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FINANCIAL SENSE ONLINE

Market Wrap Up with **Tony Allison**

Today's WrapUp by Tony Allison 12.17.2004 [Mon](#) [Tue](#) [Wed](#) [Thu](#) [Fri](#) [Archive](#)

THE DEBT BOMB

Americans are growing tired and jaded reading debt horror stories. Personal debt, corporate debt, government debt, mortgage debt, unfunded debt. It's starting to take on a "Cry wolf" syndrome. We're sick of hearing about it, nothing really bad has happened, so why not just tune out and get on with more urgent matters? The simplistic answer is the debt levels in the U.S. *are* an urgent matter, and our days of blissful ignorance are growing short.



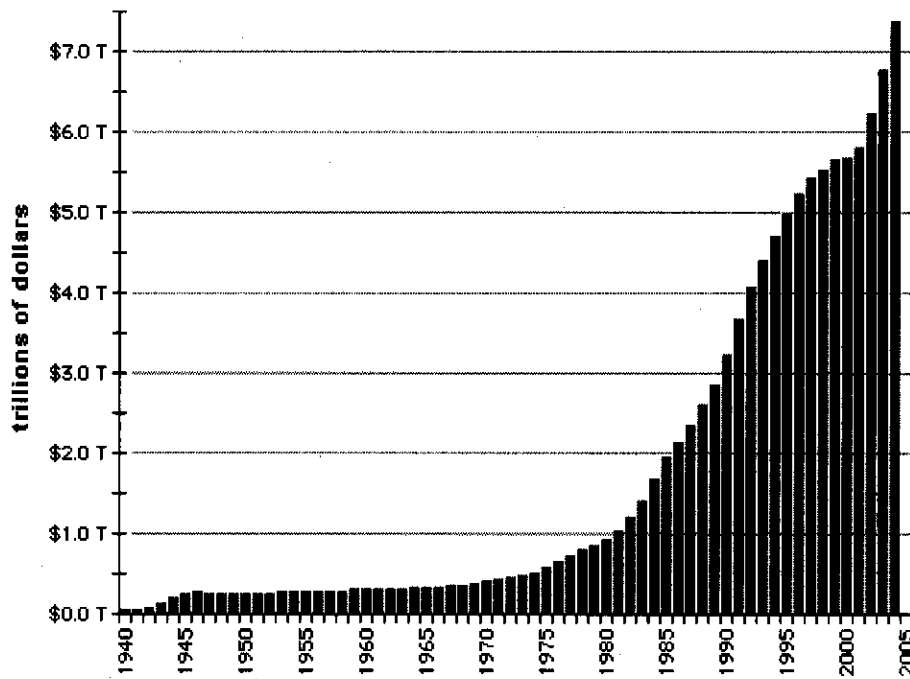
Paper Skyscrapers

Let's try to put the numbers in some perspective. Most of us hear millions, billions and trillions tossed around and our brain's glaze over, unable to grasp the enormity of the numbers. The following example may give some clarity to all the numbers that will follow. Suppose you were Warren Buffet for a day, and drove to your favorite bank to retrieve one million dollars, in crisp thousand dollar bills. The tightly wound stack would be about 4 ½ inches high. You could stuff it in a small bag and off you go. If you decided to withdraw a billion dollars (in thousand dollar bills), it would stack over 365 feet high, roughly the height of a small skyscraper. You would need a large, and well-guarded, truck to haul it home. A trillion dollars is another story, even beyond the reach of Warren Buffet's savings account. A trillion dollars would stack 69 miles into the blackness of suborbital space, beyond the sight of the human eye, and perhaps the human imagination. A trillion is a ridiculously large number.

Federal Debt Accelerating

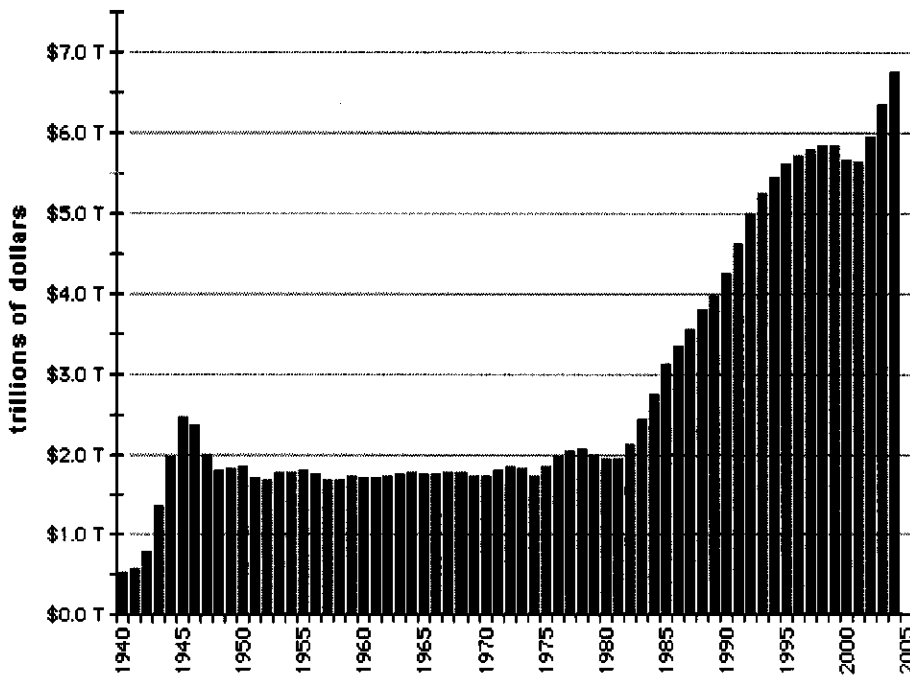
Our federal financial obligation is so big that it is hard to fathom. From the beginning of our nation in the late 18th century until the mid 1970's, roughly 200 years, our accumulated National Debt was less than one trillion dollars. This takes into account the Revolutionary War, the Civil War, two World Wars, the Great Depression, the Korean War and Vietnam. Today our federal debt is now over \$7.5 trillion, over half of which has been borrowed in the last dozen years.

While it took 200 years of American history to reach one trillion dollars in National Debt, it took only six years to build our debt from five trillion to six trillion dollars. Incredibly, in less than two years the National Debt soared another trillion dollars, reaching seven trillion in January 2004. Do you detect a frightening trend here? But no worries! Congress just raised the debt ceiling to \$8.2 trillion, so we can keep on borrowing. At the current rate, each day adds \$2.5 billion more, or 2 ½ new paper skyscrapers to the thousands already inhabiting our National Debt skyline.



National Debt from 1940 to Present

Source: U.S. National Debt Clock
http://www.brillig.com/debt_clock/



National Debt Corrected for Inflation (2000 dollars)

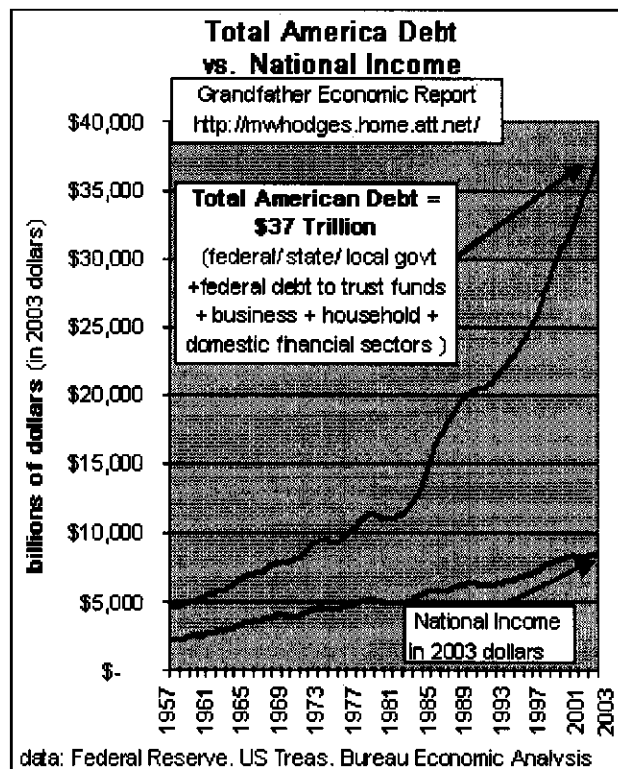
Source: U.S. National Debt Clock
http://www.brillig.com/debt_clock/

Even corrected for inflation, federal debt has exploded since the early 1980's.

In fiscal year 2004, the US government spent \$322 billion on interest payments to holders of federal debt. Compare that to \$15 billion for NASA or \$56 billion for the Department of Transportation. The Treasury Department (which includes interest expense on the debt) is now the third largest budget item for the federal

government, not far behind Defense and Health & Human Services. As interest rates rise, debt service will also, devouring huge chunks of tax revenues, forcing the government to raise taxes, or borrow even faster, or ... both.

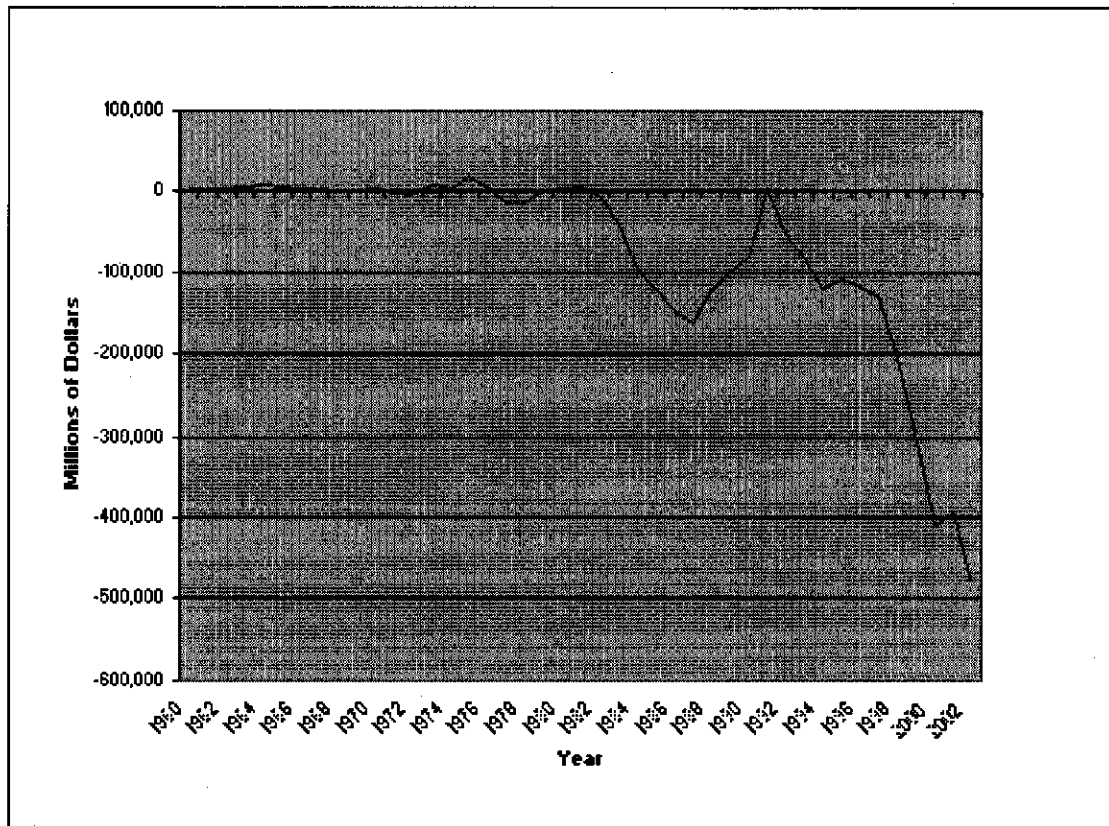
With a Total Debt load (over \$37 trillion) now measuring roughly four times America's GDP, and growing like crabgrass (28% in the last three years), our ability to repay what has been borrowed becomes virtually impossible. Higher inflation looks more and more attractive to a debt-burdened government. The Roman Empire was not able to overcome this dilemma. We have the electronic printing press and reserve currency status on our side. Will that be enough ammunition? With unfunded Medicare and Social Security mandates spiraling off into the \$50 trillion range, the alternatives looking ahead seem limited. Our "under control" and "quiescent" inflation of the last decade may give way to "unavoidable" inflation rates and a "patriotic" drop in living standards in future years.



The "Kindness" of Strangers

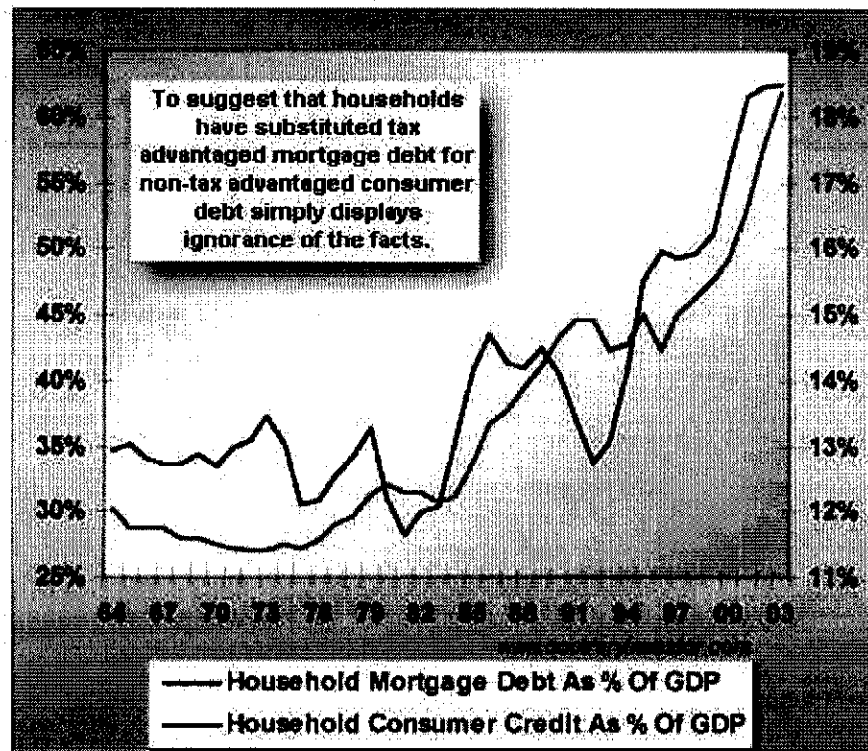
Perhaps the most daunting debt of all is that owed to foreign sources, our current account deficit. This is the evil twin to our lack of domestic saving. We must borrow savings from the rest of the world to sustain our economy. It is estimated that the U.S. is currently sucking in 80% of the world's savings. Approximately 50% of Treasury debt is now in foreign hands. The current account deficit is projected to exceed \$600 billion for 2004 and continue to increase in future years. At 6% of GNP, the U.S. current account deficit has reached a level that has precipitated currency crises in numerous developing countries.

While it is in China's and Japan's interest to protect their export market, their billions in treasury notes are not only earning very little, but actually losing value rapidly as the dollar sinks versus the world's currencies. This situation is not only unsustainable, but puts the fate of our economic future in the hands of foreign governments. The trade and political frictions that can arise from this arrangement are potentially explosive.



Survival Debt

The trend in consumer credit is disturbing at best, frightening at worst. Most of us are aware of the explosion of consumer credit in this country, but not everyone knows about the rapid growth of "survival debt". Consumers are now able to charge groceries, phone bills, mortgage payments, even income taxes. Credit cards are filling in the gaps, often gaping, in the household budget. It is one thing to cut back on vacations, shopping and restaurant visits. It is quite another to cut back on household expenses. In the first quarter of 2004, U.S. household debt rose at an annual rate of 10.9%. Household debt has risen by 30 % since 2000 to \$9.8 trillion.



Robert McKinley, CEO of Cardweb.com, an information provider on credit cards, has noted that consumers charged over \$50 billion in household expenses on Visa cards in 2003. Visa is only about half the market. This was a 27% jump over 2002. One can easily estimate that 2004 will push the total household expenses charged to well over \$100 billion. McKinley adds that some card companies are giving double points for groceries. This has a distinct drug-pusher mentality to it. Get the consumer hooked on charging groceries. Credit card companies now view the grocery business as a huge growth market. According to McKinley, the card companies have a new target to lure the debt-laden consumer, fast food franchises. With plastic in hand, that Big Mac and super size fries now look even more irresistible, especially to those short on cash.

In recent years, consumer incomes have not kept up with expenditures. This is clearly shown in the personal savings rate that has plunged to near zero. The recurring charges at the grocery store, dentist, gas station etc. will continue to add up. As interest rates rise, these household expenses will become painfully high if not paid off. Imagine how balances for mortgage and income tax payments will grow over time. This is the "magic of compounding" in reverse. "Survival debt" grows into financial suicide when credit limits are breached.

Iraq & Afghanistan – An open-ended debt burden

Much like the tumultuous 1960's in Vietnam, the cost of war in Iraq and Afghanistan is both extremely high and open-ended. The Pentagon is spending approximately \$5 billion per month in Iraq and Afghanistan. These expenses do not include rebuilding Iraq's water system, electric grid, oil infrastructure or even entire cities, such as Fallujah. Estimates for rebuilding Iraq vary from \$180 to \$250 billion, just for the next five years alone.

Marine Commandant General Michael Hagee recently estimated the Marines will need \$10 billion to repair and replenish themselves. This estimate does not include the Army, which expects to have to replace 5,400 trucks and over 1,100 tanks and tracked vehicles, in addition to the plans for more troop strength. One can easily make the case that \$5 billion per month just scratches the surface of the bills coming due.

According to *USA Today*, the US spent \$111 billion during the Vietnam War from 1964 to 1972. Adjusted for inflation, that's more than \$494 billion, an average of \$61.8 billion per year or \$5.15 billion per month. Our debt burdens in Iraq and Afghanistan should far exceed Vietnam on a yearly basis. Unfortunately, these financial commitments come when the US economy is growing only about half as fast as it was during the

Vietnam War. We were also a creditor nation in the 1960's, as opposed to the world's largest debtor nation today. Both the Johnson and Nixon Administrations tried their best to make "guns and butter" budgets work, but ultimately failed, as rampant inflation defined the 1970's. It would appear that we are on the same road again; only today the costs of both guns and butter are higher, as are the risks of failure.

Can debt grow to the sky?

In a well-ordered society, there obviously must be some debt, to help build the economy and finance great infrastructure projects and productive industry (see China). The debt to GDP ratio should be reasonable and remain fairly stable over decades. In a speculative economy, the debt to GDP ratio is continuously rising.

According to *Executive Intelligence Review*, in the 1970's for every dollar increase in GDP, there was a \$1.75 increase in debt. In the 1990's for every one-dollar increase in GDP there was a \$3.64 increase in debt. From 2001-2003, the ratio accelerated even faster. For every dollar increase in GDP, our economy produced \$7.11 worth of debt. This ratio is *far* worse (\$1:\$63) when you compare debt to the *productive* portion of GDP (manufacturing, construction, agriculture, mining, transportation etc.). These figures clearly indicate an economy geared to speculation and massive debt creation. The figures also reveal a level of indebtedness that can never be paid off out of the productive portion of the economy.

All the facts in the world won't stir the investment world until something goes awry. Everything is perfectly acceptable until one day when enough people decide it isn't. That "tipping point" is unknowable, but when it arrives the markets will likely react too quickly for an investor to calmly ponder his next move. Debt of this magnitude is like a tattoo; fun to have at first, but one day you realize it's a huge mistake. And while painful and expensive, tattoo removal may be easier than eradicating a debt burden that is on an exponential growth curve. Can the debt bomb be defused without wreaking havoc on our future way of life? That is the question that should be urgently addressed by our leaders and policy makers.

As loyal readers of this website already know, we believe the result of the frenzy of money creation will lead to higher inflation, perhaps hyperinflation. In our opinion the sectors that will best weather the storm will be natural resources (energy, commodities, base metals, precious metals) utilities, food and water stocks, as well as stable, high dividend-paying companies.

Today's Markets

The markets were only off fractionally Friday, despite negative developments in the drug sector and another jump in oil prices to \$46.28 a barrel. Oil climbed \$5.57 for the week, the largest one-week jump since March 2003. The Dow finished at 10,649.92, off .52%, the Nasdaq at 2,135.20, down .51%, and the S&P500 Index closed at 1,194.20, down .75%.

In the pharmaceutical sector, Pfizer plunged 11.5% to close at \$25.75, after a study indicated increased cardiovascular risk for Celebrex, its widely prescribed arthritis drug. In the tech sector, PalmOne, maker of hand-held electronic devices, dropped 22% to \$33.11 after a warning that fiscal third quarter earnings would not meet expectations.

The November CPI report was as expected, up 0.2 percent, as was Core CPI (which excludes pesky food and energy) that somehow dropped 0.4 percent from October. Gold closed up \$4.70 Friday at \$442.90 an ounce, gaining nearly \$8 for the week. The gold market seems to be predicting increasing inflation in our future. The CPI still shows inflation as "quiescent". The new year should reveal which indicator is more accurate. You can probably guess which way I'm leaning.

Have a great weekend and Holiday Season!

Tony Allison

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Anthony Allison
Registered Representative
Puplava Securities, Inc.

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