<u>FINANCIAL FOREST FIRES: US GOVERNMENT DEBT</u>

(c) Leo Haviland, 646-295-8385 August 15, 2012

"I never did mind about the little things" says Maggie, the assassin in the film "The Point of No Return" (John Badham, director)

OVERVIEW

The United States Federal Reserve Board and its central banking allies have furiously battled the fierce financial forest fires of the ongoing worldwide economic crisis that emerged five years ago. As the disaster developed and traveled across the financial landscape, their accommodative approaches evolved. Although central bank methods have varied to some extent, they generally have included deluges of money printing and pinning nominal policy rates (Federal Funds and so forth) close to the ground. These central bank actions not only helped to spark and sustain economic recovery, but also bought politicians time to solve, or at least substantially mitigate, troubling fiscal deficit problems.

Nevertheless, debt levels and deficit spending in America and many other countries generally remain substantial. Efforts targeted to assist recovery partly explain the size of gaping fiscal deficits of recent years. Yet in America and many other nations, they arguably reflect and are structurally sustained by a culture of entitlement. This culture, although not universally shared, extends across the economic spectrum. In any event, government budget deficits in the United States are not a new phenomenon.

America intertwines closely with Europe, Japan, China, and other players in today's global arena. In the United States, household and corporate debt levels and issues entangle with those related to government ones. Sentinels long have warned about the massive long term debt problems facing America. Current marketplace smoke and potential policy changes (both inside and outside the US) admittedly make the horizon unclear to some extent. However, even without specifically concentrating on its long term fiscal challenges, the US probably is much closer these days to a big debt problem than many believe. Focusing on the near term US government deficit and debt situation in the context of several other nations highlights the danger.

THE POINT OF NO RETURN

Your brow is sweatin' and your mouth gets dry,
Fancy people go driftin' by.
The moment of truth is right at hand,
Just one more nightmare you can stand." The Band's song "Stage Fright"

****

Despite the modest economic recovery of the past few years, the US still has run substantial government deficits. Despite forecast declines for 2012 and thereafter in deficit spending as a percentage of nominal GDP, America achieves only modest progress in slashing outlays and does not cut gross government debt. The IMF data includes not only central (federal) government debt, but also state and local debt). See the International Monetary Fund's "Fiscal Monitor Update" (7/16/12) for 2008-2013. The April 2012 "Fiscal Monitor" offers data for 2014-2017; only 2017 appears in the two tables below. Given the events since April and some revisions in the preceding years, the IMF probably would revise its 2014-2017 estimates somewhat. The IMF states that its 7/16/12 update for Spain does not reflect Spain's 7/11/12 measures.

****

<u>Overall Fiscal Balance</u> (central government and state/local balance as a percentage of GDP; the minus sign indicates deficit):

	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2017**
USA	-6.7	-13.0	-10.5	-9.6	-8.2	-6.8	-4.4
Euro Area	-2.1	-6.4	-6.2	-4.1	-3.2	-2.5	-1.1
UK	-5.0	-10.4	-9.9	-8.6	-8.1	-7.1	-1.0
Italy	-2.7	-5.4	-4.5	-3.9	-2.6	-1.5	-1.1
Spain	-4.5	-11.2	-9.3	-8.9	-7.0	-5.9	-4.1
Ireland	-7.3	-14.0	-31.2	-13.1	-8.3	-7.5	-1.9
Portugal	-3.7	-10.2	-9.8	-4.2	-4.5	-3.0	-1.8
Japan	-4.1	-10.4	-9.4	-10.1	-9.9	-8.6	-7.5

Everyone knows of the Eurozone (Euro Area) crisis. America's fiscal balances are much more in deficit over the 2008-2017 span than the overall Euro Area's. Although this analysis omits focus on the burning Greek disaster, what about the fiscal balances of Italy, Spain, Ireland, and Portugal, four other European nations in crisis? In every year, America's deficit is much higher than Italy's and somewhat above Spain's. From 2009 on, American deficits exceed the Portuguese ones. From the fiscal balance perspective, America does not have a little problem, for it generally performs worse than Italy, Spain, and Portugal. Though its deficit as a percent of GDP is less than Ireland's (especially in 2010), Ireland makes progress after 2013 (or so the IMF hopes for that and many other Euro Area nations).

****

The size and timing of any severe national (or international) debt problem (crisis) depends not only on past and future deficit spending levels and trends, but also on other variables such as overall government debt. The figures below come from the IMF's "Fiscal Monitor" ("FM" of 7/16/12 for 2008-2013, the April 2012 FM for 2017).

<u>General Government Gross Debt</u> (as a percentage of GDP):

	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2017**
USA	76.1	89.9	98.4	102.8	106.7	110.7	113.0
Euro Area	70.2	80.0	85.8	88.1	91.4	92.4	86.9
UK	52.5	68.4	75.1	82.3	88.6	92.7	86.8
Italy	105.8	116.1	118.7	120.1	125.8	126.4	118.9
Spain	40.2	53.9	61.2	68.5	90.3	96.5	[91.9; see discussion below]
Ireland	44.2	65.1	92.5	108.2	117.6	121.2	109.2
Portugal	71.6	83.1	93.3	107.8	114.4	118.6	109.2
Japan	191.8	210.2	215.3	229.9	234.5	240.0	256.6

Just because Europe has a sovereign debt (banking) crisis does not mean that the US will suffer one. And obviously some European nations have more burning problems from the gross debt perspective than others. Of course a substantial problem of one Eurozone nation to a great extent in this context is a predicament for the entire Euro Area. However, from the general government gross debt viewpoint, and especially with a view on 2012 and thereafter, the US problem looks at least as fearsome as the overall Eurozone difficulty. First, the US level exceeds the European height every year, from 2008 out to 2017. Second, the IMF indicates a fall for the Euro Area after 2013, but not for the US.

Make a brief detour through the data. The July "Fiscal Monitor Update" raised Spain's general government gross debt 11.2 percentage points for 2012 and 12.5 points for 2013 relative to the April FM estimate. Accordingly, a revised estimate for Spain's 2017 level would exceed 100. Upward adjustments in gross debt in the July 2012 FM for the Euro Area as a whole for 2012 and 2013 were much less than for Spain- only 1.4 points each year. The July FM upward revision for Ireland, Italy, and Portugal was more than that for the overall Euro Area, but much less than those for Spain. Thus one could conjecture that their 2017 debt in the preceding table will be a few points higher than displayed.

Many marketplace guardians and observers worry if budget deficits decisively exceed around three percent of GDP for an extended period of time. General government gross debt is not the only estimate that pundits monitor to assess fiscal and other economic risks. However, many marketplace professors worry when that gross debt exceeds and keeps rising steadily beyond 100 percent of GDP. National situations differ. Japan, for example, is not America. Greece in 2012 was 162.6 percent, 171.0 in 2013.

The US climbed over 100 percent in 2011 and keeps edging higher thereafter. Though its gross government debt is somewhat less than Italy's, it is not dramatically so. Also, Italy displays more budget discipline (lower fiscal deficits) than America. US gross debt likewise looks comparable to that of Portugal, Ireland, and Spain (Spain by 2017 at least, after probable upward adjustments). Thus for the near term, as these four European nations have faced (sovereign debt/banking) crises with such high gross debt levels, the US also may confront one in the relatively near future, especially given US fiscal spending trends (especially on the US federal level).

****

Is the US government debt situation at a "point of no return", in which "too high" deficit spending and lofty and growing indebtedness will cause a crisis of confidence? Not quite, but that point is fairly close. Also, it appears nearer if one stares at the impending debt obligations of the so-called distant future.

After all, the dangers of a faraway time (even 10 or more years from now) probably will begin to loom closer if it appears little will be done about those risks. When enough clairvoyants worry seriously about them, allegedly long run US debt problems smoldering "out there" can spring into flames and significantly affect near term trading decisions. Thus from the viewpoint of more and more marketplace participants, the arrival of the point of no return can accelerate.

On the crucial federal level, and for many years, Congress and the Presidency have advanced little if at all on fixing long run deficit spending and debt issues. Their progress on near term debt problems in the past few years also has been less than impressive, and thus is uninspiring as regards their ability (willingness) to handle the longer run challenges. The American political leadership deficit extends across parties and over time, thus reflecting and encouraging the federal financial deficit problems.

Substantial Washington, Main Street, and Wall Street concern about the 2013 "fiscal cliff" and a related economic slowdown hints that at best there will be only modest improvement in current federal fiscal deficit and debt trends. For example, focus on individual income taxes. Nowadays, both political parties as well as the Presidential candidates seem inclined to preserve most of the individual income tax cuts (lower tax levels) currently in place yet scheduled to expire. What do these worries about the fiscal cliff probably portend? Only modest (if any) improvement on reducing deficit spending as a percentage of GDP and a still-deepening government gross debt hole are likely. Besides, on the American political (and financial regulatory) territory, despite windy wordplay on deficit issues, few talk about running budget surpluses and paying back some of the substantial government debt.

With the 2012 election beckoning, Congressional leaders recently reached a tentative agreement on spending to pay for federal government operations through March 2013 (NYTimes, 8/1/12, pA11). However, this probably does not represent a step toward a comprehensive solution of deficit and indebtedness issues.

****

Even if the US achieves little progress on the government debt front, it may evade a significant sovereign debt crisis for quite some time. Deficits obviously must be funded, and the "flight to quality" fears of the current worldwide economic crisis have encouraged buying of US Treasury obligations, even at low or even negative return relative to inflation. The American economy is large and productive from the international vantage point. The European crisis to some extent has spurred moves into dollar denominated securities. The US dollar is the major reserve currency. To some extent, the US bank deposit insurance safety net reduces the likelihood of bank runs by depositors.

****

The Federal Reserve's basket of easy money policies, from money printing to sustained low interest rates to Operation Twist, may keep buying the federal government time to resolve its serious near term (and even more troubling long run) debt problems before some "point of no return" (a "real" crisis) is reached. Yet buying time does not necessarily last forever. Buying time is not the same as buying securities. And even if the Fed embarks on further fascinating quantitative easing forays (QE3) and purchases UST (or other debt securities), what might other players do in the UST marketplace?

Suppose America's budget deficits remain substantial. If the American general public or foreigners (or both) significantly cut down their net buying (or become net sellers) of UST, that will help to propel interest rates higher.

Flight to quality concerns may not forever encourage domestic US Treasury owners to keep holding them. Suppose US inflation heats up from current temperate levels and real returns become lower (or more negative, depending on the place on the yield curve).

Think too about foreign holders of UST, whose lending plays a crucial part in financing yawning US budget gaps. As of May 2012, major foreign holders of US Treasury securities grasped $5.26 trillion, of which the foreign official category owned $3.81tr. They want at least some positive return on their holdings, though flight to quality issues may inspire them to be patient for a while even in the face of very mediocre or negative real returns. Suppose that as part of its ongoing quest to benefit (or rescue) household, corporate, and government debtors and undercompensate ("cheat") savers, the Fed keeps interest rates on the floor and that US inflation rates increase. Despite flight to quality concerns, many foreigners (especially private holders) will wonder why they should keep tolerating unattractive yields and owning (buying) UST. What's the point of receiving no return? Or, suppose the dollar begins to depreciate significantly, perhaps alongside an increase in inflation while the Fed keeps repressing interest rates.

Japan has a much greater government debt as a percentage of GDP than America. Like America, it has run substantial government deficits. Yet Japan hasn't yet reached a near term government debt crisis situation (though it, like America, will by consensus face one at some long run point under current policies). Isn't therefore America unlikely to face a government debt crisis anytime soon? However, Japan, unlike America, has long tended to run a current account surplus and has big domestic savings. It depends less on foreign financing than America to fund its government deficit. So although Japan so far has succeeded in escaping a near term government debt crisis, this should not encourage complacency regarding the United States situation.

US GOVERNMENT YIELDS

Will the Federal Reserve manage to keep short term rates at current rock-bottom levels for the next several years? Though American yield trends may emulate the Japanese pattern to some extent, the Fed is determined to avoid Japan's problems and deflation. Despite the Fed's repeated pronouncements regarding the likelihood of keeping the Federal Funds rate low out through 2014, the parallel longstanding Fed crusade to achieve around two percent inflation tends to push UST yields up.

In addition to Federal Reserve policy, the extent of flight to quality fears (including faith in the international banking system and the extent of deposit insurance), and government fiscal deficits and gross debt levels and trends, numerous other factors influence UST rates. Household and corporate debt matter a great deal. US inflation obviously matters. Trends in the US dollar, the stock marketplace, real estate, and housing also are important considerations entangled with other variables. The US is not an island. As the worldwide economic crisis keeps showing, what occurs in Europe, China, Japan, and elsewhere influences America.

****

In recent years in America, rising government interest rates often have been associated with economic recovery, with falling (and especially "very low") rates linked to economic weakness (or slower growth; such feebleness may appear more in another key region such as the Eurozone than in the US).

Inflation is not the only potential source of higher interest rates. The lesson of the Eurozone sovereign debt crisis shows that government interest rates can climb sharply in crisis nations (Greece, Portugal, Ireland, Spain, Italy) even if inflation is moderate. Ability to pay debts (and borrow money), not just inflation levels and trends, matters for interest rate levels (and sovereign credit spread differentials). A badly stretched debtor may have to pay up to find money, right? So rising government interest rates in some cases may reflect a dreadful debt crisis, not a sunny economic recovery.

Closely nearing or reaching a point of no return on the US fiscal front therefore probably would be reflected by a spike in UST yields. The 10 year US Treasury note offers a benchmark for US yield watchers. In recent years, rising government interest rates often have been roughly tied to ascending US stocks (S+P 500), not just an economic recovery. If US equity benchmarks such as the S+P 500 start to decline significantly, and roughly "alongside" the increase in yields (thereby breaking from the guideline UST/stock relationship of recent times), that probably would confirm the existence of a debt crisis.

****

At some point, and despite the current relationship between UST and stock benchmarks, “too high” inflation also can help to generate a bear trend for US equities. Such excessive inflation alongside a US debt crisis probably would be especially bearish for stocks.

****

The US 10 year note recently reached a low at 1.38 percent (7/25/12). It is around 1.80pc now. However, in the current environment, significant further increases in UST yields may not be accompanied by a notable sustained further bull move in stocks.

****