Critical market factoid: Retiring the baby-boomers will require vast new issuance of U.S. Treasury bonds!

BCA RESEARCH

Independent Investment Research Since 1949

U.S. BOND STRATEGY

March 1, 2006

Investment strategy and recommendations for the U.S. fixed income market

Special Report

U.S. AGING TIME BOMB: WHEN WILL IT BLOW UP TREASURYS?

The following *Special Report* was written by our Washington Editor, Dr. Rudolph Penner. Dr. Penner is currently a resident scholar with the Urban Institute, a nonpartisan public policy research organization in Washington. He has been a pre-eminent and influential analyst of budget policy for the past two decades. He was also director of the Congressional Budget Office during the mid-1980s.

Dr. Penner analyses the Bush Administration's Mid-Session Review of the Budget, and reviews the long-term outlook for fiscal policy and the budget balance. The short-run budget outlook is fairly benign. The 2006 deficit will be much lower than the Administration's estimate of $423 billion. Fiscal policy will have a roughly neutral impact on real GDP growth this year, and could be slightly contractionary in FY2007.

The good news is that the budget deficit is likely to decline as a percent of GDP for the next few years, even if the President's tax cuts are made permanent. The bad news is that little progress will be made on reforming entitlements, which are set to explode in the next decade as the population ages. Congress is unlikely to tamper with Social Security and Medicare until it is forced to do so by voters or financial markets. It may take a riot in the bond market before politicians act.

The aging time bomb is ticking. Nonetheless, the bond market is sanguine at the moment, and a declining deficit/GDP ratio in the next few years reduces the risk that a riot point will erupt in the near term. Thus, we do not think that bond investors should position for a major increase in fiscal risk premiums within a one or two year investment horizon.

If, as is often said, a country's budget is a comprehensive statement of a nation's priorities, it is clear that the American people dearly love the elderly. The total amount spent on Social Security, Medicare, Supplemental Security Income, as well as civil service, military, and veterans' retirement and disability programs will equal over $1 trillion in 2006 – about 57 percent of total Federal spending outside of defense and interest.[1] And this does not count the substantial amounts spent on the elderly within the Medicaid program or the smaller amounts spent within welfare programs, such as food stamps.

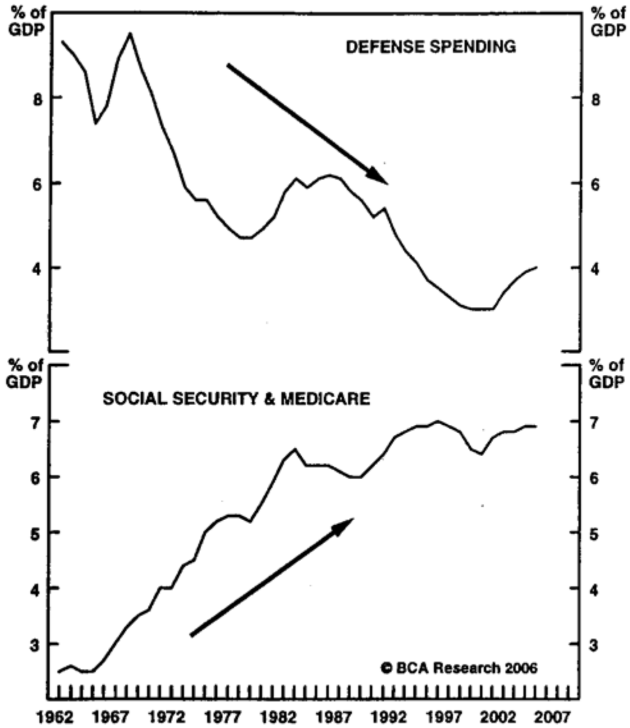
By comparison, about $500 billion will be spent on defense. Indeed, it is a secular decline in defense relative to GDP that has mainly financed the expansion of Social Security and Medicare (**Chart 1**). Means-tested programs targeted on the poor spend roughly one-third the amount spent on programs for the elderly and disabled that are not means tested.[2]

1 The $1 trillion includes amounts spent on the disabled, but elderly recipients are dominant.

2 Supplemental Security Income, a program focused on poor elderly and disabled is not included in this calculation. It should be noted that a significant portion of the spending on Social Security and Medicare goes to the poor even though they are not targeted by the programs.

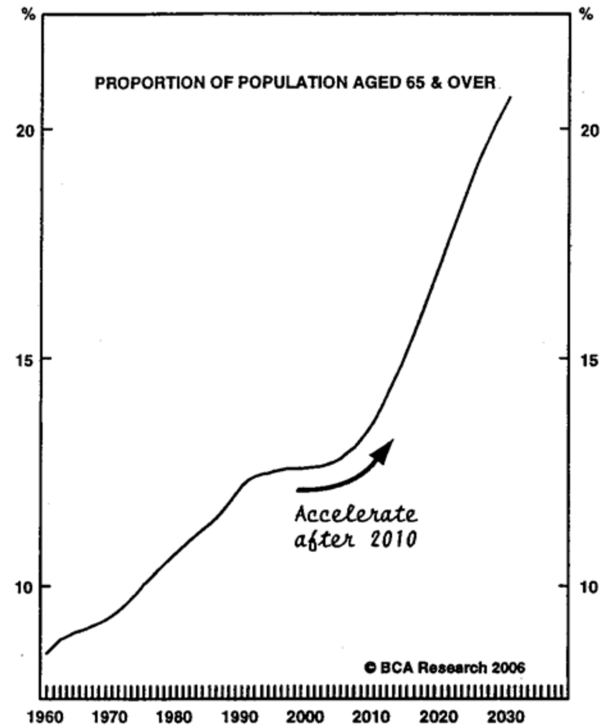
1513

CHART 1
Defense Makes Way For Entitlements



SOURCE: CONGRESSIONAL BUDGET OFFICE

CHART 2
Demographic Disaster Looms



As is well-known, the elderly population will begin to soar over the next decade because of aging baby boomers and increasing longevity. Also, the per capita cost of providing the elderly and disabled with health care can be expected to continue to grow faster than per capita income (**Chart 2**). As is also well-known, this means that the programs for the elderly are not sustainable in their current form.

This problem does not seem to make much of an impression on either Congress or Wall Street. The latter is important, because the financial community represents one of the few constituencies that could scare Congress into fiscal discipline.

A recent auction of 30-year U.S. Treasury bonds went very well, yielding lower interest rates than expected. It is, at least, interesting to note that in 2036 when these bonds mature, reasonable projections of the financial implications of current policy imply that the U.S. public debt will exceed 200 percent of GDP. The buyers of these bonds must assume either that they will be able to sell them before anyone begins to worry about this budget trajectory, or that the trajectory will eventually be made sustainable by fundamental programmatic reforms.

Financial Markets Will Have To Riot

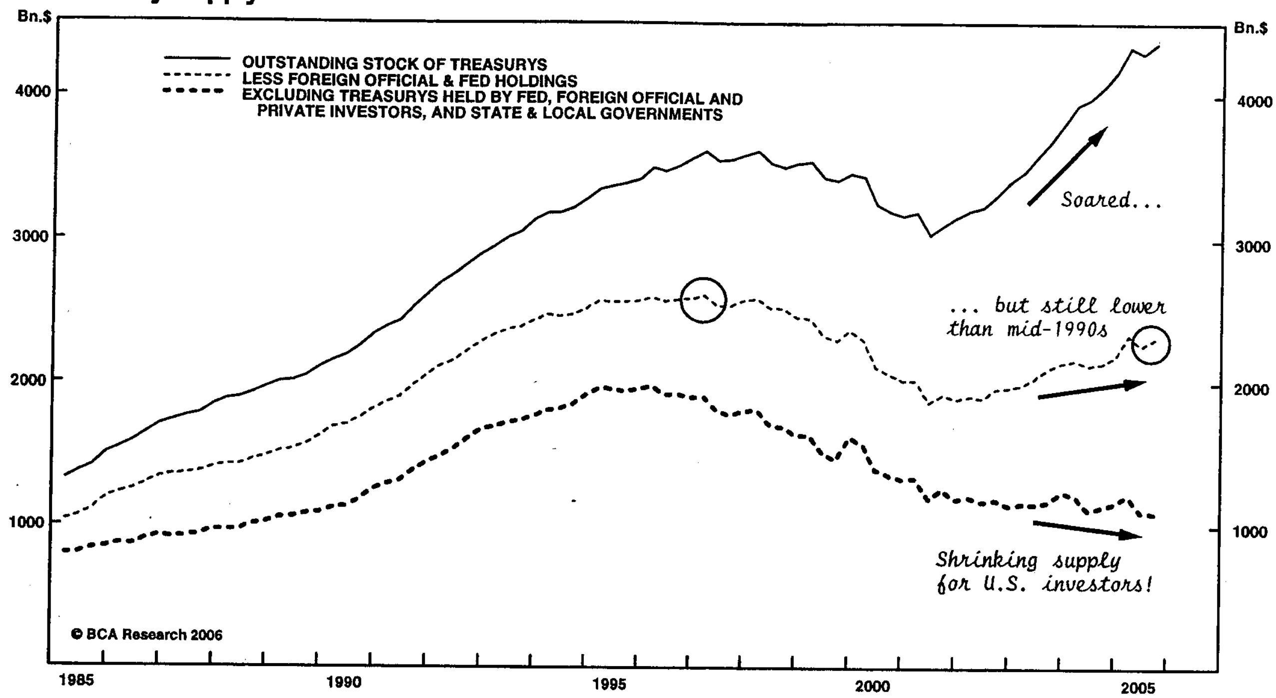
Given Congress' current mood, it is extremely difficult to envision significant reforms unless they are prompted by a financial crisis. When might such a crisis occur? It is difficult to say, because financial markets are so fickle in their attitude toward fiscal policy. They went into some turmoil when Jimmy Carter put out a budget in January of 1980 that had a deficit of $16 billion. A short time later, they accepted Reagan's deficits of more than $200 billion with total equanimity.

The bond market would likely have priced in a significant fiscal risk premium by now, if it were not for Treasury purchases by foreign central banks. **Chart 3** shows that the outstanding stock of

E14

Monetary stimulus of 2001-02 did not jumpstart the economy so we shifted to fiscal stimulus (federal deficits). The supply of treasuries has exploded over the past 4 years to finance economic recovery yet interest rates have remained relatively low. How did this happen ? Foreigners bought U.S. bonds!

CHART 3
Treasury Supply



Treasurys has surged to over $4 trillion. However, the stock available to the private sector (i.e. after Fed and foreign central bank purchases have been excluded) has risen much more slowly and amounts to a little over $2 trillion. Foreign demand helps to explain why real yields have stayed so low in the face of the budget blowout.

One can identify certain crucial events that may attract attention and provoke a Wall Street reaction. The first baby boomer applies for Social Security in 2008, and qualifies for Medicare in 2011. Entitlement spending starts to rise much faster than GDP by 2013. Later in the decade, the cash flow of the Social Security trust fund turns negative. Some time in the mid-2020s, the public debt passes 100 percent of the GDP.

The rating agencies will play an important role in the reaction of financial markets. At what point do they choose to downgrade the U.S. government debt? In my view, they have sufficient reason to do it now. But they hesitate, because that action would be so traumatic, and they still hold out hope for reform. Financial markets will likely react before the rating agencies make any moves. The 2008 Presidential election could be a turning point if reform is not seriously debated. Nonetheless, there is a good chance that financial markets will ignore the deficit until well into the next decade, when the rising proportion of retirees begins to accelerate.

The Bush Budget And The Elderly

The President made a terrible error early in his presidency by supporting a new Medicare prescription drug program that greatly worsens the budget trajectory – without demanding any significant Medicare cost savings in return. More recently, his track record is better. Last year he offered proposals for a fundamental redesign of Social Security. There were significant problems with his design, but that was almost irrelevant to the subsequent debate. His opponents were able to sink the whole notion of reform without having to offer alternative proposals. It is now generally agreed that

E15

Thanks to revenue collections in a growing economy, in the short run (next few years) deficits will be tamer, taking deficit pressure off of interest rates.

the Social Security debate is dead for a good long time.

In this year's budget for FY2007, the president repeats his Social Security proposal and begins to nibble at the much more serious Medicare problem. He has suggested cuts in payments to the doctors and hospitals who provide health care and increases to the Medicare premiums paid by the more affluent. He has also recommended a further automatic cut in provider payments when dedicated revenues can no longer finance as much as 55 percent of the cost of the program. Providers will strongly resist any reduction in their fees and they are busily organizing to oppose these reforms. The political unpopularity of Medicare reform represent one of many reasons why so many observers believe that this budget is "dead on arrival."

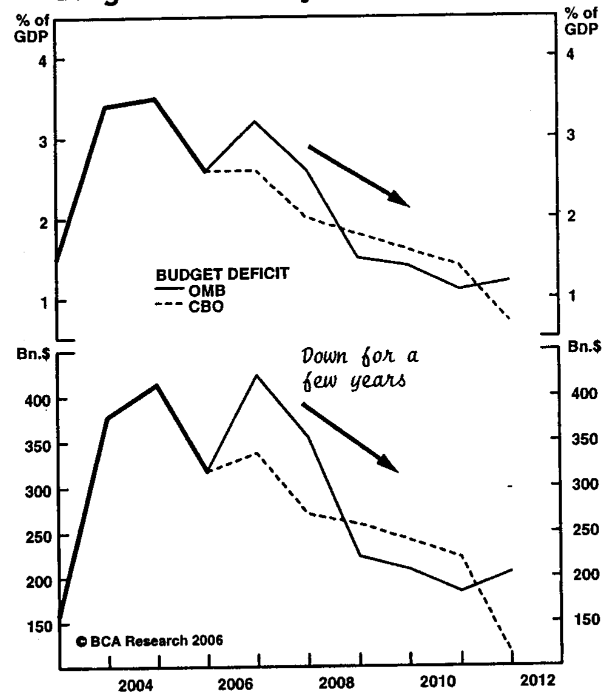
It is again probable that the President's proposal will sink without a trace, without his opponents having to propose any alternatives. If Democrats perceive that they have gained in the 2006 election by just saying "no," and Republicans perceive that they lost support because of the President's proposals, it will be a very long time before Congress returns to the long-term budget problem, unless it is forced to by financial markets.

The Deficit In The Short Run

The most curious feature of the President's recent budget is an estimate that the fiscal 2006 deficit will soar to $423 billion, or $105 billion above the 2005 level (**Chart 4**). Budget deficits are sufficiently volatile that one has to be careful about saying that this is impossible, but it sure seems implausible. The fiscal year is more than four months old and the deficit through January is $15 billion *below* that of 2005. It is true that the growth of revenues will slow significantly during the rest of the fiscal year and that the spending pace will accelerate because of the prescription drug program, but the deterioration in the last two thirds of the fiscal year would have to be extreme to reach the Administration's deficit estimate.

WILL TAKE PRESSURE OFF RATES,

CHART 4
Budget Picture Okay For A Few Years



The Congressional Budget Office (CBO), making reasonable policy assumptions, estimates a 2006 deficit of $355 billion, fully $68 billion lower than the Administration's estimate (**Chart 4**). If policies were not changed, their deficit estimate would be $337 billion, but they expect a substantial increase in spending on Iraq and Afghanistan as well as some relief from the alternative minimum tax. Fiscal policy was slightly restrictive in 2005, as measured by the change in the standardized budget deficit. The fiscal thrust in 2006 is hard to read. The initiation of the prescription drug program will push spending upward and will be counted in naive measures of fiscal thrust, but much of this will be a substitute for private spending on drugs. Will individuals spend their drug savings on other things or will they put it in a bank account? There is no major change in tax policy, although the standardized deficit will make the continued surge in individual income receipts appear restrictive. It is more accurate to think of that increase in the tax burden as

E16

True Bombshell: Who would have thought the U.S.A. would ever need an "IMF Workout" ???

IMF wins key role in closing trade gaps

FT, 4-24-06

■ Fund given mandate to target global imbalances

By Chris Giles and Krishna Guha in Washington

Leading countries secured a breakthrough in the governance of the global economy at the weekend, transforming the role of the International Monetary Fund and putting it at the centre of a more co-operative effort to resolve trade imbalances.

The IMF was given a mandate to start immediate negotiations between the countries with the largest trade imbalances. Its goal will be to secure agreements to reform economic and exchange rate policies to close trade gaps and prevent a global financial crisis. If successful, it could lead to big changes in economic policies, including an appreciation of China's renminbi.

Causes of global imbalances will come under the spotlight in the first IMF "multilateral consultation", including low levels of US savings, the inflexibility of the Chinese exchange rate and surpluses in Japan, Germany and among oil producers. Participating nations will use the IMF as a forum to seek solutions to these problems.

Rodrigo Rato, IMF managing director, said the fund's analysis would be published, putting additional pressure on countries to agree, since it would not have any tools to force policy changes.

All IMF members, including China, supported the new procedures. The members also agreed that some emerging countries should be given greater ownership and voting rights.

Mr Rato said the changes to the fund's purpose in addressing global imbalances was "a very important step in the role of the fund in tackling global imbalances but also in producing an encouraging, co-operative response to global issues".

The US, in particular, is pleased at the growing recognition that its record trade deficit is the product of global forces, not just its own government deficit, and has to be resolved in a way that sustains global growth.

A senior US official said: "I think that surplus countries are beginning to understand that there will be no adjustment unless they are a part of it."

Even senior G7 officials sceptical about the chances of progress were delighted. David Dodge, governor of the Bank of Canada, said there had been "strong support for building an IMF to do the job that it needs to do in the 21st century".

But differences remained on the responsibility for the world's trade gaps and the meaning of the IMF's new surveillance role.

European Union ministers continued to insist that since Europe's trade was in balance, the issue was primarily one between the US and Asia.

Zhou Xiaochuan, governor of the People's Bank of China, warned the IMF's governing body not to use multilateral surveillance as a mechanism to attack its exchange rate policies. "If surveillance is wrongly focused on an evaluation of the exchange rate level . . . it will hardly be objective and certainly miss more fundamental issues."

Support for deal, Page 2
Consequences of Doha failure, Page 15

"Governance of world economy..."

"...low levels of U.S. savings..."

IMF plaudits on imbalances deal

By Chris Giles and Krishna Guha in Washington

The weekend agreement to establish "multilateral surveillance" and "multilateral consultations" to address global trade imbalances may not sound like a breakthrough. The terms are steeped in jargon and the International Monetary Fund lacks the power to force changes to individual countries' domestic economic policies unless they are forced to borrow from it.

But even the most sceptical finance ministers and central bank governors viewed the IMF meeting as a great success. There was finally a shared understanding that huge trade gaps represent the biggest threat to the world economy.

A willingness to act needed an institutional framework in which to secure agreements from individual countries, which was absent before this weekend's meetings in Washington.

Rodrigo Rato, the fund's managing director, said multilateral consultations would be a "process that goes beyond analysis and description of problems, and engage in discussions with the specific governments about the linkages and spillovers of the macroeconomic situation, and in relation to others and the global economy".

The IMF will report on the effects, for example of Chinese policies on the US trade deficit, and call together relevant countries to see if agreement on policy changes can be reached. The process will have four elements.

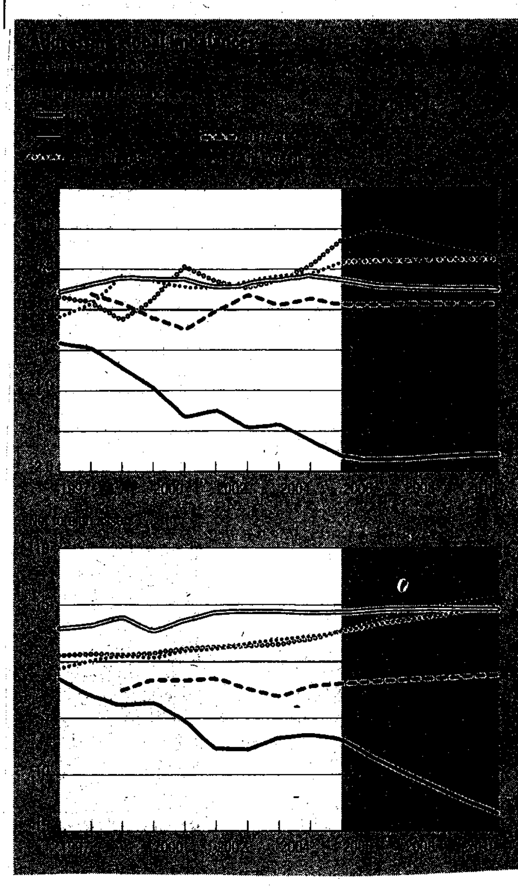
First, a strict remit for the IMF only to get involved in international issues where the policies of one country affects others.

Second, all IMF members will have to restate their commitments to each other under Article IV of the IMF. This allows them to choose their own economic and exchange rate policies so long as they "avoid manipulating exchange rates or the international monetary system to prevent effective balance of payments adjustment or to gain an unfair competitive advantage".

Third, where problems arise, the IMF's managing director has the right to call "multilateral consultations", forcing groups of countries to explain how their domestic policies are compatible with Article IV and seek agreement on changes.

Fourth, the IMF's members will annually vote on

in some ways as important as the European Union Maastricht Treaty!!



OBVIOUS TARGETS OF THIS "Governance"

U.S. Trade Deficit

U.S. Net Foreign Assets (investment flows)

FIRST IMF "PRESCRIPTION" FOR U.S. FINANCIAL MESS:

CUT DEFICIT EVEN IF TAX INCREASES ARE REQUIRED...

...ure. ... report in today's issue of the

6-8-06 Topeka Cap J.

IMF URGES MORE AMBITIOUS DEFICIT GOAL: The International Monetary Fund on Wednesday urged the Bush administration to set a more ambitious goal of eliminating the federal budget deficit over the next five years and said tax increases may be needed to accomplish that objective. The IMF proposal was included in the agency's annual review of the U.S. economy. The agency has made the suggestion before.

Gold rallies not only linked to dollar weakness but to mounting industrial world deficits… and likely to looming financing needs related to retiring the baby boomers…

Rallies in Silver, Gold May Be Tied To Debt Concerns

By Spencer Jakab

COMMODITIES REPORT

Judging by the big moves in global financial and commodity markets last week, it would be easy to conclude that a serious fear of inflation had taken hold.

Gold—the classic hedge against inflation—hit a 25-year high, while silver surged to a 22-year peak. Then there was the selloff in Treasurys, with the 10-year yield hitting 4.88%, its highest point since before the Federal Reserve started raising interest rates in June 2004. Copper and zinc hit all-time highs, crude-oil futures topped $67 a barrel, up over 10% year-to-date, and the dollar fell against many key counterparts. "The bets out there in the marketplace are interconnected," said Bart Melek, senior economist at BMO Nesbitt Burns in Toronto.

Investors took profits in many of these markets by Friday, but the confluence of moves—and the long-running rally in such key commodities as gold, silver and oil—has begged the question of whether there's a growth or inflation common denominator.

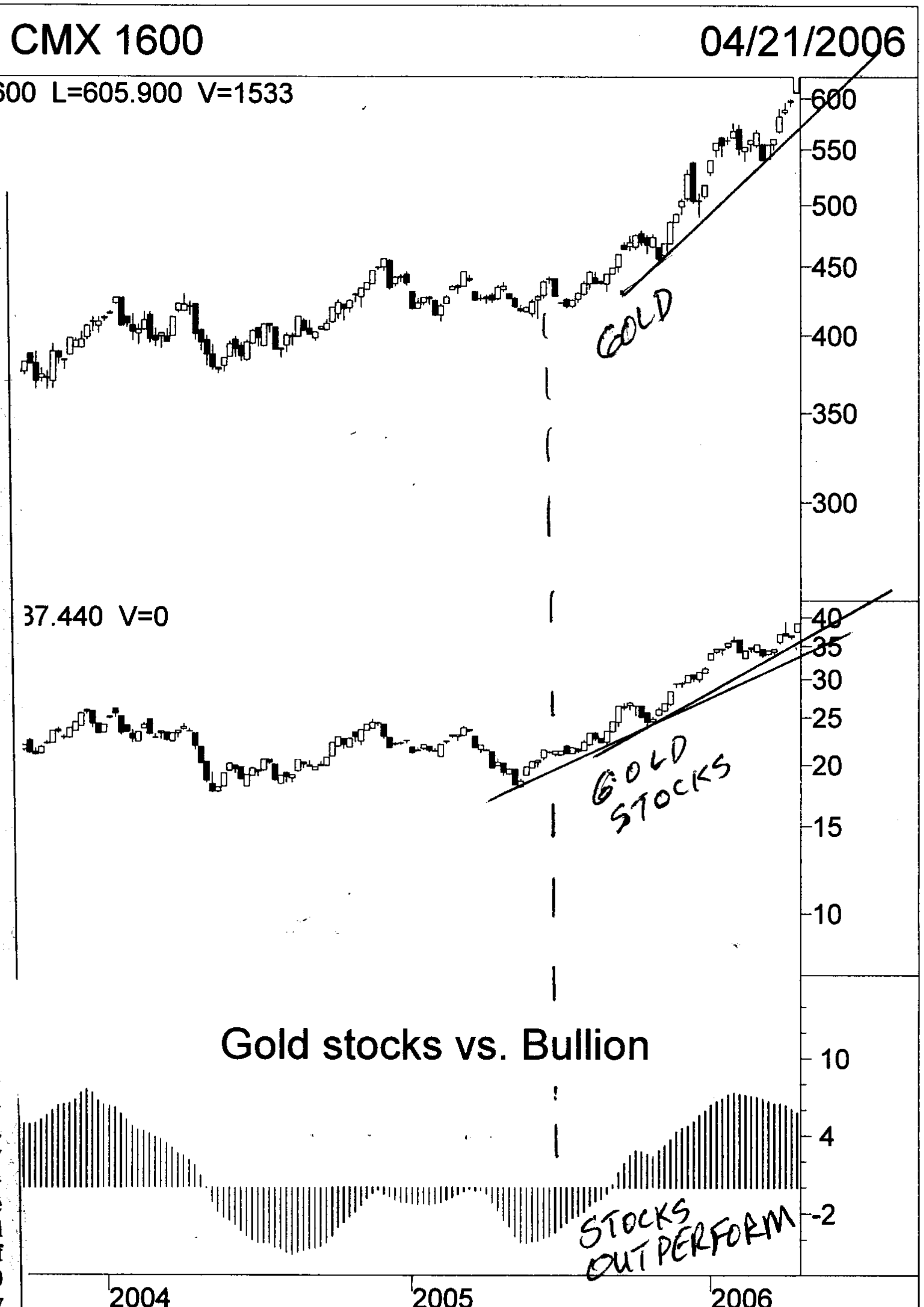
At face value, renewed inflation fears appear to be the most logical explanation. During inflationary periods, hard assets are considered a repository of value while investors demand higher yields in long-term bonds. But some economists see a major shift in global fund flows as the real culprit and say that there is more to come.

"You have these people who think commodity booms are inflationary, [but] I'm not so sure," said Anais Faraj, global strategist at investment bank Nomura in London. "Consumer-price inflation is quite low, wage pressures are quite low."

Instead, he said, the dislocations in these asset classes may be linked to a fear that the tide of cheap financing provided by Asian savers in recent years to net borrowers such as the U.S. may be slowing or even reversing, posing a risk to assets in large debtor nations and meaning potentially more gains for hard assets such as certain commodities.

The U.S., with its massive current-account deficit, is now soaking up two-thirds of global savings in order to finance its consumption. Much of this "wall of money," as some traders describe it—$3 billion each business day—is parked in Treasurys and other debt securities. Mr. Melek suggested that the flight to gold and other safe-haven investments might be a response to fears that the dollar could come under pressure from reduced foreign willingness to plug the gap.

Mr. Melek noted that hedge funds are talking about increasing their direct exposure to hard assets. This would have a disproportionate effect on commodity prices due to the relative sizes of the markets. U.S. stock and bond markets are worth trillions of dollars while physical commodities are valued in the hundreds of billions. He predicts that gold will hit $700 an ounce in the next 18 months. On Friday the price of gold was $581.80 an ounce.



0/00 3:13am Printed using SuperCharts © Omega Research, Inc. 1997