LONGWAVE GROUP

Ian Gordon Economic Forecaster & Interpreter of the Kondratieff Cycle

*Those who cannot remember the past are condemned to repeat it. Santayana*

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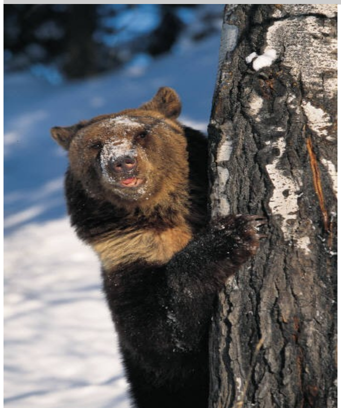
# Winter Warning



## If You Listen Very Intently, You Can Hear the Interest Accrue

Let the word go forth, the United States of America is beginning to drown in a tsunami of red ink. The U.S. national debt has recently surpassed the $11 trillion (U.S.) mark and is increasing at the staggering rate of $350 million (U.S.) per hour. In our *March 2nd. Winter Warning, a Man of Constant Sorrow (2)*, we stated that the Gross Domestic Product (GDP) growth projections set forth in President Obama's budget for the next 5 years were overly optimistic and constituted "*a pipedream of wishful thinking.*" Since then, the U.S. Congressional Budget Office (CBO) has calculated that the White House taxation and spending plans will create deficits totaling $2.3 trillion (U.S.) more than the President's budget projected for the next decade. The difference largely reflects the administration's more optimistic forecasts of economic growth through 2019. We rest our case.

Equally, if not more disturbing, was the recent press release by the U.S. Federal Reserve Board that it intends to follow the Bank of England's quantitative easing policy by purchasing "*up to an additional $750 billion (U.S.) of agency (read Fannie Mae and Freddie Mac) mortgage-backed securities, in order to provide greater support to mortgage lending and housing markets. Moreover, to help improve conditions in private credit markets, the Federal Open Market Committee (FOMC) decided to purchase up to $300 billion (U.S.) of longer term Treasury securities over the next six months*." In other words, the U.S. Government has made the lamentable decision to print money and lots of it. Indeed, this initiative began last week with the Federal Reserve Bank of New York's initial purchase of $7.5 billion in Treasury notes maturing between 2016 and 2019.

We are staunch believers in the truism that a growing debt problem cannot be solved by creating more debt. We are convinced that this FOMC initiative will not bode well for the outlook for the U.S. dollar, since it will certainly decline in value and purchasing power over time. The Obama administration cannot simply spend its way out of the current economic depression. Is not this the message that President Obama, en route tomorrow to the G20 economic summit in London, received today from German Chancellor, Angela Merkel, who said that "*no one can convince me*" that Germany should spend more money on economic stimulus packages? Ultimately, the combination of stimulus packages, entitlement programs, state and federal budget deficits, defense spending, outlays for the war on terrorism and reductions in revenue due to various tax cuts will, not only, take their toll on the value of America's currency, but also, discourage foreign investors from purchasing an ever increasing supply of U.S. debt securities. (*See Winter Warning, The Flight to Folly – September 22 /08*).

## Never Look a Gift Horse in the Mouth

Chinese Premier, Wen Jiabao, recently expressed concern about the safety of China's holdings of $2 trillion (U.S.) in Treasurys, as well as other American fixed income securities. Since Premier Jiabao made this statement, the Federal Reserve Board announced its Treasury quantitative easing initiative, causing 10-year

U.S. Treasury yields to fall by 30 basis points from 3.00% to 2.70%, or, to rally by $2.45 (U.S.) in price per bond. Accordingly, now would be an opportune time for China to lighten up on its U.S. Treasury portfolio because it would be selling into strength, ergo, avoiding any potential market disruption, while gleaning a nice capital gain. After all, just a $2.45 (U.S.) profit per bond on the sale of $1 billion (U.S.) of Treasurys registers a gift of $24.5 million (U.S.); the irony of selling bonds back to the U.S. government, notwithstanding. From this point, embracing a Treasury buy and hold strategy is not likely to reap any rewards for China, since continuing deflation means a lower U.S. dollar, while a return to inflation means lower bond prices. In either situation, a higher range of interest rates will ensue, further exacerbating the value of China's U.S. Treasury portfolio.

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