DESPERATE HOUSEWIVES (EPISODE 5)- LET'S GET FISCAL!
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Kiss sings in "Rock Bottom":
"Hard times got me down
Good times ain't around"

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CONCLUSION

We all know that America is not a single player in the economic scene. The vigorous fiscal and monetary responses of the United States and its friends to the worldwide financial crisis that erupted in 2007 indeed have supported near term economic recovery and excited some optimism. Look at the jump in key stock marketplace playgrounds and many commodity sectors!

Nevertheless, America increasingly looks married to fiscal deficits. The Federal Reserve Board not only promises, at least for now, the ongoing joys of low nominal government interest rates. It has espoused a new foray into quantitative easing. The ongoing threesome of large and growing fiscal deficits, lax Federal Reserve policy, and a feeble US dollar should worry marketplace voyeurs. US interest rates in general are in the process of mounting higher. The US dollar probably will decisively penetrate its all time lows. Rising yields alongside a falling dollar increasingly will undermine and eventually reverse a fair amount of the worldwide equity rally that began in spring 2009.

DOMESTIC FINANCE: FEDERAL (AND OTHER) DEFICITS

The Lovin' Spoonful sing in "Money": "Somehow my finances will grow,
With the interest I show,
In the interest it gives me,
And now a piece of paper from me,
Won't seem half as flimsy."

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In August 2010, the US Congressional Budget Office (CBO) underlined that relative to the size of the US economy, the 2010 deficit will be the second largest shortfall in the past 65 years. The 9.1 percent deficit relative to nominal GDP challenges 2009's 9.9pc. This prediction assumed that tax reductions enacted several years ago would expire at end 2010 as scheduled. The August CBO predicts the 2011 deficit at 7.0pc, with 2012's 4.2pc. "The Budget and Economic Outlook: An Update" (note Summary Table 1 at page xi).
http://www.cbo.gov/ftpdocs/117xx/doc11705/08-18-Update.pdf

However, it appears the legislative and executive branches eventually will enact proposals adding about $850 billion or so to the deficit over the next couple of years (NYTimes, 12/10/10, pA22. Some estimates are higher, perhaps a trillion bucks. See the Financial Times, 12/8/10, p8). In the B-52s "Love Shack", we hear "The Love Shack is a little old place where we can get together".

This $850 billion increment is not chicken feed. The actual 2009 deficit was a sky-high $1.41 trillion; 2010's is forecast at $1.34 tr. Suppose one adds $425bb to the 2011 deficit of $1,066bb to equal about $1.49 trillion. Divide that by forecast nominal GDP of about $15.15 trillion. Thus the 2011 federal budget shortfall will equal 9.8pc of GDP. Perhaps this spending will kick nominal

GDP up some relative to the CBO forecast. Suppose nominal GDP edges up two pc from the August indication. In any event, the deficit remains high, at 9.6pc (1.49/15.45); this level is 2.6 percentage points over the August CBO level. Repeat this back of the envelope calculation for 2012. The 2012 deficit grows to $1.09 tr. Divide this by the August forecast of nominal GDP around $15.76tr. The deficit reaches 6.9pc, a 2.7 pc point boost versus the August indication. Shift upward the 2012 estimate by two percent. The deficit still is 6.8pc of 2012 GDP (1.09/16.08).

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Even if one ignores the potential $850 billion deficit increase, existing federal debt is substantial. As of end 3Q 2010, federal government debt outstanding was about $9.06 trillion (Federal Reserve Z.1, Table D.3). Relative to 3Q2010 nominal US GDP (annualized, Bureau of Economic Analysis), that is 61.4pc. Compare the 2001 levels of $3.38 trillion and about 32.9pc of GDP. Going back to the mid-1970s, the prior pinnacle was 1993's 50.0pc.

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In "California Love", Tupac Shakur raps: "Now let me welcome everybody to the wild, wild West A state that's untouchable like Elliot Ness". Yet the dreary downturn has damaged mighty California and many other states and local governments. So let's not forget America's state and municipal situation. Third quarter debt outstanding is $2.42tr. Combining that with the federal debt inflates debt outstanding to 77.8pc of 3Q10 nominal GDP. This soars over the 45.5pc of 2001 and breaches 1991's 64.3pc plateau.

For more details on the local landscape, survey the CBO's recent release, "Fiscal Stress Faced by Local Governments (12/9/10)
http://www.cbo.gov/ftpdocs/120xx/doc12005/12-09-Municipalities_Brief.pdf
Also scan "The Crisis in Local Government Pensions in the United States", by Robert Novy-Marx and Joshua Rauh (10/13/10)
http://www.kellogg.northwestern.edu/faculty/rauh/research/NMRLocal20101011.pdf
See too the NYTimes, "Mounting Debts by States Stoke Fears of Crisis" (12/5/10, pp1, 28).

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In troubled times in a representative democracy of "We, the People", it perhaps should not be surprising to see such deficits mirrored in (transferred from) those in households. US household debt was $13.80 trillion at end of 2007, or 98.2pc of nominal GDP; end 2008's $13.84tr was 96.3pc. Compare the modest decline in household indebtedness to 3Q10's $13.43tr (91.1pc of GDP) with the federal government's growing obligations. Household debt as a percentage of nominal GDP rose dramatically in over the past few decades. In 1976, it was about 44.9pc, in 2001 74.5pc.

Net worth levels for consumers obviously influence abilities to shoulder and fulfill debt obligations. Yet consumer net worth suffered bloody wounds during the recent economic crisis. Even at end 3Q10, net worth was down about $9.4 trillion (14.6pc) versus end 2007, having recovered only about six trillion since end 1Q09. Owner's equity in household real estate was 56.5pc and $12.8tr at 2006's close. At end 3Q10, it was 38.8pc and $6.4tr (Federal Reserve Board, Z.1. Table B.100).

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Moreover, apart from the increased federal deficit spending of the recent past and for the near future, keep in mind concerns about long run US structural deficit issues raised by the Federal Reserve and other commentators. How long will Congress and presidents abdicate responsibility regarding solutions to these concerns? The fabulous deficit spending by Congress alongside the Fed's monetary printing extravaganza resembles a burlesque show.

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The St. Louis Fed President, James Bullard, provides interesting opinions relevant to US interest rates and deficits. "My monetarist friends are anxious to avoid creating too much inflation. This is a legitimate and important concern." However, Bullard and the Fed currently are sweating more about insufficient inflation. Moreover: "This outlook [the US long run fiscal outlook] remains very poor no matter what the Fed does." ("The U.S. Monetary Situation and Recent Monetary Developments"; 12/2/10).

IN THE DEBT BALLET, THE US IS NOT A SOLOIST

In the novel "Dangerous Liaisons" (Letter 20) by C. de Laclos, a character writes: "Once one becomes interested in the game, there is no knowing where one will stop."

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There are various ways to measure and compare government debt and sovereign risk. The International Monetary Fund provides information on gross and net general government debt, sovereign risk, and related variables for many key advanced economy nations. ("Global Financial Stability Report", Chapter 1, note Table 1.1 at p6; October 2010).
http://www.imf.org/External/Pubs/FT/GFSR/2010/02/pdf/chap1.pdf
However, this table does not list many Asian, Russia, and Latin America nations. Observers also should remember the debt chronicles and crises of these regions in past years.

In 2010, European debt (deficit) problems such as those of Greece and Ireland (and sometimes Portugal and Spain and Eastern Europe) have scared regulatory and political guardians. Will financial firefighters halt problems on some so-called periphery before they spread?

US fiscal, trade, and currency issues of course are not divorced from those of Europe, China, and elsewhere. But the European deficit vaudeville acts and Euro FX performances during 2010 to some extent have deflected attention from the American stage.

From the standpoint of some observers, Europe as a whole actually may be in better shape than the US in regard to near term debt situation and monetary policy. If so, what does this portend for the US dollar? The ECB President, Jean-Claude Trichet, notes ("Introductory Statement with Q&A", 12/2/10): "this year the consolidated fiscal deficit in the euro area is 6.3% of GDP. According to present estimates, it is 11.3% in the United States [this calculation probably includes state and local deficits] and 9.6% in Japan. Next year…the consolidated public finance deficit of the euro area is estimated to be 4.6% as a proportion of GDP. For the United States the figure is 8.9%, and for Japan it is 8.9%. And I could cite other big advanced economies that are in this category."

Moreover, at least so far, the ECB "sterilizes" its securities buying interventions. See the ECB's "Securities Markets Programme" (Press Release, 5/10/10); and the 12/2/10 "Introductory Statement with Q&A". By implication, the money printing spectacle by the US Federal Reserve, is far less sanitary, right?

Despite its debt problems, Japan is a nation of savers. Compare America.

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Will foreigners rush to purchase the looming abundance of US government securities? Certainly they won't swallow all of the supply. Foreigners held about $3.58 trillion in Treasuries at end September 2009, and $4.27tr at end September 2010, an increase of about $700bb (about 19.3pc).
http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt
This $700 billion equals roughly half of the 2009 US federal deficit (and likewise for that of 2010).

Suppose additional deficits increase as indicated above, so that the US government deficit in 2011 increases to almost $1.5 trillion. That's over twice the net buying by foreigners over the last year of so. Based on recent patterns, maybe overseas buyers will acquire half the upcoming supply. What about 2012, with its further delicious offering of $1.1tr?

Yet how appetizing will all this additional debt seem to foreigners, especially if US interest rates are rising? Suppose the dollar weakens further. What if US rate hikes or dollar weakness occur "rapidly"?

Somewhat less than adequate net foreign hunger for US government securities would be disturbing. However, sharply reduced net foreign buying relative to the past year or so would be nerve-wracking for US (and many other) economic sheriffs. Net overseas selling by foreigners would terrify such audiences. The Fed's current quantitative easing scheme offers foreigners (and others) an ongoing bid if they want to reduce their net holdings of US Treasuries. Anyway, assume foreigners and American taxpayers do not buy enough government notes, bonds, and bills. Will the Fed put on its apron and scramble to the rescue, supplementing its current money printing binge?

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Monetary policy and interest rate trends in China and other developing nations may influence America's yield trends and dollar levels. Chinese leaders say they will tighten monetary policy next year (NYTimes, 12/5/10, citing Xinhua, China's official news agency). China's consumer price index rose 5.1pc in November 2010, the biggest increase in 28 months (NYTimes, 12/12/10, p24).

DOLLAR SHIMMIES

In "Playing in the Band", the Grateful Dead declare:
"Some folks trust to reason
Others trust to might
I don't trust to nothing
But I know it come out right."

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Note the broad real trade weighted dollar of levels of October 2010 (84.05; monthly average) and November 2010 (84.18). Compare historic lows (1973-present): April 2008's 84.00, July 1995's 84.05, and October 1978's 84.13.

The Fed and other US policy makers appear willing to let the broad real trade-weighted dollar slide under these all-time bottoms. For example, the St. Louis Fed President, James Bullard recently stated (12/2/10) that dollar depreciation is a normal byproduct of an easier monetary policy, all else constant in the rest of the world. So "other countries need to have systems in place that can adjust to modest changes in U.S. monetary policy."

A weaker global leadership role does not produce a dollar rally, does it? Before the recent multi-billion dollar deficit deal of December 2010, Terrence Checki of the NY Fed remarked: "But with the U.S. public debt rising at its fastest pace since the Second World War and set to soon reach its highest level in relation to national income in over 50 years, we would be kidding ourselves if we believed that today's very large and growing structural fiscal deficits are consistent with a continuing strong global leadership role." ("Challenges Facing the U.S. Economy and Financial System", 11/17/10).

Suppose pressure for higher US interest rates increases, whether through deficit borrowing, increased inflation, or otherwise. Should the Fed insist on holding very low policy (Federal Funds) rates, this boosts the odds for dollar deterioration.

FINAL TAP DANCES

In "A Christmas Carol", Charles Dickens reminds us: "it is always the person not in the predicament who knows what ought to have been done in it, and would unquestionably have done it too".

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Central bankers and politicians continue to face a huge challenge in putting the worldwide economic crisis to bed once and for all. The Fed's quantitative easing and other rescue programs may breed consumer and business confidence and rally nominal prices for equities, real estate, and many commodities. Its pillow talk regarding exit strategies, temporary measures, fierce determination to prevent excessive inflation, and central bank independence surely comfort it and some audiences. Yet such policies and rhetoric do not preclude higher interest rates or a weaker dollar. And whether such money printing encourages noteworthy real economic growth and genuine prosperity over some definition of the long run is a fascinating question. Maybe the policy just buys time.

Watch the government yield curve. It will be interesting to see how long the Fed can suppress short rates if note and bond yields climb higher. Monitor credit spreads, both between sovereigns and between government instruments and those of business sectors.

Deficit spending can stimulate nominal GDP growth, and perhaps even increase measures of real GDP for a while. Governments of course may postpone (roll out into the future) their impending financial obligations, yet they must meet whatever their current bills are. Or else.

Economic history warns that one path for debtors- whether national, business, or consumer- eager to escape their obligations- is restructuring or default. For some countries, currency depreciation represents an additional tempting choice.

Imagine an advanced nation confronted by a so-called developing nation problem (such as too much debt). That advanced nation may need to adopt a developing nation style strategy. In the current global economy, to better pay their debts and compete in some domains with energetic developing nations, what options can the United States and its allies embrace? Exploiting existing advantages and skills and boosting productivity sound appealing. However, suppose these remedies do not provide sufficient first aid. Then alternatives may involve working longer hours, lowering labor costs (wages), and depreciating the currency.

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History is not destiny. Also, the existence and extent of- and reasons for- price convergence (or divergence) between equities, interest rate, foreign exchange, and commodity arenas are matters of opinion. So are viewpoints regarding whether one marketplace leads or lags another.

However, in the inflation era of the mid-1970s through mid-summer 1982, keep in mind that equities only managed to travel sideways.

Money printing and dollar depreciation may assist equity (and commodity) rallies, but up to what point? Suppose interest rates in general move a “notable” amount higher while the dollar weakens “sharply”.

Observers should remember the intertwining of stock, debt, currency, and commodity playgrounds during 1986-87. Bond yields rose for several months before the August 1987 stock peak. Note the yield lows for US T-Bond nearest futures in April 1986/August 1986/March 1987. During 1986-87, the broad real trade-weighted dollar continued the depreciation which had commenced in March 1985 around 128.44. By April 1986 it was 108.38. After July 1987, the TWD descended decisively beneath 100.00.

Watch not only the dollar, but also the US ten year note trend in the current economic theater. The 10 year government note plummeted to a panic (flight to quality) low on 12/18/08 at 2.04pc. But look at two years later and note autumn 2010 lows around 2.50pc. As time passes, watch prior highs around 3.90 to 4.30pc (6/13/08 at 4.27pc, 10/15/08 at 4.10 pc, 6/11/09 at 4.00pc, 12/31/09 at 3.91pc, and 4/5/10 at 4.01pc). Compared to the December 2008 time frame, how good is (and will be) US government debt quality- particularly from the perspective of foreign ownership?