April 2011

Tsunami

I don't make jokes. I just watch the government and report the facts – Will Rogers

The Japanese Government estimates the cost to rebuild from the recent Tsunami at 25 trillion Yen, or 309 Billion Dollars. On February 14, 2011 (Valentine's Day), President Obama released his 2012 Federal Budget. The Congressional Budget Office projects the 2011 US budget deficit to be $1.645 trillion. Our projected deficit in 2011 could fund the rebuilding efforts of 5 Japanese scale disasters and have money left over.

How did we get here? Since 1940 (under both Republican and Democrat control), the US has run budget deficits in 60 of those 71 years, or 85% of the time. Before I get too far ahead of myself, let me explain what this number means. A budget surplus or deficit is simply a calculation of how much money the federal government brings in (in taxes, fees, and any earnings on investments) minus what it pays out (for services, transfer payments, defense, etc.).

Now unlike you and me (and most states for that matter), the Federal government is allowed to spend more than it takes in. However, it does have to have actual currency to pay for what it provides, so it does what any self respecting spendthrift would do, it borrows the money (I would gladly pay you Tuesday for a hamburger today). There have certainly been periods of time where this excessive spending was necessary, but there are certainly a greater number of years that excessive spending was based on pandering to the electorate. This "kicking the can down the road" approach to budgeting has consequences.

Spending more that you make, as everyone knows, can only be done for so long. At some point you either have to pay up, or declare bankruptcy. Now few expect that the US will do the latter, but when the debt, and the payment on that debt become excessive, a nation approaches a tipping point (read: Iceland) where revenues generated by the government cannot keep up with the cost to run the country plus the debt payments. Before that happens, however, the debt being issued by the debtor nation becomes more expensive. As more of the debt is issued, the buyers of that debt (lenders) become less anxious to lend more. They begin to have concerns about the amount of debt they already are holding from a diversification standpoint, and begin to demand higher interest rates to offset this risk.

The poker game has begun. The Chinese are posturing like they are about to leave the table, and we are hoping to keep them in for a few more hands. We think that all we need is a few good cards and we will be back as the chip leader. To keep them playing, the US Treasury needs to raise the stakes (interest rates). This of course is concurrent with the Federal Reserve flooding the US economy with money in an attempt to keep interest rates low and foster economic growth. This tug of war is badly stacked against the Fed. If we want to keep playing (spending), the ante (interest rates) will go up.

So, what does all of this mean to us? Probably two things. The first is that an interest rate increase is inevitable. History tells us that we are still at 50 year lows for interest rates, and the Treasury needs to fund the beast. The other potential wave on the horizon is inflation. Our policy of low interest rates here in the US coupled with unprecedented spending by our government has dumped a lot of fuel into the machine (the world economy). The government continues to tell us that with the exception of **food** and **fuel**, inflation is still tame (say what?). Not that I'm a cynic, but (the operative word) the US is paying us interest on bonds we own – Treasury Inflation Protected Securities (TIPS) based on the rate of inflation. No inflation equals no upward adjustment.

We are looking to add more investments that will respond well to the coming waves. Stay tuned.