MARKETPLACE CLIFFS

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In the film “The Treasure of the Sierra Madre”, Howard, a very experienced prospector, declares: “Ah, as long as there’s no find, the noble brotherhood will last. But when the piles of gold begin to grow…that’s when the trouble starts.” (John Huston, director)

CONCLUSION

Ongoing and mounting concern regarding European problems, especially within the sovereign debt and banking sector, has distracted many marketplace observers from concentrating closely on similar major American issues. The global economic crisis is a long way from being surmounted. Fiscal, banking, debt, and leverage challenges in Europe and the United States (and elsewhere) remain substantial. For the near term, the international crisis probably will worsen. Many perceive the S+P 500 as a rough benchmark measure for overall economic strength. The S+P 500 will head downhill, perhaps precipitously at times. It probably will decisively break beneath its early June 2012 low at 1267.

EUROPEAN BRINKMANSHIP

Numerous European summits have battled to understand and overcome the region’s relentless and withering sovereign debt and banking crisis. Leaders devise clever pacts and mechanisms. Nations offer billions and more billions of Euros in bailout money. The European Central Bank pursues accommodative policies. Optimistic rhetoric from economic and political leaders and their media allies frequently has declared that a solution (or at least a suitable fix) is on the way or in process. Yet that crisis lingers, and it apparently is growing in intensity and spreading in reach. Policy disagreements between European countries remain significant. Will Germany substantially alter its stance? Will Eurozone countries tie themselves together into something resembling a genuine fiscal union anytime soon? Is there, or will there be, sufficient money in the various European rescue funds? Will the Eurozone break apart? How severe a recession do many European realms face?

The economic crisis that emerged in 2007 remains a global phenomenon, so European economic troubles are not isolated. The United States “housing (subprime) problem” that erupted in the earlier stage of the disaster did not confine itself to either housing or America. As international financial marketplace fluctuations and worries manifest, the fearsome European panorama interrelates with issues elsewhere.

AMERICA’S FISCAL CLIFF

In recent months, Europe’s avalanche economic problems often have provided a distraction from difficulties in the United States, China, and elsewhere. Despite the current widespread sharp focus on and the severity of Europe’s fiscal (banking) and other economic issues, why not spend some of our effort on America’s federal fiscal problems and a few related matters? Despite political patchwork by Congress and the President, fiscal topics that once grabbed headlines eventually will do so again, especially as election fever climbs, the deficit ceiling beckons, and changes in tax and spending rules effective in calendar 2013 approach.

The Federal Reserve's urgent rescue operations such as massive money printing, longstanding rock-bottom interest rates, and Operation Twist arguably bought the US some fiscal time. But they did not and will not provide a fiscal fix.

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Under current law, America's federal budget deficit will "fall dramatically" between 2012 and 2013. (Congressional Budget Office, "Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013", May 2012, p1). The CBO mentions that some observers call this a "fiscal cliff". Scheduled tax increases and spending reductions loom. The deficit falls $607 billion, four percent of gross domestic product, between fiscal years 2012 and 2013.

The "resulting weakening of the economy", will have "economic feedback". Such consequences include lower taxable income and higher unemployment (smaller tax revenues; boosts in spending on unemployment insurance). Thus the net deficit drop under existing law will be $560 billion rather than $607bb. The bottom line: the deficit plummets from about $1.2 trillion in fiscal 2012 to around $612 billion in fiscal 2013. (Table 1, p4).

For calendar years 2012 to 2013, the restraint is even greater- 5.1 percent- since most policy changes affecting the deficit begin in January 2013. Economic weakness from the calendar year viewpoint likewise modestly reduces the deficit cut.

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The popular "fiscal cliff" phrase apparently has two aspects. One is the momentous arithmetic descent in deficit spending. The second relates to the economy. Is the American economy "on or near the edge", at risk of falling into recession? The fiscal variable of course is only one factor affecting economic growth.

Slashing the deficit so significantly can help to make the economy stumble, or even tumble downhill. Anyway, the CBO estimates that under current law, US calendar year 2013 real GDP growth inches merely half of one percent higher. It actually contracts at a 1.3pc rate in first half 2013, marching upward at a 2.3pc rate in second half.

But suppose agile US politicians altered fiscal policy in late 2012 to remove or offset all of this upcoming fiscal restraint. The greater the deficit spending (less "fiscal restraint") now, the stronger the economy will tend to be for the near term. The CBO asserts real GDP will shoot about 4.4pc higher in 2013 if there is no fiscal restraint (see Table 2, p6). Yet America still faces a fiscal (economic growth) dilemma. The CBO confesses: "eliminating or reducing the fiscal restraint scheduled to occur next year *without imposing comparable restraint in future years* would reduce output and income in the longer run relative to what would occur if the scheduled fiscal restraint remained in place." (italics in original).

AMERICA'S DEBT MOUNTAIN: NEAR THE EDGE OF A PRECIPICE

Language of the US federal "fiscal cliff" should raise warnings regarding other risky economic elevations. For example, America's current very high deficit level, especially in light of the probable fiscal situation looking forward, probably is very close to a crisis situation.

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US federal debt held by the public is about 70pc of GDP, the highest level since 1950.

Nominal US GDP in first quarter calendar 2012 was about $15.45 trillion (annualized). Thus the 2012 federal fiscal deficit is a bulging 7.6 percent of GDP ($1.17 trillion/15.45tr). Assume that nominal GDP in calendar 2013 ascends to around $16.2 trillion, and that the current law remains in force for 2013. Then the budget deficit of $612 billion will be around 3.8pc of GDP ($612bb/16.2tr). Though the budget deficit is smaller than 2012's, and though it therefore may seem to optimists to represent genuine progress, it still adds to the debt pile.

Despite political quarrels, it is likely that many current policies will be extended for at least the near term. For example, there currently seems to be a bipartisan desire to preserve the existing tax cuts for all but the top one or two percent of income-earners. Therefore the fiscal 2013 (calendar 2013) deficit based upon current law probably will not prevail in practice. Many entrenched current policies may well continue beyond 2013. The percentage of federal debt held by the public looks set to rise for a while longer.

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The US by definition is not Europe, and the European economic and political situation of course is not identical to America's. America is a fiscal union. And not all European (or Eurozone) nations are alike. However, fiscal statistics related to Europe's awesome sovereign debt (banking) situation offer benchmarks by which to assess the dangers existing within the US fiscal situation.

The International Monetary Fund's "Fiscal Monitor" ("FM", April 2012) provides helpful numbers. Analysts can debate which tables illuminate the situation best. Events since April 2012 would adjust the data somewhat.

The FM "general government" tables include state and local government debt with that of the national governments. Look at Table 1, General Government Balance. The United States was -9.6pc (a deficit) of GDP in 2011. The FM predicts -8.1pc in 2012 and -6.3pc in 2013. The overall Euro area deficit is actually lower for these years than the American one; it was -4.1pc in 2011, with -3.2pc for 2012, and -2.7pc in 2013. The US deficit falls only to -4.4pc in 2017, notably above the Euro area's -1.1pc that year. What about some specific Euro area nations about which many tremble? In 2012, Italy's general government balance is -2.4 percent, well under that of America's. Portugal's 2012 hole was -4.5pc. Spain's 2012 balance, -6.0pc, also is beneath America's (though an update to the FM probably would raise Spain's deficit, placing it closer to the US 2012 range).

Review Table 7, General Government Gross Debt. The US gross debt was 102.9pc of GDP in 2011 (soaring from 66.6pc in 2006). The IMF predicts it will be 106.6pc in 2012 and 110.2pc in 2013. It stays at a plateau with 2017's 113.0. Thus there is no progress in reducing it. Moreover, the US gross debt percentage exceeds that of the Euro area. Euro area gross debt was 88.1pc of GDP in 2011. The FM predicts 90.0pc in 2012, 91.0pc in 2013, and 86.9pc in 2017. Thus the US fiscal situation is worse than that of the Euro area as whole from this viewpoint as well.

In addition, note the US's 2012 out to 2017 gross debt levels in comparison with those of Euro area crisis/bailout nations other than Greece. Admittedly Greece's gigantic 153.2pc is larger, and its problems interrelate with those of the Eurozone as a whole. In 2012, Italy's debt is 123.4pc of GDP, Spain's 79.0pc. That of Ireland is 113.1pc, Portugal's 112.4 pc. The average for 2012 of Italy, Spain, Ireland, and Portugal is 107.0pc. However, this is almost exactly that of the US's 2012 debt of 106.6pc.

So this perspective underlines that as the Euro area has a scary fiscal (sovereign debt) problem, so therefore does the US.

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US House Speaker Boehner threatens to hold up an increase in the debt ceiling unless larger spending cuts offset it (NYTimes, 5/16/12. pA1; NYTimes, 5/22/12, pA17). The current US borrowing authority of $16.4 trillion probably will be reached this year. The Treasury probably will manage to delay a default on government securities for a while via cash management measures. (Financial Times, 5/16/12, p3). (Some federal debt securities are not held by the public, but by US government accounts. The Treasury Bulletin shows that in March 2012, of the $15.6tr in face value outstanding, US government accounts held about $4.7tr.)

Recall Standard and Poor's early August 2011 downgrade of America's credit rating. Might the nation's credit rating be called into question again? Several key American banks suffered sharp rating cuts recently.

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Survey the US federal fiscal situation from the long run angle. The US confronts a dangerous long run fiscal situation, not merely a rocky near or medium term one. According to the Congressional Budget Office, if the US extended all current policies for a "prolonged period", the percentage of debt will "continue to rise much faster than GDP", reaching 93pc of GDP by 2022 (p8). The CBO asserts this trend cannot be indefinitely sustained, so at some point policy changes would be required.

Marketplace prospectors may conclude that it will take an economic crisis, perhaps involving a steep worldwide economic downturn (even if it is a less dreadful version of 2008) to induce such noteworthy American policy changes.

AMERICA'S DEBT CULTURE

George Best, the famed British soccer player, said: "I spent a lot of money on booze, birds and fast cars. The rest I just squandered."

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According to the CBO ("Effects of Reducing the Fiscal Restraint", p8), fiscal restraint under the current law erodes deficits "markedly". For the 2013-2022 period, they average only 1.4pc of GDP. Federal debt held by the public slips from 73pc of GDP in 2012 to 61pc in 2022.

However, even current law still shows a desire to run a national deficit year after year. In Washington and elsewhere, many speak about the deficit and its risks. But where is talk of running a surplus in order to start paying down the deficit?

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Digging into and analyzing Federal Reserve "Flow of Funds" statistics (Z.1, 6/7/12) reveals America's deep-seated attachment to borrowing and debt (and thereby its substantial reliance on debt for economic growth).

First, look at the ascent of overall (federal plus state and local) US government debt. Recall the 1981 valley of 38.1pc of nominal GDP. At the end of first quarter calendar 2012, US federal plus state and local debt was 89.1pc of nominal GDP (Z.1 statistics produce different debt levels than the IMF's FM). The federal share of 69.7pc for 1Q12 is consistent with the CBO estimate. The 2007 levels were much lower than 1Q12's but still floated way above 1981's. In 2007, the federal

portion alone was 36.5pc of GDP, with the combined federal/state/local 57.0pc. The 1Q12 overall percentage soars about twenty-five points beyond a notable peak of two decades ago (64.3pc in 1991).

Yet travel further and look at US total credit marketplace debt US (nonfinancial, financial, and rest of the world sectors combined), not government debt alone. In 1951, it was about 132.4pc of nominal GDP. It ascended gradually to 168.1pc by 1981. It climbed to 250.8pc in 1995, marching to just under 300 percent in 2002. During the marvelous Goldilocks Era economy, total US credit marketplace debt flew even higher, touching 362.8pc of GDP in 2007. It advanced more as the economic crisis emerged, reaching a pinnacle of 381.6pc in 2009.

So where is this total credit marketplace debt now? At the end of 1Q12, it remained at a very lofty altitude, 353.6pc. Not only does the long run increase in total credit marketplace debt display devotion to (economic reliance on) debt. The only slight slide from the 2009 peak to the 1Q12 level indicates that at some point more debt reduction (deleveraging) for "America as a whole" lies ahead, and thus a significant probability of a weaker economy (and even recession).

Within the US total credit marketplace debt vista, peer at US household debt levels as a percentage of GDP. It was 24.2 percent of GDP in 1951. Relentless borrowing created a consumer debt mountain. It grew to 48.2pc of GDP in 1981, to about seventy percent in 2000, expanding to 97.5pc in the good old days of 2007. It was 83.6pc in 1Q12; this slip to $12.9 trillion dollars from 2007's nearly $13.7tr is fairly large. However, the 1Q12 absolute sum remains massive (around 83 percent of 2012 GDP), and far above the percentages of 2000 and before. So consumers generally remain burdened by debt. This factor (less inclination to voraciously borrow) makes it a challenge to reestablish the amazing growth of the Goldilocks Era.

This modest retreat in the US household debt in the past few years, however, runs alongside the great leap in US federal debt over that period (put state and local aside for this as their arithmetic shifts were not nearly as significant). Federal debt (held by the public) was $5.1 trillion in 2007, $10.5tr at end 2011, and $10.8tr at end 1Q12.

Thus the "household" debt burden has voyaged to some extent- from the household sector over to the Federal government ledger. But it has not disappeared. In a representative democratic government, the households (and of course businesses to some extent) still must deal with the debt level and challenges.

MARKETPLACE CLIFFS

Stock, interest rate, currency, and commodity landscapes intertwine with and reflect fiscal cliffs, debt mountains, and other massive (as well as apparently minor) economic conditions, structures, challenges, and trends. America's S+P 500 is an important financial yardstick. The S+P 500 does not exist in isolation from other marketplace domains in America and overseas. It is a truism that interest rates can soar or dive or amble sideways; key credit spreads may expand or contract. Will the US dollar spike higher, fall out of bed, or remain stable? Everyone knows that commodities "in general" may explode upward, crater downward, or travel in various other fashions. Suppose we nevertheless focus on the S+P 500.

US corporate earnings have been strong. They may not fall off the cliff, but they can slow down, trip and fall flat, or topple backwards. Suppose US consumer spending slows substantially or shrinks. What if global growth changes from a fairly brisk pace to a crawl?

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The S+P 500's pinnacle was 1577 on 10/11/07. In Wall Street culture, many sentinels define a twenty percent or greater drop from a noteworthy (major) summit as a bear trend. A twenty percent dive from 1577 is 1262.

Remember the S+P 500's bloody retreat in 2008 and through early 2009. It achieved its major trough at 667 on 3/6/09. The final key high after the October 2007 peak was 5/19/08's 1440. The S+P 500 collapsed from its highs on 8/11/08 at 1313 and (especially) 9/19/08 at 1265. Note the 9/19/08 level relative to the 20pc signpost of 1262. Lehman Brothers declared bankruptcy 9/15/08. In this bear move context, recall the earlier lows neighboring 1262 reached after October 2011's ceiling but before the May 2008 final high (1270 on 1/23/08, 1257 on 3/17/08).

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Interest rate and foreign exchange trends emphasize that the worldwide economic crisis that emerged in 2007 is not close to a solution. On the debt front, ten year government note yields in the United States and Germany fell beneath their end 2008/early 2009 floor. The US Treasury 10 year low on was around 2.04pc on 12/18/08. It now lurks around 1.60 pc (6/1/12 low 1.44pc). Germany's 10 year government note bottom made during the dismal months after summer 2008 was 2.85pc on 1/15/09. Compare that 2009 yield with the recent 6/1/12 low of 1.13pc and the current yield close to 1.50pc. These 10 year note moves (and continued residence) under the 2008/2009 yield depths reflect not only the ongoing easy money policies by central bankers. It stresses that the financial crisis remains unsolved. Such low nominal rates also show a lack of confidence in the overall banking system; better to directly own a government note issued by a strong sovereign than to deposit money in a bank with only limited (or no) insurance. And much of the US government yield curve currently offers a negative real return. Keep an eye on sovereign and other credit spreads.

The song of "strong US dollar equals weak US stocks (S+P 500), weak US dollar equals strong US stocks" remains popular. The broad real trade-weighted dollar has risen from July 2011's 80.6 to May 2012's 85.4 (monthly averages).

Picture recent levels and movements in the S+P 500 alongside the past ones recounted above. For example, the S+P 500's highs on 4/2/12 at 1422 and 5/1/12 at 1415 are pretty near to May 2008's 1440 top. The recent low on 6/4/12 was 1267, almost exactly the 9/19/08 collapse point of 1265, and a 20pc fall from the October 2007 summit. A ten pc fall from 1422 is 1280, rather close to 1265.

Since commodities "in general" have tended to move alongside the S+P 500, briefly scan the broad GSCI. The broad GSCI trends warn of lower prices to come for the S+P 500. First, that commodity index has never rallied above the 762 highs attained in 2011 (4/11 and 5/2/11). Moreover, it has fallen sharply from 717 on 3/1/12, only about a month prior to the S+P 500's April 2012 key high. In 2009, the broad GSCI bottom on 2/19/09 at 306 shortly preceded that in the S+P 500.

A twenty pc fall from the 7/3/08 broad GSCI peak (not long after the final S+P 500 high in May 2008) at 894 is 715. Compare 717 on 3/1/12. Its fall thereafter gained speed from the 5/1/12 drop-

off point at 689. Notable breakdown points in late summer 2008 in the broad GSCI were around 680. In 2008, the GSCI then collapsed alongside the S+P 500.

What's the bottom line for the S+P 500? It probably will not free fall into the abyss as it did in 2008, but it will drop lower. The 1265 level in the S+P 500 probably will be broken. Support exists around 1220 (4/26/10 height), then around 1140 (twenty pc fall from 1422), with major support at 1075 (the 10/4/11 low) to 1040 or so (8/27/10 was the advent of the Federal Reserve's second round of quantitative easing). The S+P 500 obviously is not the only variable that would inspire central bank (and political) crisis responses. In any event, the further the S+P 500 breaks under 1220, the greater the likelihood of Federal Reserve (and other central bank) rescue quests.

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This long-running global crisis keeps not just Wall Street players, central bankers, and political kingpins, but also Main Street audiences, on the edge of their seats. Chronic sovereign debt and banking problems in Europe may accelerate those in America and elsewhere. American fiscal and overall debt troubles may damage prospects for Europe and other regions. And these fiscal, banking, and overall debt variables of course entangle with other financial factors.

Moreover, in an intertwined global economy, events outside of the United States and Europe may encourage (or reflect or reveal) American or European troubles and a related international economic slowdown. Consider China's economic situation and trajectory. There perhaps is growing concern (fear, even) that the Chinese economic miracle may be less miraculous than many gurus (including leading Western lights) have long advertised. The NYTimes headlines "Chinese data said to mask slowing Officials Inflate figures to Impress Beijing". "As the Chinese economy continues to sputter, prominent corporate executives in China and Western economists say that local and provincial officials are falsifying economic statistics to disguise the true depth of the troubles." (6/23/12, pA1, A3). Though one should not push analogies too far, recall widespread faith that the US housing marketplace was in great shape (and that banks and investment banks and consumers were not overleveraged) prior to the crisis that emerged in mid-2007.

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