

## IS THE ERA OF BIG GOVERNMENT FINALLY OVER? WEB BUZZ 2010.12.06

After the election of 1994, President Clinton announced in his next State of the Union speech that, “The era of big government is over.” At that time we believed at last the overreach of government, which is so detrimental to the private sector, was finally over. How wrong can one be? After a few budget surpluses we returned right back to the good old tax and spend days that prevail yet today.

Will the election of 2010 be any different? We think it just might. The headlines reiterate each day the massive worldwide debt problems facing primarily Europe and the U.S. What has been done to help the problem has been only a “kicking the can down the road” policy that we believe will no longer work. Let’s face it - if we as a country had a CPA audit of our financial affairs, we would receive a [qualified opinion](#) or maybe even worse, a [going concern](#) question. And guess what? Europe and England would be worse than that. We believe the problem is so serious that it has finally reached the public’s attention. Another sign of what’s in store, reflecting the mood of the market, is the return of the bond vigilantes. They are beginning to sense the final stage of the break-up of the European economic union. The Euro seems doomed - thus interest rates are rising even in rock solid Germany. Europe so far is handling the situation just as we did two year ago - solving a debt problem with more debt. This, of course, cannot work and a complete reorganization is in their future, including bond losses and bank failures.

Now what about the United States? Over the last several years many have begun to question the solvency of this country. It’s been primarily the “gold bugs” who have been talking about this over our entire business career, but even mainstream market participants are now chiming in. Yes, we do have to come to grips with our excessive yearly deficits and accumulated deficit, and it

must start right now. The latest AP poll notes a preference for expense cuts to tax increases on a 2 to 1 basis. This is a good sign. We believe the problem has finally been recognized and this too is a good sign.

Where does this leave us concerning the long government bond and its current yield of 4.10%? Based on historical numbers, this bond should be selling at a yield of 2.70% (core inflation of 0.6% plus 2.1% for a future inflation premium). We think much of the difference ( $4.10\% - 2.70\% = 1.40\%$ ) is due to the gold bug fear of hyperinflation as well as some concern about our resolve to get our house in order. How much does this amount to in price? Today vs. historic - approximately 30%, not including the coupon. And you know what, 2.70% could be closer to 2.00% where deflation kicks in.