

Government – The Biggest “Bubble” Of Them All

Looking back, most investors now understand that over-investment in housing was in large part caused by the Central Bank. The Greenspan Fed cut interest rates way too low, kept rates there way too long and – when it finally got around to lifting them – did it way too slowly.

When monetary policy is overly loose, bad things inevitably happen, usually related to mal-investment in a particular sector or across several sectors. Eventually, investment in those areas is pushed too far and will not generate enough cash flow to cover growing debt. Bust follows boom, investment (justifiably) dries up and the system goes through a painful correction.

With interest rates at essentially zero for the past year and unlikely to move for at least the next few months, everyone is looking for the “next bubble.” If you can find the asset class or sector that is frothy, and get in and out before it busts, you may generate abnormally high profits for the next few years.

There’s no shortage of candidates. Some claim a bubble has already formed in the global stock market, with prices up 60%-plus since the bottom in early March. Others claim commodities will be the next bubble. It’s hard to make it through a day without seeing a gold commercial of some sort. Still others say US Treasury securities are already in a huge bubble, with interest rates way too low.

While no fundamental model is perfect, the ones we use suggest US stock prices are not in a bubble. With profits expected to continue rising, we think the stock market remains well below fair value. And while we expect *industrial* commodity prices to remain buoyant, gold, on the other hand, looks frothy. The *euro* and other foreign exchange rates relative to the dollar also look topky as do US Treasury bond prices. Yields are being held artificially low.

But maybe the worst bubble has nothing to do with the private sector at all. The public sector, particularly the federal government, has benefitted enormously from absurdly low interest rates.

Think about it. The federal deficit was \$1.4 trillion in the fiscal year that ended in September, or 10% of GDP, the largest peacetime deficit on record. But net interest – the cost of servicing the national debt – was only 1.3% of GDP, the lowest in about 40 years. For comparison, net interest was absorbing about 3% of GDP in the 1980s and 1990s.

In other words, loose money has created a temporary mirage where a massive increase in government spending appears to be an easy burden to carry. In particular, the mirage of low rates colors the public’s view of legislative efforts to fully nationalize the US healthcare system, making it seem more affordable than it is in reality.

How is this any different than the housing market from a few years back? Homeowners thought they could afford a larger home as long as they assumed interest rates would stay low forever.

Just like homeowners who relied too much on short-term adjustable rate mortgages, the federal government’s average debt maturity remains less than 4.5 years, which means net interest costs will soar over the next several years as the government rolls over its debt at higher interest rates.

But here’s what makes a government bubble even worse. When private sector bubbles burst, investors flee that sector. Home building went from 6.3% of GDP back in 2005 to a recent low of 2.4%. Does anyone think a government bubble is going to bring about smaller government anytime soon? Of course not...government will try to keep its bubble alive by taxing and borrowing even more. But it can’t last forever...every bubble pops...eventually.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|-----------------|-----------------------------|-------------|--------------------|--------|-------------|
| 12-7 / 2:00 pm | Consumer Credit - Oct | -\$9.2 Bil | -\$9.3 Bil | | -\$14.8 Bil |
| 12-9 / 7:30 am | Int'l Trade Balance - Oct | -\$36.8 Bil | -\$36.4 Bil | | -\$36.5 Bil |
| 12-10 / 7:30 am | Initial Claims - Dec 5 | 455K | 464K | | 457K |
| 12-11 / 7:30 am | Retail Sales - Nov | +0.7% | +1.0% | | +1.4% |
| 7:30 am | Retail Sales Ex-Autos - Nov | +0.4% | +0.5% | | +0.5% |
| 7:30 am | Export Prices - Nov | +0.3% | +0.2% | | +0.3% |
| 7:30 am | Import Prices - Nov | +1.2% | +1.4% | | +0.7% |
| 7:30 am | Business Inventories - Oct | -0.2% | +0.2% | | -0.4% |
| 8:45 am | U. Mich. Consumer Sentiment | 68.9 | 69.0 | | 67.4 |