November 2012 | Vol. 2 No. 11 | Wealth Management Update

In Debt We Trust?

By Louis E. Conrad II, CFA

- With the election over, the "fiscal cliff" is getting quite a bit of attention now.
- As we wrote in the June issue of The COMPASS Chronicle (see the library page of our web site), the "fiscal cliff" is a combination of federal tax increases and spending cuts scheduled to take effect on January 1 unless new legislation is passed.
- The article to the right addresses how we reached our current financial predicament.

Our federal government is drowning in debt. The numbers are astounding and growing larger every day. The U.S. national debt, which totals over $16 trillion, amounts to over $51,500 for every man, woman, and child in the U.S. or more than $141,000 for each taxpayer. Though politicians prefer to ignore the debt problem, the longer they wait to address the issue, the harsher the fix will be.

Budget Deficits

Our national debt is the cumulative effect of incurring annual budget deficits; that is, when federal government spending exceeds federal tax revenue. The federal government has incurred annual budget deficits nearly every year for decades. In only four fiscal years out of the last 40, from 1998 through 2001, has the federal government run a surplus.

Deficit Spending

According to the Congressional Budget Office's (CBO's) baseline forecast for just-ended fiscal 2012, the federal government was expected to spend $3.563 trillion, but only receive $2.435 trillion in tax revenues, leaving a staggering $1.128 trillion deficit for fiscal 2012 alone. In other words, the federal government was projected to borrow $0.32 for every dollar it spent. Consider this analogy: you spend $100,000 per year, but only earn $68,000. To support your spending level, you borrow $32,000 on your credit card. You are effectively borrowing from your future consumption to live more extravagantly today.

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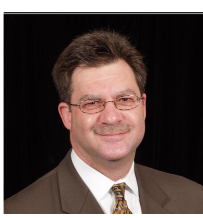
Advisor Corner



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In Debt We Trust? continued

Though the federal government has had a history of spending more each year than it receives in revenue, the past few years have seen a dramatic increase in federal outlays and a dramatic decrease in federal receipts. For the past 52 fiscal years, the federal government's spending has averaged 20.5% of our gross domestic product (GDP), while revenues have averaged 17.9% of GDP. In fiscal 2012, the gap widened with spending spiking to 24.3% of GDP, while revenues declined to 15.8% of GDP, based on CBO forecasts, resulting in the more than $1 trillion deficit for fiscal 2012 cited above.

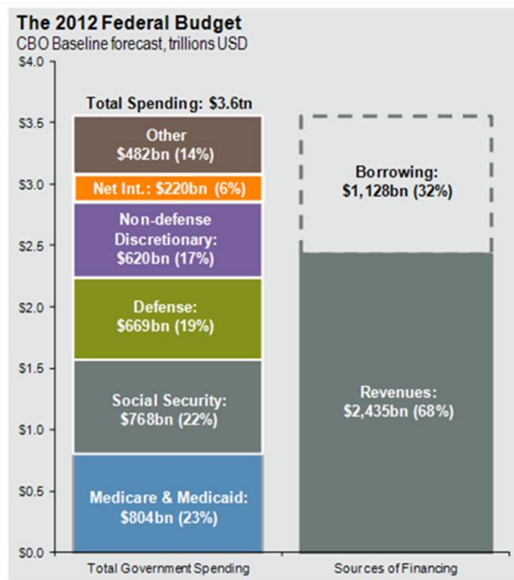
Debt Financing

This deficit, and the ones that came before it, are financed by the issuance of U.S. Treasury securities. The largest holder of such securities is actually the Federal Reserve and intragovernmental holdings, such as the Social Security and Medicare trust funds, with over $6 trillion or roughly 40% of total Treasury debt outstanding. Outside of the U.S. government, China is the largest holder of U.S. debt with $1.2 trillion or 7% of the total, followed closely by Japan with $1.1 trillion.

Tax Increases or Spending Cuts?

While politicians may bicker about whether tax increases or spending cuts are needed, the reality is that both will be required. In the future you will pay more for reduced services and programs from the federal government. Many taxpayers believe that since they paid taxes to support various federal government programs, especially Social Security and Medicare, that they are entitled to the benefits those programs now offer. However, the taxes paid to support Social Security and Medicare have fallen short of the actual cost of these programs. For example, according to the Social Security and Medicare Boards of Trustees, "Both Medicare and Social Security cannot sustain projected long-run program costs under currently scheduled financing, and legislative modifications are necessary to avoid disruptive consequences for beneficiaries and taxpayers." The trustees indicate in their 2012 annual report that expenditures will exceed revenue for both Social Security and Medicare Part A for each year over its 75-year projection period unless meaningful adjustments are made.

Though much has been made of the European debt crisis, the seeds of our own debt crisis are being sown. In fact, in just the time it took you to read this article, the U.S. national debt grew an estimated $4 million.



Source: U.S. Treasury, BEA, CBO, J.P. Morgan Asset Management.
2012 Federal Budget is based on the CBO's August 2012 Baseline Scenario.
Data are as of 9/30/12.

Monthly Market Commentary

Markets in October and early November were mostly distracted from the positive economic news in the U.S. by poor earnings reports, election jitters, and Hurricane Sandy. The earnings reports have not been pretty, with negative news from slowing emerging markets, a weak Europe (and, to a lesser degree, China), and large currency swings. Although the U.S. won't remain immune to the rest of the world forever, and our fiscal situation remains in disarray, there still are a few factors that will help the domestic economy. These include Boeing's ongoing ramp-up, a nicely improved and stable auto industry, increased oil production, a relatively stabilized banking industry, and a lumbering housing industry that has finally begun to recover.

GDP: Third-quarter real GDP grew by 2%, ahead of the second quarter's 1.3% rate. Much of this improvement was due to a very strong consumer, an improved housing market, and strong government spending. Consumption, which represents about 70% of GDP, is always the most important factor, because if consumers continue to spend, businesses will have to invest in plant and equipment, inventory, and most importantly, employees.

Employment: In October, 171,000 jobs were added, sharply exceeding expectations. While this was great news, Morningstar economists believe that at the current pace of job growth, an additional 23 months is still required to recover pre-recession jobs. Employment recovery across sectors has not been consistent. The overall service sector is nearly back to pre-recession levels, while good-producing sectors (mining, manufacturing, and construction) have only recovered 15% of the jobs lost. Furthermore, massive efficiency gains in manufacturing have moved industrial production levels to near pre-recession levels, even as manufacturing has regained a measly 25% or less of the jobs lost. The unemployment rate inched upward to 7.9%.

Housing: Despite the arrival of fall, which typically brings a drop in real estate activities, home prices, new home sales, and pending home sales all showed improvement. On a year-over-year basis, the August Federal Housing Finance Agency (FHFA) Home Price Index was up 4.6%, with all nine regions in the U.S. showing positive growth. While almost always moving in the same direction, pending sales (contract executed but not closed) have exceeded closed sales by a large margin for many months, as below-market appraisals and mortgage denials caused many contracts to not close. Recently, the gap between growth in pending and closing sales has narrowed to about 2% from as much as 6%, which Morningstar economists believe points toward an improving housing market.

Manufacturing: October's manufacturing data showed gains in new orders and an increase in employment, which suggested that the manufacturing sector in the U.S. may have bottomed and is now recovering. Auto sales in October were better than a year ago, but slumped from 14.9 million units in September to 14.2 million units in October. Hurricane Sandy was most likely the cause of this shortfall, as a large portion of auto sales occur on the last few days of the month, and the area hit by the storm accounted for 20%-25% of all auto sales. Outside of the U.S., China showed meaningful improvement between September and October as the Chinese construction market continued to show signs of bottoming. Europe's manufacturing, on the other hand, continued to contract and is currently at its lowest level in 40 months.

Election results: With President Barack Obama narrowly beating out Republican challenger Mitt Romney to win a second term in office, all attention has now turned to global woes and the looming fiscal cliff. If nothing is resolved by the end of 2012, massive spending cuts and across-the-board tax increases may occur. Markets reacted negatively on Wednesday November 7th, falling by as much as 2.73%, with energy and banking sectors among the hardest hit.

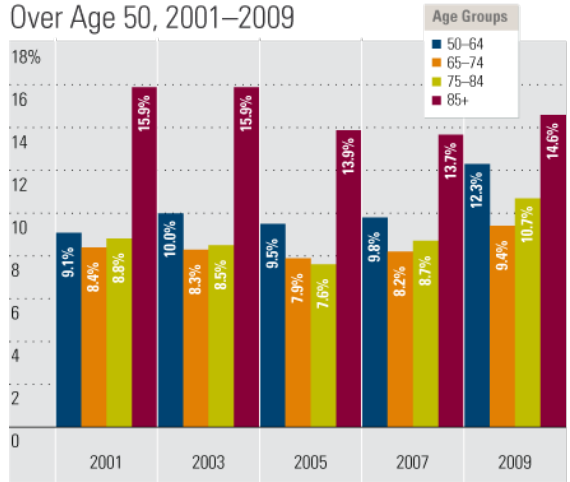
Poverty Trends in Retirement

- Poverty rates among the retired rise meaningfully for those who are at least 85 years of age.
- The elevated poverty level is the result of outliving their assets due to longevity, as well as increased health care costs in later years.

Retirement for most Americans nowadays is a far cry from the legendary "golden years." Relying on Social Security alone will simply not cut it anymore, and even people who have worked and saved diligently all their lives are worried their nest egg may not be enough. The worst-faring population group, however, may be retirees who live below the poverty line.

A recent study from the EBRI* examined poverty trends among Americans aged 50 or older from 2001 to 2009. Poverty rates are highest for those aged 85 and above, since by that time most personal savings tend to deplete. Another factor that may be at work behind these numbers is the increasing level of medical expenditures as we age. Those in poverty are almost 45–55 percent more likely to suffer from various health conditions as compared with those who are not classified as poor.

Poverty Rates for Different Age Groups Over Age 50, 2001–2009



*Report cited: "Time Trends in Poverty for Older Americans Between 2001–2009," Employee Benefit Research Institute Notes, Vol. 33, No. 4, April 2012.

This study uses the poverty threshold levels from the U.S. Census Bureau to determine poverty status. The Census Bureau uses a set of money income thresholds that vary by family size and composition to determine who is in poverty. If a family's total income is less than the family's threshold, then that family and every individual in it is considered in poverty.

2012
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