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John Dessauer's market review and update as of Wednesday May 18, 2016

The large and growing U.S. national debt has long been a topic for the pessimists, especially the gold purveyors. Companies that profit from selling gold to individual investors use the U.S. national debt as a reason to buy their gold products. Donald Trump has introduced the national debt as a campaign issue. That may gain traction because the debt has increased substantially under the Obama administration. But when the details about who owns the national debt become known, the discussion is likely to change. Over the last decade the ownership of the U.S. national debt has changed. Americans and American institutions are now the owners of more than 60% of the U.S. national debt.

Japan has a national debt of well more than 200% of GDP. But that has not been an issue because the Japanese own most of the debt. The greatest threat from a country's national debt is the potential outflow of capital when the debt comes due or foreign holders decide to sell. A capital outflow is what brought so many emerging market economies to their knees in the late 1990s currency crisis. The pessimists assume that most of the U.S. national debt is foreign owned. If that were true, they would have a serious point. It was once true that foreigners owned more than half the U.S. national debt. But that is no longer the case, and as time goes on American ownership of our national debt is set to keep growing.

Foreign ownership of the U.S. national debt is now down to 32.5%. China has often been in the pessimists' headlines. Supposedly, we are at the mercy of Chinese buyers of U.S. treasury securities. However, that is not the case. China owns only 7% ($1.25 trillion) of the U.S. national debt. By comparison, Japan owns $1.13 trillion. And over the last several years, the Chinese have concentrated on short term treasury securities. They have been worried that U.S. interest rates would rise, depressing the values of long term treasury securities.

Americans and American institutions now own 67.5% ($12.9 trillion) of the U.S. national debt. The Federal Reserve owns $2.5 trillion. Individual pension funds own $5.1 trillion. And government agencies, including Social Security, own $5.3 trillion.

Yes, our nation's debt has risen dramatically over the last eight years, and is now more than 100% of GDP. But the surprise has been that as more and more treasury securities were offered, Americans and American institutions stepped up and bought more than ever before. Given the recent massive exodus from equities, American ownership of our nation's debt has likely increased.

This raises the question, is that a good long term investment strategy? Treasury securities have delivered respectable returns over the last couple of decades. But that has been a time of falling interest rates. Fixed income securities, including treasuries, tend to appreciate when interest rates go down. The opposite is the case when interest rates are rising. Now that U.S. interest rates have fallen to record lows, it is unlikely that they will keep falling. The best the buyers of U.S. treasuries can expect is that interest rates will

stay low a while longer. If that is the case treasuries won't go down. Individuals and American institutions won't suffer large losses on their treasury holdings.

The current common interest rates assumption is that we are in a slow- to no-growth world, inflation is down and out, and therefore interest rates will stay down for a long time.

Larry Summers, who lost out to Janet Yellen to become head of the Federal Reserve, is very vocal, sharing his dismal view of the global economy with all who will listen. He has been giving talks in many world finance centers. Donald Trump once said he would replace Janet Yellen. Perhaps Larry Summers is, once again, running for that office. Summers argues that a global savings glut is what has driven interest rates down. He says we can't keep relying on easy monetary policies to fend off recession. He argues that we need far more direct action from governments to get the global economy humming again. The problem is that too many governments are so deep in debt that they are struggling to meet their obligations. They simply don't have the money to spend on infrastructure and other programs. That certainly is the case in Europe, where another Greek bailout is a hot political topic. However, the United States might be able to borrow to finance domestic programs such as infrastructure. I say "might", because it all depends on who would buy the new debt. If Americans buy the debt, we are using our own national savings to improve our economy. That is a low risk proposition. It would be much riskier to sell new debt to foreign buyers. It wouldn't be difficult to design debt to attract American buyers. New treasury securities could have a tax break for Americans. Or they could be issued in special maturities attractive to American savers and pension funds. The U.S. government has done similar things before to finance domestic projects

and wars. So let's not dismiss Larry Summers' ideas out of hand. He may be wrong about the long term outlook for the global economy and interest rates. Janet Yellen's more optimistic outlook might be right. But the U.S. economy can use all the help it can get. April was a good month for retail sales. But in March, U.S. consumer debt shot up, suggesting consumer spending is being financed by borrowing rather than by rising incomes. This is another example that the economic data on the U.S. economy remain mixed. Let's hope the current political storms will be followed by real changes that stimulate the economy.

There has been a massive exodus from equity funds in the U.S. and around the world. More than $90 billion has left global equity funds so far this year. Is this a contrary indicator as it has been in the past, or have investors finally got it right?

Of course time will tell, but odds are that the past will still be the best guide. For example, China has dominated headlines while India has been emerging fast and furiously. Oil demand from India is the reason oil has not continued falling. The International Energy Agency (IEA) recently said that demand for oil worldwide is set to grow at a "solid" rate in 2016, with India the "star performer." In the first quarter, India accounted for 30% of the global increase in demand. With India emerging as a driver of global growth, and Europe looking better, it is likely that the global economy will deliver respectable growth in coming quarters. I won't say that those who have been buying treasury securities will have regrets. But I believe owning stocks in quality companies will deliver much better returns.

I will have the next market review and update for you one week from today on Wednesday May 25, 2016.

All the best,

John Dessauer

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