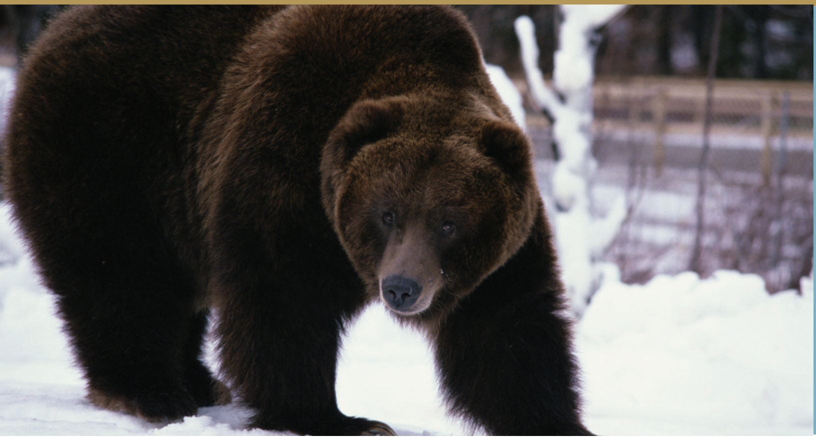
Volume 25 | Issue 1 . February 15, 2011

LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



IT'S STILL THE DEBT, STUPID

Within the Long Wave economic cycle, there exists a credit expansion cycle which results in extremely high levels of debt by the end of autumn, fueled by massive waves of market speculation.

See also, Winter Warning, July 12, 2010 – Four Long Wave Autumns in the United States. At the onset of the collapse of the last winter credit bubble in 1929, the United States was the world's largest creditor nation. In fact, America had been paying down her national debt throughout the Kondratieff autumn period of 1921-1929; so by the beginning of winter, her total budget deficit amounted to only $16 billion (U.S.). This afforded both the Hoover and Roosevelt administrations the luxury of debt financing on reasonable terms through the following 16-year period of the Great Depression and World War II. Today, however, the fixed income market affords the Obama administration no such advantage. Currently, the United States is the world's largest debtor nation. During the hugely speculative fervor in the Kondratieff autumn of the 1990's, the U.S. government made no attempt to pay down the national debt. Rather, the cumulative national debt burden grew from $1 trillion (U.S.) in September 1981 (the beginning of autumn), to $5.6 trillion (U.S.) by September 1999 (the beginning of winter) and to $9 trillion (U.S.) as of September 2007. Thus, the current Obama administration is in a very different fiscal position from the preceding administrations of Hoover and Roosevelt. At the onset of winter, the U.S. government already faces an impossible deficit and doesn't possess the means to combat the growing economic depression, caused by the collapse of the debt bubble.

The United States Constitution enacted into law in 1787, Article 1, Section 9, Clause 7 declares: "No money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." In accordance with this section of Article 1, the House of Representatives Committee on Appropriations convened a meeting on February 4th. to outline potential government spending cuts for the current fiscal year ending September 30, 2011; which are to be carried forward for the Continuing Resolution (CR) vote by Congress scheduled for March 4th. Committee Chairman Harold Rogers (R- KY) announced: "The Budget Committee today outlined a responsible and prudent level of funding for the federal government for the rest of fiscal year 2011. This top-line level will provide for significant spending reductions in the upcoming Continuing Resolution, while allowing us to meet our commitment, outlined in the 'Pledge to America' to reduce non-security discretionary spending to the pre-stimulus and pre-bailout non-security funding levels of 2008. The Appropriations Committee will, not only draft legislation that will meet the Budget Committee's non-security discretionary total of $58 billion but also, go even further to find savings in virtually every area of the federal government, reducing spending from the President's fiscal year 2011 request by a total of $100 billion."

This represents the opening salvo in a likely 20-month budget deficit/national debt confrontation, to unfold on an American playing field of political gridlock. At this time, spending cutbacks of such magnitude are just unacceptable to Democrats, so partisan trenches are likely to be dug, as Washington's dangerous war of brinkmanship unfolds; with the President holding the omni-present veto in his back pocket. As the U.S. budget deficit rapidly approaches 10% of the country's gross domestic product (GDP), increasing debt warnings are emanating from the International Monetary Fund (IMF) to Moody's Investors Service, with greater frequency. The U.S. Federal Reserve's $600 billion (U.S.) quantitative easing (QE II) policy, notwithstanding, U.S. Treasury note and bond prices are currently falling, while Treasury yields are rising, all along the maturity spectrum.

The other financial burden with which America is belaboured is its national debt, currently a staggering $14,200,450,000,000 – that's $14.2 trillion (U.S.) – and projected by the Congressional Budget Office (CBO) to reach 100% of GDP within the next decade. The U.S. Treasury expects that the current debt ceiling of $14.3 trillion (U.S.) will be reached between early April and late May; at which time the Congress must vote to raise it, or new debt issues will be curtailed and federal government departments and agencies will begin to close. The interest on the national debt already consumes 10% of the government's budget and if the situation remains unchecked, higher interest payments will eventually cause the United States to lose its 'AAA' sovereign debt rating; as well as its world reserve currency status. All this is unfolding during a period when the prevailing level of short-term administered interest rates is at an historic low. What would happen to the U.S. budget if bond yields were double the level of today, i.e. 10-year Treasurys trading at a 7.30% yield basis? In short, America would be traversing well down the road toward financial Armageddon and by extrapolation, social unrest. See also, Special Edition January 2003 – The Kondratieff Winter & the Case for Gold and Winter Warning, January 11, 2010 – It's The Debt, Stupid.

Sovereign Debt Defaults: Historical Overview

In their book, Debt Defaults and Lessons from a Decade of Crises, MIT Press 2006, authors Federico Sturzenegger and Jeromin Zettelmeyer recount: "There have been hundreds of defaults and debt restructurings involving privately held sovereign debt since the early nineteenth century. However, since the 1970s, the majority of these defaults and debt restructurings reflect subtle interactions between domestic economic policies and shocks to the economy, including changes in the external environment and sometimes, although not always, political shocks. The striking fact about these defaults is that they are bunched in temporal and sometimes regional clusters, which correspond to boom-bust (economic) cycles in international capital flows. Sovereign debt defaults in the 1970s included Latin America, Spain, Yugoslavia, Romania, Poland, Turkey, Egypt and Indonesia, as well as some African countries; and in the 1990's, Latin America, emerging Asia, and former Communist countries in eastern Europe. The origins of these lending booms varied. Several were initiated by political change that created a demand for capital, or opened new investment opportunities."

What Is Sovereign Debt Rescheduling?

"Sovereign debt rescheduling means postponing the debt payments of a country and stretching them out over a period of years, in the expectation that the borrower will be in a better position in the future to repay its loans. There are few explicit rules, except that creditors will not conclude a rescheduling until a country has reached an agreement with the International Monetary Fund (IMF) on an austerity program to put its balance of payments back in order. Debtor governments find it politically more palatable to accept terms from the IMF than from other sovereign states or the banks. Negotiations on debt rescheduling are often protracted and they are also predictable: the terms are sometimes better and sometimes worse, but a country will get its debt rescheduled. Both creditor and borrower have too much at stake to walk away from the negotiating table. Whether it blames Wall Street for its problems or not, a borrowing country knows that default might lead to the end of credit and the seizure of its assets abroad – all its bank accounts, ships and goods in transit. In effect, a default could cut off a country from the world economy and few are able to survive such economic hardship." – The Problem of International Debt, edited by Christopher A. Kojm, H.W. Wilson Co.

LONGWAVE group

The State and Local Governments of the American Union

By a significant margin, the United States is now the world's largest debtor nation, with a national debt burden recently exceeding $14.2 trillion (U.S.). Complementing this enormous debt load are many state and local government deficits which are proving very difficult for state governors and city mayors to eradicate. Indeed, since there is little appetite, if any, by the American electorate for higher taxes, most state politicians are attempting to eliminate deficits through spending cuts and by downsizing government. There seems to be a contagious truism permeating through state legislatures from coast to coast to wit: be unwilling to even hint at the prospect of tax increases, let alone new taxes, lest ye be voted out of office in the next election. Caveat gubernator!

Florida – The Sunshine State

Florida Governor Rick Scott plans to close his state's $3.6 billion (U.S.) budget deficit and create 700,000 private sector jobs within the next seven years, by cutting government spending up to $5 billion (U.S.), reducing property and income taxes; as well as restructuring the State government. Among the newly elected Republican Governor's proposals is a goal of cutting $1.4 billion (U.S.) annually from the budget by requiring state employees to contribute to the state's public pension system for the first time and by channeling new employees into 401(K)-style pension plans that don't guarantee set benefits upon retirement. Unsurprisingly, Governor Scott faces significant opposition to his plans from unions and environmentalists; as well as skepticism from some politicians within his own party.

California – The Golden State

Facing a $25.4 billion (U.S.) deficit, newly elected California Democratic Governor Jerry Brown has announced $12.5 billion (U.S.) of spending cuts in the state's budget for fiscal 2012, including big cuts in Medicaid, higher education and a 10% pay reduction for most state employees. Governor Brown also wants to shift more responsibility for Corrections and Foster Care to local governments. To avoid even deeper spending cuts, Governor Brown has called for a June election to implore voters to extend temporary increases in the state income and sales taxes; as well as vehicle license fees. These budget measures "will be painful, requiring sacrifice from every sector of the state, but we have no choice," Governor Brown recently lamented.

Illinois – The Land of Lincoln

Facing a deficit estimated at $13 billion (U.S.), Illinois Democratic Governor Pat Quinn was relieved after the State Legislature recently voted to raise the state personal income tax rate by 67%, from 3% to 5%; and the state's corporate taxes to 7% from 4.8%. State Senate President John Cullerton (D-Chicago) commented: "We have just come through the worst economic crisis in our lifetime and we have not paid our bills. We are going to have to cut spending even with these tax increases. We're going to have to spend less money than we have in the last two years and it's going to be tough, but we are going to have our bills paid."

Iowa – The Hawkeye State

Iowa Republican Governor Terry Branstad aims to cut the State's highest corporate tax rate in half to 6%: "We see the (economic) growth opportunity primarily in small businesses and entrepreneurs. This makes Iowa a more competitive and more profitable place for them to locate," Governor Branstad extolls. However, he is among the few Governors proposing some tax increases: i.e. Governor Branstad would raise the casino tax rate to 36% from the current range of 22% to 24%, to offset the corporate tax cut. In addition, Governor Branstad has proposed reducing what the State spends on preschool education to $43 million (U.S.) from $71 million (U.S.) and inviting parents to pay on a sliding scale, depending upon their income. (Iowa established free preschool for all 4-year olds in 2007, under Democratic Governor Chet Culver.) Governor Branstad observes: "I do recognize that some low income Iowans can't afford to pay for preschool, but even they can pay something, maybe just $10 (U.S.) a month."

Oregon – The Beaver State

Democratic Governor John Kitzhaber has proposed a 2-year budget that would enable cuts to mental health institutions and reduce state Medicaid reimbursements to doctors and hospitals. Cuts to Medicaid, a joint state-federal program, represents some of State Governors' largest proposed reductions. Other proposed spending cuts include fewer state agencies, fewer employees and generally, a smaller safety net for social services. State-funded universities would cost more, but local governments would play a greater role in delivering services; as well as paying for them. Governor Kitzhaber explained: "The way we responded to (economic) recessions in the past was to do less of the same; with the hope of having more money later so we could do more of the same. There's a once in a generation opportunity to do some things we should have done a long time ago, but couldn't make the politics work."

New York – The Empire State

Last week, New York Democratic Governor Andrew Cuomo brought down his first budget with a restructuring plan for State finances, citing New York had been locked into annual increases in education and Medicaid, which had little bearing on actual costs. Declaring the State to be "functionally bankrupt," Governor Cuomo recommended a 2.7% reduction in overall spending and suggested a much slower pace for the long term growth of health care and education, sectors that have long been above national state averages. Robert Ward, deputy director of the Nelson A. Rockefeller Institute of Government in Albany, N.Y. commented: "State revenues are growing, but not enough to replace the stimulus dollars, let alone keep up with baseline spending growth." Without concessions, Governor Cuomo stated he may be forced to resort to job layoffs, proposing to dismiss up to 10,000 State employees, about 2% of the work force. Moreover, an advisory panel which the Governor appointed last month has less than two months to form a plan that generates $3 billion (U.S.) in savings from the health care industry. As indicated above, education spending has also emerged as a budget target. In Rochester, N.Y. for instance, Governor Cuomo's budget has forced Anne Kress, President of Monroe Community College, to realign her school's curriculum and restructure revenues. Since the school's state funding has been cut by about 25% over the last two years, it led to a $100 (U.S.) increase in annual tuition fees and the elimination of programs such as massage therapy and court reporting. Ms. Kress expects this year's cuts may result in, not only, another increase in tuitions, but also, the elimination of several counseling programs.

The Battle of Manhattan

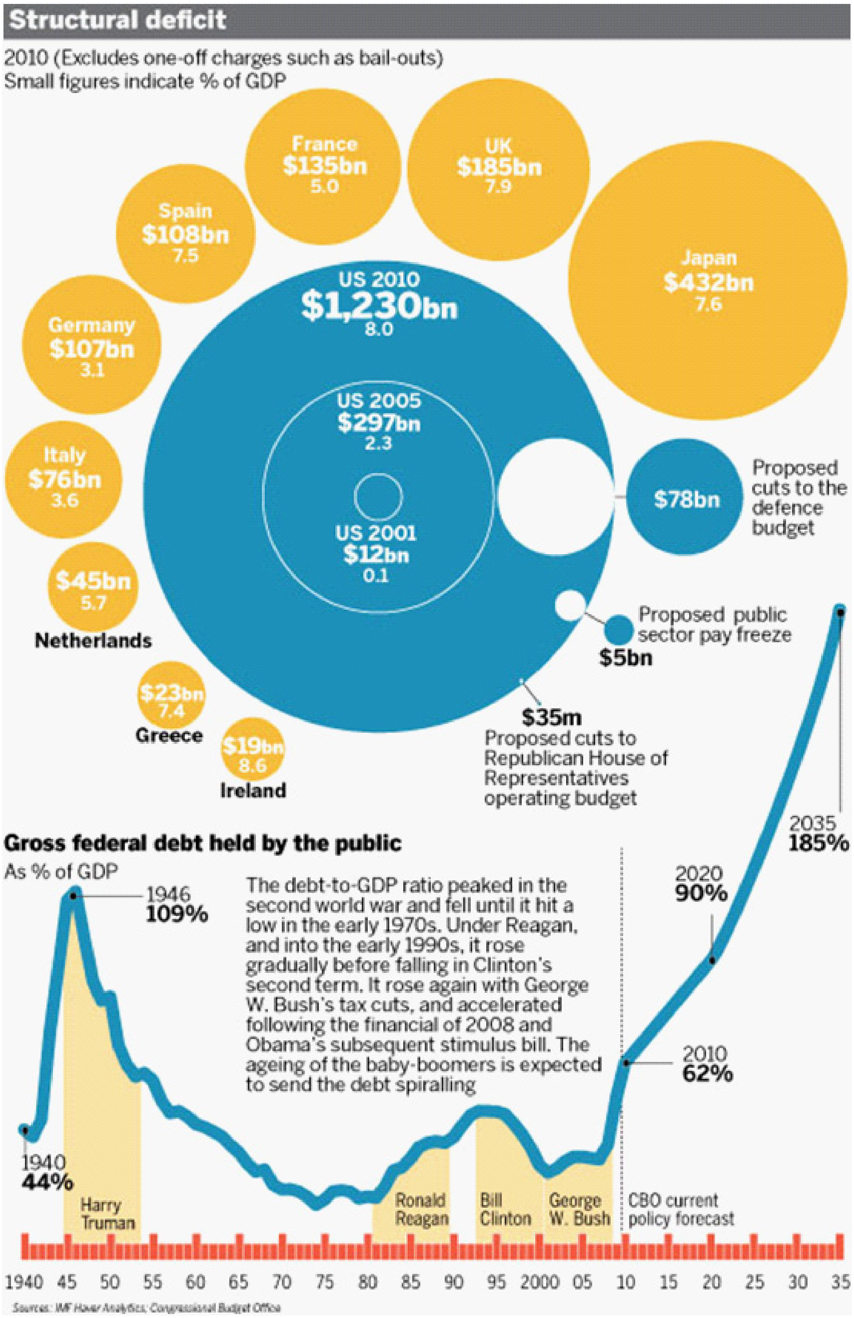
According to an analysis by New York City Comptroller John Liu, New York Governor Andrew Cuomo's proposed state budget increases New York City's deficit for the 2012 fiscal year by 58%, creating an instant budget gap of $1.4 billion (U.S.) in addition to an already existing shortfall of $2.4 billion (U.S.). Mr. Liu and New York City Mayor Michael Bloomberg will be among a group of elected officials travelling to Albany on February 14th. to testify on the budget proposal before the Assembly Ways and Means Committee and the Senate Committee on Finance. Mr. Bloomberg intends to urge the State to "make some key changes" to Governor Cuomo's budget plan. One of Mayor Bloomberg's priorities is to change state-mandated seniority rules which require the City to lay off teachers based upon the years they've spent on the job, rather than based upon their performance. Mr. Liu's office estimates the Governor's budget would reduce support for the City's students by $953 million (U.S.) next year. The Mayor's office determined the loss in state aid to education at $1.4 billion (U.S.), while the state's budget director, Robert Megna, arrived a total of $580 million (U.S.). According to a copy of his testimony provided to the media, Mr. Liu will argue: "These (spending) cuts will have an immediate effect upon the City's Department of Education to provide a proper educational environment to over 1.1 million school-aged children. If the governor is truly interested in maximizing economic development investments, he should look no further than the investment in our children's education. New York City continues to be burdened with onerous and costly unfunded state mandates, most notably special-education costs. Nearly 16% of the education budget is the direct result of unfunded state mandates." Governor Cuomo's budget also proposes cutting $302 million (U.S.) in "Aid and Incentives for Municipalities" funding to New York City, including $178 million (U.S.) in cuts to social-service programs.

LONGWAVE group

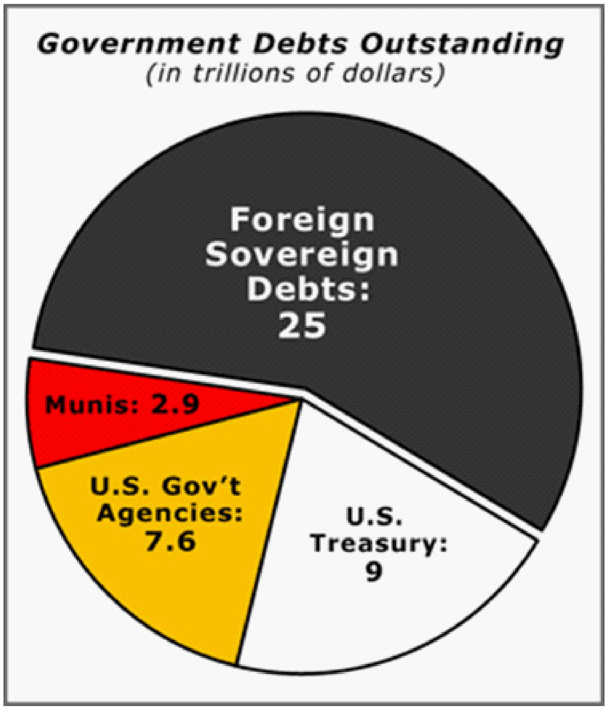
The Motown War Zone

Detroit's most recent Comprehensive Annual Financial Report reveals an annual budget deficit of $155 million (U.S.) and an accumulated debt burden of $5.7 billion (U.S.). The City's Mayor, Dave Bing, recently reflected: "When I was elected (almost 2 years ago) I thought I knew what was going on; but I got here and found out (that) in the short term, things were way worse than I ever imagined. Financially, ethically and from a policy standpoint, we were on the brink of a financial calamity." Very little has changed in a positive vein in the interim because Detroit has been downsizing in terms of business activity, population size and urban planning. At present, nearly one-third of Detroit – an area the size of Boston – is largely deserted. Robin Boyle, a professor of urban planning at Wayne State University, questions: "Bing, since he came on board, has consistently held the position publically that this is a time that requires decisive and directional changing intervention. (Albeit) there is a new day! The question is, do they (the Mayor's office) have the will and the capacity and the facility to make a change in a place that is so economically and socially and environmentally impacted as Detroit?" To date, Mayor Bing has made no commitments. He has, however, faced the affordability reality of neither, being able to send ambulances or garbage trucks, nor supply water and provide other municipal services to large sections of his city. Mayor Bing recently stated: "It's a puzzle and we've got to start putting the pieces together in ways that make sense. The key to our coming back is being focused and making sure that we've got the right kind of density in the right parts of the city." Recently, the Urban Land's Institute's Rose Center agreed to spend $100,000 (U.S.) to help revitalize the two-mile Livernois corridor, a street once known as the Avenue of Fashion. Mayor Bing is also using money from neighbourhood grants and $110 million (U.S.) in federal stimulus monies from the Department of Housing and Urban Development to tear down abandoned buildings and clean up various areas. While Mayor Bing's Detroit Works Project will eventually produce a master plan for the city, personally, he has revoked his campaign pledge to be a one-term mayor: "It's going to take more than one term to turn Detroit around."

America: Paydown Problems



U.S. House Republicans, led by House Budget Committee Chairman Paul Ryan (R-Wis.), have pledged to cut more than $32 billion (U.S.) from government agency budgets over the next few months. Independent budget analysts have stated the figure represents an unprecedented rollback that would force some domestic government agencies to cut spending by as much as 20%. While Democrats immediately vowed to fight the proposal, calling it a short-sighted plan that would curtail many critical government services, a group of conservative Republicans is demanding even deeper spending cuts and vowing to offer a plan to eradicate $100 billion (U.S.) from agency budgets when House leaders bring a spending bill to the floor of the House on February 14th. Rep. Ryan warns: "If the United States does not get its finances in order, we will have a European situation on our hands, and possibly worse. We will have riots in the streets, we will have the defaults, we will have all of those ugliness problems. Washington's spending spree is over. As House Republicans have pledged, the spending cuts will restore sanity to a broken budget process and return spending for domestic government agencies to pre-stimulus, pre-bailout levels."



Source: Money and Markets

A Bond Well Bought Is A Bond Well Sold

The U.S. bond market all by itself is the largest securities market in the world. American debt obligations outstanding total $34.6 trillion (U.S.) compared to the $19.5 trillion value of stocks traded in the United States. In his book, The Ascent of Money, author Niall Ferguson notes: "All of us are affected by the bond market in two important ways. Firstly, a large part of the money we put aside for our old age ends up being invested in the bond market. Secondly, because of its huge size, and because big governments are regarded as the most reliable of borrowers, it is the bond market that sets long term interest rates for the economy as a whole. In the words of Bill Gross, who manages the world's largest bond fund at the Pacific Investment Management Company, bond markets have power because they're the fundamental base for all markets. The cost of credit (a bond's yield rate) ultimately determines the value of all asset classes."

Summation:

The United States borrows about 40 cents of every dollar it spends. Calls for action to curb the federal deficit have multiplied in Washington in recent months, but few proposals have garnered much support. If the American political system cannot forge some consensus to restore U.S. deficits to sustainable levels, the danger is potentially even greater: a sovereign debt crisis in the world's largest economy. If little or no action is taken, fixed income investors will eventually punish America for its fiscal irresponsibility by demanding higher yields for new Treasury issues, during quarterly refundings. That would raise the cost of credit for businesses and consumers alike, forcing severe austerity measures and risking social unrest. Moreover, the threat of America ultimately losing its coveted 'AAA' sovereign debt rating is real, not imagined; as well as its status as the world's reserve currency. Surely, this would lead to a disastrous economic depression in the U.S. which would severely impact the global economy, unemployment and world trade.

A growing number of voices are calling for a viable plan to address America's strained public finances, even if it means tackling social programs such as Social Security, Medicare and Medicaid. Philip Swagel, who was a senior economic official in the George W. Bush administration, recently commented: "The situation is not urgent but at some point it's going to become more urgent. Clearly, the (fixed income) markets don't think we're Argentina, but we should send them a signal that they are right – that we will address the issue." President Obama's new budget director Jack Lew maintains the administration's resolve on deficit reduction is clear: "We need to have a bipartisan effort, which will address the serious fiscal challenges before us, while at the same time promoting an agenda that will build the foundation of the American economy in the future; which to us means continuing to invest in education and innovation even while we make reductions in other places."

As can be readily ascertained, it would appear that many state and local governments with deficit issues have a preference for cutting spending, passing the problem down the line, downsizing their administrations, or, all of the above. Their consummate belief is that economic growth will return in abundance and bail them out of their debt and unemployment problems. We believe this is purely wishful thinking, basically a pipedream. Nowhere in America is there any meaningful support for higher taxes, in any form. Elsewhere, Great Britain has a 20% VAT and Canada's HST is 12% -- but, not in America! In fact, a number of states, including Maryland, New Jersey and North Carolina allowed taxes on high income earners to expire this year. What's evident is that almost everywhere the fiscal crisis of state and local governments has grown more acute. Rainy day funds have been drained, cities and towns have laid off more than 200,000 people and Arizona has even leased out it state office building. So the outlook grows darker. Lori Grange, deputy director of the Pew Center on the States observes: "It's the time of the once unthinkable! Whether there are tax increases or dramatic cuts to education and vital services, the crisis is bad; and there's a bit of denial about how much government can provide and what it takes."

In testimony before the U.S. House Budget Committee on February 9th, Federal Reserve Board Chairman Ben Bernanke stated that the recent rise in U.S. Treasury bond yields across the maturity spectrum was not due to investor/trader worries about inflation, but rather, due to investor optimism about the outlook for growth in the U.S. economy. While we can agree with Mr. Bernanke on the inflation outlook, we believe that Treasury bond yields are rising due to investor fears regarding the U.S. deficit and debt outlook, QE2 notwithstanding.

Volume 25 | Issue 1 . February 15, 2011

LONGWAVE group

ADDENDUM:

U.S. President Obama's Budget Proposal for Fiscal 2012

President Barack Obama is sending Congress a $3.73 trillion (U.S.) budget proposal for the fiscal year ending September 30, 2012, including a deficit of $1.1 trillion (U.S.). In the same breath, President Obama projects a record deficit of $1.65 trillion (U.S.) for the current fiscal year and $7.5 trillion (U.S.) of deficit spending over the next decade. President Obama's budget proposal focuses primarily on the short term, relying heavily on a consummate belief that American economic growth (GDP) will revive in abundance. No effort has been made to revise, let alone restrain the spiraling costs to Social Security, or the medical entitlements of Medicare and Medicaid; not to mention the Department of Defense budget. Simultaneously, President Obama is giving short shrift to America's main creditors, notably China, Britain, Germany, Japan and France, by risking its coveted 'AAA' sovereign debt rating, as well as abusing its advantage of being the world's reserve currency. It would appear that the White House is more focused on the 2012 presidential election campaign than anything else. Caveat Imperator!

Pension Fund Status for 11 U.S. States

According to Professor Joshua Rauh at Kellogg Community College in Battle Creek, Michigan and via the Business Insider – Money Game, using projections including 8% year-over-year growth in benefits and 3% year-over-year growth in revenue, listed below are the first 11 state pension funds which are the most likely to exhaust their resources:

	STATE	YEAR PENSION FUND ENDS
1.	Illinois	2018
2.	Connecticut	2019
3.	Indiana	2019
4.	New Jersey	2019
5.	Hawaii	2020
6.	Louisiana	2020
7.	Oklahoma	2020
8.	Colorado	2022
9.	Kansas	2022
10.	Kentucky	2022
11.	New Hampshire	2022

Written By: Christopher Funston