Hello Everyone,

Warren Buffet once quipped, “You never know who's swimming naked until the tide goes out.”

Today's missive addresses the tide. Did companies use the "stimulus" of QE money and zero percent interest rates to increase productivity? Or, did they "financialize" their way to higher earnings per share?

I hope you become a better investor after this quick two-minute read.

Signed, Your Always-Wears-A-Bathing-Suit Financial Advisor,

Greg

KKOB 10.15.2018 Financializa on vs. Industrializa on

Bob: So, Greg, on Friday you said in passing you wondered if the market’s growth over the past several years was fueled by real growth in the companies, or was it a func on of debt? I didn’t really get that.

Greg: I should explain things better. Sorry. Let’s unpack the idea of debt as a subs tute for organic growth. And, to make my point, let’s go back to the aftermath of the Lehman crisis.

We all remember, nine years ago, everyone was s ll trying to sort through the collapse of the mortgage bubble. The Dow had fallen 42% when the Fed finally said, “Enough is enough. We’re turning on the prin ng press to prevent further damage.” So, over the next few years, they printed $4.5 trillion for the US…and, they opened a $16 trillion swap line to the rest of the world.

Soon, central banks everywhere followed suit. Japan, China, Europe, England all opened the money spigots. Trillions upon trillions flooded the world. It was a sight to behold. Think of that is as the fuel.

Now they needed a spark. So, they drove interest rates to zero and they changed accounting rules to allow more leeway in recognizing past losses…or, better said, not recognizing past losses at all. Basically, they said, "C'mon world! Borrow at super low rates! You may never have this chance again! And, don't worry about reporting that old debt…we'll cut you some slack." So, the world said, "Woo hoo! Let's go!" And, off we went.

Bob: But, that all involved more debt …or, maybe better said, new debt piled on old debt.

Greg: Right. And, as we've said before, not all debt is bad. Debt that leads to wealth-creation is great. Borrowing to build a factory that makes products the world wants is a wonderful thing. Borrowing for financialization, however, was something new...we don't yet know the consequences of these policies.

Bob: Wait. I don't know that term---financialization. That's new to me. What is it?

Greg: Sorry. When you borrow money to build a factory that makes profitable products, we call that industrialization. Your building industry.

Now, you can also use borrowed money to say---buy back your company stock. That will reduce the number of shares on the market and make <u>***profits per share***</u> more robust. Or, another example. You can use low interest rates to refinance your loans from 5% to 2%. That helps your profits, too. Now, neither one of those is necessarily bad, but in each case, you're not making new and better products. You're just taking advantage of the financial environment. That's financialization.

Does that explanation make sense?

Bob: It does. So, you're saying many companies used the printed money and the zero percent rates to drive profits----rather than really creating new wealth. So, we financialized a stock rally instead of industrializing a stock rally. Right?

Greg: Well, financialization was certainly a part of it. Some companies did use the money to make better products---or, to become more efficient. Many others though did what you said. They chose the quick hit of financialization to make things look good. So, as with all things, it's a mix. Regardless, debt soared.

The remarkable thing is, this phenomenon went global. Everywhere, markets were goosed. Stocks and real estate leapt. But, the foundation was borrowed money---and, that money must eventually be repaid… with interest.

And, as rates rise, this tower of debt is starting to sway.

Bob: OK. So, the catalyst that could flip the market from up to down could be something as simple as rising interest rates since everyone pays interest on debts. That means those companies that financialized their growth will be vulnerable than those who industrialized their growth.

Greg: Right! Perfect summation. And, we don't have to go off into woo-woo land to find catalysts that can spark a debt crisis. Rising rates. Currency adjustments. Recessions. Trade Wars. All affect debt. So, let's pick up this thread on Friday.

Bob: Sounds good. How do people reach you?

Greg: My number is 508-5550. 508-triple zero. Or, go to my website at zanetifinancial.com.