April 27, 2010 – Sovereign Debt

"This is about the future of our country, our kids and grandkids."
- David Walker, Former Comptroller General of the United States

The developed nations around the world are over-extended as debt levels are reaching the point of no return. Years of spending excess and a world financial collapse has created debt levels in some nations that have led them to the brink of default. On Friday, Greece officially asked the European Union for emergency help as they cannot pay their obligations. It seems world leaders are being forced into the realization that they cannot continue to live beyond their means and spend their way to economic prosperity.

U.S. debt is almost $13 trillion (www.defeatthedebt.com) and projected to be over $20 trillion in ten years. At this rate, the interest on our debt will be close to $1 trillion, more than we spend on national defense. It could become so large the U.S. will have to issue more debt just to pay the interest on what we owe. This leads the U.S. to three alternatives out of the crises:

1. Print money to devalue the debt
2. Reduce spending and reduce services
3. Default on our payments to those who hold our debt: China, Japan, banks, investors

From the bottom up, *sovereign default* is a terrible option. Imagine not paying those we owe? This could be devastating to our economy and likely cause a revolution of the people against those in power and strain our relationships with just about the entire world. The U.S. would lose its place in the world as a super power and faith in the world's financial systems would be destroyed. If we thought the collapse of the banking system was bad, the default of sovereign debt, especially the U.S. would have consequences of unthinkable proportions.

Next, so far our government has not been capable of instituting prudent monetary policy which would have to include reductions in Social Security, Medicare and Medicaid. They actually went in the opposite direction by passing the health care bill last month. Politicians overwhelming desire for re-election to hold on to their power, makes this option unlikely. Our fearless leaders have known about this problem since I can remember and all it has done is worsen over the last 30 years so it is my assessment, this will not change.

That leaves number one: *print money*. As the U.S. prints money, it makes the value of the currency held by others, worth less. Therefore, the amount of money we owe has less value so when we repay our creditors it will be in significantly depreciated dollars. Just like, a dollar today doesn't buy what it did in 1940! The $800 billion we owe China will be worth far less than $800 billion. What this means to you and me is high interest rates and inflation. If anyone remembers the 1970's, that didn't work out so well.

It is my assessment, printing money is what they will do to address the debt. It is the default path for politicians to get re-elected. It is also what countries have done throughout history including what they have been doing since the banking collapse in 2008.

To make the future inflation outlook worse, we will not be the only ones printing money. Japan has been in the economic malaise we are in now since 1990 and Europe with the PIIGS: Portugal, Ireland, Italy, Greece and Spain, is in worse shape than the U.S. As these nations populations continue to age, increasing entitlement payments exacerbate the debt problems.

At some point, owning gold is likely to be a very profitable investment strategy. The two main reasons for this are:

1) Currencies are going to continue to lose value and quite possibly at an alarming rate. Gold can be a substitute over simply holding dollars or another currency to hedge against the loss in value from currency devaluation.

2) Gold is priced in dollars. If the value of the dollar continues to erode, it will take more dollars to buy an ounce of gold, thus increasing the yellow metals price.

It is my assessment, now may not the time to buy gold. There could be a deflation scare later this year or in 2011 and gold performs poorly (loses value) during deflation. The reason there could be deflation first is 40% of the Consumer Price Index (CPI), the gauge the government uses to measure inflation, is Owner's Equivalent Rent (housing). If home prices continue to decline, this will put downward pressure on 40% of the CPI and could push inflation near zero.

If gold declines into the $875-$950 per ounce area, it may be a good time to begin to acquire a position in gold and/or gold mining stocks. Be careful, gold is one of the most volatile investment vehicles on the planet and investing in it is not for the faint of heart. Go to www.davefulkerson.net and see the August, 2007 newsletter on historically the best time to own gold.