

2009 SECOND QUARTER COMMENTARY



1802 Bayberry Court
Suite 400
Richmond, Virginia 23226

804.288.0404
800.787.7414
FAX 804.288.7872

www.lowebrockenbrough.com

Between a Rock and a Hard Place

Sound uncomfortable? It is. The severity of the current recession unleashed massive fiscal stimulus plans by our Government and other governments around the world. Our fiscal situation is deteriorating as the Government spends hundreds of billions of dollars on various programs – some of the funds have helped stabilize the economy, while some have disappeared into the abyss. The continued acceleration in spending and deceleration in revenues have caused an eruption of government borrowing. On May 14th President Obama said that the current level of deficit spending was “unsustainable”. Then, one week later, a flood of new programs were introduced for healthcare and other entitlements costing billions if not trillions of dollars, extending the current deficit to \$1.8 trillion or more for the next several years. Is the growing level of Federal debt a real problem or a “straw man” that is being mostly ignored by policy makers? If it is a problem, how can we contain the increasing level of debt relative to our capacity to fund it? Let’s take a step back, ignore the endless political rhetoric, stick to the facts, and see if articles by two well respected individuals in the field will help answer these questions.

A recent piece, “Staying Rich in the New Normal” by Bill Gross, the renowned Managing Director and co-Chief Investment Officer of PIMCO, states the current annual deficit level of \$1.5 trillion is now 10% of our Gross Domestic Product (GDP - the sum of all goods and services produced). This is the highest annual ratio we have seen since the 1930’s Depression. When the U. S. entered what he calls the current Great Recession, the ratio of Federal Government Debt to GDP stood at 45%, an attractive amount relative to other countries. But, with just 5 more years of deficits like the current amount, the ratio of Federal Government debt to GDP will be close to 100%. More disturbing is that this deficit level does not include the enormous looming Social Security and Medicare entitlement spending for the “baby boomers”. (On June 1st, subsequent to this piece being written, the Congressional Budget Office raised the annual deficit rate to \$1.8 trillion for this year, before any proposed new spending or stimulus programs are initiated if passed by Congress and signed into law.)

Mr. Gross contends that the 100% level for the Federal Government Debt/GDP Ratio is a “point of no return” as the interest on the debt would consume at least 5 to 6% of the economic growth and the interest would soon begin feeding on itself. He conservatively guesstimates that the added impact of current committed entitlements for Social Security, Medicare and Medicaid further increases debt ratios to levels normally seen in “banana republics” and other third world countries. Moreover, who will have the capacity or desire to buy that debt? And, how high will interest rates have to climb to make it attractive? The higher cost of financing may also stifle economic growth and increase the possibility of stimulating inflation. Mr. Gross’s recommendation is that we move rapidly to balance the budget once a recovery is in place. He also says we should not fall into the trap of believing that continuing to lower taxes is a cure-all. He states that lower taxes do “incentivize productive investment and entrepreneurial risk-taking”, but a certain level of taxes is necessary to stabilize the country’s financial condition and not just “pad the pockets of the rich.”

SECOND QUARTER 2009 MARKET COMMENTARY AND OUTLOOK

H. "Woody" Brock, PhD, president of Strategic Economic Decisions recently wrote a very insightful essay entitled "End Game Draws Nigh-The Future Evolution of the Debt-to-GDP Ratio". Dr. Brock first discusses studies that show over longer periods that governments using large amounts of debt to finance stimulus sharply increase the real rate of interest (rate above the levels of inflation) on their long term debt. The additional cost of debt offsets the positive GDP impact of the stimulus. Next, Dr. Brock focuses on the causes of the current recession and the rise in Federal debt. He projects total Federal debt to increase \$3 trillion by the end of next year, adding to the current \$10 trillion. He also uses the very straightforward analytical tool – Total Government Debt/GDP ratio - to measure the severity of debt levels. For the next 10 years, using current forecasts of program expenditures, ensuing tax collections and a 2% per annum real growth in GDP, the Debt/GDP ratio will stand close to 118%. Dr. Brock then goes on to say "this does not represent the disaster many observers assume." Over the years, the U.S. has endured very high Debt/GDP ratios during wars, disasters or other shocks. Historically in this country, peaks in debt have been followed by multi-year periods where the Debt/GDP ratio was reduced over time. The key is the response – stimulating higher real GDP growth and "vigorous fiscal discipline." Countries that did not take action to lower the ratio have experienced hyperinflation, stymied growth, outright default and a myriad of other critical problems. Federal officials must be made to understand the simple basic tenet of this relationship – over time the denominator (GDP) must grow faster than the numerator (Federal Government debt).

Stimulating the real growth rate of the economy should be at the forefront of policy, which will generate higher tax revenues and lower the need for and cost of Federal programs, thereby reducing annual deficits. Dr. Brock separates growth strategies into two primary areas – productivity growth and workforce growth. To stimulate productivity growth, he stresses that a very large part of the stimulus package should be infrastructure-related - spending that helps employment and productivity now and continues to help productivity in the future. His discussions on productivity emphasize innovation and venture capital, education (particularly for the very gifted), taxes that reward success and innovation, investment incentives, and "smart" regulation. Stronger workforce growth, he points out, is anchored by GDP growth, infrastructure spending, deregulation of labor markets, the lowering of taxes on labor, and the rationalization of demographic changes, i.e. the continuation in the work force of the "baby boomers."

Fiscal discipline is more straightforward - simply avoiding unnecessary spending while finding ways to mitigate the cost of existing necessary programs. Spending should be redirected to "investments" that build the basis to drive growth. Dr. Brock recommends that necessary counter-cyclical spending (i.e., extended unemployment or retraining programs) should be temporary in nature, mandated to expire on a specific date when better times return, without regard to a Congressional vote.

Mr. Gross and Dr. Brock both state that we are at a critical point in the relationship of the level of Debt/GDP, where we need leadership and governance that is straightforward, and alerts the nation to the ill effects of burgeoning debt ratios. Mr. Gross concludes that we need to move "to a more balanced budget once a sustained recovery is assured, but don't count on the former or the latter." Dr. Brock says that we need leadership in the White House and the Congress "to confront the problems lying ahead, and that is tone deaf to philosophical issues..."

Included among the possible investment ramifications of not taking the needed actions are slower long term real growth, inflation, higher interest rates, the "crowding out" effect, a steepening in the yield curve and higher risk premiums, which will lower equity returns. Historically, after shocks to our economic system, the built-in flexibility has allowed us to make changes, some painful at times, then recover and restore growth. We will continue to closely monitor future progress on these critical issues.

References:

"Staying Rich in the New Normal", by Bill Gross. This article was posted on Alliazinvestors.com, June 1, 2009.

"End Game Draws Nigh – The Future Evolution of the Debt-to-GDP Ratio", by Horace W. Brock, Ph.D. This article was posted on InvestorsInsight.com by John Mauldin, May 18, 2009.