Weekly Market Commentary

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A Fiscal New Year's Resolution

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Highlights

The new fiscal year likely brings another trillion in U.S. federal debt to add to the mounting total.

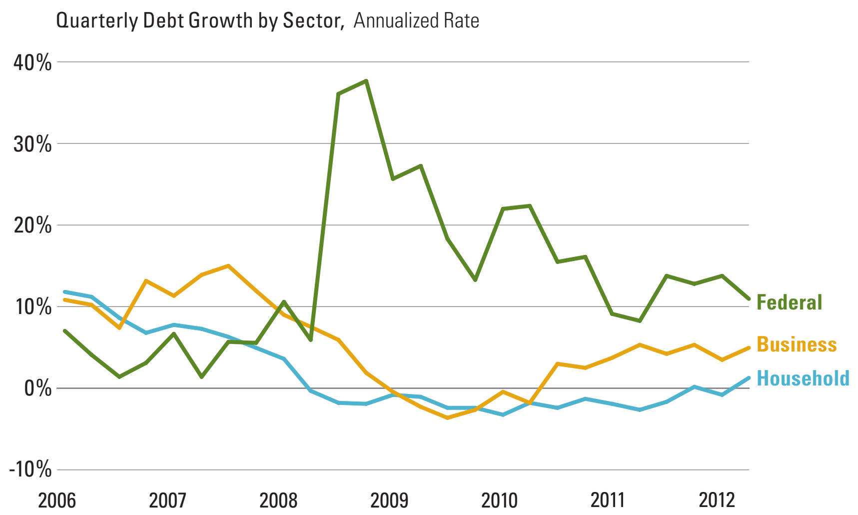
Federal debt held by the public has doubled from five years ago, before the financial crisis and Great Recession.

The big buyers of federal debt have been foreigners; further dependence on foreign demand may continue to weaken the dollar and benefit precious metals.

This week marks Golden Week, a national holiday in China. However, the United States has its own holiday to observe. Today begins a new fiscal year for the U.S. government. Unfortunately, a new year likely brings another trillion in federal debt to add to the mounting total. The proportion of U.S. federal government debt held by the public reached 70% of the U.S. economy in fiscal year 2012, while total federal debt crossed 100%. Federal debt held by the public has doubled to $11 trillion today from roughly $5 trillion five years ago, before the financial crisis and Great Recession. The turning of the calendar to a new fiscal year presents little to celebrate.

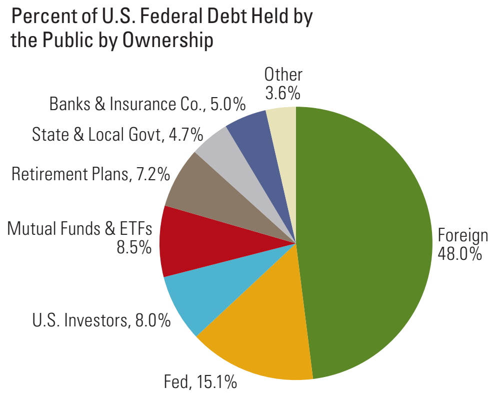
Rather than dwell on how we got here, what is most important for investors is whether demand will remain sufficient to absorb the rising supply and what the market effects may be of continued borrowing. The trillion-dollar pace of growth in federal debt requires strong and growing demand. As you can see in Figure 1, the annualized pace of growth each quarter since the financial crisis began has been very rapid. While at the same time, the growth of household and corporate debt has been modest or negative. The lack of strong demand for borrowing from the private sector has helped to support demand for the soaring supply of government debt.

1 U.S. Debt Growth Fueled by Federal Government



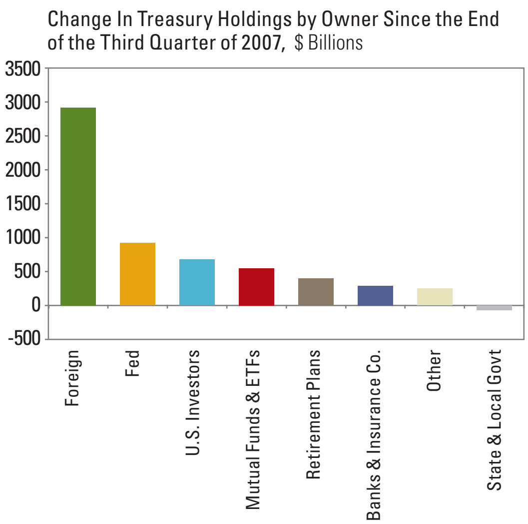
Source: LPL Financial, Federal Reserve Flow of Funds 10/01/12

2 Who Owns Our Federal Debt?



Source: LPL Financial, Federal Reserve's Flow of Funds 10/01/12

3 Who Bought All Those U.S. Treasuries Over the Past Five Years?



Source: LPL Financial, Federal Reserve's Flow of Funds 10/01/12

The pie chart in Figure 2 shows who currently owns the $11 trillion in Treasuries, and it is clear to see that foreigners hold nearly half of the outstanding Treasuries. Perhaps more interestingly, the column chart in Figure 3 shows who purchased the incremental $6 trillion in government debt that has been issued during the past five years. The big buyers have been foreigners, led by China, as well as the Federal Reserve (Fed) through its bond buying programs. Together, they have purchased about two-thirds of the Treasuries issued during the past five years. U.S.-based investors, retirement plans, banks, and mutual funds have also been big net buyers of Treasuries and account for almost all the rest, while state and local governments have been sellers.

Over the past five years, the demand for safety by investors and lack of new debt supply from households and businesses helped interest rates move down, despite the tremendous pace of borrowing by the federal government. However, as of mid-2012, household borrowing began to grow again along with business borrowing for the first time since the financial crisis. Looking forward, if the economic recovery is sustained in 2013, demand for borrowing from all sectors — household, business, and government — may result in even more dependence on foreigners to finance the United States' growing debt.

If that is the case, the dollar may continue the slide recently renewed by the actions of the Fed. A falling dollar and rising debt supply, combined with very low Treasury yields, may increasingly push investors seeking safety to Treasury alternatives such as precious metals. As China observes Golden Week, U.S. investors may take a golden opportunity to make a fiscal new year's resolution to seek precious metals as a hedge against a further rapid rise in debt in fiscal 2013. ■

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