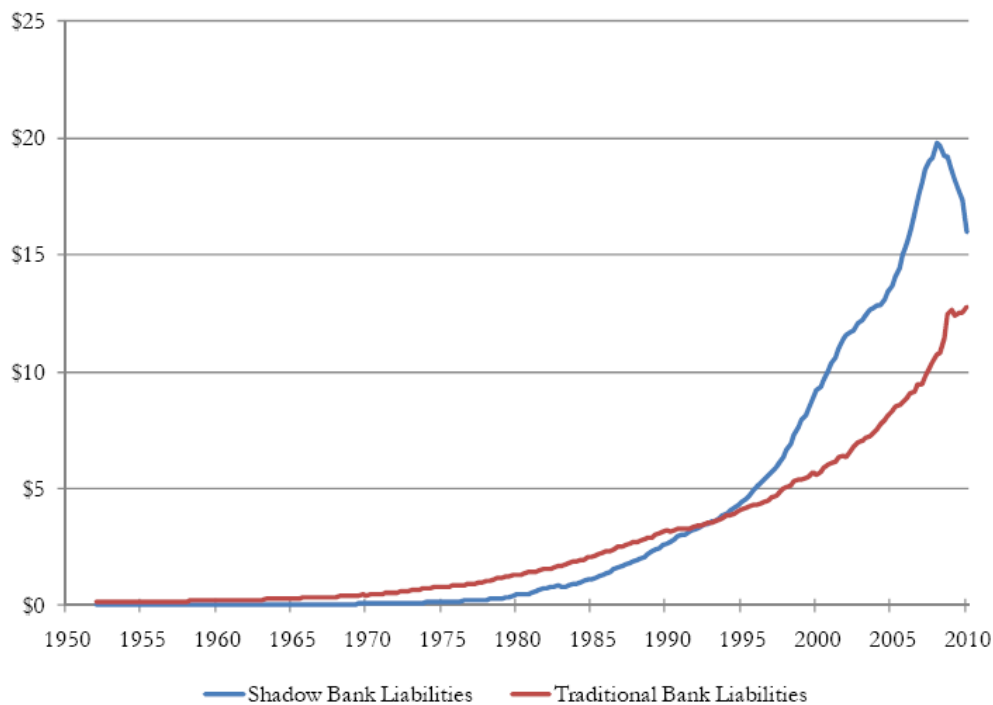
#### **So How Big is the Hole?**

We cannot overstate the role of this shadow system in creating the excessive, and clearly unsustainable, financial leverage now evident in many global economies. While the Fed thought it could monitor and control the economy through the regulation of credit and interest rates, a massive new financial world was growing outside of their direct control.

*In the 'good ol' days', consumer and business credit was issued through banks lending from the Federal Reserve under set rules, ratios and regulations. Since 1980, a second banking system has grown to overshadow the traditional one. A system unencumbered by rules, ratios and regulations.*

**The chart below shows how the shadow system has grown in size**, especially since the early 1980s. Coincidentally, the early 80s is the time when most economists date the start of the problems we now find ourselves faced with.

Shadow Bank Liabilities vs. Traditional Bank Liabilities, \$ trillion<sup>+</sup>



No one knows for sure just how much leverage needs to be taken out of the system, but the chart above shows we still have a ways to go. **Let's take Year 2000 levels as a sustainable level** - just because it's a round number. We still have approximately twice the leverage in the financial system that we did in 2000: **We are still deep in the hole.**

From a conservative fiscal viewpoint, **this means we may have another \$14 Trillion to take out of the banking system** – even at the current rate of deleverage, this means another 3 year or more of depressed banking and credit conditions. We are sure it will be much longer than 3 years, however.

It also means there are **plenty more assets for the government to move onto their balance sheet**, dramatically increasing their deficit. The Q.E. 2 (Quantitative Easing 2) is setting sail!

### Final Thoughts:

- It is clear that over the last two years, **the U.S. Government has pumped money into the traditional banking system** to allow them to reduce the size of their exposure to the shadow banking system.
- If you have read headlines talking about **“off balance sheet liabilities now back on the balance sheet”**, this is what they are talking about: Bringing investments out of the shadow system.



- In our opinion, many of the government guarantees and funding schemes launched over the last two years are the **actions of regulators and policymakers bringing shadow financial system assets back into the regulated traditional system.**
- For two years, we have called the current global environment the **"Great Debt & Derivative Unwind"**. By this, we mean the world has to find ways of cleansing the financial system of the currently egregious levels of debt and derivatives.

**The difficult question is can this, or should this, be done without causing another Great Depression and Deflation?**