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What Will Happen When We Hit the Cliff

Few places for financial assets to find shelter

by Charles Hugh Smith
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Tags: Charles Hugh Smith [3], economy [4], fiscal cliff [5]

Executive Summary

- A rising dollar negatively impacts stock market profits and valuations
- Interest rates ultimately *will* rise, and that will be a game-changer
- Investors will eventually realize that "risk-free" assets (e.g., U.S. Treasurys) are *NOT* safe havens
- Why there will be few places for financial capital to find shelter in 2013

If you have not yet read Part I: The Structural Endgame of the Fiscal Cliff [6], available free to all readers, please ***click here*** *[6] to read it first.*

In Part I [6], we covered the basics of wealth and political power in the U.S. and found that the Fiscal Cliff is only a symptom of a structural endgame in which the imbalance between what has been promised and what can be collected in taxes will continue growing until it triggers a financially driven political crisis that I believe will inevitably become a full-blown Constitutional crisis.

Though there are many facets of this long-term political crisis that are worthy of further exploration, we will to start with three financial aspects that could start impacting households in 2013: a rise in interest rates and a resultant destruction of bond valuations, a rise in the U.S. dollar that negatively impacts U.S. corporate profits and thus stock market valuations, and a reduction in upper-income households' spending as a result of higher taxes that depress discretionary consumer spending.

A Rising Dollar Negatively Impacts Stock Market Profits and Valuations

Let's start with a topic that I have covered in depth over the past year, the structural reasons behind the rise of the U.S. dollar (USD). The recurring fantasy that Europe's fiscal and debt crises are "fixed" and the Federal Reserve's money-printing/Treasury bond purchases have recently depressed the USD, but in the longer term, the USD has been tracing out an unmistakably bullish pattern of higher highs and higher lows since May 2011:

The key point here is the correlation between U.S. global corporate profits and the USD: A weak dollar boosts corporate profits when stated in dollars, and a strong dollar depresses corporate profits earned overseas. This matters because many global corporations get 40% to 60% of their total revenues overseas.

Thus any appreciation of the dollar versus the euro, yen, and other floating trading currencies will lower corporate profits. Weakening profits will then weaken the bullish argument for high stock valuations.

This currency-valuation dynamic is rarely mentioned in standard-issue stock market analysis, even though it is obviously a key factor in U.S. corporate profits and thus stock valuations.

Why would the dollar strengthen against other currencies? The reality that Japan and Europe's fiscal and debt fundamentals are deteriorating, not improving, is gaining traction. This alone is enough to push the dollar higher. China's growth rate has slowed, and this is impacting the Australian dollar and other commodity-based currencies. Once again, the dollar will strengthen not so much on its merits as on the weaknesses of its rivals.

Lastly, the contraction of global trade (just look at the Baltic Dry Index for a reflection of this) will tend to push the dollar higher, as I explained in my recent piece on Triffin's Paradox [7].

Interest Rates – Low Forever, or Set to Rise?

If there is any financial truism that is widely accepted, it is that interest rates will remain low for years to come as a result of the Fed's purchases of Treasury bonds and money managers avoiding risk assets. These are definitely low-interest-rate positive, but received wisdom may be overlooking two other forces.

The Fed has committed to buying about $500 billion of Treasury debt a year, but perhaps this bond purchasing is not quite as dominant as many seem to believe. The 2012 Federal deficit is around $1.3 trillion, just like 2009-2011, and demographics and weak household income could drive this higher in short order as the fantasy that tax revenues will reduce the deficit run into the buzz saw of political/financial dysfunction described in Part I.

In this context, the Fed purchases might cover about 35%-40% of debt issuance. That could leave around $1 trillion in bonds dumped onto the private market. The Fed's Operation Twist has suppressed interest rates by selling longer-term bonds to buy 60% to 80% of short-term bond issuance, leaving the Fed's program incapable of buying enough of both long-duration and short-duration bonds to suppress long-term rates.

We must keep in mind that billions of dollars of bonds mature every year and must be re-issued on top of newly issued bonds that fund current fiscal deficits. This increase in the pool of issued bonds further reduces the influence of Fed bond buying.

I have made the case elsewhere that the Fed may face increasing political constraints as its policies fail to sustain growth in 2013. Though some observers believe that the Fed has no choice but to expand its balance sheet to infinity in order to keep buying Treasury bonds, this view ignores the possibility of rising political resistance to Fed manipulation of interest rates and the economy. At some point, policies that have failed so visibly will no longer attract automatic political support.

In effect, the Fed's bond-buying programs have enabled fiscal recklessness. As resistance to fiscal recklessness rises, so, too, will resistance rise to the Fed's policies that enable the recklessness.

As the global recession causes phantom financial assets to vanish, the pool of money available to buy Treasurys will shrink. Few seem to ponder what happens when trillions of dollars in phantom assets disappear as debt is written down and debt-based assets are exposed to market-price discovery.

The Failure of Counterfeiting Risk-Free Assets

Stripped of public relations and economic voodoo-speak, the Fed's policy of buying hundreds of billions of dollars in bonds is an attempt to counterfeit risk-free assets – that is, to manufacture the belief that Treasurys are risk-free. The notion that Treasury bonds may carry risks that are not being priced into the current market price is suppressed by Fed buying.

Are Treasurys truly risk-free? What matters isn't the debate; it's the recognition that there could be risk as Federal debt spirals up by $1 to $1.5 trillion a year. That recognition will eventually push long-term rates higher as private buyers demand a risk premium. With rates either near-zero or negative (depending on what rate of inflation is used), any recognition of risk will eventually push yields higher.

If the Fed's programs run into political resistance, the recognition of risk could rise quickly as the market discovers that the Fed is not omnipotent and its bond buying has political limits.

What happens when yields on long-term bonds rise by a modest 10%? The market value of all existing bonds of long duration will drop by an immodest 10%, as yields and market value are on a see-saw.

What happens if bond yields rise and corporate profits decline? Those holding stocks and bonds will suffer losses. This double-whammy would leave few places for financial assets to hide in 2013.

Discretionary Spending and Recession

As taxes on the top 25% rise, those households will have less discretionary income to spend or save. Since the top 10-15% earns roughly half of all household income, the economy is dependent on the consumer spending of the top earners. As their income is diverted to taxes, consumer spending will suffer. If Federal spending is trimmed, those receiving contracts, transfers, and benefits will also have less income to spend or save. As spending declines, corporate revenues and profits will also fall – another bearish influence on stock valuations.

All in all, higher taxes are recessionary for the consumer-based economy.

~ Charles Hugh Smith

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