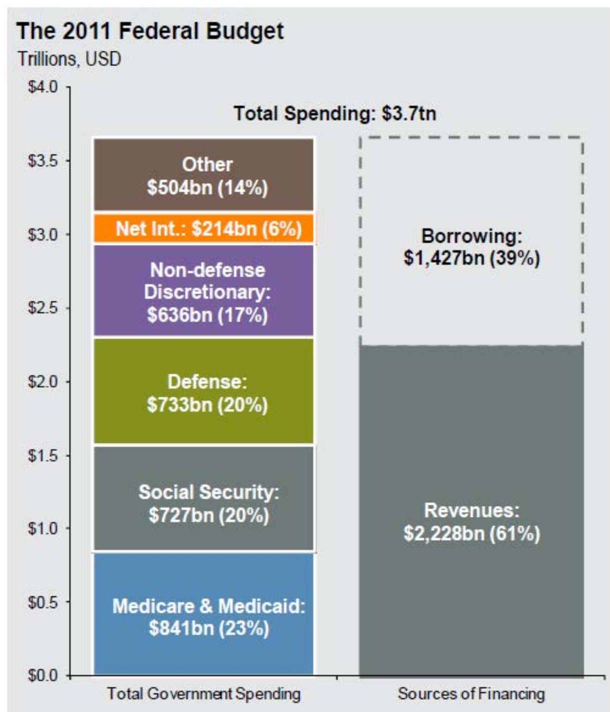
A View of the U.S. Debt Problem

July 2011

Over the past two years, the focus of economic discussions has shifted from general economic growth to debt problems around the world. In the aftermath of the 2008 financial crisis, the central question was whether businesses and individuals could regain the level of confidence required to begin investing and spending again – and when that confidence would become self-sustaining. More recently, the news is filled with concerns over sovereign debt levels and the risk such levels pose to the economy and financial markets. Although the U.S. debt problem is real and must be addressed, the current discussions over the debt ceiling are more of a sideshow. Hopefully, the debt ceiling side show does not remain on the main stage for much longer. Regardless, we believe the portfolio changes taken in May are still appropriate and that no further action is required.

Dr. David Kelly, Chief Market Strategist of J.P. Morgan summarized the problem succinctly, stating, "Many worry that we are drowning in a sea of government red ink that will eventually lead to a U.S. economic crisis. Some are worried that a too rapid attempt to fix the problem could lead to another recession. And while there is general agreement that something needs to be done about government deficits, there is an overall dread of the pain that fixing the problem will entail."



Source: JP Morgan

THE PROBLEM

The debt problem is clear. The expected budget deficit for 2011 is $1.4 trillion (revenues of $2.2 trillion and spending of $3.7 trillion). This shortfall represents approximately 9% of GDP (i.e. economic output). Although reducing the budget deficit is clearly important, if the U.S. were to suddenly balance the budget in 2012, it would represent an enormous reduction in the demand for goods and services and would likely trigger a significant recession. Reduced spending is needed, but the right mix of type, timing, and depth of cuts is a critical part of any approach. Although the debt ceiling is an interesting leverage point, it is not a meaningful issue when viewed with a long-term perspective.

More significant debt issues exist in many countries in the Euro-zone. These countries are grappling with the tradeoffs between austerity, taxes, and economic growth. The PIIGS nations (Portugal, Ireland, Italy, Greece and Spain) have significant debt loads when compared to the size of the respective economies. Due to the high debt levels in these countries, financial markets have internalized the increased risk of default and require a significantly higher borrowing rate as compensation for the extra risk. Despite the debt ceiling, talk of default, and projected increases in the debt to GDP ratio, the borrowing

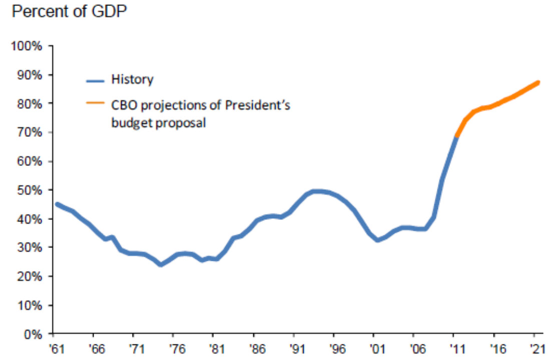
Country	% Debt to GDP	Borrowing Rate
Portugal	86%	11.8%
Ireland	95%	11.5%
Italy	101%	4.9%
Greece	152%	15.9%
Spain	53%	5.4%
U.S.	72%	3.2%

Source: JP Morgan

rate for the U.S. government still remains extremely low, partly because there are few good alternatives.

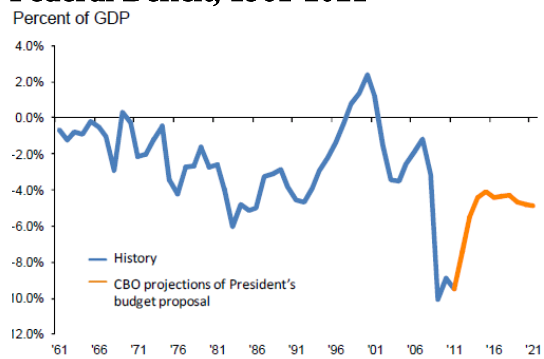
When viewed from a longer-term perspective, the U.S. debt level as a percentage of GPD (currently 72%) is increasing and expected to grow to potentially unsustainable levels (see charts to right). There is no "correct" ratio for debt to GDP. However, in a paper by Carmen Reinhart and Kenneth Rogoff, *Growth in a Time of Debt*, the amount of government debt accumulated can have an impact on future economic growth. Reinhart indicates, "Our main result is that whereas the link between growth and debt seems relatively weak at 'normal' debt levels, median growth rates for countries with public debt over 90 percent of GDP are roughly one percent lower than otherwise; average (mean) growth rates are several percent lower."

Federal Debt, 1961-2021



Sources: CBO, BEA, J.P. Morgan Asset Management

Federal Deficit, 1961-2021



Sources: CBO, BEA, J.P. Morgan Asset Management

Without action, the environment in Europe could be ours. However, too dramatic short-term changes could derail a nascent economic recovery.

POTENTIAL FOR RESOLUTION

There have been numerous, almost daily, proposals to address both the debt ceiling and longer-term problems, and the environment is quite dynamic. The debt ceiling does need to be increased; unfortunately, the polarized Congress has turned the issue into a political football.

The closer Congress pushes the August 2nd deadline, the less likely we are to have a long-term solution. In recent weeks, the most likely outcome seemed to be some combination of the 2010 deficit commission recommendations, which included some limited spending reductions and tax reform (e.g. limiting tax deductions such as mortgage interest while lowering taxes overall). As time passes, tax reform becomes less likely, and a short-term solution could entail an extension to the debt ceiling quantified in months instead of years.

Even if a short- or long-term solution is reached, the rating agencies may not view the actions as sufficient and could proceed with downgrading the AAA credit rating of the United States. In academic circles, the rate on U.S. treasury bonds is known as the "risk-free rate" due to the perception that the United States is the most creditworthy institution in the world. The impact of a downgrade is unknown, but any real or perceived change to the creditworthiness of the United States would be destabilizing to financial markets.

It would not be surprising to encounter significant market turbulence as any deal, short- or long-term, is vetted. As the deadline approaches, members of Congress will feel significant pressure from the spotlight on this issue. There are some similarities to the 2008 Emergency Economic Stabilization Act, which was not passed on the first try and resulted in significant market turmoil. It would also not be surprising for the Treasury Secretary to find some wiggle room in the deadline at the 11th hour.

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PORTFOLIO RECOMMENDATIONS

We still believe a deal will be reached, but it is increasingly likely to be short-term in nature. Looking at bond yields, the debt ceiling is not a great concern to bond investors. Since a U.S. default has never occurred, it is impossible to estimate the impact of even a temporary default; however, we would expect any turmoil to be short-lived, and timing a reduction in equities and a subsequent restoration of those reduced equities around such an event would be extremely difficult.

In terms of the economy, the bifurcated recovery continues. Headlines continue to capture the malaise about the economy – unemployment and housing continue with lackluster results while earnings are strong. Unemployment edged up in the latest report to 9.2% while home sales and prices remain soft. However, corporations are reporting record profits and continue to beat market expectations. For the second quarter earnings period, 135 companies have reported results, and 70% of those companies have surpassed earnings expectations.

One of the key concerns entering this earnings period was the potential for slowing economic growth. So far, that concern has not been realized; in fact, 83% of companies that have reported so far exceeded revenue expectations. This is positive news given that most analysts attributed past profit strength to cost reductions instead of revenue growth. As households and governments address debt burdens, we expect this bifurcated recovery to continue, and the pessimistic headlines are likely to continue for some time. Hopefully this commentary provides some context for evaluating the U.S. debt issue in the current environment.

We remind you that all investing includes the risk of loss of principal, and although we believe the current drama will be resolved, there is some risk in the short term. Also important is our current investment positioning. In May, we moved to a "neutral" position for clients, reducing the amount of stock market exposure; we also have been avoiding most treasury debt for quite some time. We continue to believe that, in most cases, the time to act is ahead of problems rather than in the middle of market turmoil. Although the situation is exasperating and it is logical to want to take action, it is our belief that more defensive positioning would hurt rather than help investment returns; however, if you would like to discuss potential options, please let us know.

Please call if you want to discuss this commentary, your portfolio, and any other questions or concerns that you might have. We are available at 734-769-7727.

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