

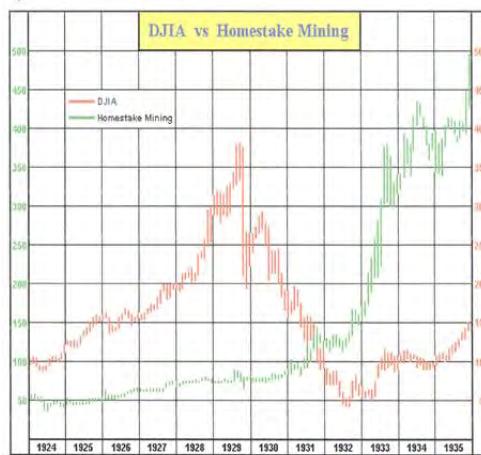


A Kondratieff Winter - Stage 3—Where Is U.S. Government Debt in this Cycle?

This piece is the second in a series exploring where the West, and specifically the United States, is in the current Kondratieff winter, a naturally occurring disinflationary cycle. The U.S. is on a credit cycle now, not a business cycle. So, with much depending on the price and availability of credit, I first look at how the current deflationary cycles were reflatated in the U.S. and then consider the final credit bubble to be popped, government debt.

U.S.—“Stage 2 Winter Kondratieff”; Reversal of the Age of Leverage

<p>*OVERCAPACITY PURGED AND ECONOMY SICK/Bubbles Burst</p> <p>*TRADE CONFLICTS WORSEN AS PROTECTIONISM GROWS</p> <p>% Cuts and Credit Booms</p> <p>BUDGET DEFICITS INCREASE & TAX CUTS</p> <p>BANKRUPTCIES, DEBT REPUDIATION, RESTRUCTURINGS</p>	<p>NASDAQ (2000) / Airlines / Autos / then US Consumer. The Credit Bubble will pop Treasury market is a bubble</p> <p>Bananas, EU, WTO wrangle with China</p> <p>Steel in 2001 – 30% U.S. tariffs on March 6,2002</p> <p>China trade issues</p> <p>U.S. Responds—Mortgage Rates went to 40 Yr. Lows/Fed buys mortgages</p> <p>T-Bills went to 0%.</p> <p>Record levels of credit outstanding/ZIRP in U.S., Japan, and eventually in Europe</p> <p>\$1 Trillion annual deficits</p> <p>Scandals start – Arthur Anderson</p> <p>(Leverage becomes the enemy) – Worldcom (700+ hundreds of dot.coms) / Adelphia / Global Crossing</p> <p>Polaroid</p> <p>Bethlehem Steel</p> <p>Enron</p> <p>K-Mart</p> <p>US Airways, UAL, TBF/Banks/Auto companies, FNM, FRE, Lehman, AIG, CIT, GM</p>
<p>*CURRENCY DEVALUATION—Change in Global Currency System—March 2009: A Minsky Moment Missed</p>	<p>The Dollar Topped in 2002</p>
<p>*BANKING SYSTEM IN TROUBLE – Leverage unwinds</p>	<p>Question now is how far down, how fast? When is Bretton Woods 2?</p> <p>Japan: 1990 – 2012</p> <p>U.S. – sub prime loans/accounting issues/derivatives/bank leverage</p>
<p>STOCKS down, Bonds, UP, Commodities down</p> <p>GLOBAL STOCK MARKETS enter extended bear markets</p> <p>INTEREST RATES spike in early winter and then decline throughout</p> <p>NEW STOCK OFFERINGS end</p> <p>ECONOMIC GROWTH slow or negative during much of the winter</p> <p>Some RUNAWAY DEFLATION and falling prices</p> <p>COMMERCIAL and residential real estate prices fall</p> <p>TRADE CONFLICTS worsen</p> <p>FINANCIAL NATIONALISM and Trade Wars</p> <p>SOCIAL UPHEAVAL and society becomes negative</p> <p>*BANKRUPTCIES accelerate and high debt eliminated by bankruptcy</p> <p>*OVERCAPACITY and overproduction purged by obsolescence and failure</p> <p>*GREED is purged from the system</p> <p>RECESSIONS long and recovers brief</p> <p>FREE MARKET system blamed and socialist solutions offered – Next (pre-election, rush to regulate)</p> <p>BANKING SYSTEM shaky and new one introduced</p> <p>NEW TECHNOLOGIES and inventions developed and implemented</p> <p>REAL ESTATE prices find a bottom</p> <p>NEW WORK ETHICS develop since jobs are scarce</p> <p>INTEREST RATES and prices bottom</p> <p>DEBT LEVELS very low after defaults and bankruptcies</p> <p>VIEW OF FUTURE at low ebb</p> <p>BRIGHT SPOTS appear and social mood improves</p> <p>There is a CLEAN ECONOMIC SLATE to build on</p> <p>INVESTORS are very conservative and risk averse</p> <p>A NEW ECONOMY begins to emerge</p> <p>STOCK MARKETS reach bottom and begin new bulls in winter</p>	



3 rd Kondratieff Cycle			
STOCKS DJIA		HOMESTAKE/GOLD	
Start of Autumn	63.90	Start of Winter	\$ 78
End of Autumn	381.19	Winter High	\$528
Gain	496%	Gain	576%
4 th Kondratieff Cycle			
Start of Autumn	777	Start of Winter	\$ 275
End of Autumn	11725	Winter High	\$3878
Gain	1410%	Gain (projected)	1410%(1)

Quote of the Day

“Affliction comes to us, not to make us sad but sober; not to make us sorry but wise.”

H. G. Wells

The five red boxes on the left hand side of the page represent the five reflation levers, which the U.S. has used twice in the past thirteen years to pull the economy and financial markets out of the post 9-11 recession and the financial crash of 2008-2009.

Interest Rate Cuts

T-bills went to near zero in 2002, then did go to zero in 2009.

3-Month T-Bill Yield (2000-Present)



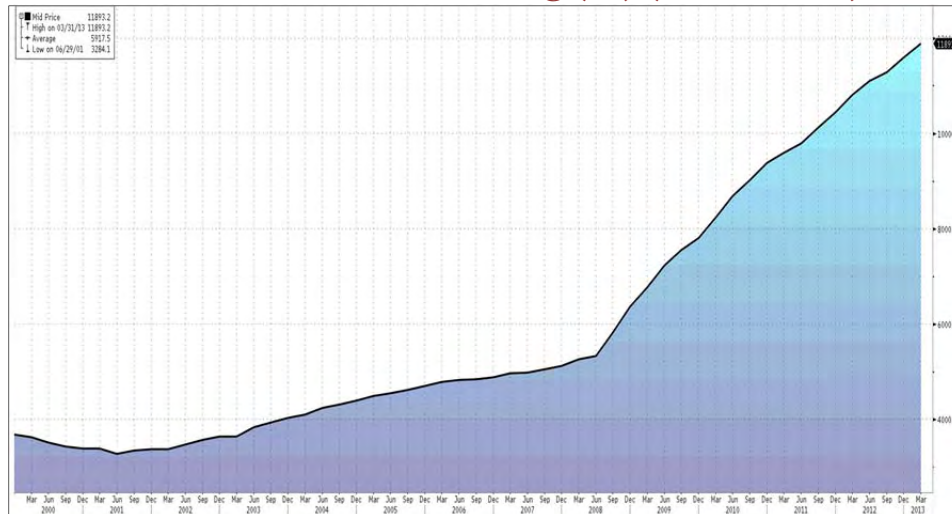
Source: Bloomberg LP

Ultra low rates spurred a housing recovery, consumer spending, and government borrowing.

Credit Booms

The post 2003 recovery featured a build-up in credit to the housing sector. And the 2009 recession was partially ended by massive government spending- funded by borrowed money.

US Federal Debt Outstanding (bil) (2000-Present)



Source: Bloomberg LP

Budget Deficits

The government relied less on deficit spending in 2002-2003 as a reflation tool, still the Bush administration managed to turn a budget surplus into a roughly \$100 billion deficit. And of course from 2006-2009, the budget deficit rose from about \$100 billion to \$1.3 trillion during the Obama years. Government spending was clearly intended to be the linchpin of the 2009 recovery effort.

Tax Cuts

The Bush tax cuts of 2003 helped foster economic recovery. They were renewed after the 2008 crash for the same reason. It is interesting that in this cycle, taxes were raised in 2013 with signs of recovery relatively weak. Was the real reason to support the Federal debt? Shades of the argument going on in Japan today.

Currency Devaluation

The Dollar's decline began in 2002 and it has been a steady, relentless trip lower, supporting U.S. exports while inflating away government debt. While talking up the Dollar for years, the greenback fell. And now the government and the Fed seem to be studiously ignoring the Dollar. Do they see something coming that will strengthen the Dollar? Rather than add fuel to the fire and push the Dollar higher than it might otherwise go, they have gone relatively quiet.

U.S. Dollar (2002-2013)



Source: Bloomberg LP

The U.S. Has All The Symptoms

Returning to the left side of the prior display, the U.S. displays many of the symptoms of a Kondratieff winter. Beginning about halfway down the page, start with the line, which says, social upheaval and society becomes negative. This is one of the symptoms after a prolonged period of higher unemployment and low wage growth, which the U.S. has had for five years or more. That society has turned more negative can be seen in a variety of public opinion polls. When we look at polls which survey the public's view of the future and whether or not the U.S. is on the right track, there is a clear discontent.

MARKET INTELLIGENCE REPORT

Global

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The Institutional Strategist

September 6, 2013

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RCP Poll Direction Of Country

Polling Data				
Poll	Date	Right Direction	Wrong Track	Spread
RCP Average	7/10 - 9/2	29.3	62.0	-32.7
The Economist/YouGov	8/31 - 9/2	28	59	-31
Rasmussen Reports	8/26 - 9/1	30	62	-32
Reuters/Ipsos	8/23 - 8/27	24	60	-36
Monmouth	7/25 - 7/30	27	66	-39
CBS News	7/18 - 7/22	35	60	-25
NBC News/Wall St. Jnl	7/17 - 7/21	29	61	-32
ABC News/Wash Post	7/18 - 7/21	36	60	-24
McClatchy/Marist	7/15 - 7/18	28	62	-34
Democracy Corps (D)	7/10 - 7/15	27	68	-41

All Direction of Country Polling Data

Source: Real Clear Politics (1)

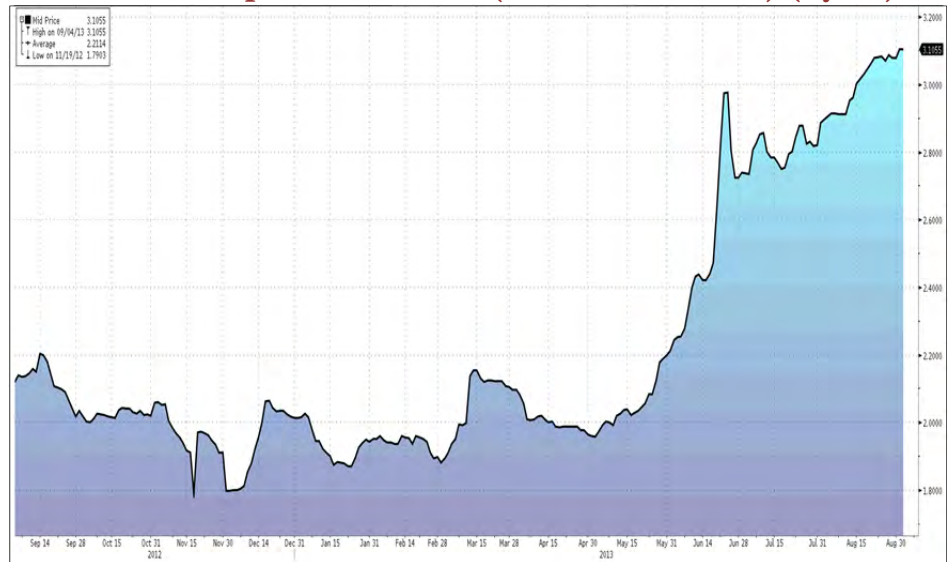
Is social upheaval present? I have not written much about this, but if societal trends are not addressed, such as the explosion in single parent families especially in the black community, income inequality (Kuznets curve), the drum beat about race relations which reminds me of the mid-late 1960s before the riots began, growing distrust of Congress (extremely low approval ratings), to name just a few trends, American societal cohesion will begin to break down. American society is always changing. Society's view of the future and where we are in the K- wave cycle are consistent.

Bankruptcies Accelerate and High Debt Eliminated By Bankruptcy

This is where we will see the next phase of the K-wave, in the government sector. I am not talking about the Federal or state governments, instead I think it will be at the city level, municipal government is where the bubble will pop. Detroit's bankruptcy was just the beginning. If Detroit cannot finance itself with interest rates this low, what happens when the tide goes out and rates are 100-200 bps higher? How many more Detroits will surface? What is also interesting about Detroit is the Federal government has apparently offered little or no help. Who will bail out America's cities? The Fed? As I understand it, the Fed cannot buy munis.

This symptom is tied together with the next line- overcapacity purged by obsolescence and failure. If cities cannot fund their operations, their choices are to raise local taxes, which are tougher because the natives pay attention to what happens in their own back yard, or they cut back. Or they can continue to sell bonds and see how far they can go until the municipal bond market chokes on supply - and bonds fall/rates rise. To some extent, the untold story this year is how municipal bond rates have risen. Everyone watches Treasury yields, but here in Minnesota, we can buy double tax-exempt munis, which also avoid the new medical tax, at 5% yields, which after tax approach 9%-10%. That's great for investors but for municipalities, funding is becoming expensive.

S&P Municipal Bond Index (Minnesota Yields) (1 year)



Source: Bloomberg LP

Meredith Whitney may have been right, just early in her bearish call on municipalities several years ago. We have an example in my own back yard of how municipalities have overdone it. Your editor lives in a suburb of St. Paul, Minnesota, in a small community called North Oaks. With a few thousand people, we don't have much in the way of services, so when I go running at the gym for instance, I use the neighboring community's massive, publicly financed facility, the Shoreview community center. This building has an indoor running track, enormous pool, hot tubs, a giant water park, a weight room, meeting rooms, a huge exercise area, and all financed by taxpayers. People like it, I like it. The facility draws people from all over the area. So, on the other side of North Oaks, a community called Vadnais Heights (about 12,000 people), got the bright idea several years ago, that they needed a facility which could be leased out to hockey teams for practice, become a training center for sports teams, etc. It has a giant bubble over it so it's an all-weather facility that has a track, NHL sized hockey rinks, it's as if these guys don't know LA Fitness or sports and health clubs exist. It was financed with public money and now I read that it is in financial difficulty and so is being sold at what looks like 50 cents on the Dollar. The facility costs \$26.5 million, is offered at \$13 million and may go as low as \$10 million. (2) The bondholders got stuffed and the city fathers who spent the money on this monstrosity, walk away, I guess. I suspect this tale has been repeated across the land, in part because the public officials who push this type of spending are relatively unaccountable. Indeed, they retire with their hefty pensions intact. The pension problem is an issue I will address in the next message on this topic.

My point in relating this story is that I am hearing the U.S. government is selling buildings all over the country and Federal employment is just starting to fall. Asset sales at the city level will occur as well, but the larger trend is going to be how to rein in pension costs. Government at several levels has too many facilities and too many people. Their downsizing has just started. Funding or rather the lack of funding is what hurries restructurings along and it is the municipal level where I think this will happen first.

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Sources:

- (1) Real Clear Politics Poll http://realclearpolitics.com/epolls/other/direction_of_country-902.html
- (2) Anderson, Jim. "Ramsey County may bid on Vadnais Sports Center" Star Tribune 29 August 2013. <http://www.startribune.com/local/east/221654521.html>

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