Pre-existing Debt Leverage

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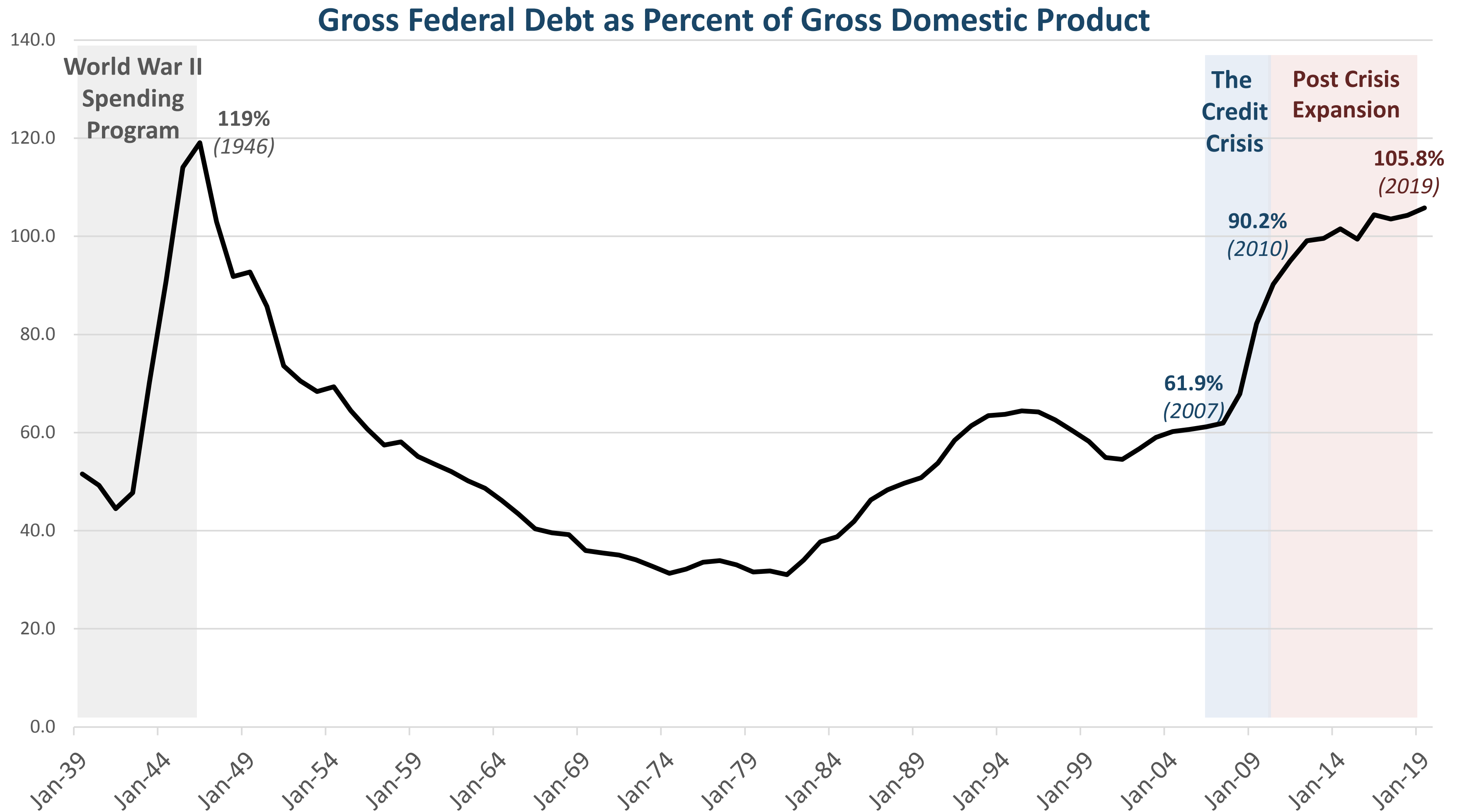
Rapidly Rising Federal Debt as a Percentage of GDP



Source: St. Louis Federal Reserve Bank

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Pre-Pandemic Starting Point

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Policy Choice Freedom Already Reached Its Tipping Points

Where we stood at the end of 2019, post the 10-year economic expansion, pre-pandemic:

GDP: $21.7 trillion

Federal debt: $23.2 trillion

Budget Deficit/GDP: 4.44% (4th largest since 1929)

Discretionary Budget: $656 billion[1]

Interest Expense on Federal Debt: $364 billion

Implied Interest Rate on Federal Debt: 1.6%

Total Debt in the U.S.: $77 trillion
(including corporate bonds, credit card debt, auto loans, mortgages, etc.)

Interest Burden on Total Debt: $3.72 billion

Implied Interest Rate: 4.8%

Tipping Points for Policy Decisions:
The government simply could not afford to permit interest rates to rise.

A 2%-point rise in interest rates would translate into over $450 billion of additional interest expense, totaling to more than the discretionary budget alone.

A 1%-point rise in rates would translate into $770 billion additional interest, equivalent to 3.6% of GDP. GDP during the 2008/2009 Credit Crisis Recession declined by 3.25%

[1] *Includes Defense spending, interest expense and mandatory spending programs like Social Security and Medicare)*

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The Alternative: Fiat Currency Debasement

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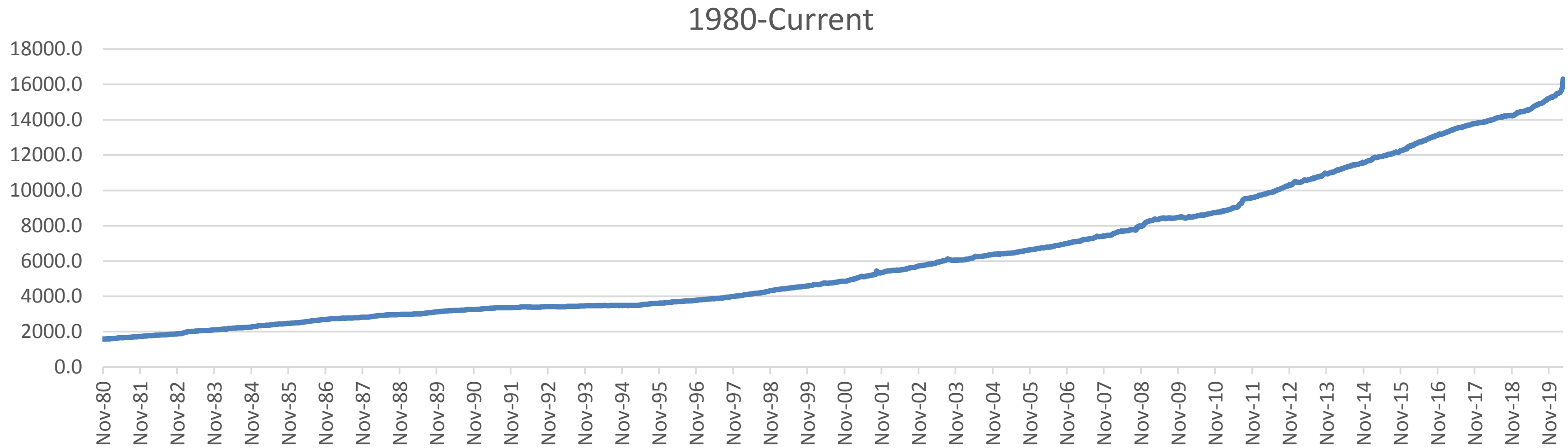
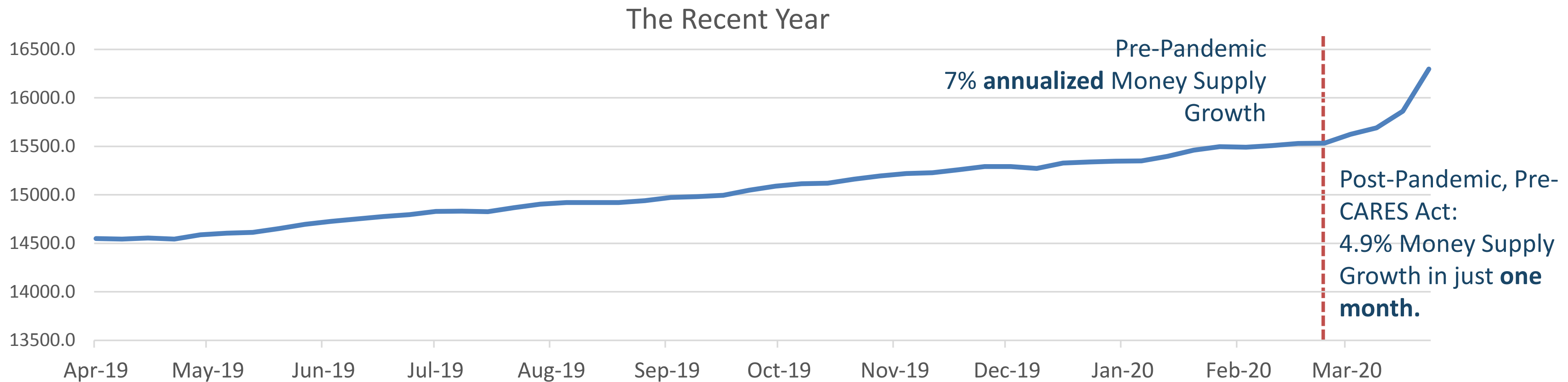
Growing Money Supply





Source: St. Louis Federal Reserve Bank

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Post-Pandemic

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The Magnitude of Government's Actions To Date

The Federal Reserve's **Assets** increased by $1.65 trillion (from $4.16 trillion to $5.81 trillion).

The **Budget Deficit** was already at $1 trillion. The $2 trillion spending bill will raise that to $3 trillion.

But there's also the loss of tax revenue, because of the mandated business shutdowns: lower personal income taxes, corporate income taxes, capital gains taxes, excise taxes. So the deficit will be larger still, which means yet more money creation will be needed.

The **Federal debt/GDP ratio,** even excluding any additional spending beyond the $2 trillion stimulus plan, rises from 105.8% to 116.3%. But if GDP is just 2% lower in 2020, the ratio becomes 118.7%. Going back to the highest ever figure, the World War II figure, that was 119.1%.

As to **money supply** – February 24th to March 23rd increased by 4.9% ($964 billion). That's almost a year's worth of money supply increase in one month. And this was a week **before** the CARES Act was even signed.

And we are just getting started, we are clearly not done spending yet.

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The Irreversible Implication of the Stimulus

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The Other Part of Money Creation

Breaking Down the CARES Act:

Of the $2 trillion CARES Act funds, the Treasury gets $500 billion to support corporations, states and municipalities. A modest portion, $46 billion, is directed to specified industries, like airlines and air cargo carriers.

The remaining $454 billion is governed by Section 4003(b)(4) of the CARES Act, allowing the *Treasury Secretary* to make loans and other investments "in programs or facilities established by" the *Federal Reserve* under various Special Purpose Vehicles or SPVs.

Federal Reserve sets up an SPV. The Treasury will own the assets. That equity investment is expected to act as a buffer to absorb any losses, which permits the Federal Reserve to then put more money in. How much? Up to 10x that amount.

Implications:

- The Federal government will now be buying corporate bonds in the open market, including ETFs.
- Scale of buying: based on the $456 billion made available to the Treasury, the additional money creation could easily be on the order of $3 trillion or more. The government can, pretty shortly, own a large portion of the U.S. fixed income markets.
- The ***Federal Reserve and the Treasury are working hand-in-glove.*** The Treasury is, in a fashion, directing the Federal Reserve to create more money, money to provide liquidity to corporations, but also to prop up securities prices and monetize the debt.

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The Bottom Line – The Old Asset Allocation Models Have Been Rendered Obsolete

Money Losing Proposition for Bond Investors

Central banks around the world will have to continue to create more money, debasing their currencies, to buy their bonds, in order to suppress interest rates. This condition will allow, over the ensuing decades, debt to be repaid with ever cheaper currency.

The good news is that we have some time. For the immediate future, the government will be supporting bonds prices. But beyond the near term, as an asset class, bonds will be more dangerous than equities. The bond/stock asset allocation standards of the past are over. Bond investors now face a binary choice:

- Either the government is able to maintain interest rates where they are or even lower, in which case bonds lose value, via inflation, relatively slowly.
- Or rates rise, in which case bonds lose value fast. What could make rates rise? In 3 months or so, when governments around the world publish the size of their budget deficits, there will be credit rating downgrades of sovereign debt. Debt rating agencies like Moody's follow strict criteria, such as debt/GDP ratios, so the downgrades are coming.
- A 10-year Treasury, now has a 0.74% yield. If the yield rises to just 3%, the price drops 20%. A 30-year Treasury, is now 1.33%. If the yield rises to 3%, it loses 33%.

So there is no scenario in which investors escape losing money in bonds. One of the most important elements in asset management in the coming decades will be finding ***inflation beneficiaries*** and business models that are protected from inflationary pressures.

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