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US Prospects

The United States is digging itself a deep fiscal hole. High budget deficits are creating large debt. There is no plan to pay it off. There is no problem that Congress and the White House are not willing to throw dollars at. And yet we don't have inflation or a weakening currency. Why not? This is mainly due to the lack of fiscal responsibility anywhere else in the world. This newsletter will look at some actions that could change this. Eventually some country will get its act together and become the new currency of choice. When that happens, all of the debtor nations will become second tier nations. The world financial model is in transition.

Interest Rates

The US Federal Reserve has kept interest rates low to help a recovery take hold and create jobs. But as we move toward a European based model, there is more friction in the system. The natural process of creative destruction is not being allowed to happen. Everyone from bankers to auto makers are being bailed out at the corporate level, and individuals want their piece of the pie as well. The US is very susceptible to a catastrophe today, either natural or man-made. Interest rates are near zero. What could the Federal Reserve or federal government do today if a Katrina type event were to occur?

Higher Interest Rates

So what would be the repercussions of higher interest rates? Most obvious would be the higher foreclosures caused by adjustable rate mortgage resets. Many of these homeowners can't refinance to fixed rate mortgages as their homes are worth less than the mortgage and their credit scores are poor. Higher interest rates would also help to deflate any asset bubbles that are forming. Treasury bonds will be poor investments in the future, although there is enough friction in the system that inflation might not take hold for several years.

Currency Implications

The difficult thing about predicting currency movements is that it takes two to tango. You could be doing incredibly bad things for your currency, as the US was in 2009, but if everyone else is also playing the same game then your currency is not hurt. In fact, if your currency is considered the safest then it will strengthen. In the long run, the US dollar will fall and energy prices will increase due to deficits and high imports. The short run could be the exact opposite.

The China Card

China provides an interesting case study. It is growing at levels that can't be maintained over the long term. It is building its military. It has limited supplies of key resources needed for a manufacturing base, like oil and coal. It is a net exporter and is the largest holder of US debt. Either of these two potential scenarios could easily play out.

In the first scenario, China develops its military in space to a greater degree than European or US programs. It needs resources so decides to take territory holding those resources. It uses lasers to destroy communications and weapon satellites, negating any former advantage held by the western powers. At the same time China sells a large portion of its US bonds, throwing that market into chaos and making it hard for the US to fund its war efforts. The US reverts to savings bonds bought by its own population. The US becomes protectionist in its trade policies, limiting the markets China can sell to. How would this play out?

In scenario two, China's economy slows to a hard economic landing after their own bubbles burst and overbuilding becomes apparent. Civil unrest breaks out, driven by the one child policy that leaves many males without a spouse. China breaks into several countries, further expanding the low growth scenario into the future.

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