

# Warren Buffett - Debt and Delusion

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A large part of Warren Buffett's success in investment has been his ability to anticipate major market corrections namely 1973, 1987 and 1990. He is again pessimistic at its current level.

This view is shared by many respected economists and writers.

Stephen Tominey writing in the Guardian on the 15th October 2001 states that the United States financial system risks implosion under the weight of accumulated mountain of credit claims. He said, "cheap and plentiful credit has been the motive force behind the great economic expansion. I fear we may be entering some form of end game since despite repeated extreme levels of credit supply, economic growth continues to slow. US corporate sector profits have been in decline since 1997. Yet perversely, investment and equity buy backs have accelerated, thus exacerbating an already dangerous situation with business debt climbing significantly. When accidents happened, the Federal Reserve has been there to support and maintain bull market confidence. By underwriting market risk in this way, the Fed has had the effect of artificially lowering its price and compounding systematic risk."

One such example was the collapse of the Long Term Capital Management Fund in 1998. Nicholas Dunbar told the story of the Fund's demise in his book "Inventing Money." In its preface he said, "according to Goldman Sachs Asset Management, during the crisis, the assets held by UK's top 50 pension funds fell to 40% below the level needed to match their liabilities. No one really noticed because the crisis didn't last long enough for these market valuations to filter through the system. Next time we might not be so lucky."

Peter Warburton is one of the UK's most respected financial commentators and a past winner of economic forecasting awards. He addressed the issue of world debt comprehensively in his book "Debt and Delusion". In an afterword to the second edition, in 2000, he stated that, "debt has many forms. For as long as there is some new source of credit available, the equity market is capable of further extension. Only when all conceivable avenues of borrowing have been exhausted will the party be over. When lenders, whether banks or non-banks, are overcome with fear of mass delinquency on their loans or investments, then credit access will seize up. September 1998 was merely a dress rehearsal for the real credit quality crisis that threatens to bring down the curtain on this deluded generation of investors"

This year, net claims in the US financial system stood at an astounding \$28,000 billion. Warburton has estimated that globally the aggregate debt was \$90,000 billion. It is difficult to see how occasional injections of \$100 billion by the Federal Reserve or the IMF can have much of an impact on global financial events.

Barry Riley in an article on the 15 December 2001 in the Financial Times said, "financial imbalances were reaching disturbing proportions, including the trade gap and the enormous private sector deficit in the US. These are together with a dangerous stock market bubble that is already in the early stages of a serious

collapse. Further economic growth would depend on the expansion of a menacing debt mountain.”

Yet, the investment community proceeds seemingly unaware of the real danger of a debt crisis. Even the collapse of a worlds largest utility, Enron, with debts in the order of \$20 billion and the defacto debt default of \$100 billion of a sovereign nation, Argentina, cause barely a ripple in the world markets. It seems unlikely that such disregard can continue.

In July 1998, writing for the first edition of his book, summing up the situation somewhat dramatically but nonetheless pertinently, Warburton concluded, “There are many indications that this departure from economic reality is destined to reach its terminus in the relatively near future.... Whatever pulls the trigger.... is impossible to know; but when it happens, we will all know. How much time do the institutions, companies and citizens of prestigious western nations have to change course? Until the end of 1999? Probably. Until the end of 2001? Possibly. Until the end of 2003? That would take a miracle.