U.S. Sovereign Credit Risk And Inflation

When future economic historians look back on the global credit crisis starting in February 2007 with HSBC's disclosure of subprime mortgage losses in its Household Finance unit and reaching its spectacular climax in September 2008, they will wonder why someone thought it was a good idea to place bad private debt on the public's books.

The losses had occurred already; they happened during the misallocation of resources during the housing bubble. The bust simply was the accounting. No amount of financial engineering or deal-making by an investment banker turned Treasury Secretary could undo what had been done. Until and unless the losses were recognized, the sooner the better, the markets could not clear by placing assets at fire-sale prices into newer and presumably stronger hands.

The only thing all of the bailout programs did in the U.S. and around the world was encourage the leveraging of the public sector as a way of offsetting the deleveraging of the private sector. As a result, governments around the world are saddled with the residual losses created by the bust, and as poisons remain toxic until neutralized, public finances increasingly are in shambles. Greece, Portugal and Spain may have grabbed the headlines last week, but if the U.S. keeps running deficits on the order of the proposed $1.6 trillion, we will be there soon enough.

All current traders know your first loss is your best loss. Those who do not figure this out in time are, by definition, former traders.

Flight To The Printing Press

On February 23, 2009, the Federal Reserve and Treasury announced what amounted to a statement that no more major financial institutions would be allowed to fail; implicit in this statement was they would print the money to backstop the banks and, if necessary, to honor the Treasury's debt issued in the process. This arrested the increase in credit default swap costs on Treasuries. TIPS breakevens (plotted inversely), a flawed measure of inflationary expectations, lead ten-year CDS costs by 39 days on average.

Credit Default Risk And Expected Inflation

We can summarize the period before September 2, 2009 (green line) as, "a little inflation is welcome in the CDS market." However, the world changed in late August. The Federal Reserve had driven short-term interest rates down so low it was now possible to borrow dollars more cheaply than yen. The market feared, and rightly so, this manic monetary creation would lead to both inflation and a reckless spending spree in Washington. As a result, both credit default swaps on U.S. Treasuries and inflationary expectations have been rising since September 2009. We can summarize this period as "a lot of expected inflation is not welcome in the CDS market."

The pre- and post-September 2009 periods are different statistically with near-100% confidence. This was two and one-half months before the Dubai default threat and the beginnings of the sovereign debt problems of the weaker Eurozone economies.

The bond market vigilantes of yore have returned to the credit default swap market. They see governments worldwide as revving up the printing presses to pay off the nominal bad debts they acquired from the private sector. A debt paid via inflation is a debt repudiated. We are going to see this struggle between governments and their creditors play out in 2010 and maybe longer. It might not be very pretty.