AMERICA THE DEBTOR

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"Words pay no debts, give her deeds", says Pandarus in Shakespeare's "Troilus and Cressida" (Act III, scene II)

CONCLUSION

In recent weeks, much marketplace and media attention has underlined growing United States household net worth as well as decreasing household indebtedness as a percentage of GDP. Pundits proclaim that federal budget deficits have substantially declined from the towering heights of only a couple of years ago. Hasn't the American and worldwide economy generally improved since the dreadful times of late 2008/early 2009? Americans point to the stratospheric rise of the S+P 500 since its March 2009 major low around 667. And look at those great US corporate earnings of the past couple of years! All such talk surely encourages optimism regarding the American financial situation, as has the related sustained highly accommodative monetary policy rhetoric and action of the Federal Reserve Board and its central banking comrades around the globe. Yet although Fed policies such as gargantuan money printing, severe interest rate repression, and fancy wordplay regarding forward guidance have boosted morale and purchased time for action on America's major debt problem, they have not bought a solution to that issue.

To better perceive and assess America's debt challenge, sentinels should adopt a wider perspective, focusing on the overall United States debt situation over a long historical period. For over five decades, from the early 1950s up through the glorious Goldilocks Era that ended in 2007, and for a couple of years thereafter, total US indebtedness as a percentage of nominal GDP climbed steadily and substantially.

Remarkably little progress has been made in the comprehensive (all-inclusive) US debt situation since 2009's very lofty percentage. Increasing federal indebtedness has substantially though not entirely outweighed improvements in the consumer and state and local government sectors. Since the national government is a representative (democratic; "We, the People") one, the general US debt situation has not mended significantly. In addition, although the federal budget deficits will remain relatively small (at least compared to the mammoth gaps of a few years ago), they gradually expand after the next few years. The ongoing substantial US debt mountain consequently remains a long run burden on, and probably also a near term problem for, US and international economic growth.

KEEPING HOUSE

Survey the post-World War Two period (Federal Reserve Board, "Financial Accounts of the United States", Z.1 data; 3/6/14). US household debt as a percentage of nominal GDP reached its ceiling at the height of the glorious Goldilocks Era at 95.5pc ($13.8 trillion) in 2007. By end calendar 2013, vigorous housekeeping efforts had slashed this percentage to 78.0pc.

The Fed's Financial Obligations Ratio, which compares required household debt payments to total disposable income, attained its summit (1980 to present) at 18.1 percent in 4Q07. It tumbled under 16.0pc with 1Q11's 15.8pc. Since then, the FOR has stayed around that magnitude, reaching a low of 15.2pc in 4Q12, resting at about 15.4 in 3Q13 (the most recent data). It thus has walked back to its 1992-94 levels.

The net worth of households (and nonprofit organizations) at end 4Q13 advanced to $80.7 trillion. This spiked 36.9pc from end 2009's $58.9tr. (Z.1, Table B.100). Stocks (and other "financial assets") played key roles in this revival; owner's equity in real estate also jumped higher.

Yet despite the decline in US consumer debt as a percent of nominal GDP and the parallel increase in household net worth, current household debt levels remain quite substantial relative to long run history. That percentage stood at merely 12.4pc in 1945. By 1965, and perhaps partly because Depression Era memories had faded to some extent, it climbed to 45.8pc. To many people nowadays, the 1945 to 1965 era represents an ancient epoch, for that was a lifetime of 50 to 70 years ago. Household debt as a percentage of nominal GDP remained relatively steady for the next decade or son. However, from 1977's 45.8pc (the same as in 1965; 42.8 was the low from 1965 to 1977), America's household debt percentage accelerated uphill. Savers become spenders (and many become debtors). It reached 60.9pc of GDP in 1991, advanced to 71.8pc in 2001, raced to 82.2pc in 2003, and jumped to 2007's 95.5pc roof.

End calendar 2013's 78.0pc level still hovers well above 2001's 71.8pc. And even 2001 soars over 1977's and earlier percentages. So from a long run vantage point, the significant improvement in the US household debt situation since 2007 probably has not yet resulted in a moderate debt level. So arguably America's culture of debt, gradually created since the end of World War 2, remains rather entrenched.

DEBT AND REPRESENTATIVE GOVERNMENT

At the end of 2013, total United States federal, state, and local debt was $15.3 trillion, with the federal share about $12.4tr. In 2013, federal debt was 73.5 percent of nominal GDP, state and local 17.5pc (based upon Federal Reserve Z.1 data).

Some commentators underline that in the past few years, despite notable variation between some states and local governments, the state and local debt position has improved modestly. Indeed, the American state and local debt percent of GDP peaked at 20.6 percent in 2009. However, the current level extends well above 2000's 11.6pc. Viewers should temper their optimism on this front. As an aside, keep an eye on Puerto Rico's dreadful debt condition.

What about the level and trend of the nation's federal debt situation? Underscore that the federal amount of 73.5pc at end 2013 leaped since 2001's 31.8pc. Despite debt reductions relative to GDP on the state/local and household fronts, the federal fiscal situation has deteriorated dramatically.

Some marketplace wizards warn of dangers to economic growth and financial stability when overall (general) national debt (federal, state, and local obligations combined) exceeds 90 percent of GDP. America recently crossed that threshold. Federal, state, and local debt a percent of nominal GDP touched 91.0 percent as of end 2013.

Admittedly this elevated general government total lurks below that at the end of World War 2, 1945's 115.7pc. However, America's overall government debt position (federal plus state/local) generally has marched upward dramatically in recent decades. Recall the 36.6pc of GDP bottom in 1974. It bounded up to 62.4pc in 1991. Although it slipped to 44.1pc in 2001 (above 1974's elevation), it stepped up to 55.0pc by 2007 during the Goldilocks Era. It spiked to 74.7pc in 2009 as the worldwide economic disaster unfolded. Despite America's recovery since 2009, that debt percentage nevertheless expanded to 2013's 91.0pc. Thus from the general government perspective, America's debt position has worsened.

So even though US household debt as a percent of nominal peaked in 2007 and state/local debt topped in 2009, the federal total continued to grow over those years. Consequently, it appears that America's debt burden simply has shifted somewhat from the household and state/local level to the federal level.

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What is the prognosis for America's federal debt situation? Some believe that significant cuts in federal budget deficits in the recent past and for the next few years relative to the summits during the Great Recession and its aftermath signal fundamental (lasting) progress. Though obviously much can happen over the next decade and beyond, the long run budget situation remains troublesome. In addition, even over the next several years, the federal outlook does not really improve; it merely ceases worsening significantly.

Finally, Washington's partisan political battles in recent years are not likely to improve the country's debt circumstances significantly as election year 2014 unfolds and Presidential election year 2016 approaches. For the next three years, a Democratic President faces a Republican House, regardless of whether or not the Senate shifts after 2014 to a Republican majority from a Democratic one. Besides, how many national leaders are talking about running a budget surplus, as in fiscal year 2000's $236 billion (2.3pc of GDP)?

Anyway, recall 2009's $1.4 trillion deficit (9.8pc of GDP) and both 2010 and 2011's nearly $1.3tr each (8.8 and 8.4pc of GDP). Remember 2012's nearly $1.1tr shortfall (6.8pc of GDP). Now focus on the next decade. The Congressional Budget Office's "The Budget and Economic Outlook: 2014 to 2024" (Summary Table 1, 2/4/14) points out that the fiscal year 2013 deficit fell to $680bb, or 4.1pc of GDP. Looking forward, the CBO forecasts that huge deficits from the financial crisis period will not reappear soon.

This clairvoyant states that the 2014 federal deficit will be $514bb (3.0pc of GDP), with 2015's deficit marking a $478bb low (2.6pc of GDP). Yet these are still deficits, right? In any event, the CBO notes that these deficits thereafter gradually rise. It predicts deficits will reach $655bb in 2018 (3.1pc of GDP) and over a trillion dollars in 2022 (4.2pc GDP; 2024's will be 4.0pc). The deficit averages 3.0pc of GDP from 2015-19 and 3.5pc over the 2015-24 span.

From the federal vantage point, America's debt situation probably will remain troublesome. Debt held by the public was 72.1pc of GDP at end fiscal year 2013. It stays around that level- and so does not diminish- over the 2014-17 period. It then gradually grows, from 72.6pc in 2018 to 79.2pc in 2024.

AMERICA: ENAMORED OF DEBT

"Let us live in as small a circle as we will, we are either debtors or creditors before we have had time to look round." Johann Wolfgang von Goethe, "Elective Affinities", Book II, chapter 4

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Total United States credit marketplace debt at end 2013 stood at about $59.0 trillion. The total includes US household, financial and non-financial business, and government debt, plus the relatively small foreign/rest of the world category. Compare 2001's $29.4tr. Thus America's credit marketplace debt has doubled in a dozen years, and there has been no yearly fall in the sum since 2001.

What does a long run examination of total United States credit marketplace debt as a percent of nominal GDP reveal? Scan the post World War II period. The bottom in overall US credit marketplace debt as a percent of GDP was 1951's 129.4pc. It inexorably edged up for about thirty years. It then started speeding up from 1981's 163.7pc. In 1985, it reached 200.6pc, in 1998 258.2pc, then 277.0pc in 2001. In 2003, it attained 301.8pc. That debt then majestically flew up during the wonderful Goldilocks period to 353.1pc in 2007. As the gloomy American (and global) economic crisis emerged and proceeded, the total US credit marketplace debt peaked at 371.0pc in 2009.

So despite lots of verbiage from many pundits in recent months about improving near term American debt conditions, that gigantic percentage has fallen only modestly since 2009. It slipped to 350.8pc of nominal GDP in 2012, rising slightly to 351.2pc in 2013. Notably, the 2012 and 2013 percentages remain around that of 2007's plateau during the Goldilocks Era.

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This review of total American credit marketplace debt portrays the development of a national culture of debt. The long run trend probably indicates a growing bias toward consumption and spending rather than saving. The increasing borrowing and massive debt accumulation arguably in part also probably reflect an increasingly widespread sense of entitlement to American Dream goals of the "good life" and a "better life".

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The Federal Reserve's long-running extraordinary and very lax monetary policy (notably money printing/quantitative easing and interest rate yield repression) seek not only to ignite and sustain recovery and buy time for serious action in the federal fiscal and other debt domains. The Fed also battles to increase inflation to an allegedly sufficient level while repressing yields on debt securities. Its strategies reflect the central bank's bias on behalf of the constituency of debtors (borrowers) relative to the one of savers (creditors).

FOREIGN HOLDINGS OF AMERICAN DEBT

The Federal Reserve's gigantic money printing program, since it has involved massive purchases of US Treasury obligations, has played an important role in financing America's federal debt. In addition, foreign players, both official and private, have purchased huge amounts of US federal government securities. The grand total of foreign holdings (official and private combined) of UST is about $5.8 trillion (US Treasury International Capital "TIC" data; 2/18/14). The foreign official category owns about $4.1tr of this (with about 90pc of that in notes and bonds). Of the $5.8 trillion, China holds about $1.3tr, Japan $1.2tr.

Of course the size of the yearly national deficit is a key consideration in the total amount of net purchases of UST, whether by governments, institutions, or individuals. However, although the annual US budget deficit size recently has declined and probably will remain relatively low for the next few years, the Fed slowly has begun tapering its UST (and mortgage-backed debt securities) acquisition rate.

Moreover, net foreign buying of US debt securities (and particularly UST) declined sharply in calendar 2013. Total net foreign buying in calendar 2013 (UST notes and bonds, long term agency bonds, corporate bonds) averaged about $10.0bb per month, with net purchases of UST averaging a meager monthly $3.6bb (TIC statistics). In five of 2013's months, foreigners were net sellers of UST. The net debt buying plummets from 2012's $43.8bb, of which net UST acquisition was $34.7bb. Also compare 2013 with 2011's net buying of $39.0bb ($36.0bb UST), 2010's $66.5bb ($58.6bb UST), 2009's $40.5bb (net buying $44.5bb UST, so net selling elsewhere that year in the debt domain), and 2008's $30.8bb ($26.2bb UST).

Assume Fed tapering continues over the next several months, with the widely-beloved central bank finally ending its voracious debt securities buying. Suppose also that net foreign UST purchases remain anemic. Suppose as well that US domestic (private) acquisitions do not pick up the slack. Keep in mind the Fed's determination to achieve its two percent inflation target. So all else equal, Fed tapering, especially if accompanied by sluggish net foreign buying, will tend to push American interest rates a bit higher. Recent highs for the benchmark UST 10 year note at just over three percent (3.05pc on 1/2/14; 3.01pc on 9/6/13) will be challenged again and eventually broken.

What happens to yields of UST (and related government and corporate debt) if foreigners, perhaps troubled by a relatively weak dollar or renewed deterioration in the US federal debt situation, become net sellers of UST?

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Admittedly the UST marketplace remains a "flight to quality" (safe haven) realm for many financial marketplace participants. Thus should emerging stock marketplaces continue their current bear trend (or if government yields in one or more key emerging marketplaces spike), or if equities in advanced nations (watch the S+P 500, European weathervanes, and Japan's Nikkei) begin to erode sharply, then UST yields may decline for a while before resuming their ascent.

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Keep in mind the long run American federal debt problem in the context of currently very high existing federal- and overall US total credit marketplace- debt levels. This scenario tends to propel UST rates upward.

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Suppose the Ukraine/Russia fight over Crimea (and perhaps over other Russian speaking lands in the Ukraine) results in noteworthy American sanctions on Russia. Might Russia retaliate by selling some (or all) of its UST holdings? These totaled about $138.6bb as of end 2013.

<u>GOVERNMENT DEBT COMPARISON: AMERICA AND THE EURO AREA</u>

America's general government (combined federal, state, and local) debt and budget deficits of course are not the highest in the world. Yet they are not the lowest, either. See the International Monetary Fund's "Fiscal Monitor" for details (though the most recent issue is October 2013's, it still offers perspective).

Many intertwined variables influence currency cross rate levels and trends, as well as broad real trade-weighted ones (such as that of the trade-weighed US dollar). However, government debt and budget levels and trends are relevant considerations to currency levels and patterns, not just interest rate (and stock marketplace) ones.

The Euro FX cross rate versus the US dollar recently has hovered close to 1.400 (1.397 high 3/13/14), having rallied from its major low of 1.204 on 7/24/12 and subsequent important interim 2013 bottoms at 1.275 (4/4/13) and 1.276 (7/9/13). Given this bull move in the Euro FX against the dollar since its major low in July 2012, and especially recently, and given that the Euro Area is a major trading partner of America's, why not briefly consider debt and deficit levels in the Eurozone region in relation to America's?

The Eurozone's GDP growth has been less than America's in recent years and probably will remain so. Relatively sluggish growth probably does not encourage a strong Euro FX cross rate. Consequently, some of this bull move in the Euro FX may result from the European Central Bank's having a relatively tighter monetary policy (and more of an inflation-fighting mandate and history) than the Federal Reserve (although the ECB probably does not want to see the Euro FX climb toward its 5/4/13 pinnacle around 1.494; beware of ECB quantitative easing talk). In addition, the Fed probably wants and encourages a relatively feeble broad real trade-weighted dollar ("TWD").

Despite all the emerging marketplace concerns of recent months, the TWD remains rather feeble. At 85.8 in February 2014 (monthly average, March 1973=100; Federal Reserve H.10), it neighbors June 2012's high at 86.2. However, these levels are not that far above July 2011's record 80.5 depth. The February 2014 and June 2012 levels are very close to prior record lows around 84.0 (84.2 April 2008; 84.0 July 1995; 84.1 October 1978). The February 2014 level resides well beneath March 2009's 96.8 peak (during the dark days of the worldwide economic crisis; S+P 500 major low likewise March 2009) and especially the major high at 112.8 in February 2002.

However, there is another big difference between America and the Euro Area that probably encourages Euro FX strength relative to the US dollar. Although individual nations within the Eurozone of course still confront debt problems, the overall European government debt situation looks less dangerous than that of the United States.

Authoritative general government debt estimates for a given nation are not necessarily identical. However, the IMF's Fiscal Monitor is a benchmark data source for the worldwide situation. Its Statistical Table 4 on general government gross debt as a percentage of GDP shows that the US level in 2013 exceeded that of the Euro Area by about 10 percentage points. This difference increases to nearly 16 percentage points by 2018. For the short term, the European Central Bank's 3/16/14 Press Conference declared that Euro Area debt would peak at 93.5pc of GDP in 2014, before declining slightly in 2015.

In addition, Europe's overall (general government) budget deficit as a percent of GDP from 2013 through 2018 averages about 2.4 percentage points per year less than that of the United States (Fiscal Monitor, Statistical Table One). The 3/6/14 European Central Bank Press Conference estimated the general government deficit at 3.2pc of GDP for 2013, with that for 2014 dipping to 2.7pc.

<u>OTHER OBLIGATIONS</u>

As a footnote, remember that other notable long run payment obligations walk on the US stage. The funding for some of them may be falling significantly short of requirements. For example, unfunded state pension liabilities probably are substantial, though the absolute total is in dispute. One expert has estimated them to be as high as $4.0 trillion. The NYTimes headlined: "Public Pension Tabs Multiply as States Defer Costs and Hard Choices" (2/25/14, pA12). Also, monitor unfunded corporate pension obligations.

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