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THE BIG BANG

You can always count on Americans doing the right thing
– after they've tried everything else. (Winston Churchill)

That old saw about forest and trees hit home. I have struggled for months to wrap my mind around the endless list of issues, accomplishments and human perverseness that we are living through. Well, it's a forest after all, not just isolated trees.

My mind hurts. For a while I thought the callous indifference of Congress was unique, but no, it is really part of an overall domestic indifference. The stock market goes up 70% in one year on temporarily "high" corporate profits – and no one calls it absurd. For months I dwelt on figures that lie – how big percentage gains off record lows were still well below prior years and, further, the bounce back in earnings was heavily a product of sharply lower employer head count . . . and the market climbs on. This is, I now believe, not an isolated incident, but part and parcel of new times, new mind set. Energy is focused elsewhere and the markets are, well, just background.

We have this massive global debt problem that is the forest. Save for the Chinese, maybe the Germans, everybody owes everybody trillions. We, the erstwhile proponents of growth, however, are currently strangling our own golden goose with loans to pay loans. In the midst of this crisis comes the following from our leaders:

> "I wish there was a miracle, but all we can do is persist with our efforts."
> (Governor Shirakawa, Bank of Japan)
>
> "All we can do on the Monetary Policy Committee is stand ready to react."
> (Deputy Governor Bean, Bank of England)
>
> "The only way we will change them is by forcing them to change."
> (Senator Schumer on Chinese Revaluation)
>
> "I do not expect any major nations to default on their debt."
> (Robert Rubin, former Secretary of the Treasury)
>
> "I don't know." (Bernanke's answer to the question of whether $5 trillion in GSEs [government-sponsored enterprises] is sovereign debt)*

My answers to these run from "what do you mean by 'react' or 'major' " to "what do you mean by 'implicit'?" Bill Clinton taught them by example, and taught them well.

In a paper some months back, I noted that there were a series of outcomes to deal with this mounting debt, and none were acceptable. They ranged from total repudiation to following Japan and piling on even more. Currently, government stimulus supporting just demand in this country is 6% of GDP . . . some $787 billion. In China, it's 15% supporting demand and $586 billion. Nobody else comes close (emerging Asia 2%, Japan 3%, etc.). Of course, that is, for us, only a small part of our debt forest of some $8-$9 trillion. How do we deal with this?

*The government took Fannie Mae and Freddie Mac into conservatorship over 18 months ago, Ben. The guarantee is beyond "implicit."

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According to Societe Generale, there are 4 basic routes to global debt reductions and our salvation. SG sees these routes as likely to reduce debt; they apply to all nations:

1) Currency volatility leads to devaluation and then inflation. (We saw it in the 70s, as did Europe, Argentina in 2002 and the U. K. in 1949.) On deck: Yuan revalued? Euro?

2) Innovation and growth – new technologies, possible new bubbles (Japan in the 70s, U. S. in the 50's, U. S. and U. K. in 2002-2007). On deck: Green technology?

3) Unsustainable debt levels leading to government defaults (Russia, 1998). On deck: Eastern Europe, Greece?

4) Reducing State (government of all stripes) employment (Canada 1996, U. K. 1980). On deck: California?

We've written extensively about emerging markets being the leaders for decades to come. The factors are many and include: low debt to GDP, evolving middle class, huge awareness of and demand for stuff we sell in garage sales and a young, eager labor force. They also represent higher commodity prices, increased attractiveness to invest there rather than here and, for all players, higher interest rates and inflation as they learn about business cycles, inventory cycles and the like. Here too, though, debt is the fuel for their growth and the fuel for our consumption of their goods. Thus the global issue: debt to grow, or debt to be retired? How do you do both?

For the United States the most likely path, it seems to me, is a replay of the 70s, but with even less growth. Inflation is to be our solution to our excess debt. We have heard rumbles of "setting inflation targets." The arrival of Janet Yellen on the Federal Reserve Board is the lead indicator; she is a hard-core Keynesian and ignores, literally, the money supply. For those who slept through Econ 101, a Keynesian, among other fallacies, is one who believes the government can, in fact, set an inflation target and add or subtract their spending to nudge it in one direction or another. In a debate with Alan Greenspan, for example, back in 1996, Ms. Yellen made her case for inflation targets (while Greenspan argued their job was stable prices, not rising). Ms. Yellen said, no, their mandate was full employment (yet another Keynesian commandment) and currency depreciation is needed, she implied. Any target, to me, is a fool's game, but they truly have no stomach for the other solutions.

(The irony, according to the historical record, is that the Federal Reserve mandate in its 1913 founding legislation was merely to "furnish an elastic currency and afford a means of re-discounting commercial paper." Price stability, as a legislative task, was long taken care of by the 1900 law that wrote the gold standard – which locked the value of the dollar to gold. [Thanks – Jim Grant])

But I digress.

There are some impacts from inflation well beyond serving as something for the Fed to do. For one, it also erodes debt for you – and your biggest, I suspect, is your mortgage. It allows employers to cut wages. Try this: inflation is, hypothetically, 4% and you get a 5% wage increase. You are net to the good 1%. Next year, inflation falls to 2%, everyone is happy and you get 2%. Net to you? Zero. Plug in your own numbers. . .

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Of course, inflation will push you into a higher tax bracket even when wage increases are not net to you, as we have just such a tax structure. Further, inflation and its bedfellow, higher interest rates, give the Feds a rate they can cut if things slow down . . . and let's not forget you are getting more interest on your savings. Sorry, your savings are in dollars that are worth less. Which sort of brings me to my generation, we the growing majority: inflation increases my Social Security check which is indexed to inflation. You youngsters who will pay that ultimate bill had best start saving because I doubt we'd relish a cut when things begin to cost more.

I would hope the idea of tweaking spending – or in this day and age, adding new debt as an inflation trigger, will cause you concern. Few think of the unintended consequence, but the big one remains: we are going to inflate our way to less domestic debt because we lack the will to do otherwise.

But you say, how can that happen with 10, 15, 20% of the population not working – don't you need excess demand to push prices up? No, not really, but we've written on that before. I mean, look at housing. I think two tidbits of data will shed a little insight:

1) Something like 60% of goods sold are bought by about 20% of the population.
2) Unemployment by income level looks like this:
    - the upper 1/5 by income: 2% unemployed
    - the middle 1/5 by income: 6% unemployed
    - the bottom 1/5 by income: 19% unemployed

If you dwell on it for a bit, it hits you these groups have widely divergent spending power – overall growth of our economy can be anemic while some sectors flourish because those employed are the ones with the highest income, while other sectors struggle to feed their family much less find a job. Welcome back stagflation.

The large unintended consequence, at least to me, is why the Chinese or any other country therefore, would want to buy our debt if we are going to actively devalue it – if we are going to set inflation targets either publicly or, more likely, privately. We are facing a 40% jump in our national debt in the next 4 years or so to an extra $5 trillion. It's already clear to me that the old "kick the can down the road" is in play – our representatives are creating trillions of future liability both by inaction (Medicare, Social Security) and persuasion (feeding the unions, hiring more and more government workers) or by outright creation (Health Care, farm subsidy, ethanol) ad nauseam. The pressure on foreign buyers to take our bonds will increase as they struggle with their debt.

So, who will buy our debt? Mutual funds are already buying German, Australian and Canadian bonds instead. The PIMCOs of the world are selling U. S. Bonds before the rates really rise and prices start to fall. Investors here who have chased yield by buying long-dated debt may well be at the same risk as the investor just jumping into our stock market. I know the very bright folks running hedge funds have thought this through and, seeing yields start to rise (prices fall), will be exiting . . . with profits made by fiercely levering their initial purchases. Pretty easy to borrow when money is cheap, lever it, and wait for the public to run the price up . . . and sell it to them.

And that's just government debt. To that add $3 trillion of public and private pension system unfunded liabilities which will, in its own way, force activity like staff and service cuts, reduced benefits, increased contribution requirements, accelerated switch to defined contribution from defined benefit and, ultimately, selling bonds. Tough to do when your state, the guarantor of these bonds, is New Jersey, New York, California, Michigan, etc. More on this some other time, but for now: a lot of debt is to be sold to someone, and most government debt now held has an

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average maturity of 5 years. Hence, the Big Bang when all the Health Care costs kick in come 2013-2017, the current Treasury holdings mature and pension participants begin to retire and make claims in ever-increasing numbers – the baby boomers – remember?

So the challenge for Washington is to have Americans think like the Japanese. In Japan the government finds it extremely easy to sell its debt to its citizens as their choices are few, they are older on average and by nature, savers.

In this country, more choices exist. We are more venturesome with our individual investments. Saving, even with the recent emphasis, does not have long-term staying power. Any way you slice it, we are unlikely to simply buy our Federal debt because we are asked to. Competitive rates will be required, especially given the potential for a downgrade from our AAA rating. Further, we have no unifying cause. A case in point was buying War Bonds in WWII, a mutually shared goal of survival. Of course, high yields <u>are</u> attractive, but as I hope is now clear, the unintended consequences are many.

One thing you can do, if you are Machiavellian enough and a sitting Senator of the United States, is to take away the relative attractiveness of other investments. Senators Wyden (D-OR) and Gregg (R-NH) are sponsoring a tax reform bill that would reduce (not eliminate) the tax advantage of municipal bonds issued after December 31, 2010. The bill is not yet law, but clearly seeks to put munis at parity with Treasuries for all tax brackets. Thus, the well-to-do who buy munis for their freedom from Federal and state tax (if issued by the state in which you are a resident) would find no tax advantage and would, it is hoped, buy Treasuries instead. Obviously, demand for munis in 2011 and beyond would likely decline at the very time municipalities and states need to sell debt to fund <u>their</u> growing liabilities. Of course, existing munis would go to a premium for they would be grandfathered. We will watch this issue and others like it (Build America Bonds) for their purposes, both disclosed and by default.

In closing I can only note that the pressure on interest rates is building, deflation is temporary, targeted inflation is, to me at least, underway and Sovereign credit quality is now broadly seen as a global issue. Why stocks go even higher is, sorry to say, beyond me. I expect to see, by the way, a national uprising against unions because of their bull-headed refusal to take any cuts while their neighbors struggle.

When inflation is low and interest rates rise – meaning the “real” rate rises, it is wise to be defensive and expect Treasury sales to go poorly. With housing rolling over yet again, in spite of stimulus, a poor GDP for the first quarter of this year (best guess: 2% after all revisions) and an overbought stock market, it seems a time of caution. At some interest rate our debt will sell. That rate will be much, much higher than today.

More than a few writers have commented that “something big” is in the wind. I concur.

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