

FEDERAL BUDGET DEFICITS are hardly the stuff of enlivening conversation over cocktails. Nonetheless, given the attention now focused on the subject and the emotional content of the labels being applied to the barrels of red ink (“unprecedented”, “destabilizing” and “massive”), it is clear that the economy has made substantial progress in the past year.

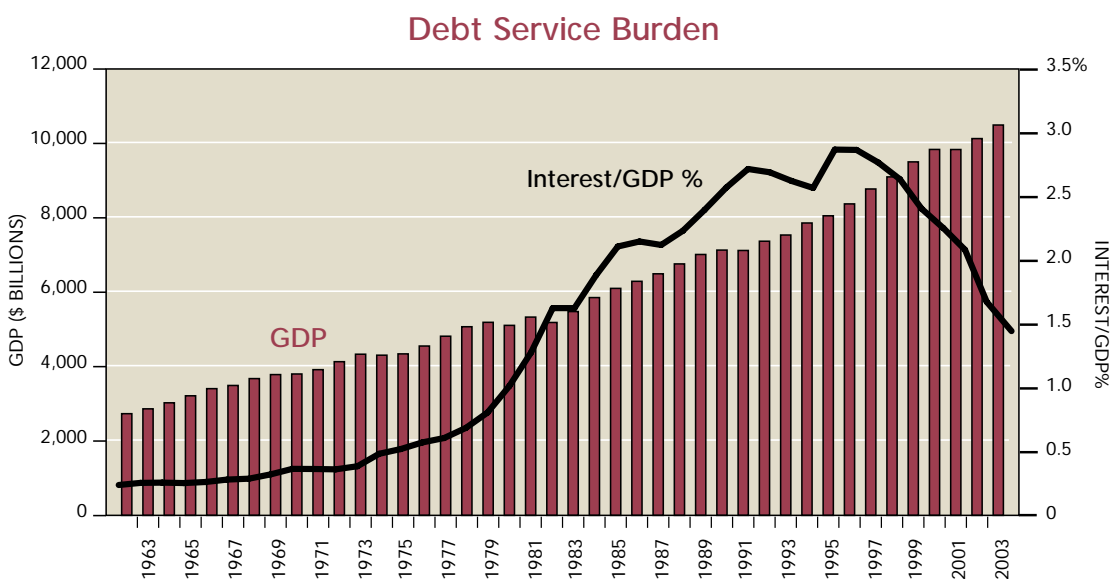
How so? Twelve months ago, conventional wisdom had it that the U.S. economy was in the grip of powerful deflationary forces. The Fed would therefore resort to unconventional tactics given the financial evisceration brought on by the worst stock market performance since the Depression. Hence, it is ironic that the very stimulus provided by these deficits (which has helped put the gloomy scenarios of 2002-03 in the rear view mirror) are now the subject of so much hand-wringing. Rosanne Rosannadanna said it best, “If it’s not one thing, it’s another.”

Perhaps we ought not to be surprised that the “deficit” is not only much maligned but also much misunderstood. Treasury finances are, after all, somewhat arcane as the government is the one entity which possesses its own printing press, allowing it to borrow seemingly without limit. Anyone ever hear of a check from the U.S. Treasury bouncing?

Granted, few investors actually view deficit spending either as some kind of free lunch or as some sort of moral outrage. Hence, the practical question becomes: are the deficits something we can live with – for now – until a truly self-sustaining private expansion takes over? In an effort to address this question, we thought we’d share some U.S. financial ratios:

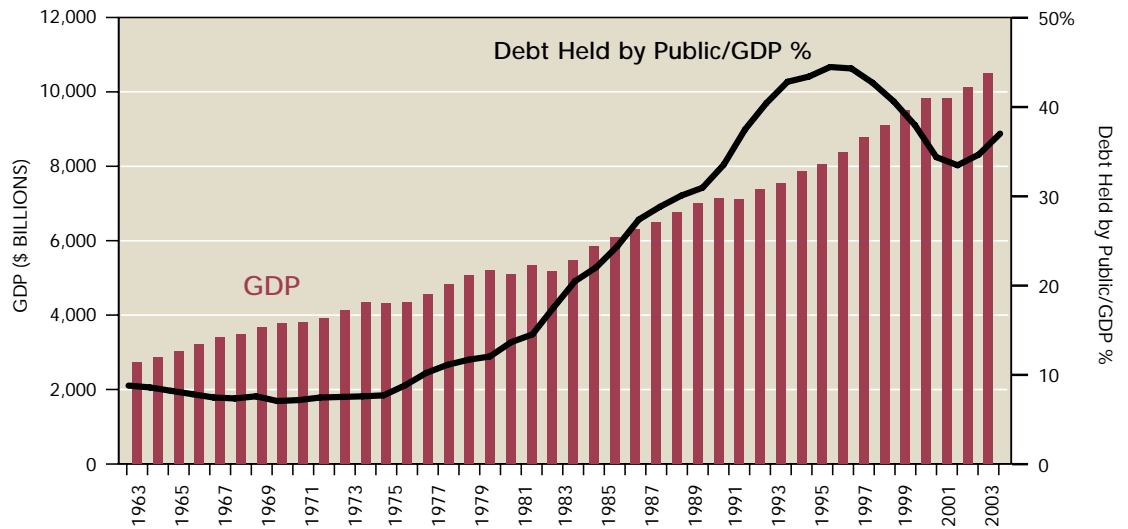
## The Best Recovery Money Can Buy

Tad Rivelle  
Chief Investment Officer



Source: Bureau of Economic Analysis, Congressional Budget Office

### Outstanding Public Debt/GDP

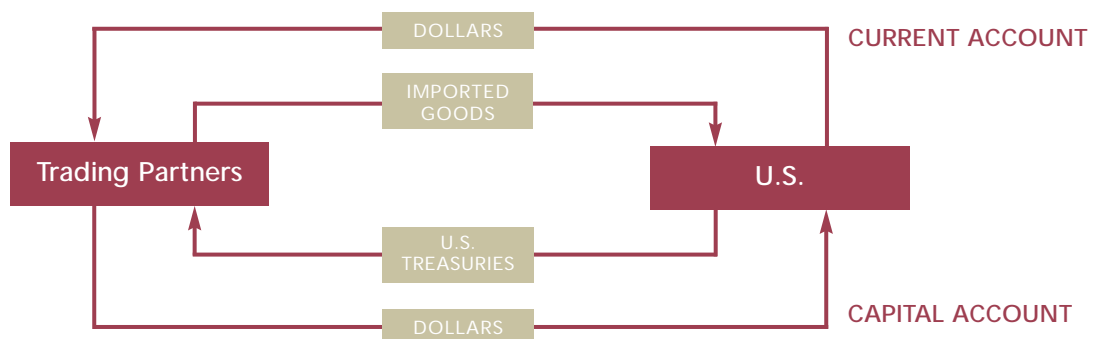


Source: Bureau of Economic Analysis, Congressional Budget Office

The charts seem to speak for themselves. Neither the debt service burden nor total debt in proportion to the GDP seem unduly high, at least not by the standards of the '80's or '90's. Further, the traditional critique that deficits “crowd out” private sector investment doesn't jive with capital market reality. Rates remain near 50-year lows, real yields are negative for Treasury maturities out to five years, and mortgage lending, corporate borrowings and overall credit market conditions are all favorable.

Amazingly, despite almost \$500 billion in issuance, the average cost of new government borrowings in 2003 was a penurious 2.36%. Thus, the deficit hawks would have us collectively turn down this essentially free (at least in real dollar terms) money, raise taxes on private sector labor and capital, cut government spending and throttle the recovery -- thereby paradoxically shrinking the tax base. (If this sounds familiar, it should. It was tried in the 1930's, under the auspices of the Hoover administration and is now known as the “Paradox of Thrift.”)

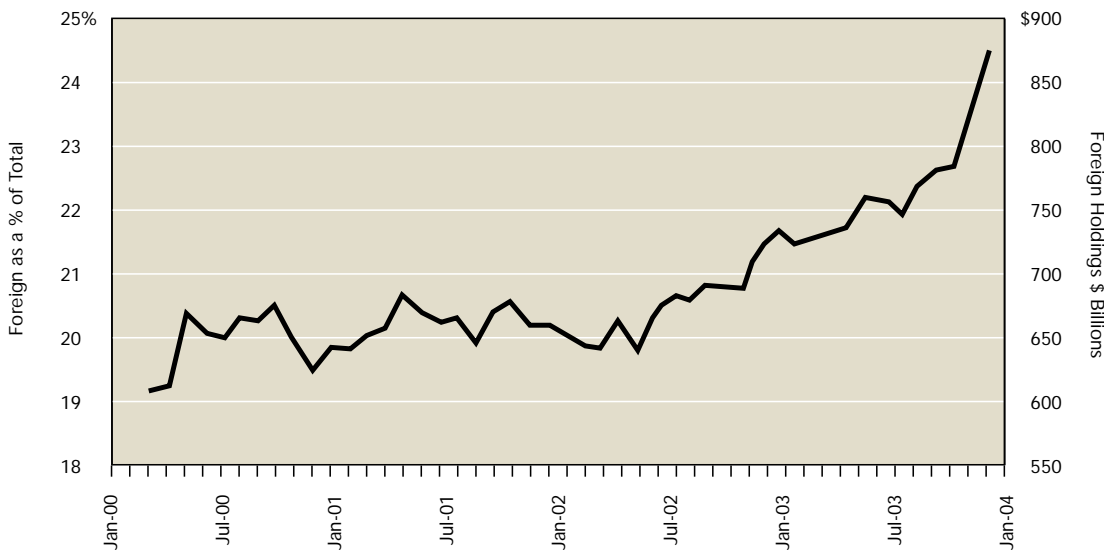
“Yes,” you say, “but this argument overlooks a critical fact.” Namely, not only is the borrowing proceeding with seeming abandon, but much of this borrowing is financed by foreign sources, placing our economic fortunes in hands we cannot control. Indeed, as our stimulative U.S. fiscal policy has helped lift us out of our doldrums, our country has fast become the world's ultimate import magnet. A simplified description of this state-of-affairs is shown herein:



In a dynamic familiar to market participants, Americans import far more than we sell abroad and hence our dollars get “shipped” overseas. These “excess” dollars are then sopped up in the currency operations of foreign central banks who wish to prevent a buildup of dollars on the foreign exchange markets from causing a further decline in the dollar exchange rate. As these dollar assets build on the balance sheets of the likes of the Bank of Japan and the Central Bank of China, they are then “recycled” back to the States in exchange for Treasury IOU’s. We buy their goods; they lend us the money. It’s vendor financing on a colossal scale.

So won’t our trading partners tire of this arrangement? Ultimately, yes. Meanwhile, the U.S. enjoys economic recovery, an expanding tax base, higher consumption, and low interest rates. For now, we get to have our cake and eat it too. Though there’s always some risk of a sudden, precipitous decline in the dollar, more likely we’ll see that economic recovery *here* will bring on economic recovery *over there*. Expansion abroad should enhance the value of foreign currencies, raise import prices and hence, reduce the flow of foreign goods to our shores as well as the overseas appetite for Treasuries.

Foreigners Have Been Active Buyers of U.S. Treasuries Since June 2002



Source: Federal Reserve Bank of New York, U.S. Treasury, CSFB

In effect, Treasury rates are being “artificially” held down due to vast and continuing purchases of Treasuries by foreign central banks (the Bank of Japan alone bought \$200 billion in 2003.) These Treasury purchases are a forced consequence of their currency operations rather than a statement surrounding the value inherent in 3% five-year T-notes. Hence, given that U.S. policy makers appear to have both the will and the means to keep the printing presses rolling until we get the desired economic result, the investor that maintains a big picture perspective recognizes that we are on course to see both continuing growth here and less appetite for Treasuries overseas.

U.S. Treasury Bond investor: Worry not for whom the deficit tolls; it tolls for thee. ■



TRADING SECRETS™ is published by METROPOLITAN WEST ASSET MANAGEMENT, LLC.

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