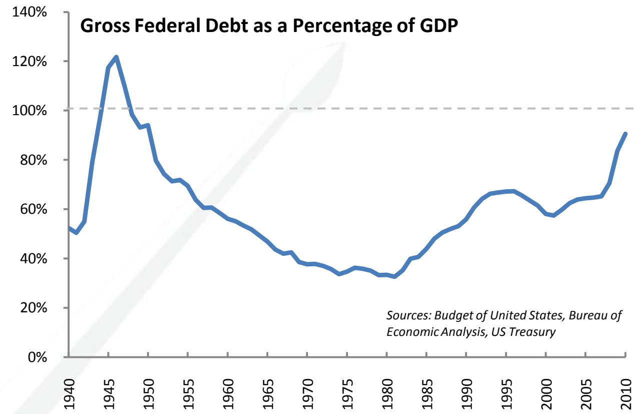
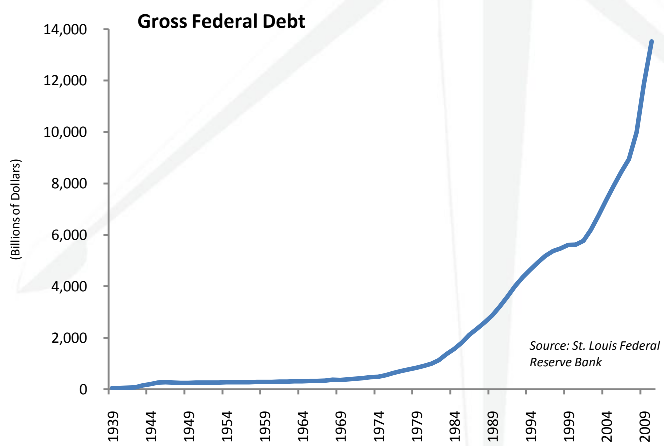
How Did We Incur So Much Debt

There's been a financial crisis…what happened, in essence, as far as I can work out is that because we were off the air so everyone got bored and banks started lending money they hadn't got to other banks that gave the nonexistent money to Mexicans in Southern California who couldn't pay it back. And, now as a result of that your cars are all worthless. – Jeremy Clarkson, Top Gear

It took the United States government nearly 200 years for the total federal debt to reach $4 trillion. It only took 13 years (from to 1992 to 2005) for our total federal debt to double from $4 trillion to $8 trillion. And, it only took six more years for our total federal debt to reach $14 trillion. The developed world is in the throes of a global debt crisis which we expect will have severe ramifications for our country and its citizens. As we discussed in the article Implications for the Credit Rating of the US Government, history shows that when a country rapidly incurs a massive level of debt, it takes a long time to reduce the debt burden. In addition, along with rising interest expense, this excessive level of debt also wreaks havoc on the economy, the capital markets, and ultimately the quality of life for its citizens. The current budget deficit is roughly $1.3 trillion and we estimate the adjusted total debt is roughly 91% of GDP. ***As a result, we are living the deterioration in the AAA credit quality of the United States.***



The growth in our federal debt was the result of easy money policies, ineffective regulatory oversight of the financial services industry, and poor decisions by legislators based on poor assumptions for revenue growth. This debt helped fund operations of the government, Social Security, Medicare and Medicaid, a war in Iraq, a war in Afghanistan, and many other federal programs which had the ultimate effect of increasing domestic consumption. During the financial crisis, the rapid acceleration in debt was used to help bailout the banking industry, a large insurance company and two auto companies. Federal debt ballooned further during the financial crisis as the government stepped in to absorb excess leverage and provide liquidity to the capital markets.



Congress has been slow and ineffective at addressing the growing debt crisis. Thus, investors should expect that our elected officials will *not* be effective in reducing expenses to a meaningful level. Since last year when Paul Ryan (Wisconsin) introduced his Road to Freedom Plan, our elected leaders have been slow to address the growing debt crisis. President Obama initiated a bi-partisan Deficit Commission in 2010, and then submitted his 2011 proposed budget to Congress which received zero votes and did not include any meaningful recommendations from the Deficit Commission report. Ultimately, the economic hardship that will be felt by potentially reducing expenses including unemployment benefits, Social Security, Medicare and Medicaid, and welfare programs will be unpopular in the least and have a detrimental impact on consumption within the economy as households are forced to further reduce debt.

The conundrum we now face is that in order to reduce the deficit, we have to cut spending and raise government revenue. It's not one or the other, it's both. However, raising government revenue requires increasing tax revenues, and cutting expenses implies lower consumption either of which will have the effect of reducing economic growth. Given the outrageous size of the debt and the extraordinary level of government spending that currently support entitlement programs, there is simply no way to address the problem without negatively impacting future economic growth.

The Budget Control Act of 2011 - The Implications for Investors

The U.S. dollar is the reserve currency for the world and US Treasury securities are considered one of the most liquid and safest investments for investors including foreign central banks, sovereign wealth funds, global banks, corporations and individuals. In part, this is due to having an economy that is the largest and most diversified of any country, securities laws that require transparency and historically a sound and safe financial system. However, we believe the deterioration in the credit fundamentals of the United States will ultimately lead to the deterioration in the credit rating of the United States from AAA to AA+.

The Budget Control Act of 2011 passed the House and is expected to pass the Senate today. The bill reduces government expenses an estimates $2.1 trillion over the next ten years, *and does not address tax reform or any expenses related to entitlement programs.* While this initiative may count as a "down payment" for further debt reduction, this Congress appears entrenched in partisan beliefs and any meaningful progress will have to wait until after the 2012 elections. ***We believe the potential downgrade of the credit rating of the United States is still a major concern for investors.***

While we are navigating uncharted territory with our current fiscal and monetary policies, we believe interest rates clearly do not reflect the risk inherent in the market. On the one hand, we are clearly experiencing deterioration in the underlying fundamental credit of the United States and, at the same time, interest rates are trading near historic low levels. Further, the rate of inflation has inched up over 2.5% which currently provides investors in short term US Treasury notes with a negative real rate of return. Investors are not being compensated for the deterioration in credit quality with higher interest rates.

The deterioration in the credit quality of the United States is first and foremost a *credit* issue. The primary players in the credit markets are the global banks where US Treasury securities are used as collateral for all types of global securities transactions including credit derivatives, certain swap agreements and repurchase agreements. To the extent that any bank around the world requires a counterparty to post a higher level of collateral against a US Treasury position, we expect to see a marginal tightening of credit. As a result, we would expect over time to see higher interest rates which would further impair the expansion of credit, business development and economic growth. In addition, interest rates on emerging markets will likely converge with developed countries as investors seek diversification away from US Treasuries.

While we expect corporate earnings will continue to show strength, the structural problems in the economy will limit the incentive for business investment and employment growth. Until there is clarity to corporate tax policy, regulation and the solution to the global debt problem, management will focus on stock buy backs, dividends and their own compensation. Stocks may look cheap on an historical basis; however, when you factor in the uncertainty of tax reform and the impact on the debt overhang, we are not expecting significant appreciation in equity prices.