



ABOUT
BILL SULLIVAN

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

Prior to joining Morgan Stanley, he was affiliated with The Bank of New York, where he was a Senior Vice President in the Treasurer's Division.

Mr. Sullivan holds a Bachelor of Arts Degree in Economics from Fairfield University and an MBA in Investments from New York University.

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Weekly Commentary by Bill Sullivan, JVB Chief Economist

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Disappointing progress on debt reduction

Despite the steepest recession since the 1930's and a recovery process that at best can be described as tepid, the U.S. continues to add to its aggregate debt burden. Clearly, the pace of credit formation has slowed over the last year or so. However, Federal Government borrowing has more than offset any repayments by the household and business sectors over this period. The net result is that total debt outstanding for the nation reached an all time high as 2009 came to a close, a development that underscores the economy's vulnerability to any meaningful rise in interest rates that may occur in the future.

The latest data on overall borrowing were contained in the recently released Federal Reserve Board Flow-of-Funds Statistics for the fourth quarter of 2009. According to the report, total debt expanded at a 1.6% annual rate over the final three months of the calendar year, the smallest increase for this series in decades. While negligible in historical terms, the gain nonetheless pushed total debt outstanding to a record \$34.7 trillion or 2.4 times larger than nominal Gross Domestic Product for the same interval. One year ago, the ratio of debt to current dollar G.D.P. was just 2.34 to one. Effectively, the nation borrowed \$1.1 trillion over the latest twelve months to produce an increase in Gross Domestic Product of only \$114 billion. Viewed from a different perspective, in the last four quarters, ten dollars in borrowing generated only one dollar of economic expansion, a worrisome relationship by any past standard.

The implication of the overall data is quite apparent. Specifically, the country as a whole has made scant progress in reducing its reliance on debt usage. As an example, the current trend on household indebtedness appears mildly positive on the surface, with this group reducing outstanding borrowings for six consecutive quarters. However, the

actual decline over this eighteen month interval is marginal, registering only \$318 billion or just 2.3% since the peak level of borrowing was reached in the opening months of 2008. Needless to say, some of the reduction represents defaults on previously arranged loan contracts and is thus involuntary in nature. At \$13.536 trillion, household debt is still 1.23 times larger than disposable personal income and nearly twice the size of employee compensation.

Business firms continue to restructure their balance sheets and have achieved some modest reductions in outstanding borrowings. In particular, the business sector liquidated debt for the third consecutive quarter in the three months that ended December, 2009. Similar to the household group, the overall decline in debt levels was marginal, totaling only \$212 billion or 1.9% since the peak was established during the first quarter of 2009. The entire decline has been in short-term instruments, including commercial paper and bank loans. In contrast, corporate bond placements accelerated dramatically over this period as the capital market environment became much more receptive for such debt offerings. It appears that some of the proceeds of these corporate bond issues were designed to bolster liquidity positions for these firms. Over the last three quarters of 2009, for instance, balances in corporate checking accounts climbed by a hefty \$122 billion or by 18.4%. Holdings in time and savings deposits also rose by over \$100 billion during this nine month interval.

Offsetting the pullback in credit usage by the private sector of late has been the active borrowing of the Government segment. Clearly, the Federal Government, in an effort to provide a platform for an economic rebound, has substantially increased its pace of spending with the bulk of those outlays

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being financed via Treasury debt offerings. With the financial markets revealing signs of healing, borrowings that were related to bank support programs have trailed off, allowing for the overall pace of debt issuance to moderate in relative terms. During the fourth quarter, Federal Reserve data reflect an increase in Treasury borrowing of \$956 billion. While sizeable from an historical perspective, the pace of Federal borrowing was actually the smallest since the April-June period of 2008, and compared with a \$2.155 trillion annualized gain during the fourth quarter of that year. Notwithstanding the increasing anxiety directed towards the credit worthiness of various state and local governments, this sector continues to be an active borrower in the nation's capital markets, raising another \$109 billion in fresh funds during the fourth quarter. The state and local government sector, it should be noted, never redeemed any outstanding debt, despite the dramatic downturn in economic activity and at year's end had \$2.362 trillion in total borrowing, another record for this group.

Although the heavy reliance on debt to fashion a recovery process is understandable, the reality of this approach is that it places the economy at extreme risk should borrowing costs escalate. This consideration is quite evident for the Federal Government, but it applies to businesses and households as well as these sectors have failed to reduce their outstanding indebtedness in a meaningful way over the last few quarters. Especially vulnerable would be any borrowing arrangements that float against the money market rate structure such as Federal funds or Eurodollar deposits. Once the Federal Reserve decides to tighten monetary policy, short-term borrowings will quickly jump in total cost to reflect the ongoing shift in interest rate targets. In fact, the upward bias to short-term credit arrangements is already occurring without any adjustment in central bank policy. Specifically, three month Eurodollar rates have

edged up by about five basis points since early March. While not large per se, it would reflect the first increase in short-term borrowing costs in literally years. Obviously if the Fed were to tighten, the added expense would move higher much more quickly. Any increase in debt service expenses could reduce discretionary purchasing power for business firms and households. In addition, the Federal Government's unified budget deficit would expand more quickly, everything else being equal, as the Treasury rolls over its bill auctions at successively higher yields. Conceivably, the recognition that interest costs could rise sharply for most entities, private as well as public, may be acting as another restraint on the Federal Open Market Committee's willingness to tighten policy during 2010. ■

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