Treasury Bonds: I learned something last week. I learned that fully 40% of the over $9 trillion in Treasury debt currently outstanding to the public has a maturity of 3 years or less. Put another way, it means that we are rapidly approaching $4 trillion in U.S. debt that matures by 2014 or sooner. As I write this, the yield (interest rate paid) on a 2-year Treasury note is 0.645% or about 2/3 of one percent. The yield, at the same time, on a 10 year Treasury note is 3.4%, and on a 30 year is 4.55%. In bond parlance, this is called a "steep yield curve" where interest rates get much higher as you go farther out in time.

It's pretty clear why the Treasury is doing this. By issuing mostly short-term notes, the Treasury is paying less interest, thereby keeping interest costs and, consequently, the deficit down. In addition, the Federal Reserve is in the middle of its "quantitative easing #2" (QE2) under which it is buying $600 billion of our own Treasury debt over about a 6 month period. The Fed is not buying the short-term notes, but is buying 10 year maturities and longer in order to hold those rates down. And, since the Fed is earning the interest thereon (paid by the U.S. Treasury), it is improving its yield. We are currently running a deficit of about $130 billion per month, so the Fed is basically buying all of the new bond issuance from the deficit for almost 5 months.

What does this all mean? I understand that the Fed and the Treasury are trying to keep interest rates low and improve the economy and the deficit. But, when coupled with the huge deficits, these moves look a bit like a Ponzi scheme that will soon unravel.

We are printing money ($600 billion) to buy our own debt so that the full effects of the deficit are not felt. We are buying long-term bonds to artificially hold down the rates on those bonds since home mortgages and many other things are based on those rates. We are selling the short-term bonds at cheaper rates to hold down costs now, but are leaving ourselves open to huge cost increases when interest rates go up. And, we are at historic lows on these short-term bond rates. If they were to rise by 3 points (which would put them where they were at as recently as 2008), our deficit would increase by another $150 billion per year, even if the long-term rates stay the same. And, once the Fed ends QE2, even if it doesn't reverse it, the markets will then have to absorb a new influx of long-term bonds at a time when our ability to pay them is in question. The Fed can cure a bunch of this simply by printing a lot more money. That, however, will result in an inflationary period with major wealth destruction and economic malaise.

In the period between 2005-2007, we were sowing the seeds of the 2008 financial crisis through too much leverage in the private sector. But, very few people could see it coming. Today, we are sowing the seeds of another crisis with too much leverage in the public sector. This time, though, it's easy to see it coming.