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THE VIEW

"Take all the fools out of this world and there wouldn't be any fun living in it, or profit." - ***Henry Wheeler Shaw***

President, Congress and the Federal Reserve on Hope Spree

It is no secret the United States is struggling with a large structural budget deficit, debt and trade deficit. The $64,000 question is how this predicament will resolve itself. When governments get near 100% debt to GDP it has been shown to heighten the risk of a government default[1.] Currently, the U.S is running at about $9.5 trillion in debt excluding intragovernment debt (i.e. obligations to social security or other government programs). This represents approximately 67% of GDP (almost 100% when those intragovernment debts are included). This percentage is rising fast. Maybe more important is the ratio of debt to revenue. By this measure debt exceeds U.S. Federal revenue by close to 4.5 times. When entitlement programs are considered the U.S. is INSOLVENT. The question then becomes how we will resolve this complex problem.

After many investment policy meetings and debates we've identified 3 possible outcomes, none of which may be mutually exclusive. Some combination of all three may exist in some form at some time in the future. They can be separated somewhat because they are each path dependent, however, the paths turn into a mud bog at times.

Deflation and Depression

Extreme debt loads tend to be deflationary because when it becomes apparent that debt service is in jeopardy creditors demand their money. This resembles what we experienced in 2008 at the height of the financial meltdown. To pay debts when there is not sufficient cash on hand, assets must often be sold at very disadvantageous prices. This leads to more selling as demand drops. A vicious cycle is created.

With impaired demand and excess supply prices continue their slide. Deflation ensues and, if not controlled, a depression is the result (by the way the U.S. is still dealing with impaired demand). There is a bit of a difference who owes the debt. What was just described is the likely result of a free market left to fetter out it's imbalances in the private sector of the economy. Our economy has been *managed* by the Federal Reserve Bank since the 1970's. The result of their constant intervention and reluctance to let the market wring out its excesses over the last 20 or so years has let imbalances build, bringing us to the crossroads we are at today. The difference between private debt and public debt (where the public debtor can print money) is quite enormous. Over the last several years debts have been transferred from the private sector to the public sector reducing the likelihood of this first path, though it still may have a place in our future. The swelling of public debt brings us to our second scenario:

Inflation and Hyperinflation

This appears to be the path we are currently on. In an effort to revive our economy all branches of government are working in coordination to pump money (borrowed money) into the economy in hopes of reflating our sagging demand. Government stimulus, quantitative easing by the Federal Reserve, welfare and unemployment transfer payments have all combined to inject life into a severely recalcitrant economy. The idea is that as people get back to work, tax receipts will improve dramatically and cure our fiscal shortfall; a virtuous cycle. Ironically, those actions have lead to only a modest rise in employment, but a rather significant rise in input prices and basic necessities (like food and oil). Employers rightly surmise future inflation and react by restraining labor, the largest component of their input costs. Inflation in most other parts of the economy remains subdued because the velocity of these monetary injections (see tech spotlight) remains lethargic. The damage we are doing on this path of fiscal imprudence is to our currency, however. The dollar is still regarded as the world's reserve currency, but that status is eroding at an alarming rate. What this means is that foreigners would like to hold less of our currency. Foreigners buy our Treasury bonds and allow us to borrow money at very cheap rates. If their reluctance to do so becomes acute, interest rates will spike and the dollar will fall swiftly. This fall in the dollar will make our imported goods more expensive as foreigners will demand more U.S. dollars to compensate for their weakness. The result is a bout of unwanted inflation. This alone may not seem all that problematic until you consider the repercussions. High interest rates will be needed to attract buying in U.S. Treasury bonds, driving the interest cost of our debt through the roof. In an effort to pay our creditors the Federal Reserve will have no option but to print and borrow even more money leading to a debt spiral. The constant printing of money will eventually cause an inflation spike or hyperinflation.

Governments inflate their economies to try to grow out of debt. We may have already surpassed our ability to do this, however. Part of the reason is our already enormous debt burden, but the other factor is that many of the U.S Government obligations are tied to inflation. Take Social Security and Medicare for instance. The former has a COLA and the latter has an inherent link to inflation. A concerted effort to inflate out of our debt problems becomes not only undesirable, but unlikely to be very successful. We will then be forced to restructure our debt and entitlement burdens so that those obligations can be met in more limited form. This outcome is important to understand as it will lead to what amounts to our third scenario which may be taken to bypass the inflationary scenario and more quickly resolve our predicament.

Fiscal Austerity

This is the second most likely path after inflation. Although there is a growing chorus of supporters, austerity measures fall on deaf ears in Washington D.C. Work done by Niall Ferguson[2] suggests that proven fiscal balancing measures generally are successful when they are comprised of about 2/3 spending cuts and 1/3 tax increases. These actions will, nonetheless, cause an economy to slow. The difficult part is accepting the reality of our situation and properly framing it to the populace. GDP growth may only reach 1 ½ to 2% per annum over an extended period of 7 to 10 years and this is much too hard for the economic and political engineers to accept. They still cling to the belief that we can inflate our way out. Fiscal prudence will leave us with a chronically high unemployment rate that will only be absorbed very slowly over time. The absorption will be more sustainable and of higher quality, however.

Entitlement programs will HAVE to be addressed. A higher retirement age, means testing and other measures will have to be considered for both Social Security and Medicare. A painful, but considerably more modest adjustment (than hyperinflation or depression) will be required by everyone. Because our economy is so complex some may have to adjust more than others, but nevertheless they will all need to adjust. Many people will read this and immediately reject the idea that it should come to this. It amounts to a lowering of their standard of living, which they cannot accept. This is why the U.S. will likely not move in this direction, at least initially. We will only act out of crisis. A weakened currency, high interest rates and hyperinflation may be the catalyst. Either way, America has been living above its means for some time and now reality is slowly seeping through the cracks in the veneer.

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