BARNETT & COMPANY Investment Counsel

Perspective

A Trillion Here, A Trillion There: How Deficits Don't and Do Matter

According to the latest pronouncements from the apolitical Congressional Budget Office, the projected deficit for the next ten years is being revised upwards by a couple of trillion dollars. Add this to the bank bailout (TARP program), credit market support (TALF program), and the purchase of US Treasury and mortgage securities by the Government, and the most recent tally for spending is in the neighborhood of $14 trillion. That is about the size of the economy itself.

All the programs have raised the perennial question: Are deficits bad for the economy and the country? The answer is more complicated than one would suggest upon first glance. The classic case of deficit avoidance during an economic contraction was the Hoover Administration. Hoover authorized cutting Government spending each year from 1929 to 1932 in response to falling tax receipts. While the budget stayed balanced, the effect of so many public employees being added to the welfare rolls in addition to the private sector layoffs resulted in a consumer culture that was traumatized into not spending for a generation. It was this cascading joblessness, where one person was laid off in response to the layoff of another, that made the Great Depression of the 1930s so hard to address by the time Roosevelt took office in 1933. Had Hoover expanded the Government's expenditures instead of contracting them and run deficits in the process, the employment implosion could have been contained at lower levels and the economic malaise of the 1930s might never have occurred.

Economists are fairly uniform in their support of Government spending getting the economy out of a rut in the short run. Where paths diverge is on the long-run implication of deficit spending. The hat trick is to use the tax receipts from higher levels of economic activity to pay down the deficit once the economy strengthens. While this may or may not require higher levels of taxes (the same level of taxes will generate more revenue with higher levels of economic activity), it does require that the extra revenue be used to pay the principal on the debt generated when the economy needed a boost. To fail to do so can be a harbinger of inflation.

At this point the economic argument becomes a political one. Many (but not all) Republicans consider the proposed deficits to be beyond the pale, never mind that the Federal debt increased some $5 trillion during the eight years of the Bush Administration alone. Many (but not all) Democrats say that the current economic circumstance justifies the fiscal stimulus given the shape of the economy and that the long-run will be tackled in time.

If a means of paying off the Federal debts of both parties is not implemented then the results will be higher interest rates and inflation rates than would otherwise be the case. At some point foreign buyers of US debt will curtail purchases, sending interest rates and savings rates higher still. For this to happen the level of economic activity will have to be far higher than current levels. Thus while this is a problem for the future, the future in this case is closer than we may think.

Historically, high inflation was dealt with by implementing temporary higher levels of taxes or coming up with additional tax brackets. In light of other issues such as the environment it may make more sense to consider a higher tax on gasoline. An increase in Federal gas taxes of five cents every three months would by the fifth year generate $50 billion per year in additional tax revenues (assuming no change in gasoline demand). In order to reduce the burden on the poor, the personal exemption can be raised to reflect the amount the average person pays in higher fuel taxes based on a vehicle driving 12,000 miles per year getting 30 miles per gallon. Most European countries tax gasoline at $2 per gallon equivalent or more. People respond by buying more fuel-efficient cars. This tax policy towards energy makes a lot more sense than subsidizing ethanol or solar in that it attempts to influence demand rather than supply. Like taxing tobacco and alcohol, it is an effort to influence behavior in a way that is beneficial to the country as a whole.

The nature of the next expansion will be directed by the way the economic stimulus is spent. If it is spent constructively on roads and other forms of infrastructure, then the funds should pay dividends both now and in the future. If the funds are used to finance financial bubbles like housing or securities purchases, it will result in yet another round of asset inflation followed by deflation. There are those who say that in a free market asset bubbles are not the Government’s business. So long as the Government is expected to go into debt to clean up the ensuing damage it is very much the Government’s business. The trick is how to provide enough Government oversight without having to create a bureaucracy that stifles the existence of the marketplace.

The Economy

Economic activity is beginning to decline at a slower rate. The biggest focus has been on housing. At this point parts of California are showing signs of stability for the first time since the housing decline began in late 2006. As California was the leader in the housing decline it is assumed that its stability has positive implications for other markets. On the other hand, New York and Boston real estate markets are showing signs of freezing up after having few problems previously. Both areas are centers of financial services employment so the recent downturn and consolidation has had a greater impact there than elsewhere.

At this point the best guess is that the economy will turn positive sometime in the third quarter. Bear in mind that employment gains tend to lag the economy at turning points. Unemployment may continue to increase into 2010 before peaking and declining at that time.

Inflation

At this point signs of inflation are few and far between. Few companies have pricing power to push through higher prices due to slack demand. Services will probably see higher inflation due to the increase in the minimum wage in July.

There has been some firming in oil and commodity prices in the past couple of weeks. Much of this is spurred by the fall in the dollar relative to other currencies. With deficit financing expected to be at record levels for some time, it is expected that the dollar will fall further.

Interest Rates

The slope of the line tracking interest rates will continue to be positive, with returns on short-term investments such as one-year certificates of deposit to be minimal while 10 to 30 year bonds will be higher. At some point the investing public will realize that the safety of short-term investments carries a cost and will regain at least some appetite for risk.

The reason Government deficits have not generated higher interest rates to date is the fact that public debt is offsetting the decline in private borrowing in the marketplace. This suggests that consumer demand will have to come back before interest rates will track higher in any meaningful fashion.

The Stock Market

The stock market has staged a strong rally over the past three weeks. The loss year to date has been more than halved. The perennial question is whether this is a temporary rally that will fade away or the beginning of an up leg.

While markets seldom move in a straight line, it appears that time is on the side of the optimist regarding the course of stocks in general. Historically stocks have turned up 4-6 months before the economy. Also, the sheer volume of money being used to motivate the economy insures that there will be at least a short-term uplift in the economic numbers.

Longer term the market will be propelled by the public's appetite for risk. Investors have short memories, especially when someone else is making money and they are not. As the return on stocks starts to exceed the return on more conservative investments look for the public to return to the market in greater numbers.

Due to the lower rates of economic growth being projected, the market will become increasingly selective as time goes on. Volatility will remain, due to the presence of hedge funds and computer trading that exacerbates price swings. This will become in short order a market of stock picking instead of index or passive investing.

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