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Stealth default?

Markets ignore symptoms of creeping fiscalitis

April 29, 2011 – Has the US caught the Greek disease? Ratings agency Standard & Poor's Corp. warned recently that preliminary symptoms of Greek fiscalitis are becoming apparent. Without some quick action to curb the gargantuan federal budget deficit, S&P says the country's valued triple-A credit rating could be at risk. The agency announced a change in its outlook for US Treasurys to "negative" from "stable." The primary impact was felt in forex markets, where traders continued to sell off the US dollar, and in commodity markets, where speculators drove gold through US$1,530 per ounce. Stock markets, it appears, ignored the flap and returned to business as usual.

As US politicos battle over the budget in Washington, DC, the deficit keeps notching up. Recent estimates put it at somewhere between US$1.5 trillion and US$1.65 trillion, or about 10% of gross domestic product (GDP). After the government reached a debt ceiling a couple of weeks ago, Congress and the White House managed to keep the government afloat with some band-aid solutions. But the budget issue remains deadlocked between Republicans (cut and save) and Democrats (tax and spend). US Treasury debt stands at US$14.219 trillion, perilously close to the mandated debt cap of US$14.294 trillion. That cap is likely to be raised in the next month or two, just before a potential US debt default on July 8. The fireworks between now and then should be exciting.

S&P and Moody's, the main credit-rating agencies, "are far behind the eight ball," according to Bill Gross, the founder of Pacific Investment Management Co. (Pimco), which runs the world's biggest bond fund. That's probably an understatement, considering the US debt crisis has been brewing for a couple of years. As reported a couple of weeks ago, Pimco has not only moved out of US Treasurys entirely, it has also established a short position. And the foofarah over the S&P downgrade warning pretty much vindicates Pimco's move.

In his April 2011 *Investment Outlook*, Mr. Gross goes further, suggesting that the budget deficit has become intractable, owing to the fact that 75% of the US budget is non-discretionary. Entitlement spending by governments is unlikely ever to be cut (it rarely is, throughout recorded history), so Mr. Gross believes the US will default on its debt, "not in conventional ways, but by picking the pocket of savers via a combination of less observable, yet historically verifiable policies – inflation, currency devaluation, and low to negative real interest rates."

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So let's see: The headline all-items U.S. consumer price index for March rose to an annual 2.7%, the highest since December 2009. The US dollar index (DXY), dropped to 74.44 last week, a 16-month low. And the five-year US Inflation Indexed Treasury Bond yields –0.67%. Unless we're mistaken, these points in fact indicate "inflation, currency devaluation, and low to negative real interest rates." The stealth US debt default is already underway.

The US dollar continued its slide, falling to its lowest point since the summer of 2008 last week, as the Dollar Index posted a 3.9% drop in April – so up goes gold and the prices of most commodities. Meanwhile, the Fed announced last week it would keep its benchmark federal funds rate unchanged at between 0% and 0.25% for the near future. The Fed also announced it would phase out its current round of quantitative easing (QE2) as planned in June. The greenback went slip-slidin' away while gold futures hit a new nominal record high of US$1,566.50 per ounce. Ten-year US Treasury yields closed April at 3.30%, dropping 18 basis points for the month.

In Canada, the loonie climbed to over US$1.05 on both the aforementioned US dollar weakness and on the rather unexpected jump in the rate of inflation. Statistics Canada reported that in March, the annual pace of consumer price inflation jumped to 3.3%, up from 2.2% in February, and the highest it's been since mid-2007. Core inflation, which excludes supposedly volatile prices for food and energy, also rose more than expected, to an annual 1.7% in March from 1.4% in February. However, Canadian GDP retreated in February, shrinking 0.2% month over month, after expanding 0.5% in January. Weakness in manufacturing and wholesale trade got the blame. The contraction in GDP is seen more as a "take-ten" effect following a period of strong growth than as the beginning of a slowdown. GDP is expected to pick up again in March and remain positive. Consequently, watch for a more hawkish tone on monetary policy from the Bank of Canada in the next few months.

Over in the eurozone, a *real* Greek debt default (as opposed to a stealth US-style default) is underway. A restructuring in now almost certain by June according to most observers, as 10-year Greek bond yields hit 14.55% last week. Portugal has stepped up to the bailout window ahead of the June 5 elections, as its debt touched a new high of 9.4%. And Spain too is rapidly succumbing to fiscalitis, with 10-year bond yields climbing over 5.5%. Still, the euro remained firm, around US$1.45, as the US dollar slumped and a preliminary survey from Markit Economics indicated a surprise pickup in the region's economic growth in April.

After a brief spell of the vapours over Dr. S&P's warning a couple of weeks ago, stock markets generally resumed business as usual.

In Canada, the S&P/TSX Composite Index struggled to break even on the week, closing on Friday with a hairline 0.2% week-over-week loss. For the month, Toronto's benchmark index lost 1.2%, but remained ahead 3.7% for the year to date. Toronto's resource-weighted market remains heavily influence by commodity prices, which dipped

in early April but began to rally towards the end of the month on persistent US dollar weakness.

In New York, quarterly earnings have been consistently coming in better than expected. In addition, the New York-based Conference Board's index of leading indicators rose for the ninth consecutive month. The Dow Jones Industrial average advanced 2.4% week over week, approaching a three-year high, as component companies Caterpillar Inc., Johnson & Johnson, International Business Machines Corp. and Intel Corp. reported better-than-expected earnings and boosted full-year forecasts. For the month, the DJIA climbed 2.8% and remains 10.7% ahead year to date.

Likewise, the S&P 500 Composite gained 2.0% on the week, advancing 2.8% in the month, and 8.4% for the year to date.

With the CBOE Volatility Index (VIX) down below 15, investors seem to be less worried about things in general (Japan, eurozone debt, US debt, and so on) than they have been for awhile. With the VIX long-term average of 20 or so, such a low reading may indicate a troubling degree of complacency.

To add further substance to the complacency question, I noticed an uptick in the VIX during the last hour of trading on Friday. Nothing of substance by itself, except that it occurred at a time when the S&P 500 was rallying. We do not normally see VIX rising in tandem with stocks. Usually it moves in the opposite direction to the market. Mind you, one hour of trading does not a trend make, but a contrarian might argue that it indicates some nervousness below the surface. Time will tell!■

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