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The Investment Implications of the Federal Debt

Last month, the Office of Management and Budget released its Mid-Session Review of the federal budget. While the numbers were not surprising, given the deep recession, they were still huge, projecting a cumulative \$9.1 trillion in deficits over the next decade. Left unchecked, this rising tide of debt could boost Treasury interest rates substantially, while only postponing harder choices for a later date. Alternatively, Washington may decide to make some of these choices today, and attack the debt problem through lower spending or higher taxes, or more indirectly, through encouraging stronger economic growth or higher inflation. The key point for investors is that the federal debt is now so big and growing so fast that either path it takes, in the absence of action or any steps taken to correct it, will profoundly affect the investment environment for years to come.

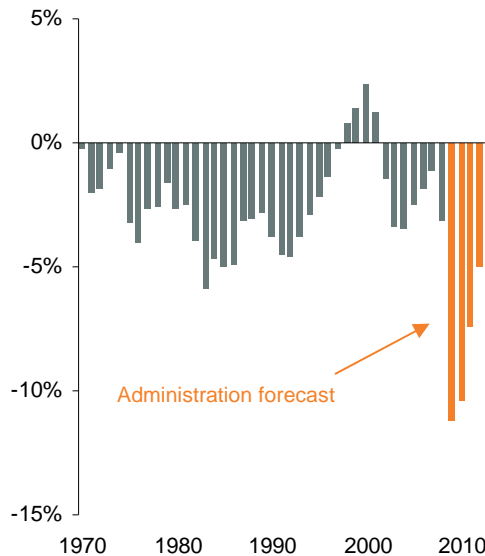
The rising tide

The speed with which the fiscal situation has deteriorated has been breathtaking. Just one year ago, in the Mid-Session Review of the last budget of the Bush Administration, the federal budget was expected to move from deficit to surplus in 2012 with debt equaling 36% of GDP¹. Today, the deficit is expected to be almost \$800 billion in 2012 with the debt at over 71% of GDP and rising².

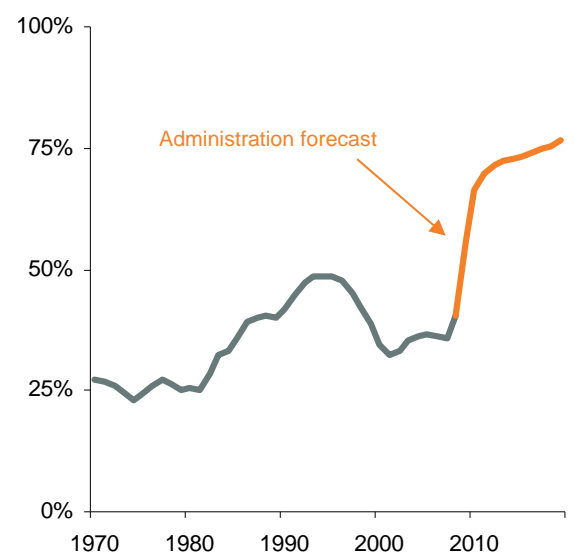
¹ See "Mid-Session Review" Budget of the U.S. Government, Fiscal 2009, Office of Management and Budget, July 2008, Table S-13.

² See "Mid-Session Review" Budget of the U.S. Government, Fiscal 2010, Office of Management and Budget, August 2009, Table S-1.

Federal Budget Surplus/Deficit
% of GDP 1970–2019



Federal Debt
% of GDP 1970–2019



Source: Mid-Session Review, Office of Management and Budget, August 2009, St. Louis Fed, Bureau of Economic Analysis, J.P. Morgan Asset Management.

One reason for this swelling tide of deficits is the measures taken to try to stabilize the financial system and jumpstart the economy—\$700 billion in TARP money and \$787 billion in fiscal stimulus is serious money. However, the biggest problem has been the recession itself. The Administration now projects that the unemployment rate will average 9.8% next year and fall by an average of just 1% per year over the next four years, reaching 5.9% in 2014³. This massive unemployment will erode the tax base while boosting social spending. Meanwhile, interest costs on the debt incurred over the next few years rise very sharply, and by 2019, these annual interest costs reach \$774 billion, accounting, on their own, for almost the entire annual deficit.

Not dealing with the debt

There are basically four ways to deal with a debt problem. You can try to cut your way out, tax your way out, grow your way out or inflate your way out. But before looking at any of these possibilities, it is worth considering the implications of doing nothing—or in other words, letting the debt grow along its current path.

The most obvious impact of this decision, or rather non-decision, should be higher Treasury interest rates. As this is being written, 10-year Treasury bonds are yielding a super low 3.4%. However, it is hard to see how they can stay there in the face of a rebounding economy and soaring debt.

³ See “Mid-Session Review” Budget of the U.S. Government, Fiscal 2010, Office of Management and Budget, August 2009, Table 2.

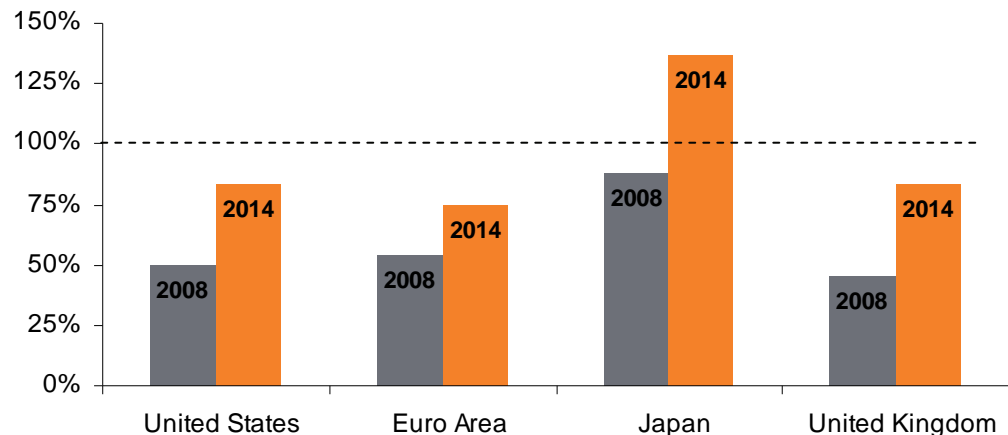
The problem is that vastly increased government debt, relative to the size of our economy, pushes up real yields on Treasuries—that is, Treasury yields less inflation. More people have to be induced to lend money to the government and they will need significant encouragement to do so.

A simple regression analysis, modeling changes in real 10-year Treasury bond yields as a function of real 3-month T-bill rates, the federal debt-to-GDP ratio and the change in the federal debt-to-GDP ratio, explains 88% of the variation in real 10-year yields over the past 54 years. This model, combined with the Administration’s own forecasts of short-term interest rates, federal debt and inflation, suggests that the 10-year Treasury yield could rise as high as 6.5% in 2014 from 3.4% today, as the federal debt soars from 55% of GDP to 72% of GDP and the Federal Reserve maneuvers short-term interest rates back to normal levels.

It should be emphasized that this model, or indeed any statistical model, has severe limitations given profound changes in global financial markets and investor attitudes over the past few decades. It is possible that increased personal savings, both here and abroad in the wake of the financial crisis, will partly absorb this increased supply of Treasury bonds. On the other hand, the U.S. government will be trying to borrow this money at a time when governments around the world are also trying to tap the world’s capital markets. As show in the chart below, the biggest economies outside the United States are also bleeding red ink. This suggests that the traditional safety valve of foreign purchases of U.S. Treasuries won’t be sufficient to absorb our growing debt and that the Treasury will have to offer higher interest rates to move it. These higher Treasury rates, needless to say, would inflict capital losses on current Treasury bond holders.

IMF Projections of Net Government Debt

% of GDP



Source: IMF World Economic Outlook, Table A8, April 2009.

There are other issues, of course, also associated with the “do-nothing” scenario. Some have worried that the U.S. dollar might fall sharply from the weight of all this debt. However, the obvious question is, “Against what?” The fact that the Euro Area, Japan and the U.K. are facing

similar economic and budget problems to the U.S. reduces the risk of a dollar collapse against the world's biggest currencies. Having said this, the next few years may well see the dollar decline against some emerging market nations that have been less impacted by the crisis.

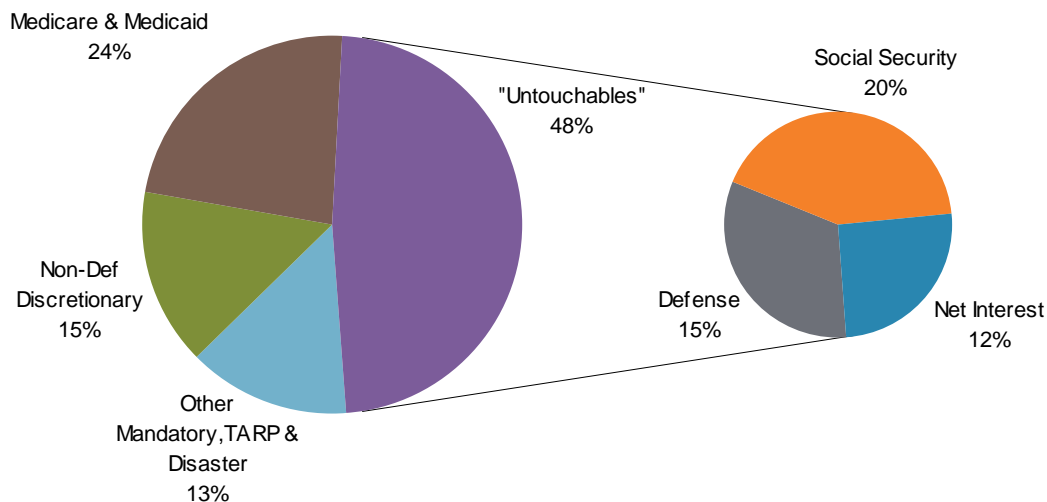
Another concern is that rising Treasury bond yields may also have the undesirable impact of "crowding-out" some private sector investment that otherwise would have occurred. This could be an issue for capital spending in general, but it is perhaps more of an issue for the housing market, where a rebound in 30-year fixed rate mortgage rates towards 8% could slow the recovery of this battered sector.

Dealing with the debt I: Cutting spending

While outlining the dismal prospects for the budget, the Administration has made it clear that they'd like to do something to improve the situation, and that they will be proposing some further steps in the 2011 Budget to do just that. One option, of course, would be to cut spending. The question is, "Where?"

The pie chart below, based on the Mid-Session Review, illustrates the difficult choices that would have to be made.

Federal Spending: 2010 to 2019 totals



Source: Mid-Session Review, Office of Management and Budget, August 2009, Table S-4.

From 2010 to 2019, total spending is projected to equal \$43.3 trillion. Of that total, net interest costs (12%), defense costs (15%) and Social Security (20%) are all probably off the table.

Non-defense discretionary spending, another 15% of the total, is projected to grow by just 2% per year from 2009 to 2019, which is probably on the highly optimistic side already, while "other" mandatory programs are forecast to fall between 2009 and 2019.

In fact, the only big slice of the pie which seems susceptible to big cuts is Medicare and Medicaid, which are budgeted to grow by 7% per year over the next decade, accounting for 23% of federal spending.

Controlling costs is, of course, one of the rationales for tackling health care reform right now. However, it is not clear whether universal coverage or cost containment is the Administration's first priority in health reform. These, of course, don't have to be contradictory goals, but if the political road to universal coverage requires pacifying the doctors' organizations, the insurance companies, the pharmaceutical companies, the hospitals and consumers, it is hard to see how reform will contain costs.

Dealing with the debt II: Raising taxes

Higher taxes could also be used to try to balance the books. Proponents of higher taxes would probably invoke the memory of the Clinton tax hikes of 1993 and how those tax hikes achieved a narrowing of the budget gap without pushing the economy into the ditch.

However, it should be noted that the Administration's budget already assumes tax increases in line with statements made by the President on the campaign trail—namely a restoration of the 36% and 39.6% tax brackets for married couples with incomes over \$250,000 (or individuals with incomes over \$200,000) and an increase in the dividend and capital gains tax rates from 15% to 20% for the same group.

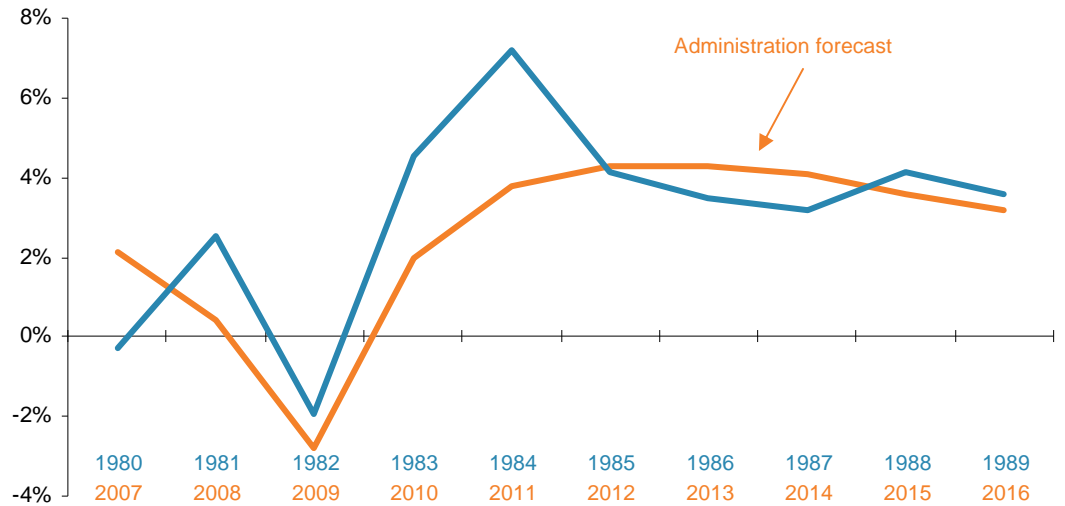
It is possible that the Administration may seek to raise tax rates further on this group to pay for health care reform. However, the President would likely pay a very heavy political price for reneging on his pledge to avoid income tax hikes for the rest of the population. Moreover, if the Administration sticks to increasing taxes only on the wealthy, the math is not encouraging.

To see this, consider one version of health care reform currently being debated in Congress. This bill includes an income tax surcharge of 1% for married couples earning \$350,000 to \$500,000, 1.5% for those earning \$500,000 to \$1,000,000 and 5.4% on those earning over \$1,000,000. These substantial tax increases were estimated to raise \$544 billion over 10 years. While this money was earmarked to pay for health care reform, if it had been dedicated to deficit reduction, instead it would only have reduced cumulative deficits by 6% over the next 10 years. Given the limited ability of tax hikes to really reduce the budget deficit, there is a political question mark about how far this, or any, Administration will want to go down this road.

Dealing with the debt III: Growing our way out

An easier way out would be for us to try to grow our way out of the debt. In the early 1980s, in the aftermath of a similarly ugly recession, many people worried that the enormous deficits would kill economic growth. In fact, it was the other way around, with very strong economic growth pushing deficits down from 6.0% of GDP in 1983 to 2.8% of GDP by 1989, as a result of a long and strong economic expansion.

GDP Growth Through Two Business Cycles
1980–1989 and 2007–2016



Source: Mid-Session Review, Office of Management and Budget, August 2009, Table 3; Bureau of Economic Analysis.

As can be seen in the chart above, the Administration is assuming a more lack-luster expansion in the years ahead than occurred in the years following the 1982 recession. For example, in 1983 and 1984, the first two years of the 1980s expansion, real GDP growth averaged 5.9%. By contrast, in 2010 and 2011, the Administration is assuming real economic growth of just 2.9%.

While caution is probably very advisable, it is worth considering the implications of stronger expansion.

In an analysis of the federal budget released last year, the Congressional Budget Office calculated the impact of stronger or weaker GDP growth assumptions on the budget. Scaling these numbers to the current budget outlook gives some insight into how stronger economic growth could help ameliorate the current situation. In particular, assuming 2% stronger real GDP growth in 2010 and 2011 and then 0.3% weaker economic growth from 2012 through 2019, implies 3.5% GDP growth on average over the next decade compared to the 3.3% estimate currently being used by the Administration. While 3.5% average growth is above trend, this merely reflects the extra growth from putting a large number of unemployed Americans back to work. It is also the average growth rate seen from 1983 to 1992.

Simulating this growth path leads to a \$1.25 trillion reduction in accumulated deficits over the next decade, a strong impact due, in part, to smaller deficits in the early years slowing the buildup of federal debt and thus interest costs in the later years⁴. While \$1.25 trillion is still only a small reduction from the \$9.1 trillion expected in cumulative deficits over the period, it is

⁴ While these calculations are rough, they may also be biased to the downside as they do not include the potential knock-on effect of higher capital gains taxes from any increase in stock or real estate prices in response to stronger growth.

probably much more than could realistically be achieved by either higher tax rates or bigger cuts to government spending. In other words, the best deficit reduction strategy is encouraging stronger economic growth.

Dealing with the debt IV: Inflating our way out

If economic growth is the best method for dealing with deficits, inflation is probably the worst.

The only reason inflation is ever suggested as a deficit cure is that if a government has sold a large quantity of long-term debt at low interest rates, then inflation can, in theory, lessen the burden of servicing that debt. A surge in inflation should push up nominal tax revenues, but, of course, doesn't push up required coupon payments.

However, apart from the real economic pain and disruption caused by inflation, it is no long-term cure for our debt problem. Over 7% of U.S. Treasuries in the hands of the public are now Treasury Inflation Protected Securities (TIPS) and, by definition, higher inflation doesn't reduce the real cost of servicing inflation-protected securities. Moreover, more than 80% of the rest of the federal debt matures within the next 10 years. Even if higher inflation managed to tax current debt holders, it would quickly increase the cost of servicing new bonds, and given the maturity schedule of current U.S. debt, it would not be long before inflation was actually worsening rather than improving real debt service costs.

Two other points are worth making on this issue. First, the federal government can't inflate its way out of a debt problem without the active collusion of the Federal Reserve (in printing money and buying U.S. securities) and it is hard to imagine that Ben Bernanke (or any of his recent predecessors for that matter), would be willing to sacrifice the Fed's independence for such a scheme.

Second, given the degree of slack in the U.S. and global economies today, deflation is probably a greater threat than inflation. Deflation would actually increase the difficulty in servicing debt, as revenues would fall while coupon payments remained untouched.

Investment implications

While the financial crisis has eased and the economy appears to be moving from recession to recovery, one painful legacy of the last year is a dramatic worsening of the federal government's fiscal situation. It is hard to see how this situation can be improved much by either spending cuts or tax increases, although both are possible. Growing our way out of debt is undoubtedly the best answer to this problem, while trying to inflate our way out is probably the worst.

Having said all of this, there are three clear conclusions to be drawn.

- First, beware of Treasuries—an economic recovery combined with burgeoning federal debt could push 10-year Treasury yields above 6%, eating into total returns on short-term maturities and generating actual losses on longer-term bonds.

- Second, recognize the risk of higher taxes, particularly if you are wealthier than average, and take advantage of tax-aware strategies.
- Third, build a bigger nest egg. Any attempt to deal with the deficit will likely involve higher taxes on the rich or lower spending on the elderly, because this is where it is easiest to raise revenue and slow spending. If you are older and richer than average, then you are in the crosshairs.

Sometimes, when you pass an angry dog on the street, you are advised to ignore it and it will go away. This is not such great advice, however, if it lunges for your throat. The federal debt today is like an angry dog and, for investors, the best strategy is not to ignore it but rather to build a strategy to protect against it.

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