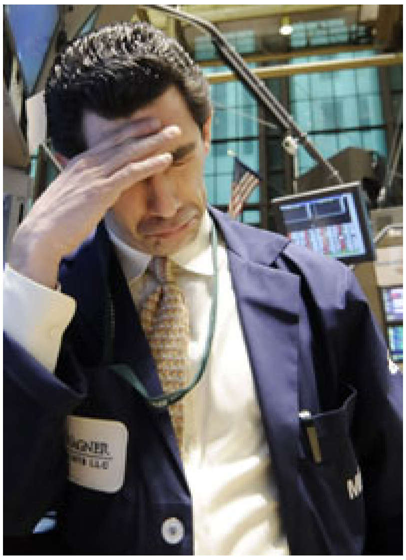
# Deficits vs. Stock Market Rally



The federal government will auction some $2.5 trillion in debt during fiscal 2009, and the enormity of the debt is only now becoming evident.

CNN Money reported that a stock market rally on March 10 curtailed bidding on Treasury securities. "The Treasury Department said it received healthy demand for the record $34 billion in 3-year notes it auctioned Tuesday," CNN reported. But it also added: "Treasury prices slumped Tuesday, as stocks rallied and investors responded to yet another large government debt auction."

Bloomberg.com has reported the same phenomena: prices for Treasury debt issuances sold well and cheaply during 2008. Increasing deficit spending culminating in passage of the TARP legislation left plenty of U.S. Treasury securities for shell-shocked stock market investors to buy and wait out the bear market. But just as investors are prepared to re-enter the stock market, they are discouraged from doing so by the higher yields the government must offer in order to sell off an ever larger supply of federal debt.

The federal government ran a $192.78 billion deficit for the month of February alone, raising investors' yields on Treasury securities across the board. Ten-year Treasury bonds have risen from just above 2 percent at the end of 2008 to 2.92 percent this week. Higher yields for investors is drawing them back into Treasury debt mechanisms and away from the more volatile stock market that has traditionally driven economic recoveries.

The deficit-spending lifestyle in Washington is already strangling the economic recovery before it can even get started.

Moreover, the current mother lode of federal debt issuances is also creating borrowing troubles for states and municipalities, which have been unable to borrow funds on the bond markets. Bloomberg.com reported March 10 that state and local taxpayers paid out some $211 million to bond dealers to auction off long-term debt securities that were either not sold, or bid at interest rates higher than municipalities were willing to pay (some at nearly 20 percent). The $211 million figure represents a significant amount of unsold bonds, as the average price fetched by bond dealers to put debt up for auction is only one-fourth of one percent of the bond's face value.

As federal debt continues apace throughout the year, the question remains: will the ocean of new federal debt keep investors out of the stock market and permanently prevent a recovery? Or will investors leave federal debt in the dust like they've left loads of municipal debt, and let the federal government go bankrupt?

The question is particularly relevant when one contrasts the different approaches to economic crisis that the federal government followed after massive recessions in 1921 and 1929.

In 1921, the U.S. government cut spending by more than 50 percent from 1920 and created a surplus that retired debt. And the recession lasted only a year, followed by a record economic boom.

In 1929, the U.S. government dramatically increased government spending and turned a surplus into a deficit for a decade. And the recession lasted more than a decade, eventually becoming labeled the "Great Depression."

Right now, the fiscally responsible approach of cutting spending and balancing the budget is not on the table as an option in Washington, D.C.

*Photo: AP Images*