



L. R. Levin Consulting, L.L.C.

# Newsletter

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## Will The U.S. National Debt Level Affect Our Recovery?

The word “recovery” is a broad term that covers many different economic conditions. The meaning can range from a strong, V shaped recovery to a weak, flat recovery. Even in a “recovery,” different segments of the economy may do well or continue to decline. Each segment of the economy in 2010 may see any one or more of the 5 different cycle scenarios, including stagflation, variable interest rates, and substantial unemployment problems.

When a recovery is weak or shallow any one of a number of actions can have unintended consequences and cause multiple changes to the short and long term business cycle. *What type of recovery are we experiencing and*

*will government actions negatively affect it?*

The Institute For Trend Research (ITR), a premiere economic forecasting organization and our strategic partner, believes that the most recent U.S. Leading Indicators, which run through November 2009, indicate **“the nascent recovery will be sustained into 2010.”** ITR also believes that weaker consumer expectations, coupled with the level of supplier deliveries and new capital goods orders “show the 2010 recovery is likely to be *shallower* than the historical norm.”

In lay terms, this is how economists describe a weak, jobless leveling off of the economy. As we have previously discussed, different segments of the economy will experience the 2010 recovery very differently.

Most of the underlying fundamentals of the U. S. economy were relatively strong going into this recession and that is why, with essentially little government help to

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date, we avoided a real collapse or depression, and are now leveling out.

If the government had recognized how free market systems work and tried to effectively work within that framework, as had been done in most past severe economic down turns, we should be looking at a strong recovery now.

Transitions through economic cycles are never without pain. Even Congress cannot repeal the laws of economics. What down turns should do is cleanse the system and permit a fundamentally viable economic system to rebuild on a stronger foundation.

In terms of this cycle, for example, that meant removing the toxic debt and related housing bubble. To do this the economy certainly would have experienced the pain of a substantial number of failed businesses and institutions that would have paid the price of assuming inappropriate high risk levels.

The path chosen this time has not been to cleanse the system. Rather, we have propped up ailing businesses that assumed inappropriate risk levels such as auto manufacturers and high risk taking banks, and created pools of old toxic assets and

new risky securities. There is a big difference between the Fed selling off, at fair market value, the assets of a failed bank or insurance company to a sound institution, and the Fed compelling a formerly sound institution to take on the problems of the failed institution. We call this later policy, killing the well chickens to make chicken soup for the sick chickens.

Taking taxpayer money to prop up auto companies, without changing work rules or eliminating imprudent past union pension obligations while transferring equity to foreigners and the unions that created the problem, isn't cleansing the system by any measure. It may be good politics, but it's bad economics.

The effect of killing the well chickens to make soup for the sick chickens is to continue the problems created by the past mistakes and extend their long term negative impact. With the patient still suffering from the illness, even a slight cold may turn into something much worse. That is where we find ourselves today, with a "shallower" than normal recovery.

The housing market continues to have problems, the credit markets

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are artificially creating potential new bubbles, and the consumer is being stripped of its buying power. *What has taken the place of a fundamentally economic driven recovery, nurtured by government policies designed to assist the process?* In hind sight, current policies may look a lot more as if they were designed to plan and control the economy at taxpayer expense.

Areas where the government has pumped in huge amounts of cash are doing better, such as hedge funds and the mortgage market. Such massive infusions of liquidity should in the short run (2010) improve the employment situation. The problem is that this is artificial, and if the government ceases to pump in cheap money, conditions will change. The government is poised to spend a substantial amount of money in 2010 and areas of the economy that are the beneficiaries should continue to improve. Whether or not this will help the rest of the economy beyond 2010 remains to be seen.

Like “the patient still suffering from the illness” even slight miscalculations could have very real consequences, given the nature of the present recovery. One very real

“virus” is the government’s financing its very broad expanse of new initiatives with borrowed funds.

In the last month the Budget Act, Jobs Bill, and Supplemental Defense Bill have set an expenditure floor of \$4.3 Trillion for 2010. The deficit for fiscal 2009 was \$1.4 trillion or 10.2% of our GDP. Even before other pending legislation, the White House has projected a \$1.5 trillion deficit for this fiscal year!

A \$1.5 trillion deficit represents approximately 10.71% of GDP. In fiscal 2009 the federal government paid \$383 Billion of interest on the national debt. To put that in perspective, that exceeds by more than 30% the costs of running the departments of Transportation, Education, Energy, Commerce, Interior, and NASA combined!

The National Debt is currently increasing by \$3.7 Billion per day or **\$26 Billion per week**. That means the National Debt is increasing each week by more than it takes to run NASA for a year!

If all this spending had resulted in a “V” shaped recovery as the government predicted that might not be so bad. In a normal “V” shaped recovery, tax receipts go up

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substantially as the recovery progresses, and temporary stimulus spending and the National Debt come down. *Even with the most optimistic White House prediction, does the National Debt keep growing over the next 5 years?* Yes!

Let us compare the U.S. debt to some of the Euro countries. Projected 2010 deficit as a % of GDP:

Belgium	3.4%
France	8.3%
Germany	3.4%
<b>Greece</b>	<b>12.7%</b>
Italy	5.0%
<b>Ireland</b>	<b>12.5%</b>
<b>Spain</b>	<b>11.0%</b>
Portugal	8.0%

The bond rating agencies have been very concerned about and been down grading the sovereign bonds of Greece, Ireland, and Spain for example. **It should give us real pause that our percentage of deficit spending to GDP is only 1% below theirs.** Ireland's total National Debt as a percentage of GDP is 64% as compared to ours at 68% of GDP.

There are many aspects that distinguish the true strength of our economy from the rest of the world, which hopefully will not cause our debt to be downgraded to BBB like Greece, for example. But with that

said, it does not follow that we can continue to escape the pressure to raise the interest rate required to sell our sovereign debt to independent third parties, if our debt keeps growing. (Interest rates are not the only problem caused by our unsustainably high level of deficit spending.)

Currently, we are financing a substantial part of our debt with short term securities. The current interest spread between 6 month Bills and 5 year Notes is approximately 2.46%.

Assume we do not increase our debt further by even 1 penny. If the term of our borrowing shifted only slightly, say from 2 year notes to 3 year notes or rates rose slightly causing an average increase in our current borrowing cost of just ½ a percent, it would add \$60.5 Billion per year to our borrowing costs!

That added ½% cost is more than the annual budget of either the department of Education or Energy. In fact it is more than the budget of Commerce, Interior, and NASA combined! Interest rates on our National Debt have been kept artificially low because 43% of debt is now owned by the Fed and other U. S. government agencies (\$5 Trillion).

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An increase of over 3% in recent years. Short term financing of the debt has also been a major factor in reducing the interest rate.

When the Fed supports the government by buying our debt as it has, it does so by printing money with no value behind it. If our gross national product were expanding in constant (non-inflated) dollars, then this could support an expansion of our currency. But, of course, the opposite is true and the rapid expansion of debt held by the government and financed by the Fed has only created greater pressure on the value of the dollar and interest rates.

We hear increased talk about the spread between short term treasury interest rates and long term treasury interest rates. The spread is widening because the Fed has artificially kept the short term rate low by buying short term debt and setting a low federal rate for banks. If economic conditions force a change to this policy, then the cost of funding the National Debt will rise far more than ½%.

The other major portion of our National Debt is held by foreign countries. This represents 30% of our current debt, more than a 6% increase

in recent years (\$3.4 Trillion). The major holders of this debt are China, Japan, United Kingdom, oil producing states, Brazil, Russia, and India. All of these countries have warned the U. S. about their concern with our deficits. China, the oil producing states, Brazil, Russia and India have taken steps to reduce their holding of U. S. debt. They have increased their purchases of gold as a reserve for trading, and moved to purchase IMF drawing rights denominated securities rather than U.S. debt.

The indications are that this shift away from supporting our debt may continue and intensify during the coming year. This is especially true if our debt levels continue to increase and are funded as they have been lately. One reason our more recent debt sales have held up is that they are of shorter term duration securities, giving these foreign purchasers the ability to abandon our debt quickly as it matures over the next year, if they choose to do so.

The increasing National Debt takes liquidity out of our economy, hurting job creation and reducing consumer purchasing power. The increasing National Debt problem is but one issue that could profoundly

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impact our “shallow” recovery over the next year.

The cost of health care, cap and trade, Iran, the cost of overseas wars, the federal and state pension crisis, and increasing taxes to name just a few, all could impact the recovery in the next 6 to 18 months.

## THE WISE OLD OWL



The question remains then, how to anticipate the 5 different economic scenarios that different segments of the economy may face at different times, over the next 6 to 18 months? Because each of the 5 scenarios will have such a different business impact, businesses tend to hunker down and do nothing at this point in the cycle.

That is the opposite of what you should really do to be successful. This is the point in the cycle where the uncertainty is very valuable, if you are able to negotiate long term leases on realty or equipment, union contracts, and the like. You may want to advance capital expenditures for plant and equipment, taking into

accounts what you normally would do over the next two years or so.

By developing and implementing employee training programs, you will be able to take advantage of conditions as they develop, differentiating your company from the competition. Your marketing programs, should be designed to be in front of the cycles and adjust as the cyclical changes develop. This may also be the opportune time to acquire confused competitors.

This is a critical time to develop scenario based action plans that take all of these factors into account. Factors like the level and nature of our National Debt and the tepid economic situation mean that conditions can change rapidly and you should be prepared in advance to adjust quickly and take advantage of changes as they occur. We can help.

### Recent Cartoon



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