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Tax Reform and the Debt Ceiling

Dear Readers,

F. Scott Fitzgerald once said "the test of a first rate intelligence is the ability to hold two opposed ideas in the mind at the same time and still retain the ability to function." Surely, that maxim can be applied to the current need to raise the U.S. debt ceiling while simultaneously taming the deficit.

The debt ceiling was first implemented in 1917 (prior to which congress had to vote each time the U.S. issued debt) and has been increased repeatedly ever since - 74 times since 1962. It currently stands at $14.294 trillion and was breached on May 16th. Perversely, given today's debate, when congress votes on tax cuts or spending hikes they are tacitly agreeing to change the debt ceiling since they have already passed legislation creating an obligation to pay. The argument now is fraught with posturing and politicking because public scrutiny is high - and rightly so - as a result of the recent "great recession." Perhaps this will eventually lead to good compromise, but the reality is that cutting spending and raising taxes now puts economic recovery in jeopardy and that we can't afford.

Dramatic growth in the debt/gdp ratio generally follows long periods of war. For example, in 1860 - prior to the civil war - U.S. debt was a mere $65 million. By 1863 it was $1 billion and rose to $2.7 billion by the end of the war. A similar phenomenon was experienced during world wars I and II. In fact, the last time the U.S. debt to gdp ratio rose to the roughly 100% we are experiencing now was on the heels of WW II - the war to end all wars. In January 2001 (during the Bush administration), before the war on terror began, U.S. public debt was $5.7 trillion. By December of 2008 it had risen to $10.7 trillion and, as we know, it has increased to the current $14.3 trillion under the Obama administration.

The good news historically, is that following war years the government has shown an ability to reign in spending, generate economic growth, create jobs and, consequently, pay down the debt level. This happened following the civil war when the U.S. generated budget surpluses in 36 of 47 years and paid down over 99% of the debt and again after WW II when debt to gdp declined from 100% in 1950 to less than 35% by 1980.

A report from the Congressional Research Service published on March 29, 2011 indicates that since the commencement of military action in Iraq and Afghanistan following the terrorist attacks in the U.S., the cumulative total amount approved by Congress for operations in those areas through 2012 is $1.415 trillion. In 2010 alone, we spent $1.3 trillion, 36% of the total U.S. annual budget, on defense, non-defense discretionary and one-time discretionary items. $872 billion of this went to the defense department's official budget. It is worth noting that the U.S. Government Accountability Office was not able to provide an audit opinion on the 2010 financial statements due to "widespread material internal control weaknesses…" and that the primary impediment to providing that opinion was "serious financial management problems at the department of defense" - so the real numbers may be higher. To put this in context, in 2000 the defense budget was approximately $267 billion. Clearly, military spending - while necessary to fight and defeat Al Qaeda and other agents of terrorism - has been a significant part of our spending problem.

Some combination of reducing military spending while ensuring conditions conducive to economic recovery and, most importantly, job growth, is the long run solution to our deficit problem. This is why the Federal Reserve Board is unlikely to tighten monetary and fiscal policy until unemployment has declined substantially. While many economists parse Fed-speak closely, it is not necessary to do so in the prevailing environment. The Fed has been quite transparent regarding policy intentions over the last several years, consistently telling us that they would effect policy necessary to stabilize the economy and reposition it for growth. They have been creative in devising and utilizing the tools of government in doing this and, I believe, will continue to be over the next several years as they work with the Treasury department to shrink the governments' balance sheet and stabilize the budget.

Lastly, one of the recent fears of investors has been the specter of inflation as a result of rapidly rising commodity prices. Fortunately, the speculative bubble of many of these commodities has begun to burst. Witness the price of silver which dropped from $48/oz to $33/oz over the last 3 weeks (a 31% correction). Core inflation is running at approximately 2%, a level which the Fed has clearly stated is not a concern to them at this time. Over the last 60 years the market has been accorded an average p/e multiple of 19X when inflation ranged between 2 and 4%. The current multiple on forecast S&P 500 earnings for 2011 of $99 is only 13.3X. Not just incidentally, this estimate has increased from $96 just a few weeks ago. This would suggest a market which still has substantial upside potential.

The research report attached from Credit Suisse has some clear and important insights into the battle in Washington regarding these matters. I hope you find it helpful.

Best regards,

Terry