

Your Money

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Budget and Debt Battles in Washington

Debates in Washington over how to deal with the debt ceiling and burgeoning budget deficit are fueling investor frustrations as experts warn that failing to act will have disastrous consequences. Why is this such a complicated issue? Why does immediate action need to be taken? What is our position on this matter?



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Your Money: Budget and Debt Battles in Washington

Balance the budget; curtail spending; reduce debt – three aspects of simple fiscal management. At one time or another, nearly every American has done these things to keep their financial house in order. Now it's the government's turn. Trouble is, the powers that be haven't agreed on how to do it. Meanwhile, all the posturing in Washington is fueling investor frustrations as experts warn that failing to raise the debt ceiling will have disastrous consequences. Why is this such a complicated issue? And perhaps more importantly, why does immediate action need to be taken?

At a fundamental level, the problem is that the U.S. government spends more money than it takes in (See Chart). In order to cover the bills, it borrows money, thus the national debt. In theory, the debt ceiling is supposed to help Congress control spending, in reality, it isn't working. Since 1962, the ceiling has been raised 74 times, 10 of which have occurred since 2001.¹

What is the debt ceiling anyway?

It is a limit set by Congress on the amount of debt the federal government can borrow. The limit applies to debt owed to the public (e.g. U.S. bond holders) and debt owed to federal government trust funds such as those for Social Security and Medicare.²

How high is the debt ceiling right now? The ceiling is currently set at \$14.294 trillion. The country's accrued debt reached that mark on May 16, 2011. Currently, Treasury Secretary Timothy Geithner is taking various measures to allow the government to continue borrowing until August 2nd.³

What now?

Nobody knows for sure how things are going to play out and the uncertainty is frustrating to say the least. Here are a few of the options that are currently being debated:

1) *Do nothing.*

This is *not* an option we want to see elected. If no action is taken, the Treasury will not have authority to borrow any more money. And since the government borrows to make up the difference between what it spends and what it collects, funds would not be available to pay the country's bills.

Failure to act would create serious economic repercussions. At a minimum, a default would hurt U.S. bonds, the dollar, and investors' portfolios. And while a total government shutdown is unlikely, many who depend on government checks – from active-duty soldiers, veterans, and federal workers to name a few – could find their mailboxes empty. Which payments would be delayed is not known, but any choice

would cripple parts of the economy and anger many groups of Americans.⁴

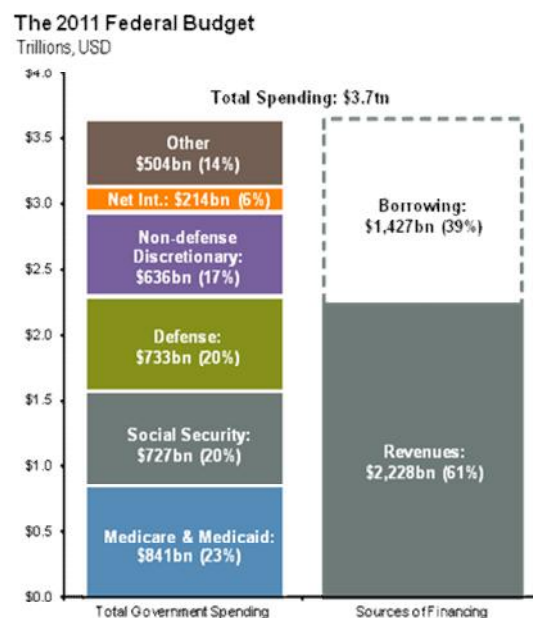
2) **Agree on a plan to reduce the budget deficit and national debt.**

A package of \$4 trillion in spending cuts and revenue increases is widely considered by fiscal experts to be the only way to start reining in the runaway U.S. debt.⁵ In this respect, the key issue is not just that a deal be made, but that it qualifies as a long-term solution.

Two key ratings agencies have said they expect policymakers to agree on a plan to meaningfully reduce the debt. Moody's Investors Services said Wednesday it would likely change its outlook on U.S. debt from "stable" to "negative" unless "substantial and credible agreement is achieved on a budget that includes long-term deficit reduction."⁶ Standard & Poor's went farther on Thursday by announcing there is a fifty percent chance it would downgrade the U.S. within 90 days if a credible agreement is not reached.⁷

And while most Americans understand that changes need to be made, the politicians can't agree on what those changes should be. To quote the president, "The American people are sold" on the idea of balancing spending cuts with tax increases. The problem is members of Congress are dug in ideologically."⁸

To be fair, deciding where to cut and where to spend is challenging. Take a look at this chart.



Source: U.S. Treasury, BEA, CBO, OMB, J.P. Morgan Asset Management.. Numbers reflect CBO estimates for FY 2010. Data reflect most recently available as of 6/30/11.

Even if the government agreed to cut *all* discretionary spending it wouldn't make up for half of the deficit. Even eliminating social security and all defense spending would barely cover the deficit. And of course, that can't be done. So as you see, policy makers have a serious challenge on their hands.

3) *Raise the debt ceiling again.*

Most experts agree that policymakers will raise the debt ceiling. If for no other reason, because the consequences of not doing so are too great. If the debt ceiling is breached, interest that the government pays on its debt will rise, pushing the deficit even higher.

Federal Reserve Chairman Ben Bernanke was on Capitol Hill Thursday, warning that failure by Congress to raise the debt ceiling would create "a calamitous outcome." Global confidence in U.S. Treasuries and the nation's AAA credit rating are among our nation's greatest economic assets, and according to Bernanke, "Losing that credit rating would be a self-inflicted wound".⁹ It would also be bad news for the labor market, the Fed chairman explained, which is an area of growing concern since the June jobs report showed hiring slowed to a crawl. In short, failing to raise the debt ceiling would be bad news all around.

It is our hope that a combination of efforts involving raising the debt ceiling and implementing a plan to begin reducing the deficit will be agreed upon promptly.

Continue reading on the next page.

What are we doing in the meantime?

We have determined that it is too risky to try and predict what the outcome of this situation will be, and if we get a prediction wrong, it could cost our clients money. Overall, we have confidence that some sort of agreement will be reached and we do not think now is the time to take drastic action. We realize it may not be especially reassuring for you to hear this, but we believe it is the best choice.

Rather than reacting too conservatively or aggressively, we continue to maintain that a balanced approach to investing, including diversification and maintaining long-term vision, is the best way to weather storms like this. We will, however, keep a close eye on the situation and monitor how any developments have the potential to affect your portfolio.

If you have any questions or concerns, please don't hesitate to reach out to us. It is a pleasure serving you.

Warm Regards,

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¹ <http://thomas.loc.gov/cgi-bin/bdquery/z?d112:h.r.1908>

² http://money.cnn.com/2011/01/03/news/economy/debt_ceiling_faqs/index.htm

³ http://money.cnn.com/2011/01/03/news/economy/debt_ceiling_faqs/index.htm

⁴ http://money.cnn.com/2011/07/13/news/economy/debt_ceiling_fallout/index.htm?iid=EAL

⁵ http://money.cnn.com/2011/04/13/news/economy/debt_commission_obama/index.htm?iid=EL

⁶ http://www.moody.com/research/Moodys-Places-US-Aaa-Government-Bond-Rating-and-Related-Ratings?lang=en&cy=global&docid=PR_221800

⁷ www.standardandpoors.com/ratingsdirect

⁸ <http://www.bloomberg.com/news/2011-07-15/house-to-vote-on-2-4-trillion-debt-increase-spending-cuts.html>

⁹ http://money.cnn.com/2011/07/14/news/economy/bernanke_testimony/index.htm?iid=EL