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Issue II

True or False?

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My six-year old daughter came home from a friend's house last week announcing that she'd learned a new game: "It's called True or False," she boldly stated. "You wanna play?" She explained that the essence of the game is embedded in the name: she makes a statement and I guess if that statement is true or false. Simple enough. We played for a little while and out of frustration with my early success, (I totally nailed the truth behind her entering the first grade in the fall, my wife's given name and also the fabrication of her contention that her brother is indeed an alien), she modified the rules to allow for a less binary outcome - a hybrid expression that may possess both true and false components. This broadened the range of answers to include machinations of: "sometimes", "kind of", and "almost". My success rate plummeted.....or did it? Replacing objectivity with subjectivity may actually heighten my rightness by virtue of obscuring any wrongness. This, I passionately purported, is exactly why so many of today's hotly contested topics on the economy and financial markets cannot seem to be considered conclusively - the spectrum of interpretations is wide and each topic's voracity varies, fanning the current state of market funkiness. Well, I lost my daughter at "funkiness", so when she darted out to ride her bike, i jumped on my laptop to engage you in a modified round of "True or False", courtesy of this monthly bulletin. Let's address a couple duplicitous developments below.

#1: True or False, the end of the second Federal Reserve Bank Quantitative Easing Program, QE2, is very bad for the stock and bond market? Before I answer, some context: QE2 was enacted last fall by Federal Reserve Bank Chairman, Ben Bernanke. Under this program, the Fed was authorized to purchase $600 billion worth of agency debt and mortgage-backed securities. This infusion provided a deep pool of liquidity to the banking and credit markets, stimulating the economy and prodding it along a path of recovery initially charted at the onset of QE1 in 2008. How is this accomplished? Ideally, (and ideologically), by trading dollars for debt, the Fed is making ample capital available, (that's the $600 billion figure), at very low prices, (the Fed utilizes policies and open-market operations to hit certain interest rate targets), with the hope that companies or individuals will access, (read: borrow), these dollars to invest or consume at rates of return, or satisfaction, that are higher than their cost. So, if QE2 is set to expire at the end of June, is it True or False that it will adversely impact the financial markets? Well, it is kind of true and kind of false......

It could be true insomuch as the bond market will experience a reduction in demand while it continues to bring additional supply on-line, (through additional borrowings to raise capital essential to funding the operations of our country and our housing market), resulting in higher interest rates. Reduced demand = lower prices, and for bonds, lower prices = higher interest rates. Theoretically, the higher the rate of interest, the more difficult it is to produce a return on capital greater than its cost, paralyzing the uncourageous borrower and jeopardizing the perpetuation of the aforementioned prodding.

Alternatively, expiration of this stimulus may stave off significant corporate margin pressure that could accompany an economic recovery in the presence of loose monetary policy. Think about it like this: my daughter starts a lemonade stand business and simultaneously plants a lemon tree. The tree has a pretty long growing cycle, so in advance of it bearing fruit, my wife and I advance her some lemons, very inexpensively. This will help keep her costs down while her entrepreneurial endeavor is in its infancy. As time passes her lemon tree, and her business, blossom we begin to reduce the availability of our lemons, (by increasing their cost and reducing our level of lemon inventory), avoiding a market saturation, (bad pun), and allowing her operation to maintain its profitability by preserving the prospects of reasonable pricing power.

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True or False?

#2: True or False, raising the debt ceiling will have dire consequences for economic and financial market stability? OK, first things first – what is the debt ceiling? The debt ceiling is the maximum amount of money that can be owed by the US Government at any point in time. The current debt ceiling stands at roughly $14.3 trillion dollars[1]. Therefore, our Federal government is prohibited from having debt obligations in excess of that figure. The debt ceiling can be raised through Congressional order which has in fact occurred 10 times since 2001 and an amazing 74 times since 1962[2]. Like a governor on a golf cart that is careening downhill, the benefit of having a debt ceiling seems more theoretical than practical - it has done little to deter the burgeoning balance of our federal liabilities.

Bear in mind that there is but one source of revenue for our Federal government – taxes. If tax revenue is insufficient to cover spending, then one of two (or both) things must occur – taxes go up or spending goes down. Clearly, 10 elevations of the allowable borrowing limit in 10 years is an indication that there is neither a philosophical nor an economic alignment amongst the policy makers who have been content to expand the capacity of indebtedness instead of addressing the causes of its creation.

So, to answer the question above, will raising the debt ceiling have dire consequences for economic and financial market stability? Most likely not, but left unchecked, possibilities exist that could undermine any firming of the fiscal foundation of the country.

Treasury Secretary Timothy Geithner has set August 2nd as the deadline before which a decision must be made to raise the debt ceiling[3]. Our country spends approximately $120 billion more each month than it takes in[4] and funds this gap with borrowed money, the suspension of which could be destabilizing for the financial markets until an alternate plan is promulgated. Secretary Geithner was quoted as saying that a, "toolkit of emergency measures can provide up to eight weeks of additional borrowing room," back in May[5]. Thankfully, tax revenue was in excess of expectations last month which is how we came to the August 2nd deadline[6].

Congressional convalescing has become critical. Democrats in Congress are clamoring for tax hikes to offset the economic exacerbation of any ceiling lift, and Republicans are clamoring for spending cuts to evidence legitimacy in leveling the largesse. The 2012 elections are quickly approaching and the posturing has been more nauseating than nimble, raising the probability that little beyond immediate concern gets addressed between now and next November. I think that the debt ceiling will be lifted on or before August 2nd and I think that the financial markets will be relieved. I hope that our country can make a pronounced weaning off of the debt addiction without suffering severe symptoms of withdrawal. The test of such will be relatively soon, as the prospect of revisiting an additional lift shortly after the 2012 elections is very high in my opinion.

So the expiration of QE2 and the debt ceiling deliberation will cook thru this summer, intensifying the heat in the financial markets. Contemplation of the outcome of each lends itself to multi-factor analysis and is starved of simplicity. Like playing "True or False" with my daughter, successful results may lie in expanding the range of acceptable answers - but only if they are consistent with a long-term strategy intending to promote sustainable growth.

[1] http://www.fas.org/sgp/crs/misc/RL31967.pdf

[2] http://gvfinancial.wordpress.com/2011/05/16/the-national-debt-ceiling/

[3] http://money.cnn.com/2011/01/03/news/economy/debt_ceiling_faqs/index.htm

[4] http://thehill.com/homenews/news/155955-congress-has-little-choice-but-to-raise-debt-ceiling?page=2#comments

[5] http://en.mercopress.com/2011/04/05/us-government-and-republicans-clash-over-legal-debt-limit-and-budget-cuts

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