



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

GOTO: bfsinvest.com.

July 2011

2011 U.S. Federal Budget Deficit of \$1.6 Trillion: An Existential Crisis

We believe there is a material risk that U.S. policymakers might not reach an agreement on how to address medium- and long-term budgetary challenges by 2013; if an agreement is not reached and meaningful implementation is not begun by then, this would in our view render the U.S. fiscal profile meaningfully weaker than that of peer 'AAA' sovereigns.

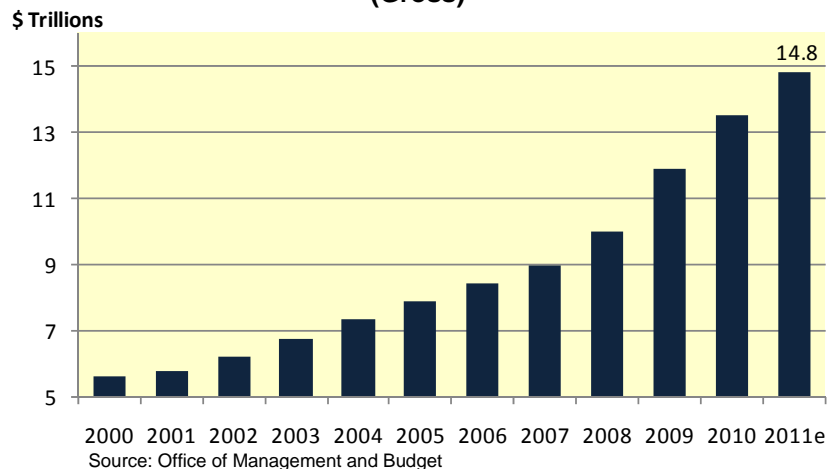
Standard & Poor's, April, 2011

A bankrupt, faithless republic would be a novelty in the political world, and appear among reputable nations like a common prostitute among chaste and respectable matrons.

Robert Morris, Signer of Declaration of Independence and
U.S. Constitution, Financier of American Revolution, 1779

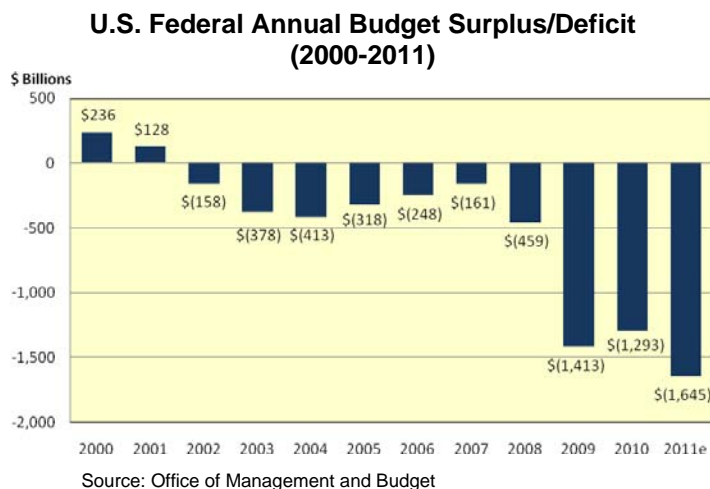
Over the past several years, the U.S. Federal Debt has been increasing at an average rate of almost \$125 billion per month! A whopping \$4 billion a day! In June, 2011, the U.S. Federal Debt reached the astonishing total of \$14.46 trillion – a number so large that it is difficult to comprehend. Since President Obama entered the White House 2½ years ago, the U.S. Federal Debt has increased almost \$4 trillion. In April, 2011, Standard & Poor's changed its outlook on U.S. Federal Debt, which has always been rated AAA since Standard & Poor's was founded in the 19th century, from a “stable” to a “negative” outlook. The chart below shows the growth of U.S. Federal Debt over the past decade:

**U.S. Federal Debt (2000-2011)
(Gross)**



As can be seen above, the U.S. Federal Debt in 2000 was just above \$5 trillion. By the end of 2011, the Federal Debt will have tripled to exceed \$15 trillion (including intra-governmental debt owned by the Social Security “trust fund” of approximately \$4.6 trillion). How has this happened? The narrative begins in 1999, when the U.S. government achieved budget surpluses each year from 1999 through 2001. During

Federal Reserve Chairman Alan Greenspan’s testimony to the Senate Budget Committee in January, 2001, he laid out some reasons why the U.S. government’s annual budget, which had not seen a surplus since the 1950s, went from a deficit to surplus: excellent real GDP growth; lower defense spending; accelerated productivity growth; and finally, the surge in asset values in the 1990s caused by the powerful bull market in stocks and the Internet bubble. Chairman Greenspan, however, ended his testimony on a cautious note: “With today’s euphoria surrounding the surpluses, it is not difficult to imagine the hard-earned fiscal restraint developed in recent years rapidly dissipating. We need to resist those policies that could readily resurrect the deficits of the past and the fiscal imbalances that followed in their wake.” He was prescient. The chart below chronicles a profligacy never before witnessed in U.S. history:

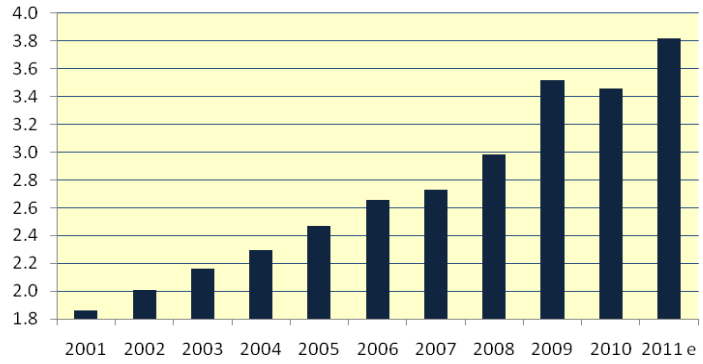


As seen above, the 2000-2001 surpluses turned into deficits, which ranged from 1%-3% of GDP each year from 2002-2008. The main causes for these deficits pre-2009 were the 2000-2001 recession, the fierce 2000-2002 bear market (which saw the NASDAQ plunge 78% from peak to trough), and 9/11 and the “War on Terror” response in Afghanistan and Iraq. (The deficits were exacerbated by the fact that President Bush did not exercise a single veto during the first 4 years of his presidency. It has often been necessary in recent decades for presidents to use their power of veto to rein in Congressional pork, and this did not happen from 2001-2005). In 2008-2009, Federal spending really ramped up, as the full force of the 2008 financial crisis and accompanying recession took center stage. This acceleration in spending was largely due to the “bail out” of the financial system, the large increases in social programs intended to cushion the impact of the recession, and the economic stimulus policies enacted by the White House and Democratic-controlled Congress to accelerate GDP growth. Annual Federal spending has increased from \$2.7 trillion in 2007 to a projected \$3.8 trillion in fiscal 2011:

U.S. Government Expenditures

(2001-2011)

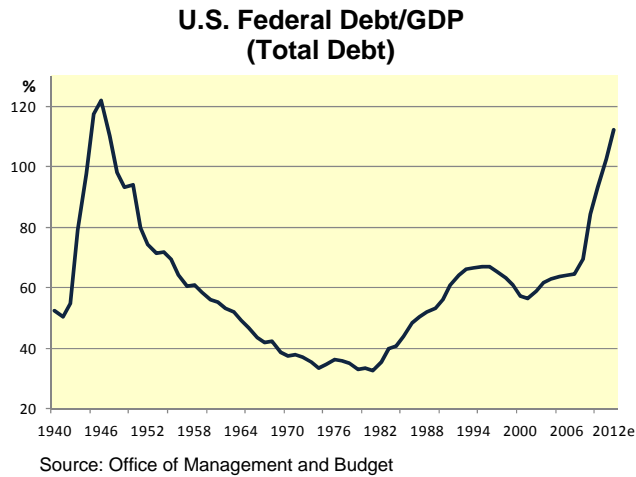
\$ Trillions



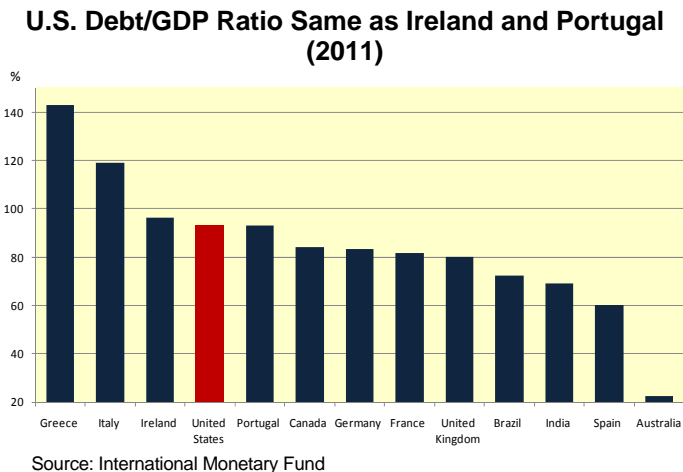
Source: Office of Management and Budget

Precarious U.S. Financial Situation

The financial situation of the United States has rarely been so worrisome. The two periods in U.S. history which are comparable resulted from major cataclysmic wars – the War of Independence and World War II. The creditworthiness of the U.S. government was sorely tested by the War of Independence, when U.S. government bonds became nearly worthless until Treasury Secretary Hamilton’s plan for funding the U.S. Debt was enacted in 1790. The other instance was at the end of World War II when the Debt/GDP ratio rose to 120%. Currently, the Debt/GDP ratio is nearly 100%. This time, the U.S. government’s precarious financial situation is due primarily to the recent large increase in spending, which has not had its intended effect of lowering unemployment or accelerating GDP growth. The chart below tells the story:



At this juncture, it will unfortunately be impossible for the U.S. to cause a similar rapid decline in the Debt/GDP ratio as that which followed World War II. At that time, total U.S. Federal Debt was roughly \$300 billion, and there was enormous pent-up consumer demand (both in the U.S. and abroad) following the Great Depression and World War II. Annual GDP growth of 5% and higher was not uncommon in the 1950s and first half of the 1960s, so the denominator in the equation (GDP) rose much faster than the Debt. Also, the Eisenhower administration kept a tight rein on spending and turned in several years of budget surpluses. Now, with U.S. Federal Debt of \$14.5 trillion and U.S. Debt/GDP close to 100%, it will be very difficult for the U.S. to achieve even a 2.5% average annual GDP growth rate. This was the conclusion that Professors Carmen Reinhart and Kenneth Rogoff reached in their important study, which we wrote about in our October 2010 quarterly investment commentary (see BFS website for more details of this study). U.S. Debt/GDP ratio is in the same range as several of the troubled European nations:



The Current State of Play

To right the U.S. financial ship of state, the first task is to analyze the current economic situation accurately. Many believe that Carmen and Vincent Reinhart have the most cogent analysis in their book, *This Time is Different*. In this book, they examined 15 severe post-World War II financial crises in advanced and emerging economies and three synchronous global contractions – the 1929 stock market crash, the 1973 oil shock, and the 2007 U.S. subprime collapse. If the U.S. follows the historic pattern (and so far it has), ***the deleveraging process and the weak housing market will weaken GDP growth and employment for 7 years or more.*** As the crisis commenced in early 2008, the U.S. is now roughly halfway through the biblical 7 lean years in Egypt described in Genesis. According to the Reinharts, U.S. GDP growth will be lowered by 1% or more during this period, and median housing prices will take up to a decade to recover. This is exactly what is happening in the U.S. with a weak economic recovery and a continuing modest decline in housing prices. It is also likely that the U.S. median unemployment rate will be as much as 5 points higher than historic levels since the Depression, i.e. 9%-10% U.S. unemployment for 7 years or more. In other words, this means that ***the U.S. economy may be struggling until 2015*** or longer. It also means that time is needed to allow the economic wounds to heal. In the midst of the current debt ceiling negotiations, it has become clear that the fiscal stimulus programs of 2009-2011 have had very little effect on U.S. economic wounds but have rather put the life of the patient at risk by increasing U.S. Federal Debt to worrisome levels. Taking the medical metaphor one step further, the key principle of the Hippocratic oath is: “Do no harm!” U.S. policies must be designed, therefore, to concentrate on two vital goals: growing the economy and reducing the budget deficit.

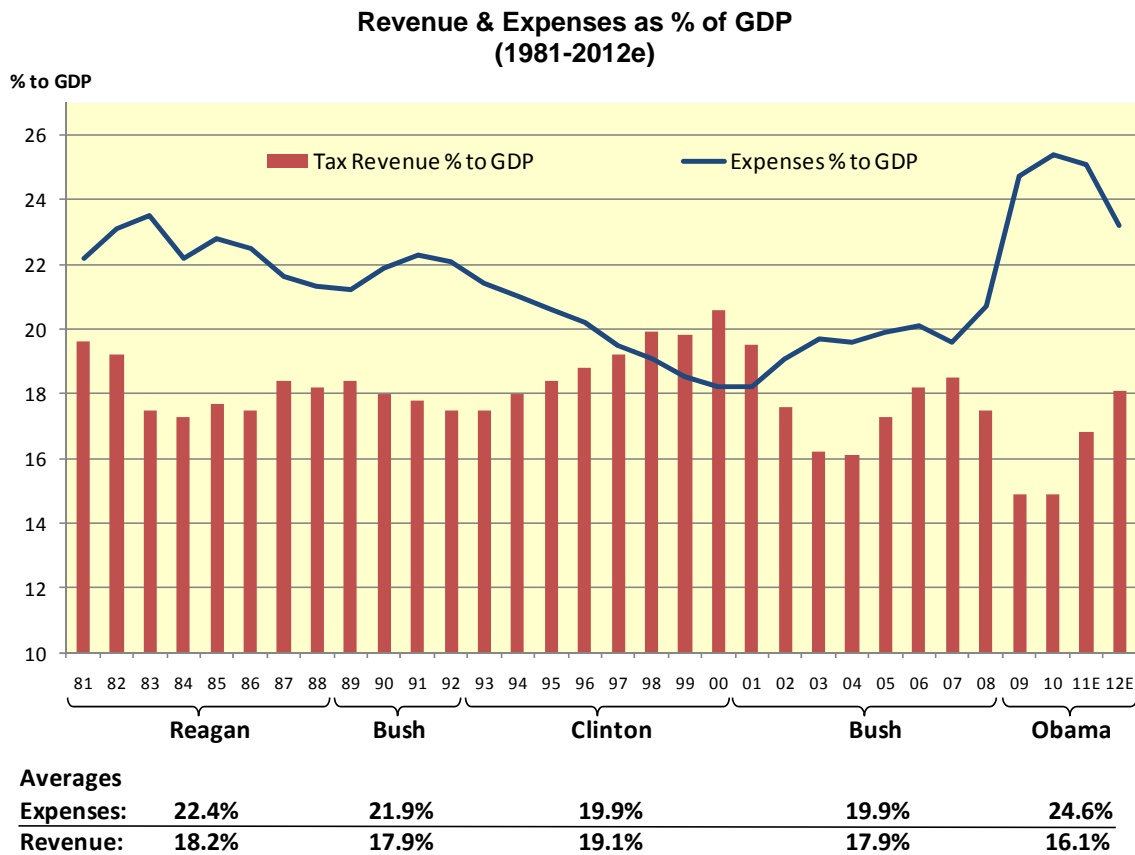
What Must Be Done

Accordingly, decisive and immediate steps must be taken to reverse the U.S.’s precarious financial situation by accelerating growth and reducing expenditures. Recent research by professors Alberto Alesina and Silvia Ardagna of Harvard University showed that successful efforts to balance the budget relied overwhelmingly on reduced government expenditures – not “balanced” programs of raising taxes and fees as well as cutting expenditures. Professors Alesina and Ardagna analyzed fiscal consolidations in 21 countries over 37 years, and the results of their research showed that the majority of the steps to balance the budget successfully were made through expenditure cuts (social transfer payments) and reduction of government salaries (reduction of personnel and salaries). Reducing entitlements and government pay was found to be vital because it spurs people to work and save more. These are the very steps that the more economically prosperous and successful U.S. states have been undertaking recently; most of the economically developed countries in Europe have launched these “austerity” programs over the past year. Similarly, U.S. government annual expenditures must be reduced to the 2007-2008 level of \$2.7-\$3 trillion. To achieve this, the White House and Congress need to enact some or all of the following steps before the creditworthiness of the U.S. becomes severely damaged and other nations jettison the U.S. dollar as the primary reserve currency:

- Cut government expenditures now rather than planning to make budget cuts in 2015-2020, which in all likelihood will never take place.
- Lower U.S. corporate tax rate to 25% or less (U.S. now has the second highest corporate tax rate among developed nations) and remove all corporate loopholes.
- Reform individual tax rates so that all income earners pay some income tax (everyone should have some skin in the game).
- Let Bush income tax rates expire in 2013 to accomplish above.

- Reduce unemployment benefits from 99 weeks to 52 weeks to create greater incentive for unemployed to get back to work sooner.
- Adopt, on a Federal level, the tort reform which several states have enacted, thereby reducing the practice of defensive medicine which would save Medicare and Medicaid hundreds of billions of dollars annually.

It is imperative to bring about a faster growing U.S. economy (only faster growth will increase government revenues and lower unemployment) and to reduce government expenditures dramatically so that the annual U.S. budget deficit returns to its pre-2009 level of 3% or less of GDP (\$450 billion). The chart below shows the U.S. Government revenues and expenses as a percentage of GDP over the last three decades. It is vital for the nation's health, and that of its citizens, to reduce spending to 20% or less of GDP and to grow revenues to 18% or more according to the historic pattern:



Source: Office of Management and Budget; 2011 Budget

Investor Game Plan vis-à-vis Washington Politics

The debt ceiling talks underway in Washington will hopefully end in a compromise which will address some of these key steps. However, there is a possibility that an agreement will not be reached by the August 2nd deadline. Another clear possibility is that a bargain will be struck that does not really address the critical issues and that the can will simply be kicked down the road. At Bradley, Foster & Sargent, Inc., our guess is that the current debt ceiling talks are only the first few innings of the debate and that these great issues will be played out in the 2012 election. How should investors position their portfolios during this extended period of uncertainty?

The stock market usually looks forward three months or so, and, true to form, most investors do not appear to be focusing on the possibility of a downgrade of U.S. debt at the end of 2012 or the long term weakening of U.S. creditworthiness. On the question of the success or failure of the debt ceiling talks currently underway, investors seem to assume that either a bargain will be struck in the next two weeks, or if no compromise is reached by August 2nd, that the U.S. Treasury will find a way to service the debt until a successful conclusion of the talks is reached. The stock market also seems to be unconcerned about a possible train wreck because the U.S. does have two advantages that most other nations do not have: 1) U.S. citizens have a net worth of almost \$60 trillion and therefore, the U.S. has the capacity (unlike many countries in Euro-land), if not yet the willingness, to solve its fiscal problems; and 2) the U.S. dollar is still the world's main reserve currency so that the U.S. government can continue to monetize its debt for some years to come before there is severe global economic dislocation.

Nonetheless, each investor needs to adopt a game plan which conforms to his or her unique mix of risk, reward, income needs, and tax situation. There is a strange dichotomy present at the moment: Quality U.S. multi-national companies are in remarkably good shape with great brands, strong balance sheets with lots of cash, excellent cash flow, and global reach. Moreover, the stocks of many of these companies are selling at modest valuations. On the other hand, the macro-economic situation of most developed nations is troubled. In the 20th century, investors with a long view have preserved and grown their capital by holding shares of these great companies – even as their nations have undergone severe economic and political dislocation. One can point to many examples of this such as the hyper-inflation of Germany in the 1920s, the economic hardship of the Great Depression, or defeat and occupation by foreign powers in World War II. When these nations finally emerged from their hardship, the value of shares in these great companies maintained their value. So, if history is a good guide (and we think it is), we do not believe that selling quality U.S. and international multi-nationals stocks in the face of current fiscal challenges makes sense – unless capital preservation over the very short term is absolutely paramount. We would also caution against dumping U.S. Treasuries for credit risk – even if the debt ceiling talks are unsuccessful for a short period. Investing in “hard assets” of oil, gas, real estate, and minerals is also a vital strategy to protect against the real possibility of rising inflation due to monetary stimulus programs. Finally, investing in international stocks (including emerging markets) can be a good hedge against the possibility that the U.S. does not yet have the political will or receive enough pressure from global markets to put its economic house in order. In summary, we believe that investors can ride out this storm by acting wisely and nimbly. But there is little question in our minds: the U.S. is at a crossroads over the next 18 months, an existential crisis which will determine what kind of country our children will inherit.