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Debt Chaos, Financial Repression And Gold

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With the official U.S. debt-to-GDP ratio passing the 100% mark over the past couple days, it is time to once again address how investors can position themselves for the quagmire we like to call "the U.S. economy."

US Government Debt is High and Growing

Officially, the U.S. debt is at $15.24 trillion as of January 6, 2012. If this debt were calculated using accounting rules that apply to U.S. corporations, the debt would include off balance sheet liabilities raising the present value of U.S. government debt to as much as $120 trillion. Currently about 30% of every dollar spent by the U.S. government is borrowed money. How much more will be needed to pay for off balance sheet promises?

Government spending is out of control. According to the Cato Institute:

> *If there is no change to current policies, by 2050 federal government spending will exceed 42 percent of GDP. Adding in state and local spending, government at all levels will consume nearly 60 percent of everything produced in this country.*

Big spending means big deficits. And big deficits create more debt, which is already choking the U.S. economy. According to Reinhart and Rogoff, when debt levels for developed economies surpass 90% median GDP growth falls by 1%. What this means to the man in the street is greater unemployment and real wealth erosion. This is where the downward debt cycle begins.

When debt levels reduce growth potential, government tax receipts fall and the cries for fiscal and monetary stimulus intensify. Consequently, budget deficits worsen and debt-to-GDP ratios climb even further.

How to Stop the Debt Spiral

To control the worsening debt spiral, the U.S. government can follow one of four paths:

1. Grow the Economy

This is the best solution because all economic participants - creditors, workers, business owners - are satisfied. Unfortunately, it is also the most unrealistic. If growth were something governments could simply turn on there would never be any recessions. The best governments can do is foster an environment that rewards innovation. Even then, lasting real growth occurs when those innovations improve societal productivity. Unfortunately, those types of developments don't occur according to a planned schedule.

2. Default on the Debt

This option quite simply reduces or eliminates the debt burden via debt restructuring or outright default on debt service obligations. While many countries have defaulted on their debts and lived to tell the tale, it is clearly not an option for a country wishing to remain in good economic standing with creditors. For the U.S. to default on its debt, it would also have to default on the entitlements owed to its citizens, which could lead to revolt. Moreover, as the U.S. Treasury bond is the bedrock 'risk free asset' used by modern portfolio theory and all its derivations, a default would bring unforeseeable chaos to risk models throughout the world. This could potentially destroy the global financial system.

3. Impose Austerity

At first glance this sounds like a feasible plan - each individual makes a little less and pays a little more to help balance the government's books. Unfortunately, reality is wrought by politicking, lobbying and revolt. Consequently, the distribution of responsibility is often applied unevenly and unfairly. Also, a politician who cuts spending or raises taxes is soon kicked out of office by his constituents. Worse yet, even if governments do raise taxes and cut spending, the short run economic impacts would cause an economic recession. Recession leads to weaker tax revenues, and as we've seen throughout Europe austerity measures can exacerbate budget deficits, spark domestic unrest and end political careers.

4. Inflate

Because inflation causes hard asset prices to rise, inflation can be used to shrink the *relative* size of debt on a government's balance sheet. Except for cases of hyperinflation, inflation is silent and can occur without most of the population knowing. It is also difficult for the layman to pinpoint the cause of inflation, thereby insulating politicians from blame. Even while inflation is occurring, governments are incentivized to deny its existence and keep rates artificially low (to keep the cost of debt growing slower than nominal GDP). At the same time, governments maintain a captive domestic audience for Treasury securities, usually through the banking system. This system of distortion, perversion and coercion is sometimes referred to as 'financial repression'. I believe financial repression is the current unspoken policy of the U.S. government, as the Treasury and Federal Reserve work to push Treasury yields and official CPI numbers below real inflation rates.

The most realistic *planned* way out of the current debt spiral is via inflation. With financial repression set as unofficial U.S. policy, the U.S. government is likely to keep rates and official CPI numbers artificially below the real rate of inflation. As a consequence, the average American's wealth will erode without them knowing.

Of course, any number of variables and miscalculations can send the U.S. economy deep down the debt hole.

Protect Yourself with Gold, Silver and Other Hard Assets

The difference between a planned exit and a chaotic exit from the debt spiral simply changes the glide path towards inflationary consequences. (A chaotic exit may start with a deflation, but the massive monetary response would be inflationary.)

When a U.S. debt crisis will occur and how long a planned inflation will take is anyone's guess. After all, many have predicted the demise of Japan - which as at 2010 had a debt-to-GDP ratio of 220% - only to be proven wrong year after year. Given America's military, economic and currency hegemony, the country may be far from crisis. However, until a discontinuous break in policy or full blown crisis occurs I believe a prudent investor will seek to protect himself from calamity.

Just as nobody knows when a crisis will break, nobody really knows how to best protect assets during a crisis. Anyone who pretends to know what will happen is either delusional or deceitful. However, investors can prepare themselves for a range of outcomes, linked to either inflationary outcome.

Inflationary policy and inflationary chaos are manifested by currency depreciation. Precious metals and hard assets priced in domestic currency have long protected from the debasement of the dollar. Since gold is not connected to industrial demand, it is the purest non-fiat alternative to dollar exposure.

Investors looking to protect from inflation may be served well by the following precious metals and commodity ETFs:

- ETFS Physical Swiss Gold Trust ETF SGOL
- ETFS Precious Metals Basket Trust ETF GLTR
- SPDR Gold Trust ETF GLD
- iShares Silver Trust ETF SLV
- Sprott Physical Silver Trust ETF PSLV
- PowerShares DB Commodity Index Tracking ETF DBC

Guard your money. Until America's debt crisis comes to an end, the risk of inflationary chaos or financial repression are a threat to your wealth.

Disclosure: I am long SGOL.

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