U.S. Debt

Public – Intra Government

Deficits Current and Projected

1. U.S Government debt includes debt owed to the public and intra-government debt owed to trust funds. At the end of 2008 total U.S. government debt was about $10.8 trillion. Approximately $6.4 trillion was owed to the public and $4.4 trillion was owed to government trust funds ($2.2 trillion to the Social Security Trust Fund).

2. The government trust funds have had annual surpluses (in 2008 estimate $180 billion). The surpluses are used by the Government General Fund to reduce the annual deficit. When the government uses these dollars it creates a book entry liability to the trust funds. The government does not pay out cash interest to the trust funds (it accrues interest). If the government did not use the trust fund surpluses, federal deficits would be much higher and the public debt would theoretically be $10.8 trillion all which would require cash interest payments.

3. The public debt is mostly in Notes and Bills (≅ 73%), the balance in Bonds, Tips and other instruments. The average maturity of the debt is three years - ten months.

4. The public debt is expected to increase significantly over the next three years as deficits swell and the current government spending programs are implemented. The $6.4 trillion in three years will likely exceed $10 trillion.

5. Annual interest on public debt has been very low of recent due to low government interest rates. Assuming interest rates go back to normal levels in three years, annual interest payments on debt could exceed $500 billion per year.

6. The annual surpluses generated by the trust funds will shrink and eventually disappear. The deficit offsets the government has "benefited" from will eventually turn into annual costs which will cause more spending pressure and larger deficits.

7. It seems apparent that three of the main challenges the U.S. economy will face are:

   a. Growing with significantly less consumer leverage. We know G.D.P. growth has been enhanced by the amount of leverage created over the past decade. Going forward, there will be less spending. Many economists estimate that to negatively impact GDP growth by 1% per year or greater.

   b. The large increase in debt will cause significant annual deficits and the interest to service these will compound the problem. There will be pressure on increasing tax rates, which will slow economic growth, reducing expenditures which is politically very difficult, or having the debt swell causing the global market to be flooded with U.S. government debt forcing interest rates up significantly, hyper-inflation and or a weak currency.

c. The trust funds have been tapped, putting off actual funding of social security and Medicare. These problems will grow and the longer we stay on track of using the surpluses the worse the problem gets. The demographics of the country are such that over the next twenty years the two systems needs will grow to a point that annual shortfalls will become enormous. The government has already floated the idea of increasing tax such as unlimited social security tax. This would divert consumer spending to taxes and have a very negative effect on GDP. On the other end the government could tamper with the system and only make payments to lower income and lower net worth individuals or defer payments to older ages. Some combination of these ideas are likely and all present challenges to the U.S. economy.

Strategy

The above issues point to a likelihood of future increases in interest rates and increased inflationary pressures after the economy stabilizes and GDP turns up. In addition, there will likely be reduced real economic growth and the possibility of stagflation.

Maintaining a large amount of short term high grade debt, TIPs or Municipal Ladders of 10 years and under, should provide protection against large interest rate increases. Alternative investments which perform well in inflationary environments may be included in portfolios. In addition, equities strategies which are managed tactically or deploy hedging may reduce volatility as we experience large swings in the equities markets over the next decade.