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*“Easy is the descent  
into Hell; all night long,  
all day, the doors of  
dark Hades stand open;  
but to retrace the path;  
to come up again to  
the sweet air of Heaven  
— there is the task,  
there is the burden.”*

--- Virgil (70 B.C.–19  
B.C.), *Aeneid*

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The structural macroeconomic currents that have been self reinforcing the global economy over the past three decades appear to be evolving. This evolution is likely to foster profound changes in the future and we may be misguided if we insist on extrapolating the past to gain perspective on the future. Although this approach has worked for over 30 years I believe a fundamental shift is now taking place. Many aspects of this period of prosperity are elastic (think oil supply, income disparity, leverage, asset bubbles, win-win globalization ...) and are showing the first signs that the pendulum might swing back. Does this imply a bleak future? No, not necessarily. However, what it does imply is that the next wave of prosperity may only be achieved by innovation and that the current geopolitical picture could be radically changed in the process. The financial innovation and asset bubbles witnessed these past few years are symptoms of denial and indications that we may be approaching a period of extended contraction. My first few letters are an effort to map the early trends of this boom/bust cycle and an effort to lay the ground for understanding why we might be at an important juncture. As we assemble the pieces of the puzzle we should be able to improve our understanding of the different paths ahead of us.

Last month, I shared with you my thoughts about the household balance sheet and mentioned the issue of household debt. I argued that the household balance sheet is not to be looked at in terms of aggregates as the distortions created by income disparity lead to many popular but faulty assumptions and that the ramifications of this disparity reached very much further than households.

This month I am going to touch upon the great paradox that is public debt as I believe it represents one of the greatest macro-economic changes of all. Only touch upon, the subject being so gigantic that even a lifetime dedication would be insufficient to cover this confusing pillar of finance and economics; moreover, I clearly do not have enough aspirin to do so and I suspect you might be inclined to use my letter as an effective sleeping pill. Debt is as much the nucleus of capitalism as it could well be its epilogue.

*“The first thing you should do when you find yourself in a hole, is stop digging.”*

— Will Rogers

*“As often, the best place to start is by crunching the numbers so we can get the big picture. Which I did: US debt is now between 7.8 trillion and 110 trillion. Useful indication is it not? There is over a 100 trillion difference, and here officially starts the headache and worst of all, one could argue that both numbers are in some ways correct including many other between these two extremes.”*

## How much debt?

As usual, the best place to start is by crunching the numbers so we can get the big picture. Which I did: US debt is now between 8 trillion and 110 trillion. Useful indication is it not? There is over a 100 trillion difference, and here officially starts the headache and worst of all, one could argue that both numbers are in some ways correct including many other between these two extremes. Gross debt, net debt, national debt, federal debt, public debt, total government obligations, unfunded obligations, U.S. debt, you name it, are some of the terminology used to simply determine how much debt is owed by the government. No wonder the subject creates feverish debate and sensationalist titles in the likes of “the U.S. has one of the lowest debt-to-GDP ratios amongst developed economies” or “the US is a Ponzi scheme ready to default”.

So before going any further let’s first try to find out how much debt there really is. The next few pages are going to be excessively academic and for many, utterly boring, so for those of you who wish to skip the long definitions of debt please skip to page 4.

I shall be focusing on the non-private debt, public debt, the one for which the sky appears to be the limit these days. In fact, public debt may be considered *gross* or *held by the public*. Gross debt includes intra-governmental debt whilst *held by the public* excludes it. Intra-governmental debt is federal debt held by other federal agencies. It is debt that the federal government in some way “owes to itself” and is held in more than 200 trust funds, most of it held by a very few, and in particular the Social Security Trust Fund. When a trust fund receives payroll taxes or other income that are not needed to pay benefits immediately, the Treasury credits the trust fund with nonmarketable treasury debt, “special issues”, enabling it to use the excess funds for other government expenses and/or reduce the amount of traditional Treasury debt (the one named *held by the public*) it shall need to issue in the credit markets. This is a good time to take the first tablet of aspirin, feel free to do the same.

So the first issue we have to deal with is whether one should include the federal debt that is owed to other federal agencies (intra-governmental debt invested in “special issues” that do not compete for buyers in the credit markets and held in the Trust funds) or only consider the federal debt that is owed to the public (bonds, notes, bills).

*“A billion here, a billion there, pretty soon it adds up to real money.”*

—Senator Everett Dirksen, U.S. politician (1896 - 1969)

*“...it projected under the extended-baseline scenario that the Social Security Trust Fund will be exhausted in 2043 at which time full payment of scheduled outlays will no longer be possible and only yearly collected revenues will be distributed and enable the payment of only 83% of scheduled outlays at that time.”*

As per the “Monthly Statement Of The Public Debt Of The United States as of the 31<sup>st</sup> of December 2009” published by the US Treasury, the main intra-governmental funds are:

- The Federal Old-Age and Survivors Insurance Trust Fund	2’319 billion
- Civil Service Retirement and Disability Fund	750 billion
- Federal Hospital Insurance Trust Fund	304 billion
- Military Retirement Fund	296 billion
- Federal Disability Insurance Trust Fund	200 billion
.....	
<b>Total Intra-governmental debt</b>	<b>4’490 billion</b>

There are a good hundred others not really worth mentioning in a world where only trillions appear to make the headlines.

The Federal Old-Age and Survivors insurance Trust Fund (OASI) and the Federal Disability Insurance Trust Fund (DI) are referred together as the “Social Security Trust Fund”. The combined 2.52 trillion held in this trust fund is the result of years of accumulated surpluses as the annual revenues currently still exceed annual outlays. However, as the baby-boom generation (born between 1946-1964) continues to age, outlays are expected to increase much faster than revenues. The Congressional Budget Office (CBO) performs regular projections based on demographic and economic trend assumptions. In its August 2009 update titled “CBO’s long-Term Projections for Social Security: 2009 Update” it projected under the extended-baseline scenario that the Social Security Trust Fund will be exhausted in 2043 at which time full payment of scheduled outlays will no longer be possible and only yearly collected revenues will be distributed and enable the payment of only 83% of scheduled outlays at that time. The current period is all the more crucial as the trust is expected to switch from running a surplus to running a deficit in 2015, therefore reducing the value of it.

The Civil Service Retirement and Disability Fund (CSRDF) is the trust fund for the defined-benefit plan (meaning the employer, in this case the government, bears the financial risk) of civilian federal employees. According to the projections of the fund’s actuaries, it will be able to meet its financial obligations in perpetuity. We can therefore dismiss this one for the time being.

*“The CBO projects that the HI fund will exhaust its balance in 2017.”*

The Federal Hospital Insurance Trust Fund (HI) serves to pay Medicare Part A spending and is financed by a payroll tax (Part A covers inpatient services provided by hospitals as well as skilled nursing and hospice care). Part B and D are served by the SMI Trust Fund which is adequately financed since its receipts are reset each year to match expected costs. Medicaid has no underlying trust fund. The CBO projects that the HI fund will exhaust its balance in 2017.

Finally, the Military Retirement Fund serves to accumulate funds in order to finance on an actuarially sound basis the liabilities of the DOD under military retirement and survivor benefit programs. The military retirement system provides benefits for retirement from active duty and from the reserves, disability retirement benefits, and optional survivor coverage. The system is a funded, noncontributory defined benefit plan. The plan has estimated unfunded liabilities of 901 billion at FY 2009.

*“Intra-governmental debt should therefore be viewed in times of surplus as excess “savings” that allow Social Security taxes collected in the past to reduce the need for taxes in the future. In times of deficit they should be considered as a currently unfunded liability.”*

There are many arguments both ways on whether one should or not consider intra-governmental debt. I believe the answer simply lies in the state of the government fiscal position. Let me explain. Intra-governmental liabilities are non tradable “special issues” guaranteed as to both principal and interest by the Federal government and issued irrespective of the government’s financial position. This implies that when the government is running fiscal surpluses, publicly held debt will be paid back but the government will need to continue to issue intra-governmental debt because these trusts have no other choice than to be invested in them. If these surpluses persist, the intra-governmental debt will continue to grow giving a misleading indication that the government is more and more forced into debt. In this case I believe that considering intra-governmental holdings provides a misleading picture of the financial situation of the government as the increasing size of the intra-governmental debt fails to reflect the improving overall fiscal situation. In times of deficit, it’s a very different story. Surplus social security taxes are used to pay other government programs, and therefore, in times of deficit, it is clear that the rise in intra-governmental debt is not the result of this forced practice of issuing special securities but the simple absence of sufficient receipts. By investing the trusts’ balances in nonmarketable treasury debt, the government needs to borrow less from the public; the debt held by the public alone therefore fails to reflect the worsening overall fiscal position of the government. Intra-governmental debt should therefore be viewed in times of surplus as excess “savings” that allow Social Security taxes collected in the past to reduce the need for taxes in the future. In times of deficit they should be considered as a current unfunded liability.

*“Gosh! What a difference 9 years makes, and how completely different today is from what was then forecasted! In 2001, it was expected that next year, the US would be running a surplus of 889 billion. Those were clearly the good old days. Fast forward nine years and let’s check out the estimate from the CBO in “The budget and economic outlook: Fiscal years 2010-2020” published January 2010: estimated deficit of 980 billion. A complete 180 degrees change!”*

This brings us to the second issue: unfunded liabilities. The question once again is whether these should or should not be considered when assessing the debt levels of the US government. As described above, many of these trusts have expected unfunded liabilities. So when one reads that total US debt is in the 20 to 110 trillion brackets, it is generally because the author is in favor of including them. The argument to include them is simple: they reflect the government’s obligations to future beneficiaries. Sure, this makes sense, but how are these future obligations calculated?

You guessed correctly, by extrapolation, the holy grail of forecasting. My intent is not to ridicule the estimates done by rigorous professionals or the assumptions behind these estimates. They are particularly interesting, have been performed with extreme attention to detail and by individuals with far greater knowledge than your humble writer. My point is that they are precisely what they are, estimates based on a large number of assumptions. Sure, they are scary. But not so long ago they were just the opposite, reassuring and hugely positive. To gain some perspective I suggest we look at “The budget and economic outlook: Fiscal years 2002-2011” published by the CBO back in January 2001. Gosh! What a difference 9 years makes, and how completely different today is from what was then forecasted! In 2001, it was expected that in 2011, the US would be running a surplus of 889 billion. Those were clearly the good old days. Fast forward nine years and let’s check out the estimate from the CBO in “The budget and economic outlook: Fiscal years 2010-2020” published January 2010: estimated deficit of 980 billion. A complete 180 degrees change! What is the cumulative deficit expected over the next ten years? 6 trillion! What was the expected accumulated surplus back then? 5.6 trillion, an almost 12 trillion divergence, almost the amount of existing gross government debt outstanding! Ever since estimates have been performed you will notice the same pattern: An extrapolation of the recent trend that leads either to gigantic expected surpluses or monstrous deficits. None of them have ever proven correct. See the size of the “miss” over less than ten years, and now consider that unfunded obligations of Social Security and Medicare are calculated over a period of 75 years or infinite. To say the least, estimates of unfunded obligations don’t appear to provide a reliable indication on what to expect even 10 years out. A continuation of the current trend always looks the most probable, but in fact, at every occasion, history has proven that this simple continuation rarely takes place in the much more path dependant “real” world.



Anyhow, for the sake of providing the information, here are the numbers taken from the “2009 Annual Report Of The Boards Of Trustees Of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds” published May 12<sup>th</sup> 2009 and “The 2009 Annual Report Of The Board Of Trustees Of The Federal Old-Age And Survivors Insurance And Federal Disability Insurance Trust Funds” published May 2009:

(In trillions of US dollars)	75 years	Infinite
Social Security Unfunded Obligations:	5.3	15.1
Medicare Unfunded Obligations:	45.8	88.9

One finale note: One other reason these numbers are misleading is that the size of the numbers create a comparative fallacy. To put that in perspective what if I told you that these same 45.8 trillion of present value of additional resources that are estimated to be needed to meet projected Medicare expenditures over the next 75 years represent “only” 5.8% of the present value of projected GDP over the same period. Yes, the present value of GDP projected over that period is 791 trillion. Putting side by side the 75 year unfunded obligations estimate with the current GDP size is like determining your salary based on the cost of living in 1935, in other words, informational but useless and probably dangerously misleading. At best it provides a roadmap for the social reforms necessary that must be addressed in the medium term, but most often this comparison simply creates confusion and is used to sensationalize the headline.

Now to the third issue and probably a good time to take a second tablet of aspirin. I covered federal debt but what about state and local government debt? Again, the question is whether one should include it or not when assessing the US public debt position. Most state and local debt takes the form of long-term bonds (“municipal bonds”). This debt is not guaranteed by the federal government but is backed either by specific revenue sources or on the full faith and credit of the issuer. From this perspective it should not be included as the federal government is not guaranteeing the state and local debt in any way. Also there have been some well known defaults of municipal bonds that suggest that the government is generally unlikely to intervene. Considering it would then clearly be in contradiction with the historical practice and would have no legal supportive. An argument can be made, however, that in the face of multiple state defaults the government would intervene and back the debt.

*“Putting side by side the 75 year unfunded obligations estimate with the current GDP size is like determining your salary based on the cost of living in 1935, in other words, informational but useless and probably dangerously misleading.”*

State and local debt as per the “Flow of Funds Accounts of the United States, Fourth Quarter 2009” published by the Federal Reserve is:

State and local government debt:	2'362 billion
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This brings us to the final but no less controversial issue of Government Sponsored Enterprises (GSEs) and FHA/Ginnie Mae.

The first controversy surrounds Fannie Mae and Freddie Mac which certainly serve a public purpose and where the government now owns 80% of both companies. These two entities should now be considered as government backed, there is no question about it. This does not mean however that the government share of the 6.3 trillion of liabilities of these companies must simply be added to the government debt position as suggested by some. A balance sheet is made of liabilities but also assets, in this case homes. The loans the enterprises own or guarantee represent more than half of the US single family mortgages outstanding. We could do a dirty extrapolation to try to estimate the losses both entities may occur over the next 10 years, 75 or even to infinity. The chances to hit anywhere close to the actual losses that will be incurred are close to nil. A conservative and more accurate approach would be to simply take the extent of the amount invested by the government to this date and consider that amount irrecoverable. This would give a relatively good representation of the current possible cost for the government without undue extrapolation based on numerous assumptions. The maximum amount either enterprise may draw from the Treasury is the greater of \$200 billion or \$200 billion plus the cumulative amount of deficiency amounts covered by Treasury preferred purchases as of December 31, 2012, less any surplus at December 31, 2012. Deficiencies are negative net worth measured in any quarter; these require the enterprise to sell preferred stock to the Treasury to maintain net worth at zero. Basically what this means is that the treasury has no clue whatsoever on the costs and there is no limit on the amounts it may provide. Last month when assessing the household balance sheet I took a 20% hair cut to the household real estate asset position. To be consistent and without even considering the current loss reserves, I shall do the same as I believe this hair cut fairly simulates a good worst case at this time.

*“Basically what this means is that the treasury has no clue whatsoever on the costs and there is no limit on the amounts it may provide.”*

As for FHA/Ginnie Mae securities, they carry the full faith and credit guaranty of the United States government, so the off-balance sheet liability risk cannot even be questioned here. Ginnie Mae guarantees 826 billion in MBS at FY2009. So to be consistent, lets attribute the same 20% credit loss as for Fannie and Freddie:

<i>Off-balance sheet US debt (non accounted losses estimate)</i>	
Fannie Mae & Freddie Mac (80%)	1.00 trillion
Ginnie Mae (100%)	165 billion

So all in all, although it has been a lengthy and labored process simply to share my thoughts on what I believe should and should not be accounted for when assessing the US national debt level, I now have a ballpark number to play with. A useful exercise when these trillions are thrown in our faces and with everyone, myself included, coming up with radically different numbers. You may of course disagree, but at the least, I hope to have provided some light on what all these numbers imply.

To sum up, I shall consider the gross debt (debt held by the public + intra-governmental holdings) as well as the off-balance sheet exposure described above. I shall neither consider the state and local government debt and neither the estimated unfunded obligations constantly sensationalized in the media.

So below (finally!) are the numbers I personally believe more or less reflect the current state of US national debt. The numbers are taken from the “Monthly Treasury Statement as of the 31<sup>st</sup> of December 2009” provided by the Treasury and my conservative estimate of non accounted off-balance sheet losses:

Debt Held by the Public:	\$7'811'009'000
Intra-Governmental Holdings:	\$4'500'341'000
Off-balance sheet estimated losses:	\$1'165'000'000
<b>Total Federal Debt:</b>	<b>\$13'476'350'000</b>



## A Ponzi scheme, really?

Now that we have some number to play with, there are two important questions that must be answered:

What is the solvability of the US government?

Is there a supply and demand issue for US government bonds?

The basic issue that first comes to mind is whether the size of this number creates a solvability issue. After all, the real issue when purchasing someone else's liability is to assess his creditworthiness. What can be said of the above total other than it is huge and not rounded just for the fun and ridicule of its size? Not much, unless they are looked relative to the size of something. In this case that something is also huge, it's the US economy. The US economy as of the same date is 14.46 trillion as per the latest BEA release and so the Debt to GDP ratio is 93% based on my adjusted total.

*“It is widely accepted that a ratio of 60% or below for debt to GDP is sustainable over the long term. However, most fears concerning the government debt level are likely to start abating as soon as the budget is trending towards a surplus and even more so when confirmed by the first surplus budget year.”*

It is widely accepted that a ratio of 60% or below for debt to GDP is sustainable over the long term. However, most fears concerning the government debt level are likely to start abating as soon as the budget is trending towards a surplus and even more so when confirmed by the first surplus budget year. The reason no one appears to be considering that possibility at this time is because the Congressional Budget Office does not project any surplus, ever again. As I mentioned previously I don't believe these projections are of any help to determining the actual path of the fiscal accounts. The assumptions and extrapolations performed have never ever provided the correct path in the medium term. In the short term however they offer some guidance. The CBO estimates in “The Budget and Economic Outlook: Fiscal Years 2010-2020” published in January 2010 are the following:

Fiscal year	Deficit	% of GDP
2009	1.414 trillion (actual)	9.9%
2010	1.349 trillion	9.2%
2011	980 billion	6.5%
2012	650 billion	4.1%
2010-2020	6.047 trillion	3.2% on average

*“So basically, the outlook contains two frightening components; all years are deficits and the trend after 2014 accelerates again. No wonder we hear about sovereign default!”*

*“Put simply, when the time comes to pay, you go knocking on the doors of those who have the money. In a democracy where each individual has one vote, income disparity is elastic and we may be reaching the limits to this elasticity.”*

In the ten year outlook, 2009 had the worst nominal deficit with 1.4 trillion gradually improving to 475 billion in 2014 and then worsening consistently until 2020 at 687 billion. These numbers are constantly growing and the 2010 deficit is now expected to be 143 billion more than that of 2009. So basically, the outlook contains two frightening components; all years are deficit years and the trend after 2014 accelerates again. No wonder we hear about sovereign default!

With that kind of data the doomsayers are partying. Why question this path? There are a number of reasons.

First of all, as hinted in last month's letter, I believe we may be entering a period of contracting wealth disparity. The current fiscal situation may very well be the catalyst for a significant change in the rapid pace of wealth disparity witnessed over the past few decades. The pendulum could well be swinging back. As per last month's letter *“An increase in the tax rate imposed to the top 5 percentile has an impact on over half of income taxes collected. Talk about a small change, which impacts very few voters but makes a big difference to the fiscal situation.”* Other than the super-wealthy, the upper middle class has historically been the most affected by a change in taxation. The perceived origin of this crisis (a crisis which actually originated from incredibly low long term rates due to global structural imbalances) is only likely to add fuel to this reversion. Put simply, when the time comes to pay, you go knocking on the doors of those who have the money. In a democracy where each individual has one vote, income disparity is elastic and we may be reaching the limits of this elasticity. But individual income taxes are not the only target for higher taxes. Of the 2.1 trillion in budget revenues for 2009, 915 billion were individual income taxes but only 138 billion were corporate income taxes. The 30% corporate tax rate is a myth for most large international corporations. As an extreme example consider Goldman Sachs who generated a 2.3 billion profit in 2008 but paid only 14 million dollars in taxes and this after distributing close to 11 billion in employee compensation and benefits. When facing the risk of social unrest and a loss of confidence in fiscal solvency the changes that appear unthinkable today may very well take place at lightning speed tomorrow. You may be thinking I have just taken an extreme example.

*“Many countries have succeeded in lowering debt from very high levels in an orderly fashion. New Zealand reduced its debt from 72% to 30% of GDP between 1986 and 2001, Canada from 102% to 63% between 1996 and 2008 and Sweden from 73% to 38% between 1996 and 2008. After all, the debt ratio always converges to a level that depends just on the nominal growth rate of the economy and the level of the deficit, not the initial debt level.”*

*“Over the past two decades we have witnessed on average a 2 percent growth rate coupled with a 2 percent inflation rate. A balanced budget in these conditions would bring the debt to GDP ratio from the current 93% we calculated earlier back below 60% in ten years.”*

You are probably right, but consider this: since 1960 individual income taxes have grown from 40 billion to about 1.1 trillion pre-crisis (28x) whilst corporate taxes have grown from 20 billion to 300 billion (15x) pre-crisis.

Considering that this slow rise has taken place during one of the longest bull markets in history where multinational companies have become giants, one has to wonder why taxes have grown by only half that of individuals. Don't misunderstand this statement; I am in no way suggesting that the corporate tax rate should be higher, only that it appears that many of the largest corporations have simply found a way to avoid paying their share. Basically, the US has the means to increase its receipts when it has to do so.

On the expense side, you only have to look back at 2002 to gain some perspective. Back then the US gross debt to GDP ratio was at 57% (equal to that of Switzerland). Although the US has been running budget deficits most of the time, these deficits have remained relatively small and only minor adjustments to spending or taxes would have balanced the budget. So although the current situation is unprecedented during peace time, it is very recent in nature and caused by the recent crisis and a return to pre-crisis levels should be regarded as a reasonable goal. Many countries have succeeded in lowering debt from very high levels in an orderly fashion. New Zealand reduced its debt from 72% to 30% of GDP between 1986 and 2001, Canada from 102% to 63% between 1996 and 2008 and Sweden from 73% to 38% between 1996 and 2008. After all, the debt ratio always converges to a level that depends just on the nominal growth rate of the economy and on the level of the deficit, not the initial debt level. Although this fact is currently used by extrapolation to show ever larger debt levels, the opposite extrapolation also stands true. Over the past two decades we have witnessed on average a 2 percent growth rate coupled with a 2 percent inflation rate. Considering the US is able to return to a balanced budget, these conditions would bring back the debt to GDP ratio from the current 93% we calculated earlier to below 60% in ten years. Again, this is an extrapolation, and a decade of uninterrupted growth with contained inflation is an unlikely outcome, my only intent is to show that extrapolation may be used both ways with completely different outcomes. It is clear that the fiscal adjustment will also require reforming pension and health entitlements as they represent over a third of total spending.

*“... these dire projections on debt levels are mostly the result of ageing. Take away ageing from the equation and most projections actually point to surpluses.”*

*“So much so that the study reveals that a two-year increase in the retirement age in EU countries would reduce the debt stock by 40% of GDP in net present value terms!”*

Finally, these dire projections on debt levels are mostly the result of ageing. Take away ageing from the equation and most projections actually point to surpluses. In a particularly interesting discussion paper by Ray Barrell, Ian Hurst and Simon Kirby “How to pay for the crisis” May 2009 (link: <http://www.niesr.ac.uk/pdf/EWLfin.pdf>), the authors offer a very attractive and simple solution to what most consider an inextricable problem. They basically demonstrate that the simple extension of working lives will not only raise consumption and tax revenues but also reduce pension spending. Consumption would increase naturally as individuals can reduce their savings given their shortened retirement period. Tax receipts would increase in line with the working population whilst outlays for pensions would be reduced. So much so that the study reveals that a two-year increase in the retirement age in EU countries would reduce the debt stock by 40% of GDP in net present value terms! An announcement by the government that the working age will be extended and the excess taxes will be devoted to reducing the debt stock would alone trigger a significant reduction in interest costs. I highly recommend that you read this report that brings some perspective to this frightening issue.

Although I strongly believe that the medium term fiscal prospects are unlikely to follow the dire path projected and that there are many tools available to change the trend, this does not yet solve the issue of supply. Will there be sufficient demand in the short term for this gigantic supply of government debt? Let’s first take a look at what happened in 2009, a record year of debt issuance. Again, a lot of number crunching, discrepancies, and a large number of crucial but confusing footnotes. From the monthly Treasury Statement, as of the 31<sup>st</sup> of December 2009 there was:

Debt held by the public 12/2008	6’369’319’000
Debt held by the public 12/2009	7’811’009’000
<b>Added issuance</b>	<b>1’441’690’000</b>
Intra-Governmental 12/2008	4’330’486’000
Intra-Governmental 12/2009	4’500’341’000
<b>Added issuance</b>	<b>169’855’000</b>

*“The flow of funds report goes back to 1978 and since then, this is the first year where households have decreased their borrowing, the first in 30 years! If this is not a broken trend, what is? In fact, as a whole, household and business debt has simply been substituted by federal debt issuance. It is the structure of the debt supply that is radically changing with public debt trying to plug the gap left by a fall in private debt borrowing...”*

We know that Intra-Governmental holdings do not compete for supply with debt held by the public; as they are special issues held by the government itself, they are not sold to the public, have no supply/demand dynamic and do not compete for funds in the credit markets. So there has been 1.4 trillion of added supply. Now the shortcut here would be to say, that one needs 1.4 trillion more dollars to support this issuance. This is the same type of argument thrown around when one reads the phrase “huge amount of cash on the sidelines” when making a bullish argument that there are funds waiting to be invested in stocks. This misses the fact that there must always be a state of equilibrium across asset classes. What goes into one asset class has to leave another. If investors are in cash they are effectively invested in some form of short term debt paying an interest. Buying more equities for example will simply mean that someone else will have to buy the short term debt unless it is retired. The same reasoning has to apply here. Yes there is an increase in supply of treasury’s but what about the level of issuance of other kinds of debt?

In this case, the rise in government debt has been coupled with a fall, and even a retirement of both household and business debt. In the Flow of Funds report we find that as of the 31st of December 2009:

<i>Year over year change in debt outstanding</i>	
Household debt outstanding	- 245 billion
Business debt	- 82 billion
<b>Total</b>	<b>- 327 billion</b>

We must also consider that Household debt has been growing between 300 billion and 1 trillion dollars per year since 1994 and the business sector debt increasing on average by about half a trillion. The flow of funds report goes back to 1978 and since then, this is the first year where households have decreased their borrowing, the first in 30 years! If this is not a broken trend, what is? **In fact, as a whole, household and business debt has simply been substituted by federal debt issuance as the simple accounting identities suggest. It is the structure of the debt supply that is radically changing with public debt trying to plug the gap left by a fall in private debt borrowing and thereby slowing the pace of deleveraging and economic contraction.**

So if the rate of supply does not appear to be an immediate issue, how about demand? To find out we need to turn back to the Federal Reserve Flow of Funds report as of the 31<sup>st</sup> of December issued in March 2010 as well as the TIC Data for December 2009 published by the US Department of the Treasury:

<i>Purchased amount between 12/08 and 12/09:</i>	
Foreigners' Acquisitions of	
Treasury Bonds and Notes net	\$ 534
Household sector	\$ 531
Federal Reserve	\$ 301
<b>TOTAL</b>	<b>\$ 1'366 billion</b>

*Also of interest in the Federal Reserve balance sheet is the amount of Agency and GSE backed securities it has purchased in 2009:*

Mortgage-backed Securities	\$ 1'048 billion
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These three groups clearly represent the bulk of US government debt purchasers. Foreign official institutions purchased 159 billion out of the 534 billion purchased by foreigners. Overall they purchased about 233 billion more than in 2008 essentially because they did not add to their holdings of treasury bills (short term paper) but purchased twice as much as they did back in 2007 and 2006. Although the headlines keep on bragging about the dependence on foreign purchases and how much foreigners have lost interest in the US, the truth is that the interest of foreigners for treasury securities has increased, it is in agency securities and corporate bonds that the interest by officials has weakened which, I suspect, is correlated with liquidity risk aversion and quantitative easing, not default risk. On the subject of the household sector a word of caution is necessary which highlights the importance of footnotes. The Household Sector in the Flow of Funds report is actually a balance category, where after having obtained the data from all other sectors, the balance is assigned to the household sector. Unfortunately, other than being aware of this fact, any interpretation would be wild speculation that I will leave to those always fond of conspiracy theories.

*“Although the headlines keep on bragging about the dependence on foreign purchases and how much foreigners have lost interest in the US, the truth is that the interest of foreigners for treasury securities has increased,..”*



Instead, I will refer to last month’s letter in which I presented the results of a study by Arthur B. Kennickell of January 7, 2009 entitled “Ponds and Streams: Wealth and Income in the U.S., 1989 to 2007”. In it, we find on page 56, the **percent of families** having various types of assets and debts for 2007 by percentile of family net worth, among which:

Item	<50	50-90	90-95	95-99	99-100
Certificates of deposit	6.2	24.3	34.2	32.9	27.0
Stocks	7.2	22.7	43.7	59.5	65.4
Bonds	0.2	0.9	6.1	15.6	24.4
Non money market fund	2.3	15.0	36.5	47.6	52.7
Principal residence	42.9	93.7	96.6	96.9	98.8
Mortgage (principal)	33.5	64.2	60.5	66.3	54.4

*“Nevertheless, there is clearly lots of room for a substantial increase in bond ownership. Notice how stocks are widely held across all net worth percentiles. A small change in the aggregate portfolio structure away from equities and into government bonds would be sufficient alone to provide ample demand for new issuance.”*

Notice how bonds are the least owned category of assets amongst all income categories. Unbelievably, if you add up the ownership of bonds across all percentiles, only 1.6% of the population had a direct holding in bonds in 2007! Now this number is understated because it does not include ownership through mutual funds, retirement funds and excludes savings bonds. Nevertheless, there is clearly lots of room for a substantial increase in bond ownership. Notice how stocks are widely held across all net worth percentiles. A small change in the aggregate portfolio structure away from equities and into government bonds would be sufficient alone to provide ample demand for new issuance.

Now in terms of ownership of this debt held by the public (remember that intra-governmental debt does not impact supply as they are special issues issued by the government to the government), the three largest holders can be found in the Treasury Bulletin as of the 31<sup>st</sup> of December 2009 published by the Treasury department in March:

Foreign and International	46%
Other Investors (household & other)	14%
Mutual Funds	8%

*“Essentially, the Federal Reserve has become one of the largest holders with the objective of keeping mortgage rates as low as possible. This suggests that if there is a credit market that is in an uncomfortable supply/demand position it is clearly the mortgage backed securities market, not the Treasury bond market. As the fed exits its quantitative easing strategy, it shall be selling close to a fifth of the market of Agency and GSE backed mortgage pools outstanding!”*

So the largest buyers in 2009, except for the newcomer, the Federal Reserve under the Treasury Purchase Program (TPP), appear to be consistent with the historical ownership of treasury securities. In case you wondered, of the 3.6 trillion held by Foreign and International holders, China owns about 24%, Japan 20%, UK 5%, Brazil 5% and oil exporters almost 6%. In 2009 these purchases have continued unabated with China adding 167 billion, Hong Kong 71, Japan 139, the UK 47, Russia 35, Brazil 42 and oil exporters about 21 billion.

You will have noticed that I have added the amount of mortgage-backed securities purchased by the fed as it goes a long way in explaining what is occurring in terms of money flows across the different categories of credit. The Fed has been a trillion dollar purchaser of mortgage backed securities, which has been the main reason for the more than doubling of the Federal Reserve’s balance sheet. Other than the Fed, there appears to be no domestic or foreign interest in this paper although there have been no net issues in 2009. As per the flow of funds report (F.210) foreigners have sold over a 130 billion of Agency and GSE backed mortgage pools issues. This trend already started in 2008 during which time they had sold 218 billion reversing all their 2007 purchases of 250 billion. Essentially, the Federal Reserve has become one of the largest holders with the objective of keeping mortgage rates as low as possible. This suggests that if there is a credit market that is in an uncomfortable supply/demand position it is clearly the mortgage backed securities market, not the Treasury bond market. As the fed exits its quantitative easing strategy, it shall be selling close to a fifth of the market of Agency and GSE backed mortgage pools outstanding!

*“If true, and yield seeking investors have poured into corporate bonds, then one should expect spreads on high grade corporate bonds to reverse as the fed exits its quantitative easing.”*

*“... contrary to popular perception the current fiscal situation is unlikely to follow the path predicted by extrapolation of the most recent trend in fiscal deficits. There is still significant room in the US to increase the level of tax receipts and reduce expenses.”*

Considering the distortion the Federal Reserve has created by artificially reducing the supply, we may soon notice that a lot of the traditional demand for agency and GSE mortgage securities has gone into the corporate bond market in an effort to replicate the yield of those securities and that the unintended consequences of this unwinding shall impact both markets. If true, and yield seeking investors have poured into corporate bonds, then one should expect spreads on high grade corporate bonds to reverse as the fed exits its quantitative easing. I shall come back to the mortgage markets in future letters suffice it to say that the headwinds for housing are still everywhere one dares to look.

## Summary

Government debt is simply substituting itself to the fall in borrowing from the household and business sector. The subject of government debt has become highly emotional and is being tangled with dogmas to create sensational headlines. At the end of the day, debt is a measure of how unhealthy the economy is. We are witnessing the early signs that there is very limited room for further government leveraging. Further stimulus proposals are going to be tougher to bring forward by the politics as the population grows increasingly worried about the levels of public debt, more so given the perceived origins of this crisis and the deflationary environment it is creating. What I have tried to demonstrate is that contrary to popular perception the current fiscal situation is unlikely to follow the path predicted by extrapolation of the most recent trend in fiscal deficits. There is still significant room in the US to increase the level of tax receipts and reduce expenses. Just as the surpluses ten years ago provided little guidance on what the fiscal picture would be today, I believe the current level of deficits offers little insight on what the government debt situation will be in 2020. Also, as a Gallup poll recently indicated, 34% of American nonretirees today say they will retire after age 65 versus 15% in 1995, another indication that these scary extrapolations related to ageing are likely to profoundly evolve in the years ahead. The supply and demand equation of US government debt that has so often been used to ignite fear of a possible collapse in Treasury bond prices is presently not at all pointing in that direction.

*“The percentage of mortgage borrowers who have not made a payment in at least three months has reached 9.67%. One in every ten mortgages is delinquent! The reason the rate of foreclosures has slowed is essentially because the lenders have become reluctant to add these properties to the supply of homes for sale. As prices stabilize this “shadow inventory” is likely to be gradually foreclosed, putting a lid on any price recovery.”*

Alan Greenspan once admitted, “[A] government cannot become insolvent with respect to obligations in its own currency.” As much as this statement may seem scary for monetarists, it is nevertheless absolutely true. A sovereign government issuing debt in its own sovereign currency cannot become insolvent. This is the difference between Japan and Greece and goes a long way in explaining why the first can bear a debt-to-GDP ratio over a 150% without enduring an iota of solvency risk priced in its government bonds whilst the other is literally priced as “junk” with only half the ratio of debt-to-GDP. A sovereign government with control on its currency may control not only its debt demand but also the interest paid on that debt. In fact, not only could a central bank simply purchase all the government debt it deems necessary so that the yields reach the levels desired, it could actually consider to stop issuing any bonds at all. Since the Fed has set the target rate equal to the rate paid on reserve balances, the Treasury can spend by simply crediting bank reserve accounts at the Fed as and when it needs funds and without incurring any interest cost. Yes this is monetization, an increase in M1. Given the incredible depth of this subject, I will continue writing next month on this issue of monetization and compare the debt level of the US with that of other developed nations. I shall also share with you some thoughts about the impact of higher levels of debt on economic growth and how this may give support to a prolonged deflationary outcome.

## Long, long, long

The ideal time to start considering contrarian trades is when extrapolation and consensus reach extremes. It is very likely that we are reaching such extremes on the subject of government debt. The consensus is that since government bonds have hugely outperformed equities over the past 10 years, the pendulum shall swing back in favor of equities and a bond price crash shall soon take place. The trigger for the crash can be either a rise in US sovereign spreads or a change in the interest rate cycle. I hope to have given the big picture on why I believe a rise in sovereign spreads in the US is an unlikely outcome at this time. As for a change in monetary policy there are currently very few of the ingredients necessary to ignite it. The headline unemployment rate is still firmly hovering around double digits without even adding all those who are no longer being considered in the statistics.

The deleveraging process has not even begun if you consider that overall debt growth is still positive, up 3.3% in 2009. As the Fed reverses its quantitative easing program, higher spreads on mortgages and corporate bonds are likely to put pressure on the equity markets which will in turn lead to a rise in risk aversion and an increase in demand for government bonds. The percentage of mortgage borrowers who have not made a payment in at least three months has reached 9.67%. One in every ten mortgages is delinquent! The reason the rate of foreclosures has slowed is essentially because the lenders have become reluctant to add these properties to the supply of homes for sale. As prices stabilize this “shadow inventory” is likely to be gradually foreclosed, putting a lid on any price recovery. Capacity utilization is over 7 figures below its 38 year average. Home prices are still declining and mortgage rates are no longer supported by the Fed. The Consumer Metrics Institute Growth Index, which has been a good leading indicator for GDP growth, is already rolling over. Wealth disparity, the subject of last’s month letter, has a profound impact on consumption patterns and explained its resilience. However, this resilience, which is the juice of discretionary spending, is in large part provided by upper- income households. Gallup’s most recent figures on the spending of upper-income households have shown new record lows, indicating that they are still pulling back on discretionary spending. This is consistent with my expectation that the elasticity in income and wealth disparity is reaching its limits, that the upper-income households are anticipating a less favorable fiscal environment and are still assessing how the business conditions are going to affect their personal wealth. Finally, the consumer metrics institute reported that as expected, the favorable year-over-year increase in sales in March was simply the result of the forward shift of the Easter holiday and that their retail index is pointing back to a contraction in excess of 5% this year over last.

In the face of all this data, the recent rise in long term yields suggests that market participants have focused their attention on the stock market. The S&P has almost doubled from its lows, how can this not be the ultimate leading indicator for a strong and sustained recovery? No outcome must be dismissed. But rather than run after this growing consensus, I believe the rise in yields offers an attractive entry point to get paid to wait and see.

There are no supply issues, no disruption in demand, and a large bearish consensus positioned to profit from a change in monetary policy. The secular shifts appearing in income disparity, consumption and private sector debt levels appear to be inconsistent with the recovery consensus that expects private sector leverage to be the answer to a private sector balance sheet contraction. In Japan, the last private sector balance sheet contraction pushed long term interest rates from 5.7% in 1989 to 1.1% in 2008. The average long term US Treasury rate since 1870 is 4.3% and the average annual CPI is 2.1%. At just about 4.3% on the thirty year, I will be going long, long, long and adding to this position if yields reach above 4.75% again.

*My portfolio*

New trade:

LONG 1 UNIT OF 30 YEAR TREASURY BOND (TLT) @ price USD 94.88

(closing price May 14, 2010)

Past trades:

LONG 1 UNIT OF XLU @ 30.24 (closing price April 9, 2010)

SHORT 1 UNIT OF XLY @ 33.97 (closing price April 9, 2010)

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Yours truly,

*Stuart Staines*



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