



## **Sutton & Associates, LLC**

The following compilation consists of three essays issued starting in early October 2008. The essays were written by Andy Sutton, Founder & Chief Strategist of the firm. For more information about related reports and our firm, please visit our website [www.suttonfinance.net](http://www.suttonfinance.net)

### **10/03/2008 – “Anatomy of a Disaster – Part I”**

For a minute, let’s forget about all that has happened in the past year. Forget about the signing of the bailout into law. Let’s forget about the failure of some of America’s most iconic Wall Street firms. Let’s forget about the insolvency of Fannie, Freddie, and FDIC (yes, they’re broke too). Let’s forget about Northern Rock, Countrywide, and AIG. They are all but casualties and symptoms. They are not the problem. Adjustable rate mortgages were not the problem, nor were 0% interest credit cards. No, there was one single source of all that ails not only the US economy, but the world, and that problem is greed. That greed has spread from sea to shining sea over the past thirty seven years as America decoupled totally from its monetary and spendthrift roots.

The amazing thing about the free markets though is that they are self-cleansing. Get too far out of line and the market zaps you. You’re punished and you learn your lesson and get back in line. Unfortunately, for much of recent history, we have sought as a society to mitigate or even eliminate the consequences of one’s actions. This is not purely a monetary phenomenon, but one that permeates every corner of our society. I’m sure you can all think of a myriad of examples of this mindset at work. It was this very mindset that prompted me to warn readers about the coming barrage of bailouts in March of 2007:

*“After the stock market collapse of 2000–2002, the economy faced a stiff headwind and the Federal Reserve reacted by creating the most credit-friendly monetary policy in American history with low interest rates and liquidity abound. However, the tragic flaw of easy money is that it leads to speculation, and ultimately, malinvestment. Low interest rates caused speculation in the residential real-estate market to a level that has been unprecedented. Double-digit home appreciation led lenders to make more and more risky loans based on the faulty assumption that appreciation was infinite and could always be*

*relied on to make the payments when the borrowers were unable to do so. Developers took the cue and built a massive inventory of spec homes, creating a glut looking for a reason to happen. That reason came mostly in the form of 18 consecutive rate hikes by the Fed from 2004 – 2006. Mortgage gimmicks designed to allow fast-food workers to buy half million dollar homes began resetting at much higher rates and the defaults and foreclosures began. We are now seeing only the tip of the iceberg. While the media chooses to pretend this is a non-issue, the snowball gathers speed.*

*The fact that there will be a bailout is a foregone conclusion. We should be more interested in the timing and ultimately the cost of any such bailout and who is going to bear the cost. It is my guess that most of the people reading this column will not like the answer to the last question.”*

Given all that has transpired over the past two decades, the fact that there would be a bailout could be mailed in. It was a slam dunk. I reference this prior posting not to gloat, but rather as a springboard into what will happen next because of the massive intervention in the free market system and particularly because of our failure to understand the true causes of the problem. There are certain irrefutable rules of economics, of markets, and of nature. While they can be altered for short periods of time, in the long run, they always reassert themselves. One would think that we'd have learned this lesson from the 1930's and 1970's. Apparently, we have not. Because of this failure to grasp these simple realities, we are destined to relive what otherwise would have been memory lane.

### **The Great Depression – A market crash or something else?**

Despite the position of the history books that the stock market collapse of 1929 caused the Great Depression, it must be noted that the US Economy had already dipped into a serious recession as early as August 1929. But what was at the root of that recession? It certainly wasn't the stock market crash. While the seeds of the 1929 recession were germinating, the stock market was headed for Mars, riding a bolt of lightning. Between May 1928 and September 1929, stock prices increased around 40%. This happened despite the Federal Reserve banning bank borrowing for margin purchases on February 2nd of 1929 in order to curb speculation. What a novel idea.

Despite the rapid climb in the stock market, by the middle of 1929, business inventories had grown to three times the prior year's levels. Production would quickly decline at an annualized rate of 20%, wholesale prices by 7.5%, and per capita income by 5%. While worker productivity had grown by an amazing 43% from 1921 to 1929, the wealth for the most part had been consolidated in the top 1% with the per capita income actually dropping 4% during the course of the decade.

The seeds of the 1929 recession had been sown by a decade of decadence. Unfortunately, the bulk of Americans were left out of that prosperity. Here are some 1920's trivia that should help connect the dots and make some parallels.

- The number of people reporting a \$500,000 income grew from 156 in 1920 to 1,446 in 1929 – a greater increase than any other decade, but still represented less than 1% of the wage earners.
- The top 1% owned 40% of the nation's wealth by the end of the decade.
- During the course of the decade, over 1,200 corporate mergers would gobble up more than 6,000 independent companies. By the end of the 1920's, 200 corporations would control approximately one half of American industry.
- In 1929, more than half of all Americans were living on below a minimum subsistence level. Per capita income was \$750 per year.

### **New century – same problem?**

Now let's take a look at the situation we have before us in 2008. When looking at statistics, it is very difficult to draw parallels between the actual numbers of that time and the numbers of today. Decades of manipulations (some justified, some not) have made it nearly impossible to do side-by-side comparisons.

- In 2007, approximately 37 million Americans or 12% of the population are living in poverty. Clearly this is much lower than the greater than 50% in 1929, but the devil is in the details. In 2008, the threshold income for poverty was listed as \$10,787 for a single person under the age of 65, and \$21,027 for a family of four with two children. I don't know what kind of standard of living this entails, but I found it extremely odd that when using BLS' inflation calculator, the \$750 per capita income in 1929 is worth \$9,094 in 2007 dollars. Given what we know about the relevance of the CPI, it is safe to say that the poverty rate is grossly understated. Even that aside, \$21,027 is not much of a living for a single person let alone a family of four.
- A 2005 study conducted by the University of California at Berkeley, and the Paris School of Economics contended that income concentration in the top 1% of wage earners was equivalent to 1928 levels.
- According to the Census Bureau, the top 1% held nearly 46% of all wealth in the United States in 2007 with the top 10% holding over two-thirds of wealth. Compare to 1929 when the top 1% held around 40% of the nation's wealth.
- The average US household now owes nearly \$10,000 on credit cards, and pays an average of \$1,478 in interest each year.

The consumer's balance sheet is in shambles. Granted, a good deal of the responsibility for this lies at his own feet, but without the consumer, this economy is sunk and doomed for a serious contraction. As in the 1920's, the average American is struggling. Where he barely made a subsistence level wage in the 1920's, today, he is burdened with debt. The result is the same, although the causes are different. Consumption now represents nearly 70% of GDP, with the bulk of that consumption coming from Main Street. Without it, the prospects for prosperity are slim to none. From a wage perspective, we are not faced with a 1920's style nominal wage decline, however, we are faced with real wage declines as the inflation rate continues to outpace expansion of earnings.

In the 1929 recession turned depression, there was greed in the usual places as power and wealth were consolidated. The rest of America was compromised by sub-poverty wages with the majority lacking the ability to participate in the boom. During the past 10 year runup, there was an almost universal greed. Those at the top consolidated more and more wealth as evidenced by massive bonuses and merger activity, however, much of the rest of America decided that this time they were going to try to follow suit. They were already half compromised by stagnant then falling real wages; credit cards and home equity loans took care of the rest.

One could certainly make the argument that there has always been a fairly high level of poverty and concentration of wealth. Hasn't there always been greed? What made 1929 different? What was the trigger? What makes 2008 different and what was (or will be) the trigger now? In 1929, the real economy began to contract because it had outgrown itself. Simply put, it came too far, too fast and there was no more fuel to sustain it. Exporting at that time was more difficult, so once the economy exhausted domestic consumption potential, it was game over. Due to the majority of Americans being unable to support continued rapid growth through consumption, the boom quickly ground to a halt. Simply put, there were too many products made, and no one to buy them.

In the case of the new century, we have had a lack of real growth. Much of the growth that has happened has been due to debt, and therefore, the debt must be figured in when considering the sustainability of growth. Point of fact if the credit cards, home equity loans, and deficit spending had been taken away we would have seen very little, if any, growth during the past decade. While credit is an accoutrement to any healthy economy, and is in fact necessary for growth, when an economy comes to rely on credit for its growth, that economy is doomed.

In our 21st century economy, we don't rely on the consumption of our own products, but on vendor-financing from the producers in Asia and elsewhere. Our economy by and large 'produces' services, but if there are too many

services, and no buyers, you end up with the same result: economic contraction. The biggest difference between 1929 and now is that we have the ability through our own contraction to affect the world economy since our consumption has created a demand for their products.

None of the above should be taken as an indictment of capitalism. Certainly ingenuity, industry, and hard work should be rewarded while the opposite discouraged. If anything, our problem is that we didn't stick to capitalism, but tried to intervene in the normal cleansing process of the free markets. We've tried to have Capitalism during the good times and Socialism in the bad times. Even in the best of capitalistic societies, the lesson has to be learned that if the consumer-worker base isn't included in the prosperity, the prosperity will soon come to an end. You simply cannot balance long-term healthy economic growth on the consumption of the top few percent of wage earners. There needs to be sustainable demand for the production of an economy, and the ability of the populace to participate in that demand by the sweat of their brow as opposed to VISA is absolutely essential.

Next week's issue will deal more specifically with the nature of the upcoming recession/depression. Will it be a 1930's style deflationary event, a 1970's style inflationary event, or a hybrid? What will it be like on Main Street when this event begins? (We've already gotten a good sneak preview). And most importantly, what can be done to lessen its effects at both an individual and national level?

### **10/10/2008 – “Anatomy of a Disaster – Part II”**

Last week we looked at some historical milestones as we compared the events leading up to the Great Depression to what we're seeing now. While apples to apples comparisons are problematic due to vast differences in the way economic statistics are measured and reported, it is a much more simple matter to see the big picture. This week, we take a look at things from a monetary perspective.

Perhaps one of the biggest misconceptions deals with deflation. How exactly is deflation (an actual shrinkage in the money supply, not falling prices) achieved? Conventional wisdom points to falling prices, and debt defaults as a source of deflation. Does the theory really hold up though?

#### **Are defaults deflationary?**

In order to understand the situation of a default (and falling asset prices) let's create a microcosm of our economy. Let's say for example that we have 5 people. In the initial phase, we set our money supply at \$600 with each person possessing an unequal portion of the total. In the Loan step, Person 5 borrows \$150 from Person 3 for the purposes of buying a home. In the Purchase step,

Person 5 buys the home from Person 1. Then person 5 defaults after making 2 payments of \$5 each to person 3. Notice that the default to this point has not changed the money supply. Then Person 3 forecloses on the house and resells it to person 2 for \$100. Even after the loss of 1/3 the home's value, the total money supply is NOT affected! However, we can see that Person 3, the original lender is worse off by \$40. Person 1 has seen a \$150 increase as a result of selling the house in the Purchase step. Person 2 is \$100 worse off, but now has the house. Person 5 is \$10 worse off, but enjoyed the ownership of the house for 2 payment periods. Person 4 was unaffected as he wasn't involved in any of the transactions.

<b>Step</b>	<b>Person 1</b>	<b>Person 2</b>	<b>Person 3</b>	<b>Person 4</b>	<b>Person 5</b>	<b>Total</b>
Initial	\$100	\$150	\$200	\$100	\$50	<b>\$600</b>
Loan	\$100	\$150	\$50	\$100	\$200	<b>\$600</b>
Purchase	\$250	\$150	\$50	\$100	\$50	<b>\$600</b>
Default	\$250	\$150	\$60	\$100	\$40	<b>\$600</b>
Resale	\$250	\$50	\$160	\$100	\$40	<b>\$600</b>

In any case, in the above scenario, we had a sale, some payments, a default/foreclosure, and the resale of the property at 2/3 its original value. Even after all that, the total money supply wasn't affected. We had neither inflation nor deflation. The \$600 we started with is still there, able to be spent. Certainly some parties are better off and some are worse off, but in the aggregate, nothing has changed.

Now let's look at what happens when Person 3 is a bank that lends out \$2 for every \$1 it has in deposits. In our case, the bank lends out \$200 to persons 1 and 5 for houses. Persons 1 & 5 each take their \$200 and give them to Person 4 who has two houses for sale. So Person 1 and 5 see their cash balance go back to where it was originally while Person 4's balance is up to \$500. Persons 1 and 5 each make 2 payments of \$5 to the bank before defaulting. The bank then takes the houses back and sells them at a loss to person 2 for \$75 each.

<b>Step</b>	<b>Person 1</b>	<b>Person 2</b>	<b>"Bank"</b>	<b>Person 4</b>	<b>Person 5</b>	<b>Total</b>
Initial	\$100	\$150	\$200	\$100	\$50	<b>\$600</b>
Loan	\$300	\$150	\$200	\$500	\$250	<b>\$1000</b>
Purchase	\$100	\$150	\$200	\$500	\$50	<b>\$1000</b>
Default	\$90	\$150	\$220	\$500	\$40	<b>\$1000</b>
Resale	\$90	\$0	\$370	\$500	\$40	<b>\$1000</b>

In the above scenario, we saw the money supply grow from \$600 to \$1000 as the bank lent out \$2 for every dollar on deposit. Notice, its cash balance didn't change after the loan. In fact, it created more money for itself because the loans it made were made from nothing, and real capital was in fact owed back to the bank. At the end of the exercise, the money supply was still

\$1000 even with two defaults and the bank selling the houses at a substantial discount. And if you look at the bank's tally, it made out quite well DESPITE the 100% default rate and loss of value of the houses.

The second scenario is a simplified version of how our banking system works. As can obviously be seen, the best way for the bank to make money is if it makes loans because of the multiplier effect. And the multiplier effect in the US banking system is much higher than the 2:1 observed multiplier used in the example. Contrary to the popular belief that the Fed is the only creator of money, the banking system is where most of the heavy lifting is done. For reference, the multiplier in the US is closer to 10:1.

Let's tally the two situations. Without a multiplier, you get no change in money supply, which should be expected, and when we made the multiplier 2:1, we saw a 40% increase in the money stock. If the bank still 'makes money' despite a 100% default rate, how exactly is it that money can disappear from the system? The multiplier is the first possibility. If the multiplier were lowered (ie: reserve requirements raised), banks would have to readjust their loans, maybe make less loans, call in some loans that were callable, or find ways to increase deposits. Unfortunately, raising the reserve requirements would only slow the rate of money supply growth. Even if reserve requirements were raised to 100% (which is a practical impossibility in our banking system), this would ONLY result in a stable money supply as demonstrated by our first example. Still no true deflation even though we have falling asset prices.

The central bank can drain money from the banking system by cutting off loans to commercial banks or by selling assets off its balance sheet to withdraw cash from the system. Perhaps a more ridiculous and anecdotal way money could be destroyed is if people removed cash from their banks accounts and burned it. Given the current economic realities, the latter is more likely to happen than the former.

### **Savings and Loan banks insolvent by nature**

This is one of the biggest reasons why the banking system cannot afford to have a run on it. By design a commercial bank is insolvent. Its assets are spread out over time while its liabilities (deposits) can have zero time preference. People can demand their deposits in full at any time. Plus, runaway withdrawals from bank accounts in addition to causing the bank to run out of cash also cause the bank to have to curtail loan structures to maintain reserve requirements. While all of these things happen to a certain degree on a daily basis under normal conditions, the system is able to smoothly cope by interbank lending facilitated by the central bank. However, in extreme situations, the system itself can come under extreme stress. We have seen a

good bit of this recently with the bank runs on Northern Rock in England and IndyMac Bank here in the US.

### **Did you know?**

- That the growth of consumer credit and GDP have a .97 correlation since the 1970's? This means that without consumer borrowing, our economy essentially goes nowhere. (Note: consumer credit decreased in August 2008)
- US total money supply as measured by M3 is over \$14 trillion. We have debt over \$10 trillion. While it is not due and payable in its entirety at one time, we're either going to have to take money from other parts of the economy to pay it or we're going to have to create more money. It's as simple as that. And the debts moving forward only continue to mount. More and more dollars will be necessary to accommodate both the principal repayments as well as the interest on the debt. While the expectation has always been that foreigners will be willing to lend our exported dollars back to us, we will reach a point where they either refuse to do so or a point of exhaustion. Plus, we need ever-increasing dollars here at home if we are to continue to have 'growth'.

### **What does this mean for the US?**

The implication here is that if the money supply cannot be grown to accommodate the payment of this debt that the US government will be forced to default. At this point, it would seem we don't have to worry too much about real deflation unless for some reason it is intentionally created by the central banks or as a byproduct of further misguided policy. The biggest concern for the financial system now is rather the lack of ability to continue to inflate. As the debt mounts, the lack of ability to create money to both enable the real economy to function and the repayment of the debt would cause deflationary affects such as a shortage of dollars, and therefore falling prices since there would fewer and fewer dollars available for goods and services. This is why the credit and lending function is so important. It is why banks are willing to renegotiate loans. As long as the money keeps coming in, it can be multiplied. A few years back, Ben Bernanke said he'd drop money out of helicopters if needed to keep the spending spree going. Maybe Ben wasn't so dim after all. That he would even make such a comment underscores the fact that he understands exactly what is going on and discredits any supposition that he didn't see this crisis coming.

In summation, it would appear that our position moving forward is very similar to the Field of Dreams byline "If you build it they will come". However, in our case, the sixty-four thousand dollar question is "If you create it, will they borrow?"

## **10/24/2008 – “Anatomy of a Disaster – The Next Stop”**

These past few weeks we have laid the groundwork for the upcoming economic and financial mess. Lacking a textbook definition of a depression and outright refusal by the media and government to even admit we're in a recession, I will use the unscientific and arbitrary term 'mess' to describe both the current and upcoming realities. After all, 'mess' is a scalable term.

We are currently in the eye of the hurricane. While it certainly doesn't seem like it, this is the best things are going to be for quite some time. With job losses leading the way, the US economy slides into the clutches of irrelevance with those in charge unwilling to acknowledge the magnitude of the situation. We've hit the iceberg, bulkheads 1,4,7, and 11 are flooded, and our leaders are on the Promenade handing out free water. Where do we go from here?

### **RIP US Consumer**

One month a trend does not make, but given all that is going on, it seems increasingly likely that August's decrease in consumer credit outstanding is not an aberration. In August, consumers actually began to repay debts faster than they accumulated new ones. It is about time. Of course, this reality has led to political spin, particularly from Condoleezza Rice about how we need to be 'leaders in the world economy'. Worried about consumption? You ought to be. The dirty secret is that without debt accumulation, there is no growth. Period. The second dirty secret is that without the abandonment of credit standards and pedal to the metal monetary policy, this day of reckoning for consumers would have come back in 2001. By the Fed's count, that was \$1.6 trillion ago in outstanding consumer debt. The pump was housing and now the pump is irreparably broken. This reality leaves our leaders frantically trying to figure out how to maintain debt growth in the absence of a handy asset bubble. Maybe they will start allowing banks to lend to people against the 'equity' in their retirement account next? I bite my tongue. Contrary to the political speak, consumers overall did the right thing in August. Keep doing it. Pay your bills. Trim your budgetary excesses and streamline. When your next stimulus check arrives in the mail, pay down your debt some more. Money is the least of the government's problems; the Fed is really good at creating it from nothing and the Treasury is the 21st century version of Daddy Warbucks on steroids. No, money isn't the problem. Creating endless amounts of it while trying to keep the public convinced that it is actually worth something is the problem.

### **Avalanche of Obligations**

Somewhere in all the turmoil the fact that we have a demographic tsunami headed for the Federal balance sheet has been forgotten. True, with a stock market crash, dizzying losses in almost all asset classes, bailouts, and

bank failures, it is hard to remember everything. None of what has happened though in the past 6 months changes the fact that both Social Security and Medicare are heading for outright insolvency. A recession (or worse) will cause inflows to these programs to drop even more, thereby exacerbating the problem. Baby boomers headed towards retirement have seen the value of their savings chopped by a third or more. This will cause them rely even more on Social Security and seriously hamper their ability to spend. These programs will need trillions moving forward. At this time those trillions don't exist. We have an immovable object and an irresistible force. Either we're going to have to create the money or else we're going to have to cut the benefits. To this point there has been no talk of cutting benefits. An interesting observation to make here is that a year ago, bailing out Social Security with printed funny money would have seemed far-fetched to the average person. Not so anymore. The bailout mentality is firmly in place, and in fact, the scope of monetary magnitude has been lost. We used to say millions and it was a lot of money. Then it was billions. Now we discuss trillions of dollars like it is pocket change. This is a hyperinflationary mindset. Get used to it.

### **The Battle of the Backstop**

More than ever, it will be necessary to be able to discern between nominal and real. Our website has dozens of articles, and the focus of a good many of them has been to differentiate between nominal and real. It's not the numbers of dollars, it's what they buy. It will be critical for individuals to understand what your money buys. If you fully grasp this, you will know when the tide changes. You will not need the Sunday paper. Right now we are focused on falling asset prices, and in the case of energy, consumer prices. While falling consumer prices are a welcome breath of relief, do not get too used to it. Enjoy it while it lasts and watch for signs that the trend is reversing. The biggest problem is the scale of the monetary creation to date that the Fed is willing to admit. Monetary inflation leads to consumer price inflation and when those spinning wheels hit the road and get traction, look out. Things will change quickly. It is imperative to be up on the wheel here so to speak.

Make no mistake, your wealth is in harm's way unlike any other time in history. While the assault has been ongoing since we decoupled from the backing of real money, for a time, our money was backed by some degree of common sense. However, common sense dictates that you do not create trillions upon trillions of dollars to rescue the financial economy while leaving the foundations of the real economy to reap the whirlwind. Common sense dictates that your money supply growth should not exceed the growth of your underlying producing economy. Common sense should tell you that you don't allow financial institutions to leverage their portfolios at 100:1. Common sense should tell you that you don't allow a bank to lend out \$10 for every \$1 in deposits. Common sense tells you that FDIC is insolvent. It also tells you that

California and New York are going to need a bailout. It might even suggest that many of the remaining 48 will require one at some point in the near future along with every pension fund and entitlement program currently in force. The magnitude of the final quantity of money that must be created is astronomical. From the standpoint of the authorities, it would be best if we continued to go into neverending debt. This way money could be multiplied through the banking system in an 'orderly' fashion. The next choices are handouts (think 'stimulus' packages), and direct monetization of debt (think outright purchase of new Treasury issues). The multiplier method leads to a 'slow burn' inflation such as what we've experienced to this point. However, there is an actual moment in time when the population cannot continue to accumulate debt at a level that will perpetuate the fiat system. Then we move to the latter two options which have a much greater likelihood of creating hyperinflation and the eventual end of the paper currency.

We have now reached the tipping point where debt accumulation on a meaningful scale cannot continue. Therefore, we are left to watch the remains of the current liquidation of assets then reap the whirlwind of rampant, undisciplined monetary creation.

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