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# *What, Me Worry?*

## ***Warning: Inflating our way out of debt can be hazardous to your wealth***

On January 31, the Congressional Budget Office said the United States was expected to bump up against its borrowing limit earlier than previously expected, a function of last year's $1.5 trillion tax cut, which is resulting in less revenue for the Treasury Department. As a consequence, in the pre-dawn hours of February 9, Congress acknowledged that warning by passing a budget bill that included a suspension of the federal debt limit until March 2019. Suspended, as in no limit whatsoever. Congress, for all practical purposes, just issued itself a black American Express card.

Now consider this. The Reagan tax cuts of 1981 took place with federal debt as a percentage of GDP at 31%. The Bush tax cuts of 2001 were at 54%. Then there's the Trump tax cut, passed into law with federal debt escalating to 104% of GDP[1]. Do you see a pattern here? The desire to cut taxes is wired into a Republican's DNA, and hell hath no fury like a Republican president who actually raises taxes. Just ask George Bush #41.

But wait, there's more.

The interest on the federal debt was $253 billion in 2008, which consumed 8.5% of the FY 2008 federal budget[2]. Since then, it's remained around $225 billion. That's despite the fact federal debt grew from roughly $9 trillion in 2007 to $20 trillion in 2017[3]. In fact, interest on the debt declined to $187 billion in 2009 because interest rates fell due to the Federal Reserve's response to the 2008 global financial crisis, consuming only 5.3% of the FY 2009 budget. Rates continued to fall, with the rate on the 10-year Treasury note falling by half, from 3.7% in 2008 to 1.8% in 2012, and they have remained below 3% due to strong demand or U.S. Treasurys[4].

But that movie is about to end. "The Sound of Music" is about to be replaced by "Pulp Fiction."

According to the Office of Management and Budget, interest rates on the 10-year Treasury are projected to rise above 3% in 2018, and increase to nearly 4% by 2020. By then, the interest on the debt will almost double, to $474 billion, consuming 9.7% of the budget. By 2026, the interest on the debt will be $787 billion, and take up 12.2% of the entire federal budget[5]. That means by 2021, at present levels of expenditures, the government will spend more on interest than on national defense. And by 2022, it will surpass all other discretionary spending, including Social Security, Medicare, and Medicaid benefits[6].

That's four years from now. Four. Years.

How does the United States solve this problem? Top mainstream economists such as former Federal Reserve Chairman Ben Bernanke have pushed the theory that the U.S. should force inflation onto the economy:

*"A successful effort to eliminate the price-level gap would proceed, roughly, in two stages. During the first stage, the inflation rate would exceed the long-term desired inflation rate, as the price-level gap was eliminated and the effects of previous deflation undone. Call this the reflationary phase of policy. Second, once the price-level target was reached, or nearly so, the objective for policy would become a conventional inflation target or a price-level target that increases over time at the average desired rate of inflation[7]."*

Warren Buffet, the sage of investing, argues;

*"A country that continuously expands its debt as a percentage of GDP and raised much of the money abroad to finance that, at some point, is going to inflate its way out of the burden of debt[8]."*

And in 2013, New York Times columnist and liberal economist Paul Krugman praised Japanese Prime Minster Shinzo Abe for trying to inflate away Japan's debt:

*"Enter Mr. Abe, who has been pressuring the Bank of Japan into seek-*

> ***"A country that continuously expands its debt as a percentage of GDP and raised much of the money abroad to finance that, at some point, is going to reflate its way out of the burden of debt."***
>
> ***-Warren Buffett***

*ing higher inflation- in effect, helping to inflate away part of the government's debt- and has also just announced a large new program of fiscal stimulus. How have the market gods responded? The answer is, it's all good[9]."*

My sermon on the relationship between debt and inflation begs two obvious question; Where are we now, and where are we going? Let's roll the dice and speculate, since that's all any of us can do.

So how much money does the U.S. government actually owe? The official federal debt cash register approximates $20.4 trillion. And counting. But that doesn't include over $9 trillion of federal agency debt, which is debt issued by federal agencies and government-sponsored enterprises (Think Fannie Mae and Freddy Mac). And it doesn't include the so-called unfunded liabilities of government entitlement programs like Social Security and Medicare[10]. So, there's that.

Meanwhile, the U.S. economy is humming and looks as though it has plenty of room to run. A virtual double-down on the Federal Debt during the Obama Administration has lifted the economy off the proverbial mat, and a decade of near-zero interest rates has injected a tsunami of of performance enhancing dollars into a thundering bull market in asset values, in particular real estate and stocks. After years of lying dormant in the economic equivalent of Camelot, a spark of inflation has been lit.

A corollary of economic theory suggests core inflation isn't sustainable unless its accompanied by wage inflation. With the national unemployment rate hovering near 4%, a level many economists consider to be "full employment," the labor market has become tighter than an open house at Fort Knox. Add to that the stampede of city and state governments raising their local minimum wages, and you've planted the seeds to a garden full of inflationary expectations.

Enter President Donald J. Trump. His administration's policies of corporate tax reform and commercial deregulation have added a Category Five tailwind to an already booming economy, and he's got a chorus of stock market records to prove it. Meanwhile, annual budget deficits are creeping toward $1 trillion. Treasury Secretary Steven Mnuchin recently said that the U.S. will need to borrow $441 billion in privately held debt this quarter, the largest sum since 2010, when the economy was emerging from the worst downturn since the Great Depression. And let's not forget the $1.5 trillion in infrastructure spending President Trump asked for during his State of the Union address. As the high rollers in Las Vegas like to say when their luck is going the wrong way, "Another marker, please."

The phrase "too much money chasing too few goods" best describes an economic phenomenon called demand-pull inflation. Inflation caused by increases in wages or other resource prices is called cost-push inflation. What do you call it when you have both demand-pull and cost-push inflation? Think 1970's style stagflation, an era when polyester suits weren't the only thing that thankfully went out of style. Then again, there's nothing better than paying 3% debt with dollars inflating annually at 6%.

What does this mean for financial markets? Imagine pulling a bottle of soda from the refrigerator. Then fill it with some Mentos candies. Now shake it.

Lee Geiger, Managing Director

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