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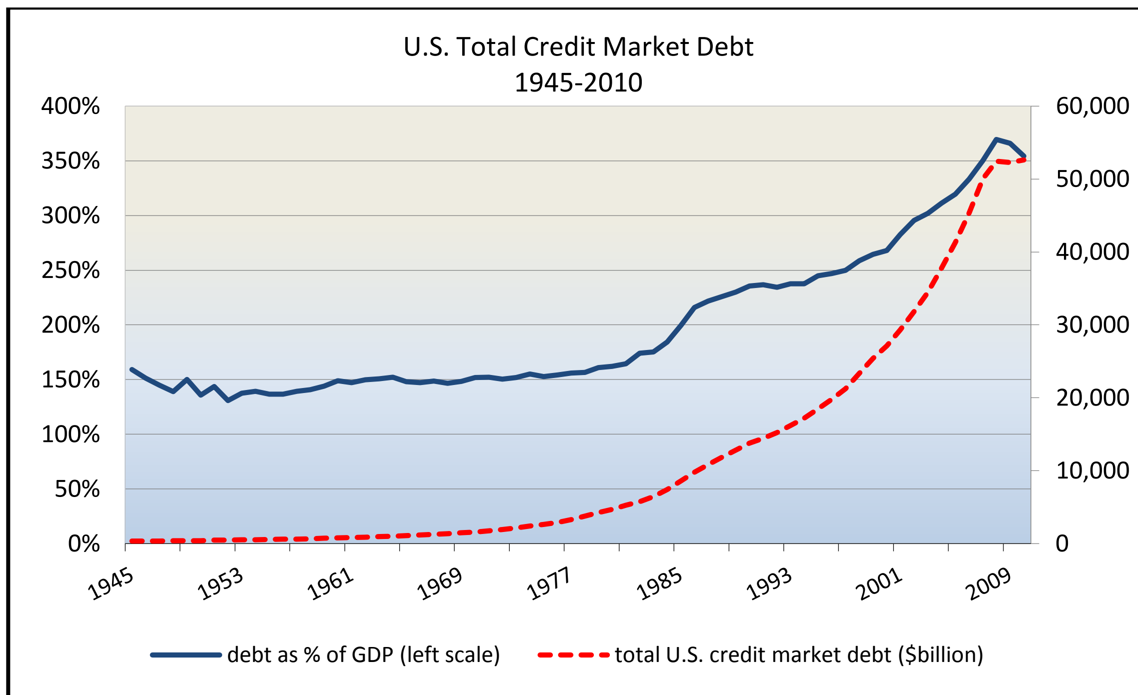
US Debt Woes

The Federal Reserve provides extensive US credit data on a quarterly basis. With several months of lag time, the year-end figures were recently released. The data is reported in various categories, from who owes the debt (federal government, municipalities, households), to what type of debt is outstanding (Treasuries, mortgages, consumer loans). For the most part, the real story is told in two parts -- the aggregate data, and federal government obligations. Neither one presents a pretty picture.

Let's start with the aggregate figures. Total credit in the US is at a record level of $52.6 trillion. That number is so staggeringly high, it needs some perspective to make sense of it. Roughly speaking, total debt in the US equates to $170,000 per person -- working class, retirees, and new-born babies alike. Of course it's not just individuals with a capacity to borrow; businesses and governments can borrow to a much greater extent.

So a better perspective is seen in comparing total US credit to the overall size of our economy. Unfortunately these numbers provide no comfort. Debt as a percent of gross domestic product (GDP) is now 354%, down from its recent high of 369%. For comparison, in 1945 -- at the end of World War II and at a time when the nation really had an excuse for excessive debt -- the ratio was only 159%. By 1960 the figure was down to 148%, and by 2000 it had risen to 276%.



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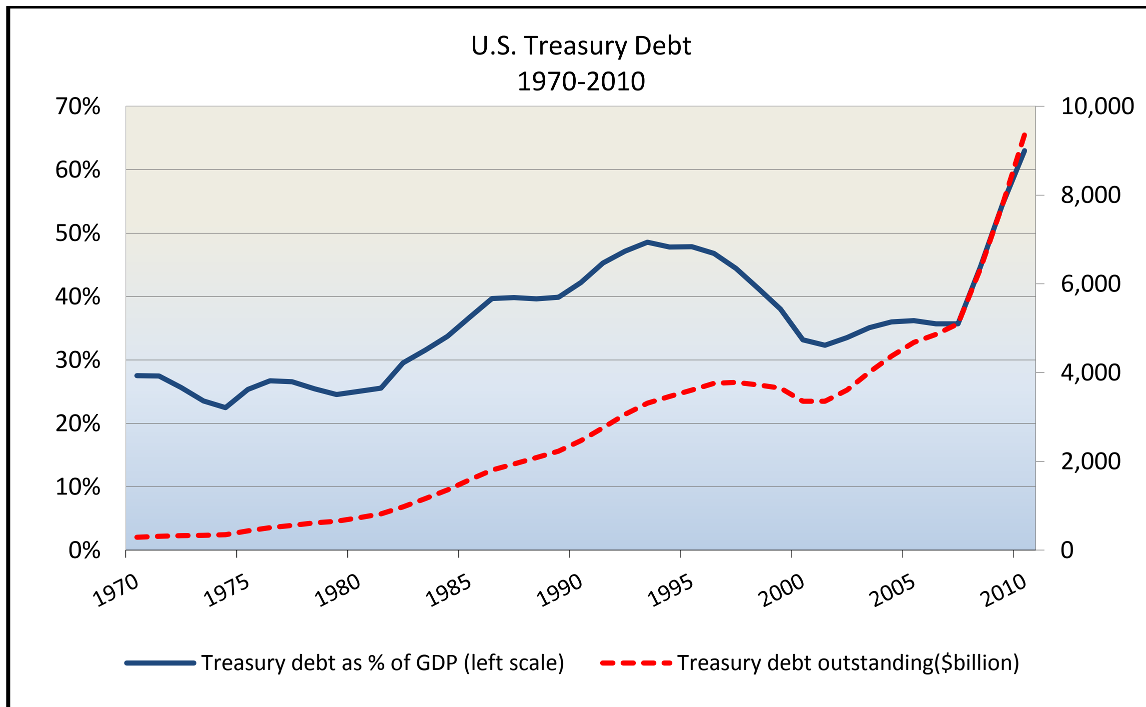
Two immediate thoughts come to mind. First, as the Federal Reserve must be aware of this debt condition, our central bank consciously allowed -- and in many regards encouraged -- continued leveraging of our economy. Did they not believe there was a tipping point anywhere in sight?

Second, as credit is an integral part of capital formation, and as capital formation is a key component of economic growth, any reversal of this credit bubble will act as a drag on the economy. This partly explains the feeble recovery, now almost two years out of recession and still struggling to make lasting headway.

Okay, time for the bad news. Let's look at federal government debt, again both the raw numbers, and expressed as a percent of GDP.

US Treasury debt has risen from $5.1 trillion to $9.4 trillion since 2007 -- a tidy 84% increase, and in the past three years we have taken on as much new Treasury debt as in our nation's first 227 years combined. Treasury debt as a percent of GDP is now 63%, up from 36% in 2007, and just 25% in 1980.



Once again, we have two initial thoughts. First, the $9.4 trillion Treasury debt figure understates current federal obligations, which are closer to the $14 trillion level. Otherwise Congress would not need to raise the existing debt limit. The big missing piece is GSE-debt -- Fannie Mae and Freddie Mac -- which everyone knows the US government is backing, but nobody wants to put on the books. So much for honest accounting.

Second, there is a magic number where Treasury debt is too large for any nation, at least according to the conventional wisdom. That number is 90% to 100% of GDP, where the debt load

becomes a permanent anchor on the economy. Four years ago that magic number was nowhere in sight. At our current rate of deficit spending, it is less than four years away.

What happened? The solution to every problem became more government spending. Collectively, we have gone from fretting over hundred billion dollar budget deficits, to accepting trillion dollar deficits. Of course this mindset is completely backward, but go tell Congress and the White House. All this comes before the monumental spending on retiree health care kicks into high gear. There is a tipping point, and we have reached it. The mountain of debt, especially government debt, is too high. Enough already.

Source: Federal Reserve, Bloomberg

Fading On The Yellow Metal

We seldom dwell upon individual trades. Buying and selling are a part of the investment process, and in the end we hope to be right more often than not. Still, when we sell a long-term holding that represents an entire asset class, it bears mention. In this case, the asset is gold.

As multi-year owners, we recognize the numerous attributes of gold: a precious metal with remarkable physical qualities; a measure of wealth and store of value for thousands of years; a medium of exchange older than any existing paper currency; and an investable asset class unto itself with extremely limited supply.

We also understand the limitations of gold: it pays no dividend, no rate of interest; it offers no nourishment, has limited industrial use. Gold will not feed the world's hungry. It will not rebuild Japan, nor fuel the next phase of growth in Brazil or China. It provides neither heat nor electricity.

Gold's demand profile is a multi-factor model. People treasure it as jewelry, where beauty, and worth, are in the eye of the beholder. Investors value it as an alternative asset, again providing no cash flows. Central banks maintain it as a form of reserves. And it is traded and hoarded, a blend of currency and speculative coin rolled into one.

Most importantly, the price of gold has risen for ten straight years. In dollar terms, gold is five times more expensive than at the turn of the millennium. It has benefitted from runaway fiscal spending and opening of monetary floodgates. Its purchase has been cheaply financed while interest rates have held near zero. It served as a safe haven when the global financial system was on the brink, and provided insurance against a collapse of fiat currencies.

Will these conditions persist? Some of them will, to a certain extent. But not to the same degree. And some of them will fade away, not disappear overnight, but in the end become irrelevant. Have we seen the peak in gold prices? Probably not. Our exit is early, as intended, for top-ticking a sale is not the investor's task. Weighing risk and reward is more important, and for now the scales have tipped toward other assets, away from gold.

Gold 2001-2011

Tidbits..

White House suggests investigating cause of higher oil prices.
Three-part US energy policy: change clocks in March, ban drilling wherever possible, pray.

Exxon Mobil capital spending to approach $100 million per day.
Finding and producing oil is not a cheap and easy endeavor.

Buffett's Berkshire Hathaway to acquire specialty chemical maker Lubrizol for $9 billion.
Along with prior purchases of utilities and railroad Burlington Northern, a meaningful shift to industrials.

AT&T to purchase T-Mobile wireless business for $39 billion.
Significant industry consolidation and time for a long, hard regulatory review.

New home sales hit record low in February, down 82% from 2005 peak.
A bloodbath, and hard to believe any homebuilders have survived.

US corporate profits reach record level of $1.7 trillion.
Up 70% from the recession trough despite weak economic recovery.

Wal-Mart US CEO warns of "serious inflation" ahead.
Someone wake up government officials.

Portugal joins Greece and Ireland as Euro-nation needing bailout.
Not yet a Euro-contagion, and perhaps it never will be.

White House, Congress offer alternative plans for curbing runaway deficits.
Still early, and still just talk, but it has to start somewhere.

US in jeopardy of losing AAA credit rating, S&P warns.
Someone had to say it.

Treasury Secretary Geithner says US will never lose AAA rating, never pursue weak dollar policy.
In Washington, when telling tales, make them whoppers.

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