Debt Hangover

As you are receiving this, it is quite possible that my bride and I will be on Islay, one of the islands off the west coast of Scotland. She has graciously allowed me to add distillery tours of Laphroaig, Lagavulin and Ardbeg to our journey to the Highlands, Islands and Borders of Scotland.

One must be careful when sampling *uisge-beatha,* the Gaelic term for Scotch Whiskey, which translated means "the water of life". A little bit goes a long way and it does not take a lot for a good thing to be overdone. In reasonable amounts it provides a wonderful warm feeling on a cold rainy evening in Scotland.

Overdo it and you may be reminded of your overindulgence the next morning. Funny how the same thing can be said of government debt, except instead of one person experiencing the hangover, we all get to share in consequences of the debt hangover…..and it lasts much longer.

Where's the Aspirin?

One of the more interesting perspectives that has come across my desk over the past several weeks is the idea that when government debt is very high, relative to the size of the country's economy as measured by their Gross Domestic Product (GDP), then the debt itself inhibits or restrains the ability for that economy to grow or improve. In turn, this acts to bring interest rates down and keep them low for a long time.

In their paper for the National Bureau of Economic Research "*Debt Overhangs: Past and Present"* by Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff found that growth is reduced by more than one percent when public debt to GDP exceeds 90%.....and that the impact lasts 23 years on average for the periods studied.

The ironic thing to me is that economic growth, which often means more revenue for government too, is one of the very best ways to pay down excessive government debt. However, a country's debt equaling roughly 90% of its GDP seems to put the country in the equivalent of low gear for a long time. That's where we seem to be these days according to everything I listen to coming from economists and clients alike.

Hair of the Dog

One would expect that returns on stocks could suffer when an economy is stuck in low gear, but how about interest rates. As it turns out, these periods are associated with low interest rates too, often below the rate of inflation. The problem is that say you receive 2% interest, then let's subtract ½% for taxes and 2.5% for inflation……… you have experienced a -1% "real" rate of return.

One investment management firm, PIMCO, has coined the phrase "*financial repression*" to describe the situation where the Federal Reserve has lowered interest rates to the point where savers and investors experience these "negative real rates of return". When the money you save and invest doesn't grow, you and others like you are often less likely to do things that collectively cause our economy to grow. Can you see how we get stuck in low gear?

Getting Rid of the Headache

Making a positive real rate of return is not that easy in this environment. Often there is a push to consider things that offer potential higher returns, yet one needs to understand the nature of the risk associated with the possibility of that higher return. The only wisdom to offer here is that it is wise to diversify broadly and to build some cushion into projections for the future, especially retirement calculations.

Ultimately, it is possible that these conditions we are experiencing today could last a while. Becoming a little more conservative with your spending, finding ways to enhance your income and making regular investments will help you tip the math in your favor. Funny thing, the same could be said for the countries in Europe that are having problems….and might work right here in the good ole "US of A" too!

Bottom Line

If this period of high government debt to GDP plays out as it has at other points in history, slow growth and low investment returns might be with us for quite a while. The adjustments we need to make as individuals are achievable. It just depends if we have the resolve, tenacity and will to work through this period. It will also be interesting to watch the governments that have created these circumstances to see if the political will, resolve and tenacity is present to bring about lower government debt and better economic conditions for all of us.

Your Feedback

I would love feedback on this newsletter. Future issues may include a host of good ideas, insights, specific steps to take financially, life insights and of course "Wit and Wisdom". Most importantly, I'd like it to be of value to you and to encourage an exchange of great ideas and insights. Please send your feedback to:

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