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Investing Environment

“Slowly, then all at once.”

— Ernest Hemingway (1899-1961)
On how people go bankrupt
The Sun Also Rises (1926)

“Highly indebted governments, banks or corporations can seem to be merrily rolling along for an extended period of time, when bang! – confidence collapses, lenders disappear and a crisis hits.”

— Carmen Reinhart and Kenneth Rogoff
This Time is Different: Eight Centuries of Financial Folly (2009)

Blaise Pascal was a French Enlightenment-era philosopher and mathematician well-known for Pascal’s wager which is a suggestion that, although the existence of God cannot be proved by reason, a rational person would wager that God exists; to wager against God’s existence leaves one with no advantage over the believer if God does not exist, but leaves the bettor with potentially catastrophic results if God, in fact, exists. As theology, Pascal’s wager is questionable, but as a guide to investing and public policy, the principle is invaluable. Simply stated, don’t make a wager in which the downside is total disaster, however small the probability of realizing the downside. Sadly, the United States of America is on a fiscal path that seems imprudent when viewed through the lens of Pascal’s wager.

Last quarter, this letter took up the issue of the European debt crisis, profiling Ireland.¹ This quarter, we stay at home, analyzing the U.S. fiscal situation. The picture that emerges is not a pretty one. Arguably, this situation represents a stinging indictment of the political class in the U.S., but I will leave the political judgments to each reader. Let’s start by looking at the facts of the U.S. fiscal situation. Next quarter, we will discuss the challenges involved in addressing this issue and conclude with a few thoughts on how this situation might play out.

Where We Stand

Just 10 short years ago, the U.S. Federal government was operating a budget surplus. The non-partisan Congressional Budget Office (CBO) forecasted surpluses indefinitely. Under CBO projections, the national debt would be paid off by now. Investment professionals wondered about the implications of a world without Treasury Bonds, the risk-free asset off of which other assets are priced. In retrospect, investors seem to have been afflicted with a childlike naiveté. Facing such apparent bounty, political leaders of both parties over the last ten years have cut taxes, jacked up spending and, for the first time in history, waged two wars solely with borrowed money.

¹The never-ending European debt crisis has only gotten worse since last quarter’s letter. The market’s attention, at this writing, is focused on Greece. S&P again downgraded Greece’s debt sending yields soaring. Since receiving a €110 Billion bailout from the EU and the IMF, Greece has failed to meet its budget target as severe austerity measures have choked the economy, resulting in lower tax revenues. The market is clearly pricing in a major restructuring, with Greek two year notes yielding in excess of 20%. Because Greece’s troubles are well understood by markets, it seems unlikely that a Greek default will lead to a repeat of the 2008 financial crisis. That said, the complexities and interconnectedness of the financial markets make it impossible to rule out contagion.



The purpose of this letter is not to relive the fiscal history of the past ten years. Any review of that period of fiscal deterioration is, inevitably, tinged by the political sentiments of the reviewer. The data is all there on the CBO website. Draw your own conclusions.

Instead, I will focus on the future, again using CBO data. Let's lay out the numbers.²

CBO Baseline Projections – Billions of Dollars						
	2011	2013	2015	2017	2019	2021
Deficit (-) or Surplus	-1,480	-704	-551	-617	-696	-736
National Debt	10,430	12,386	13,625	15,064	16,557	18,253

CBO Baseline Projections As a Percentage of GDP						
	2011	2013	2015	2017	2019	2021
Deficit (-) or Surplus	-9.8%	-4.3%	-3.0%	-3.1%	-3.2%	-3.2%
National Debt	69.4%	75.5%	74.9%	75.2%	75.8%	76.7%
Interest Expense/Revenues	10.1%	10.5%	12.6%	14.5%	15.5%	16.0%

Before analyzing this data, it is important to understand the assumptions that underpin these projections:

CBO Baseline Assumptions				
	Forecast Annual		Projected Average	
	2011	2012	2013-2016	2017-2021
Nominal GDP	4.1%	4.3%	5.2%	4.4%
Real GDP	3.1%	2.8%	3.4%	2.4%
Unemployment Rate	9.2%	8.2%	5.3%	5.2%
Three Month Treasury Bill	.3%	1.1%	3.6%	4.4%
Ten Year Treasury Note	3.4%	3.8%	4.7%	5.4%

These assumptions could be characterized as a “return to normalcy” set of assumptions. Federal Reserve policy is normalized as the unemployment rate falls and the yield curve assumes a more traditional shape. **The critical weakness among these assumptions is that there is no forecast of a recession during the next ten years.** In sum, the CBO Baseline is alarming as it stands, but the assumptions that underpin the analysis seem unrealistically optimistic.

However, that is not the end of the story. A few words about the CBO are in order. The CBO, an independent budget agency established in 1974, makes projections based upon current law. If a tax or spending program is set to expire, CBO projections assume it will expire. However, several papers including *Eichengreen, Feldman, Liebman, von Hagen and Wyplosz (2011)* and *Auerbach, Gale and Orszag (2006)* have shown that policy makers schedule policies to expire that are intended to be permanent in order to hide the impact on the deficit. Among many examples, a large set of business tax preferences expire and are renewed annually; Congress annually indexes the income thresholds for alternative minimum tax purposes, but only for one year at a time and so on. Adjusting for such charades, the budget picture looks even worse.

²Source: Congressional Budget Office; *The Budget and Economic Outlook: fiscal years 2011 to 2012, January 2011*. Note: in order to keep the blizzard of data from becoming overwhelming, I have included every other year's data.



	Budget Projections As a Percentage of GDP					
	2011	2013	2015	2017	2019	2021
CBO Baseline Deficit (-) or Surplus	-9.8%	-4.3%	-3.0%	-3.1%	-3.2%	-3.2%
CBO Adjusted Deficit (-) or Surplus	-9.8%	-6.3%	-6.1%	-6.3%	-6.7%	-7.0%

So there you have it. The picture looks bleak when CBO projections are taken at face value. Then consider that CBO projections assume that the U.S. does not experience a recession in the next ten years. Then adjust for the fiscal chicanery. But wait, there's more

What About State Debt?

Unlike many other countries, governmental debt is held at the state and local level, as well as the federal level. Because state level debt is the ultimate obligation of citizens and future citizens, it is appropriate to add state level indebtedness to federal indebtedness. Importantly, it is not sufficient to look simply at the stated obligations of states. There are significant liabilities of states in the form of pension obligations that are not reported as debt on a state's balance sheet. One of the most comprehensive studies of on and off-balance sheet debt of state was done by Rauh and Novy-Marx, published in fall, 2009. Rauh and Novy-Marx calculated value of the fifty states pension obligations at \$5.17 Trillion. The states hold \$1.94 Trillion in assets set aside against those liabilities, leaving \$3.23 Trillion.³ In fairness, this study was based upon September 2008 market values, a point from which the S&P 500 has risen approximately 17%, as this is written. Even so, the off-balance sheet debt remains substantial. On-balance sheet state and local governments show \$2.43 Trillion of debt.⁴ Combining on and off-balance sheet net debt gives us an approximation of state and local debt of \$5.66 Trillion.

A true apples to apples comparison is difficult, because the studies I am quoting are somewhat dated. For the sake of discussion, let's assume that state level on and off-balance sheet debt falls to \$4 Trillion, based upon the rebound in the equity market. Recall that at the end of 2011, the CBO is forecasting national debt of \$10.4 Trillion or 69.4% of GDP. If state level debt of an assumed \$4 Trillion is added to the national debt, total governmental debt rises to approximately 100% of GDP.

Let us ask a basic question: "So what?"

Does this debt matter?

This simple question is remarkably controversial. Even within political parties, views can differ dramatically. The influential Tea Party faction of the Republican Party has made the deficit its centerpiece issue, while Dick Cheney, former Republican Vice President, once famously said to then-Treasury Secretary Paul O'Neill, "Deficits don't matter."

Moreover, the bond market is certainly not concerned about the U.S. fiscal situation, with the 10 year Treasury yield under 3%, as this is written. Politicians are one thing, but the verdict of the bond market is pretty clear and must be taken seriously. If the bond market is not worried, why should we worry?

A seminal study of the implications of sovereign indebtedness is *This Time is Different: Eight Centuries of Financial Folly* by Carmen Reinhart (University of Maryland) and Kenneth Rogoff (Harvard University). Reinhart and Rogoff catalogued 250 financial crises in 66 countries over 800 years. The financial crises were analyzed for similarities and differences. A more recent work by Reinhart and Rogoff is their January, 2010 paper *Growth in a Time of Debt* published by the National Bureau of Economic Research. Reinhart and Rogoff have found in their study that when developed countries reach a debt/GDP ratio of 90%, median growth rates fall one percent.⁵ Including state and local debt, we estimate that government debt is approximately 100% of GDP, implying that debt is currently pinching growth.

³Source: *The Liabilities and Risks of State –Sponsored Pension Plans*; Robert Novy-Marx and Joshua D. Rauh, **Journal of Economic Perspectives**, Fall, 2009.

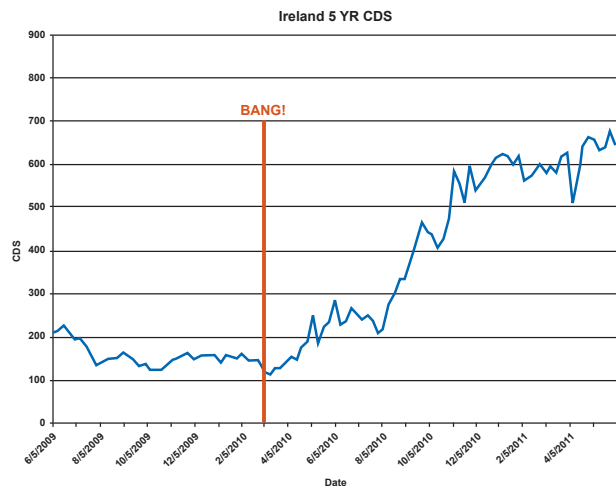
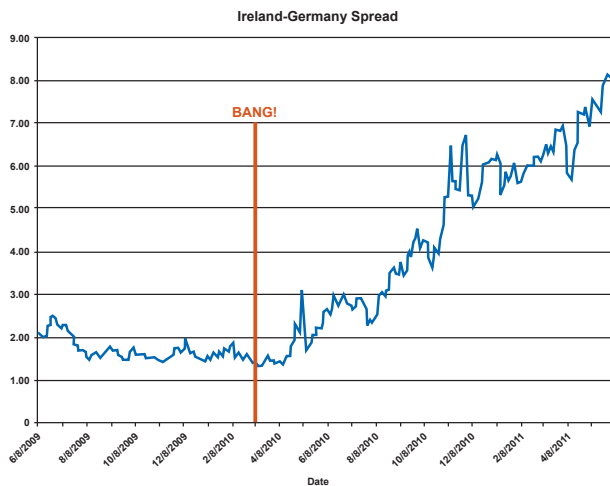
⁴Source: *Federal Reserve Board*

⁵*Emerging markets face a lower threshold. When external debt reaches 60% of GDP, annual growth declines by 2%.*



However, the key insight from this book is that there is no magic point at which a crisis develops. Affairs of state proceed along a “business as usual” path when the bond market loses confidence, countries have trouble rolling over their debt at affordable rates, and the situation begins to spiral downward. See the “Bang” quote that opens this essay. Unfortunately, there is an ephemeral quality about confidence that is very difficult to predict and/or model. All we can say with certainty is that complex systems, ranging from plate tectonics in the natural world to bond markets in the financial world, can enter into what physicists refer to as a “critical state” in which the system is vulnerable to a disequilibrium event, like an earthquake or a financial crisis. Is a country that allows itself to enter a critical state, operating prudently from a Pascal’s wager standpoint? Can we accept the downside of a sovereign debt crisis in the United States? If not, corrective action is in order.

To demonstrate the fickleness of the bond market, consider Ireland, the subject of last quarter’s letter. As the charts below demonstrate, things can come unraveled pretty quickly. For quite some time, Ireland was able to borrow at a modest premium over Germany, the benchmark credit in the Eurozone. Moreover, the cost of a credit default swap (CDS), essentially an insurance policy against default was relatively small. Then, to borrow Reinhart and Rogoff’s term, bang!



Conclusion

Simply stated, we are deeply concerned about this issue. Despite the reassuring signals from the bond market and the solid performance and dividends from our best corporations, the fickle nature of confidence in financial markets keeps us from resting easy. The stakes we are gambling are frighteningly high. Prudence dictates that we manage our affairs more wisely going forward. That prescription is easy to offer, but difficult to implement. Tough choices lie ahead. But that is the topic for next quarter.

John O'Connor
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