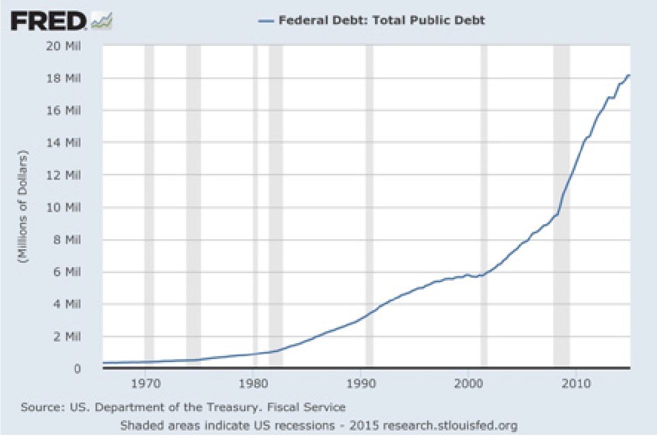
Does The U.S. Debt Situation Pose Risk To Your Portfolio?

SYNOPSIS

- The U.S. has accumulated over $18 trillion in debt over the last decade, which is right around what our country produces in gross domestic product (GDP) annually.
- Despite justified concerns over this enormous amount of debt, our government debt is rather unique and plays by a different set of rules.
- The U.S. will not see a debt crisis anytime soon, and investors should not allow their political beliefs and concerns impact their investment decisions.

THE U.S. OWES $18 TRILLION

The U.S. government has amassed over $18 trillion in debt, and the chart below shows just how quickly it has grown since 2008.



Excessive debt is one of the most effective ways to derail a country, company, or even an individual's finances. What makes matters worse is that the endless spending from our fearless leaders in D.C. will likely keep this trend headed in only one direction for the foreseeable future.

Many investors are concerned that their hard-earned nest eggs could be at risk down the road, or at the very minimum, wonder how future generations will ever pay it all back.

Our government debt will not impact your portfolio, unless you let it.

While these concerns are more than justified, one of the most challenging aspects of maintaining discipline is to eliminate emotion from the investment process. We aren't robots, so this is easier said than done, but emotion is nothing short of a virus waiting to infect a portfolio.

Few subjects ignite more emotionally-charged debates than our nation's debt, but when it comes to investing, we must check our emotions at the door. Only then can we properly assess the situation and determine the true risk that this debt carries.

Within this context, I will thoroughly analyze and explain five reasons why our debt presents no risk whatsoever to your portfolio, and that the odds of a debt crisis in this country over the next century is infinitesimally small.

1. THE AMOUNT OF DEBT IS IRRELEVANT

The first rule in debt analysis is that the total amount of debt on its own is completely meaningless. Some of the most successful companies in the world carry billions in debt, and they continue to operate for decades with little risk of default.

Debt must be put in context by using some tool of comparison. Unfortunately, one of the more popular metrics is the debt-to-GDP ratio, which compares the total size of debt for the country to its annual GDP.

U.S. GDP is right around $18 trillion, so our debt-to-GDP ratio is effectively 100%. Those who observe this ratio tend to get nervous around this level, but on its own it carries no value at all.

Debt is an amount accumulated over several years, but GDP is a flow of income measured annually. Since the total amount of debt does not have to be repaid in a single year, it would be like comparing a 30-year mortgage to one year of a homeowner's after-tax income.

Several countries have debt-to-GDP ratios that exceed 100% and are doing just fine. In fact, the U.K. has been above 100% for 83 of the last 172 years, and Japan has had the highest ratio in the world for decades, which is currently 230%!

Not only are these two two superpowers still around, their interest rates have fallen like rocks in the face of these debt loads. Meaning, even though their debt-to-GDP ratios surged, investors still want to own their debt so badly that they accept lower rates today than twenty years ago.

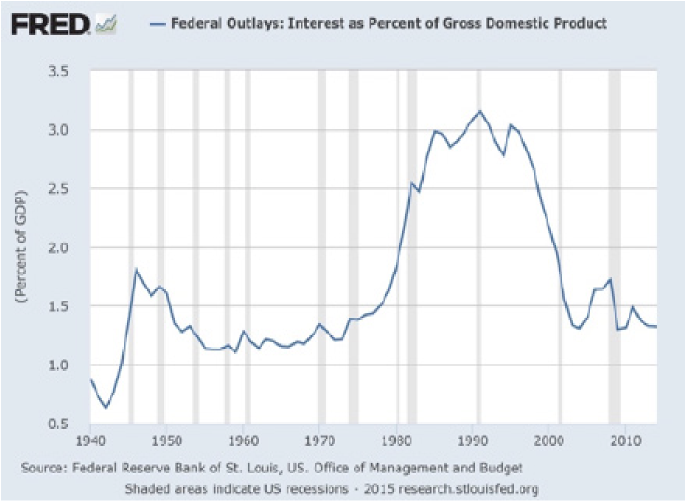
Admittedly, some countries with high debt-to-GDP ratios do have problems (Italy, Spain, etc.), but other countries that maintain low debt-to-GDP ratios are also in terrible shape (Russia).

Simply put, proper analysis of government debt cannot rely upon the debt-to-GDP ratio because it carries no predictive power on its own.

2. WE CAN EASILY AFFORD OUR DEBT

It's not the size of the mortgage that matters, but rather if the buyer can afford the payments. If two neighbors have the same $1 million mortgage, but one makes $500,000 a year and the other $50,000, then the neighbor with the higher income should be far better off.

Within this context, the U.S. can easily afford its interest payments on outstanding debt. The chart below confirms this statement by comparing the interest as a percentage of GDP.



This chart is effectively doing what a bank does when a buyer applies for a mortgage. Banks compare the monthly mortgage against a salary to see just how much the mortgage will constitute of the total income.

Here, the chart shows that the current interest payment for our government is around 1.4% of GDP. Said another way, only 1.4% of our income as a country goes to paying interest on debt.

How can that be, given the massive increase in debt over the years? The answer has to do with low interest rates and a slowly growing economy. In fact, we are actually sitting at a level not seen in four decades.

A natural pushback to the reasoning is if the total debt continues to grow in the face of rising interest rates, then this percentage will climb.

This summation is correct. There's no question that if debt climbs faster than GDP while interest rates are rising, then this chart will move higher. However, this trend will take decades to rise to the point where any concern would be warranted.

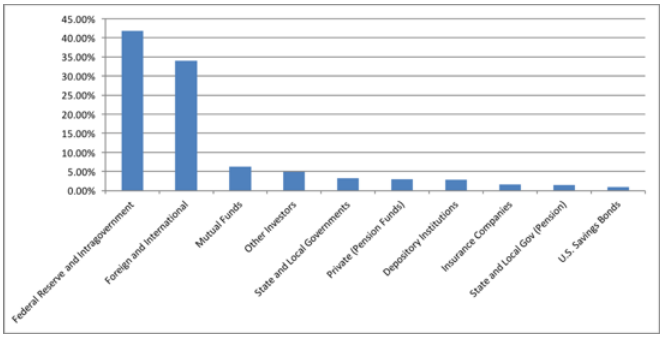
For example, Italy and Portugal both exceed 5%, and they are considered to be "at risk" but still clearly operational. The U.S. would need to quadruple its interest payments while keeping GDP stagnant to come even close to the level of these two countries. The potential for our economy to average zero growth for enough years for this effect to take place is unlikely.

3. FOLLOW THE MONEY

One of the more prevalent concerns with our nation's debt is that since China is the largest holder of Treasuries, we will one day be at their mercy.

In fact, a TV commercial back in 2010 prophesized about a day in the future where the U.S. would end up working for China (https://www.youtube.com/watch?v=TYKAbRK_wKA).

Although this video is technically correct regarding the impact of debt on the great nations of the past, the rest is dead wrong. It's not even close to accurate. To start, the chart below shows lists the major holders of U.S. debt.



Source: Aviance Capital analysis, Bloomberg

Only 34% of our total public debt is owned by non-U.S. entities, and although it varies over time, China is usually right around 6% of the total. Currently, Japan actually owns slightly more.

NOTE: *A tangential observation is that since U.S. entities hold the other 66% of the debt, our government ends up paying most of the interest back to ourselves.*

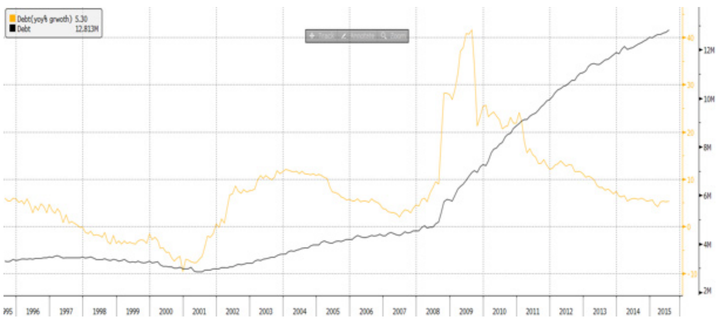
Furthermore, holding a country's debt is very different than a bank owning debt of a company. If a company defaults, the bank can seize assets and force change under a court of law. When a country defaults, it does not end up in a court, and there is little recourse. Our nation's debt is only backed by a promise to repay, and there is no collateral.

Simply put, the U.S. holds the overwhelming majority of our debt, and China or any other country's share gives them no leverage whatsoever to change governmental policies.

4. DEMAND FOR U.S. DEBT FAR SURPASSES SUPPLY

One of the most basic fundamental principles of economics is that the law of supply and demand will determine asset prices over the long run. The same goes for government debt, so let's first start on the "supply side" to see if the supply has been rising.

The chart below details the amount of debt issued by the federal government since 1994.



Source: Bloomberg, Aviance Capital analysis

The black line indicates the total debt level, which has exploded since the financial crisis in 2008, and the orange line indicates the growth rate for new debt issuance. Although the total amount of debt is rising, the rate at which it is rising has slowed dramatically since late 2009, leaving us with the smallest deficit in seven years.

The net result is that although the U.S. government continues to increase the amount of debt, the rate at which they do so is slowing.

NOTE*: Imagine if the U.S. paid back all of its outstanding debt, where the supply of Treasuries completely disappeared and our country was truly debt-free. Treasuries are the backbone of the bond market, and if there was no basis to price mortgages and car loans, the ramifications would be unthinkable. As the saying goes, "the cure would be worse than the disease!"*

Now the supply side is much easier to quantify than the demand side, but let's do our best to determine why the demand for Treasuries has been so strong for so long. Three sources of demand are worth mentioning:

1. **Pension Funds:** New rules designed to plug shortfalls and the selling of equities to lower fund volatility after such a strong 2013/14 appear to be fueling a surge of demand from pension funds.
2. **Attractive Flight to Safety:** Investors with near-term concerns over emerging markets and instability in countries like Greece have preferred U.S. Treasuries to other ultra-safe government debt because of the attractive yield. For example, 10-year German bonds are also risk-free, yet pay half the yield of a 10-year U.S. Treasury.
3. **Banks:** New rules designed to thwart another possible financial crisis has forced banks to own more Treasuries because they are considered ultra-safe and can withstand another potential crisis.

Strong demand from these sources says a lot, given buyers of Treasuries are some of the most sophisticated and well-informed investors in the world. If they felt that our debt was even remotely unsafe or unstable, they would demand a much higher yield or simply reduce their holdings to better manage the risk.

Case in point: The U.S. debt was downgraded in July 2011, and institutional investors mostly ignored it. There's simply nowhere else in the world that offers the safety and liquidity that exists in the Treasury market, and a downgrade over our government's dysfunction meant nothing.

Now that both the supply and demand sides have been addressed, the last step is to see if there is an imbalance. A useful measure that I frequently use is the bid-to-cover ratio.

This number compares the interest level to the amount of new debt being sold by the government. Since 2008, the bid-to-cover ratio for three-year Treasuries has exceeded 3.0, which means that there has been 3x the amount of demand for 3-year Treasury bonds than available supply.

Simply put, the short and long-term demand for Treasuries far exceeds the available supply.

5. DEBT CAN BE ROLLED AND MONETIZED

The U.S. must pay back billions in principal when retiring debt each year, which has the potential to drastically impact our ability to service debt over the long run.

Our government manages this situation by issuing new debt to pay this principal that is due each year. This process is known as "rolling" debt and is a very common practice by governments and corporations alike.

For example, if the government had to pay back $1 billion in principal this year to investors who hold 10-

year Treasury bonds purchased back in 2005, they would issue $1 billion in new debt that expires in 2025, and then use the proceeds from the new debt sale to pay back the $1 billion it owes to investors who initially loaned the government back in 2005.

Hence, rolling debt can last for as long as demand exists to buy the new debt. An obvious question would then be how we could handle the situation where demand for our debt disappeared (a near impossible scenario).

Under these fictitious circumstances, the government could just "print" new money to pay back the principal it owes. This practice is known as "monetizing" debt, and although it would be a widely unpopular strategy with foreign debt holders, there's nothing they could do to stop us.

NOTE*: The ease of printing new money is one of the reasons why the U.S. will never return to the "gold standard," where our currency will return to being backed by gold instead of other currencies. Politicians can't print gold like they can currencies.*

A common pushback, anytime the subject of printing money arises, is the fear of inflation. In most circumstances this retort would be spot on, but it's different for the U.S. because we are the world's reserve currency.

Since most international transactions are completed using dollars, we hold a unique spot where everyone wants our currency, so the effects would most likely be minimal.

In summary, the U.S. has the ability to "kick the can down the road" for a time period that extends further than any realistic investment horizon.

IMPLICATIONS FOR INVESTORS

I rarely share my political views with investors, but it's important to be crystal clear on where I stand on the subject of government debt and spending, given my position as your Chief Strategist, with an extensive background in finance and economics.

Just because I strongly believe that our debt situation poses no risk to investors from a financial perspective, doesn't mean I like it. The fiscal stupidity displayed by both the Democrats and Republicans over the past decade is sickening at times.

Rest assured that if I were elected as the benevolent dictator of our fine country, my first decree would be to fire everyone who has access to the government checkbook. Then, I would reduce the useless spending and tie any future debt creation to only those projects that could grow GDP.

NOTE*: That rant was in no indication a pitch for any personal desire to ever run for office.*

But that's not going to happen, so I have to separate my emotions from the task at hand, or else I risk making flawed or biased investment decisions.

In doing so, even though I share the anger pervasive in so many of my investors about the direction of our country at times, we are not the next Greece or Argentina. We aren't even close. A debt crisis will not occur in your retirement, nor will it during the lifetime of your grandkid's grandkids.

Lastly, I don't want you to read my commentary and walk away feeling better about our country. I urge you to stay mad, make your voice heard and your vote count. However, what I don't want you to do is let the U.S. debt situation influence your investment decisions.

The bottom line is that our government debt will not impact your portfolio, unless you let it.

Any attempt to protect your portfolio from potential negative externalities from rising government debt will most likely do more harm than good.

Sincerely,

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