The Bounce Phase of the Economic Depression

by Bill Bonner
Ouzilly, France

"It looks like things are finally turning around," said a friend at Saturday night's dinner.

"Not at all..." we replied.

Paul Krugman says the world "avoided a second Great Depression." He's wrong too.

The stock market crashed in '29. The market then bounced. After a few months almost everyone was persuaded that the "worst was over." But the worst was just beginning. It wasn't until 1932 that the stock market finally hit bottom. By then, it was beginning to seem like a depression...and only years later did economic historians tag it as a 'great' depression.

This depression is still wet behind the ears... We're still in the bounce phase. On Friday, the Dow went 113 points higher. And as the bounce continues, more and more investors will come to believe that stocks are in a new bull market and that the economy is back in growth mode.

Neither will be true.

The stock market is in a bear market rally, not a genuine bull market. **The economy is entering a long depression...possibly a 'great' one.**

How can we be so sure? Well, we're not sure of anything. But all the signs point in that direction. Household debt as a percentage of disposable income hit a low of about 2% just at the end of WWII. It's been going up ever since. By 2005 it nudged against 15% - seven times higher than it had been 60 years earlier. Household debt represents spending that has been taken from the future. But you can't take an infinite amount from future earnings. You reach a point when the future can't handle it. As more and more future earnings are absorbed by past consumption, pretty soon there's not enough left to live on. At some point, so much of earnings are devoted to paying the interest and principle on past borrowings that the poor householder cannot to pay his expenses. And imagine what happens if his disposable income goes down.

Guess how many jobs the US private sector has added over the last 10 years? Almost none. Private sector employment is back to levels of 1999. There are more jobs in restaurants and health care...but many fewer in manufacturing. Net gain: zero.

The only job gains have been in the parasite sector - government. On the evidence, this trend is going to continue. Now, the feds have a new post called "pay czar." As near as we can tell this is a busybody who undertakes to control salaries in the industries that the feds have bailed out. **There will be a lot more jobs running the regulatory/bailout apparatus.** Then, too, there are all the make-work jobs of the shovel ready boondoggles the feds began in an effort to replace private spending.

Back in the private sector, 72 banks have failed so far this year. And a record 34 million Americans are getting food stamps.

Naturally, incomes are falling. Now, imagine the consumer...he's already paying 15% of his disposable income to debt service...and then his income is cut in half! This means that 30% of his remaining income must be used just to service the debt. **Impossible to do without big cuts in spending...**

The poor consumer hit the wall in 2007. He was spending all he earned...and paying more of his income in debt service than at any time in the last 60 years. He couldn't continue to living on future earnings - there just weren't enough of them. That is why the finance industry has topped out. It loaded Americans up with enough debt already.

And it's why the credit cycle has turned. All of a sudden savings rates are back up to 7%. Consumers are cutting back...raising chickens in their back yards...driving less...planting gardens and squeezing their nickels. The private sector is de-leveraging. And there won't be any durable economic boom or lasting bull market on Wall Street until this process is finished.

Let's see what The 5 Min. Forecast has in store for us today:

"The US budget deficit rose $181 billion in July to a record $1.3 trillion, the Congressional Budget Office reported over the weekend," writes Ian Mathias in today's issue of The 5. "You know the drill by now...tax receipts are plunging while bailout spending is soaring. In budget parlance, revenues in this fiscal year are down 17% while outlays are up 21%.

"That's a $530 billion increase in spending from fiscal 2008.

"The CBO still projects the government budget deficit to exceed $1.8 trillion, about four times 2008's record $455 deficit. More to come tomorrow, when the Treasury unveils official budget numbers.

"Sounds like a great time for the government to buy a bunch of fancy jets! Congress recently earmarked $550 million in a defense-funding bill to buy themselves eight private passenger jets. That would be the same Congress that went out of its way to publicly embarrass Big Three execs for jet setting from Detroit to DC.

"Prepared for a public backlash, Congress has several lame talking points at the ready...that the current fleet of private jets is outdated...that having new high tech planes will be better for the environment and ultimately lower cost...and that these planes will be used mostly by the Pentagon, only about 15% of the time for lawmakers.

"But here's our favorite: Legislators are eager to complete the transaction so that they can have a new fleet in time for the busiest Congressional travel period of the year... August, when they are all on holiday!

Ian writes every day for The 5 Min Forecast, an executive series e- letter that provides a quick and dirty analysis of daily economic and financial developments - in five minutes or less. It's a free service available only to subscribers of Agora Financial's paid publications, such as the Hulbert #1 Performing Investment Letter, Outstanding Investments.

And back to Bill, with more thoughts:

Harvard professor Ken Rogoff says it will take 6-8 years for households to reduce their debts to a more sustainable level. Let's see. We reported on Friday that the big upswing in credit over the last 60 years added about $35 trillion in excess debt to the system. But not all of that is private debt.

Taking the period of the bubble years, in 2000 total debt in the United States came to $26 trillion. Now, it's twice that amount - $52 trillion, of which $38 trillion is private...or more than two and-a- half times GDP. **At this level, the private debt absorbs roughly one out of every seven dollars in consumer earnings - in interest and principal payments.**

If the private sector undertook to reduce debt back to 2000 levels, it would mean eliminating all the debt accumulated during the bubble years - or about $19 trillion. How long will it take to pay down, write off, inflate away and otherwise shuck $19 trillion? Well, inflation is running below zero - so that is not now a source of debt reduction. Between write-offs and pay-downs, about $2 trillion has already been cut - over, very roughly, the last 2 years. At least the math is easy. At that rate, it will take 19 years.

Now, let's go back and look at the Japanese. How long have they been deleveraging?Gosh all mighty...19 years. From 1990 to 2009.

Are we looking at a 20-year period of on-again, off-again deflation...of bear market rallies followed by real bear markets...of weak employment and weak or no growth? That's what we argued, along with Addison Wiggin, in our first book, *Financial Reckoning Day*. Then, the stock market took off...and the bubble years came. It looked like we were dead wrong. Maybe we were just early. Or maybe those bubble years were just a feint...a fake-out that convinced the entire world to invest in stocks and property, just before the biggest crash in history.

In that book, we guessed that the crash in the tech sector marked the beginning of the end. By 2005, it didn't seem at all as though we were in a down-cycle. But adjusted for inflation, stocks never beat their January 2000 high. And outside of government, the economy has no more jobs than it did in 1999. We've had wars against terror, bubbles in practically every sector, trillion-dollar boondoggles, bailouts, bamboozles and Michael Jackson's tragic cooling...but **what is the only durable thing to come out of the last 10 years? Just Google and debt.**

[Incidentally, the newly-updated second edition of *Financial Reckoning Day* was just released. Get your copy here.]

"When you have a big family there is always someone in the family who is in trouble," said another friend.

"I thought that when the children left home to go to college, we'd be more or less free from problems. They'd be on their own. We could turn our attentions to other things.

"Well, it didn't turn out that way. **There's always one of them that has a problem.** And we spend a fair amount of time worrying about them...even if there's nothing we can do to help. Or trying to help them if we can...

"And then the grandchildren come...and then we worry about them. It just goes on and on. It's not disagreeable, of course. I'd rather have children and grandchildren to worry about than not have them. But there doesn't seem to be any end to it..."

Until tomorrow,

Bill Bonner
The Daily Reckoning