Economic Perspectives

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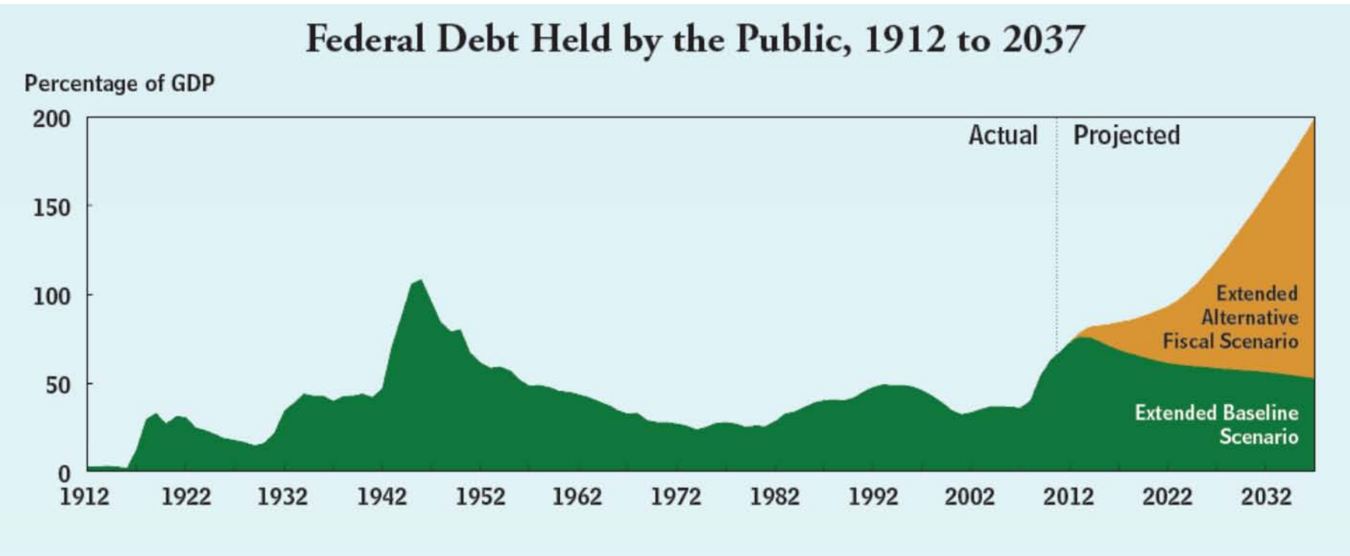
This month we diverge from our normal format in order to take a deeper look at the pending "fiscal cliff" and the status of debt in America.

THE FISCAL CLIFF AND AMERICAN DEBT

Here's an idea for stimulating the economy: A credible long-term budget plan. The U.S. economy remains mired in the slowest post-recession recovery of our time; and normal avenues of relief, monetary policy (i.e. interest rates) and fiscal policy (government spending), are in no position to help. In fact, politicians could make the situation even worse if they act irresponsibly over the intermediate-term. The U.S. economy is all but certain to enter a new recession in 2013 without some rational action from Washington. Under current law, federal tax rates are scheduled to jump and spending set to drop on January 1, 2013 – i.e. the oft-termed "fiscal cliff". Democrats and Republicans have pledged their desire to avoid such negative near-term economic consequences. However, the dilemma for policy makers is that without some of these adjustments, U.S. government debt continues to rise, and could soon embark on a very dangerous path.

Time to choose our course. The chart below shows U.S. federal government debt as a percentage of gross domestic product (GDP) on a historical basis, as well as two potential paths as projected by the nonpartisan U.S. Congressional Budget Office (CBO). Under the Extended Baseline Scenario (EBS), federal government debt is projected to stabilize over the near-term and start on a downward sloping path beginning in 2015. This path is based on current law – that is, the assumption that all of the tax hikes and spending cuts currently scheduled to start in 2013 are actually implemented.

The Extended Alternative Fiscal Scenario (EAFS), meanwhile, represents the projected debt path if no tax hikes or spending cuts occur (i.e. the path of least resistance for short-term focused politicians looking to get re-elected). Under this scenario, U.S. Federal debt rises ever higher before reaching 200% of GDP in 2037 and breaching 250% just 5 years later. Under this scenario, more than half of government revenue could be required just to cover interest expense by the end of the projection period. Clearly, changes are needed.



Source: Congressional Budget Office

The most likely path ahead is somewhere between the CBO's two projections. Over the intermediate-term (the sooner the better) elected officials must develop a rational long-term budget plan whereby the debt burden eventually embarks on a declining path. However, the difficulty is doing so with as little harm to economic growth as possible, as growth can be a very powerful part of the solution. Stronger economic growth generates higher tax receipts (all else remaining equal), thus lowering deficits for any given level of spending.

Forecasters have long warned of a day of reckoning for the U.S. federal government, and it seems the time for hard decisions has finally come. If politicians wait until interest rates start to rise due to concern over the nation's debt burden, it will likely be too late. Currently, the federal government enjoys historically low borrowing costs. This is largely due to a lack of available alternatives at a time when Europe is suffering under its own government debt crisis. Central banks have also been pumping-up liquidity and there is a glut of global capital looking for safe havens amidst an uncertain economic environment.

However, even a modest one percentage point rise in average government borrowing costs would cost the U.S. Treasury an additional $120 billion annually (based on the CBO's projection of U.S. federal debt at the end of fiscal 2012). For fiscal 2012, CBO projects interest expense will consume about 9% of government revenue. Thus, if average borrowing costs were to rise by just one percentage point, interest expense would grow to consume 13.5% of government revenue. A two percentage point hike would lift interest expense to over 18% of revenue. This story gets very ugly, very quickly.

Clearly, the challenges of the U.S. federal budget are significant, and these challenges bring us back to that chart on page one. If we, as a nation, raise taxes sharply, and cut spending with equal fortitude, future budget deficits can be controlled and our debt burden reduced over time. This is exactly what current law calls for beginning in 2013 (i.e. the CBO's "Baseline scenario"). However, such changes bring a significant cost to economic growth and paying down the government credit card could mean significant economic hardship. Really, the only question is whether we endure the hardship of these necessary changes all at once or slowly over time.

This brings us to the "fiscal cliff". The term "fiscal cliff" refers to the multitude of tax hikes and spending cuts scheduled to start in 2013 under current federal law. The term implies that the economy could "go over a cliff" if all these fiscal changes are implemented at once. Among the most pronounced changes, the personal income tax cuts enacted during the George W. Bush presidential term expire, the payroll tax cuts that working Americans have enjoyed over the last two years (from 6.2% to 4.2%) end, many more Americans would see their tax burden rise as they fall under the Alternative Minimum Tax (AMT), extended unemployment benefits run out, and the spending cuts negotiated under last year's debt ceiling agreement are automatically implemented.

In total, these and other scheduled adjustments could subtract nearly $800 billion from the U.S. economy next year, or about 5.5% of U.S. Gross Domestic Product (GDP). (Note: the projections in the table below, as sourced from the CBO, are for the federal government's 2013 fiscal year which runs from October 1, 2012 to September 30, 2013.)

The Fiscal Cliff:	$$ Value in billions
Higher taxes:	
Expiration of certain income tax and estate and gift tax provisions (1) as well as the indexing of the alternative minimum tax (AMT) for inflation.	$221
Expiration of 2% cut in payroll tax for workers	$95
Other expiring provisions	$65
New taxes associated with the Affordable Care Act	$18
Subtotal	$399
Lower spending:	
Automatic spending cuts specified under the Budget Control Act of 2011.	$65
Expiration of emergency unemployment benefits	$26
Reduced Medicare reimbursement for physicians	$11
Subtotal	$103
Other scheduled changes in Revenue or Spending	$105
Total Value of changes in federal government taxation or spending in fiscal 2013 before economic consideration	**$607**

Source: Congressional Budget Office

Fortunately, we believe the odds of these changes all occurring as currently scheduled is slim. Both major political parties have voiced their strong desire to seek an alternative path as to avoid the negative economic consequences of these sudden adjustments, and there do appear to be many areas of common ground. For instance, Democrats and Republicans both support maintaining marginal income tax rates at 2012 levels for most income brackets. Republicans, however, want to keep current rates for all income brackets while Democrats propose allowing rates for upper-income groups to revert to prior levels. The chart at the top of the next page shows a comparison of 2012 tax rates to the 2013 rates as currently scheduled.

Major tax rates slated to change in 2013 - under current law.

Marginal Income Tax Rates:	2012 rates	2013 rates
Over $388,350	35.0%	39.6%
$217,450-388,350	33.0%	36.0%
$142,700-217,450	28.0%	31.0%
$70,700-142,700	25.0%	28.0%
$17,400-70,700	15.0%	15.0%
Investment income tax rates:		
Top dividend tax rate	15.0%	personal income rate
Top capital gains tax rate	15.0%	20.0%
Payroll Taxes	4.2%	6.2%

Note: Investment income above $200,000 for individuals and $250,000 for couples will also be subject to a 3.8% tax under provisions of the Affordable Care Act starting in 2013.

Source: Wall Street Journal, Congressional Budget Office

While we believe most if not all of the marginal income rates may be extended, the Wall Street Journal recently reported there seems to be some consensus building for allowing the payroll tax cuts to expire. We believe extended unemployment benefits are also unlikely to be renewed.

Automatic Spending Cuts: The Budget Control Act of 2011 (the compromise agreement that finally ended last year's debt ceiling debate), requires automatic government spending cuts amounting to approximately $1.0 trillion over the next 9 years. The cuts are split evenly between defense and non-discretionary programs (including constraints on Medicare spending growth) and are set to begin January 2013. For fiscal 2013, defense spending is slated to be cut by $55 billion, or about 9%, and another $55 billion will be culled from other non-defense programs.

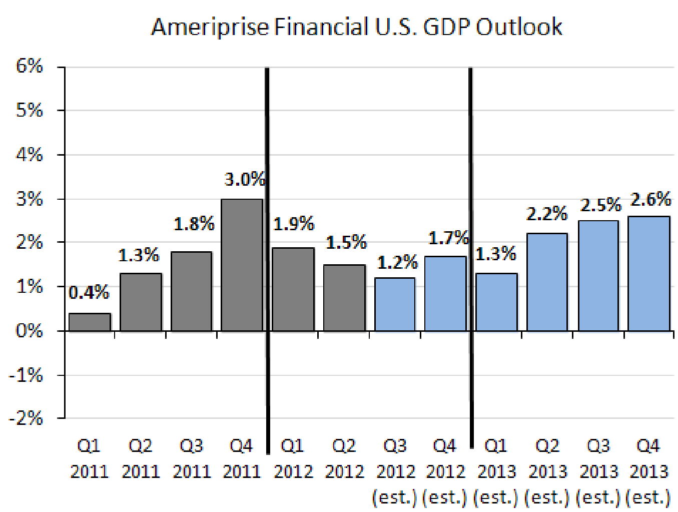
If fiscal cliff concerns were not enough, the Federal government is also closing in on its statutory debt ceiling once again. A recent Treasury Department statement noted that the debt limit will likely be reached by year-end but "extraordinary measures" would be used to fund the government through early next year. Overall, we believe the debt ceiling issue is much less likely to become the "crisis event" it was last year, at least not as a singular issue. Why? Primarily because resolving the myriad of challenges that make up the fiscal cliff will already require some sort of grand long-term budget plan. If a compromise is reached, the debt ceiling will likely be adjusted accordingly as part of any such deal.

Currently, we believe Congress will act before year-end to provide a temporary extension of most fiscal cliff related issues into the first half of 2013 (June maybe?). A temporary extension would provide time for a more rational discussion of these very important long-term issues, but it would also likely delay improvements in consumer and business confidence.

Near-term Economic Implications: U.S. economic activity could fall by 3% to 4% in 2013 if Congress were to take no action and all of the fiscal cliff related issues were allowed to proceed as scheduled. Businesses are understandably concerned about their future business prospects under such a threat – and confidence in Washington to fix the problem in a timely manner is understandably questioned. As such, we believe job growth is unlikely to improve much until businesses see greater clarity on the fiscal front. Currently, we see economic growth for the second half of 2012 as being no better than the first half's anemic pace.

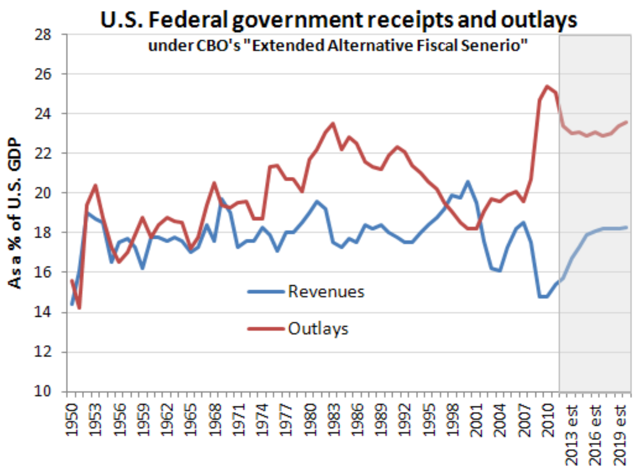
For 2013, we are currently assuming the payroll tax cuts are allowed to expire and that some level of spending cuts (~$50-$100 billion) are indeed implemented. Adjustments of this magnitude should still enable the U.S. economy to continue on its path of modest economic recovery while allowing greater budget rationalization to be implemented over time.

Additionally, U.S. economic activity is clearly not dictated by government tax and spending policies alone. While the government sector struggles, consumer and corporate fundamentals are much improved. The recession in Europe should also largely have run its course by the end of this year, and many of the world's developing economies should see the benefit of the economic stimulus programs currently being implemented.



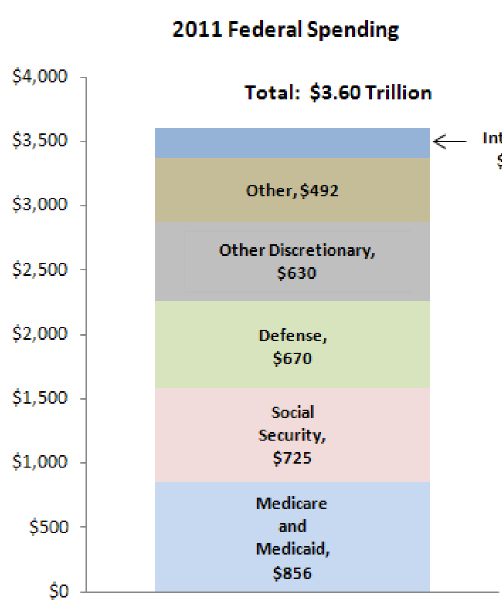
Source: Commerce Department, Ameriprise Financial Services, Inc.

Long-term View: The chart below shows U.S. government revenue and spending as a percentage of GDP since 1950. The grey shaded area depicts revenue and spending as projected by the CBO under its Alternative Fiscal Scenario. The tremendous budget gap projected under this scenario is simply incompatible with the long-held American assumption of a sound economy.

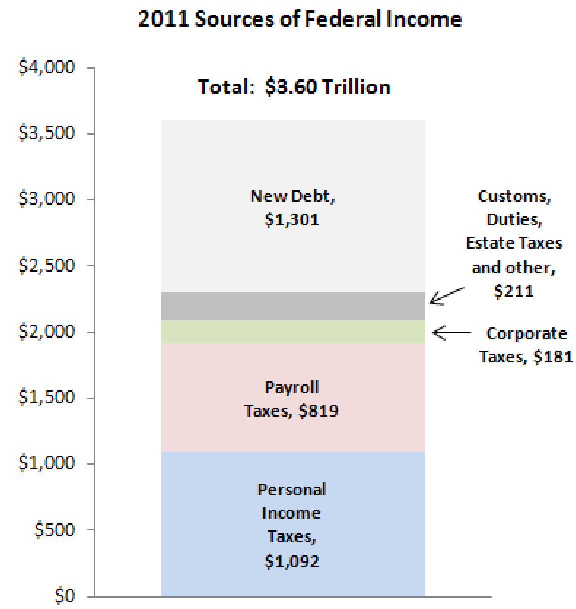


Source: Congressional Budget Office

Over the last six decades, federal government revenue has generally run in a range of 18% -20% of GDP. Spending, meanwhile, has generally been in a range of 19%-21%, albeit for a few temporary, recession related spikes. In our view, targeting a return to these historical averages over the intermediate-term is the most responsible course of action. This would likely require a 20/80 split between higher taxation and spending cuts.



Source: Congressional Budget Office



Source: Congressional Budget Office

Democrats and Republicans have different views on how best to manage the federal government's role in the American economy. Either side, however, will find their policy desires significantly constrained by budget realities over the next decade and beyond. The unfunded promises made to the American people by past legislators are now coming due.

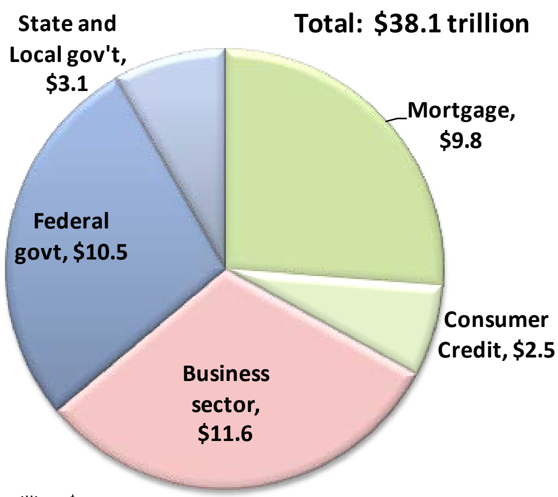
Did you know? Federal government debt is sometimes referred to as being approximately $10-$11 trillion, and other times referred to as being about $14-$15 trillion. Which is right? Actually both are.

At the end of Q1-2012, the U.S. federal government had issued and outstanding Treasury securities amounting to $10.9 trillion. However, the federal government has also "borrowed" approximately $4 trillion from the Social Security Trust Fund and other inter-government sources.

In evaluating the government's debt position, analysts typically use the $10.9 trillion figure. Why this one? Most notably because this is the amount of debt that is actually issued and outstanding. The Social Security Trust Fund is, functionally, little more than an accounting entry. In reality, the federal government treats Social Security income taxes as revenue and makes payments to recipients out of incoming revenue – a process often referred to as a "pay as you go" system.

DEBT IN AMERICA: A BROADER PERSPECTIVE

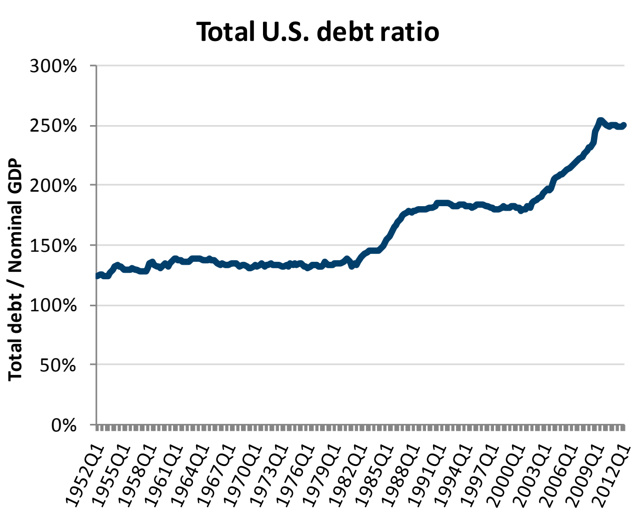
The news on American debt is not all bad. At the end of 2011, total U.S. debt, for all sectors of the economy, stood at $38.1 trillion, according to Federal Reserve data. The break-out of where that debt stood is shown in the chart below. The dollar figures are certainly huge, but we believe a closer examination supports our view that consumer and business debt loads are actually quite manageable, and even in a position to support economic growth going forward.



All figures in trillions $
Numbers may not add up due to rounding

Source: Federal Reserve, Ameriprise Financial Services, Inc.

The total dollar figure of debt does not tell us the whole story needed to make a proper evaluation. The first order of business should be to look at the total debt in relation to the underlying economy that it supports. As a ratio of nominal U.S. GDP, total debt currently stands at a historically high 250%. Debt levels started the 1980's with a ratio of about 140%, a level that had basically been maintained consistently since the mid-50's.

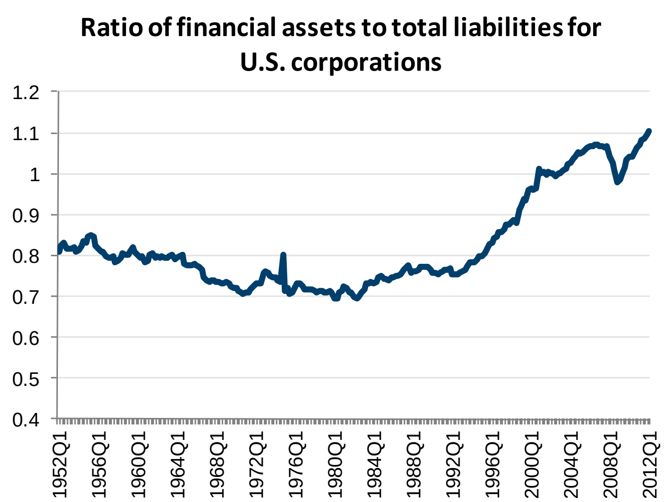


Source: Federal Reserve, Ameriprise Financial Services, Inc.

Debt levels jumped in the early 1980's as the Federal Reserve began lowering interest rates from their historic highs (in July 1981 the average 30-year mortgage came with an interest rate of 16.8% according to Freddie Mac) and government spending on Defense was sharply expanded. Federal debt as a percentage of GDP ended 1981 at 25% and closed the decade at 40%.

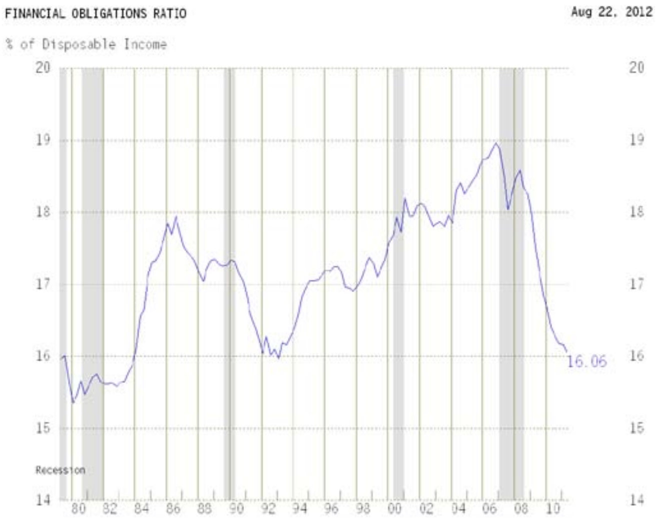
The total debt ratio then held fairly steady at around 180% of GDP through most of the 1990's. But beginning in 2001, a combination of rising federal deficits and a sharp expansion of mortgage debt due to the "housing bubble," the debt ratio progressed to its current lofty levels.

The debt ratio, however, does not tell us the whole story either. If we look at the absolute financial health of each economic segment, it shows sharp differences in exactly who is too deeply in debt, and who holds what could be considered efficient leverage. Most notably, the U.S. business sector appears to be in strong financial shape despite its large dollar value of debt. As shown in the chart below, corporate debt in relation to corporate financial assets is currently at its best levels since the Federal Reserve began tracking the data in the early 1950's.



Source: Federal Reserve, Ameriprise Financial Services, Inc.

Consumers have also done a fairly good job over the last several years in deleveraging. Of course, current debt burdens are softened by today's record low interest rates, but the dollar value of consumer debt has also declined. In the first quarter of 2012, consumer credit card borrowings were 16% below their 2008 peak. The improved consumer balance sheet is also evident in the Fed's Consumer Financial Obligations Ratio (see chart at top of next page).



Source: Thomson Baseline

The Federal Reserve's Financial Obligations Ratio measures required consumer debt payments (principal and interest) associated with mortgage payments, rent, auto leases, homeowners insurance, property taxes and credit card payments; all as a combined percentage of disposable income. As shown, the ratio has declined sharply over the last few years and is close to matching the 20-year low set after the last financial crisis induced recession (the Savings and Loan crisis) in the early 1990's.

Additionally, according to the credit rating agency TransUnion, the number of auto loans with a past-due payment fell to its lowest level in over a decade during the second quarter. The company has been tracking such data since 1999 and the 0.33% of loans with a payment at least 60 days past due was the lowest ever recorded. More broadly, in the first quarter (second quarter data not yet available) the percentage of consumer loans and credit card payments considered delinquent fell to its lowest levels since the Federal Reserve began keeping track of the data in 1991.

Source: Thomson Baseline

SUMMARY

How Washington handles the "fiscal cliff" will be very important to determining America's near-term economic path. However, we believe there is political consensus for allowing tax hikes and spending cuts to ease into the economy over time as to cushion the economic impact. Additionally, we believe fundamentals within the consumer and corporate sectors of the economy are in much stronger position to support economic growth and thus offset our necessary government austerity.

Currently, we expect the U.S. economy should grow at an approximate pace of 1.5% to 2.0% over the first half of 2013 and ultimately achieve a full-year growth rate of 2.0% to 2.5%.

Regardless of who wins in November, elected officials face very stark budgetary decisions. The Federal government simply cannot pay the promised level of benefits with the promised level of taxes. This has long been the case, but the shortfall was obscured by easy borrowing. Without rational adjustment, borrowing could become an untenable proposition - as currently evidenced in Europe.

RISKS

Though we have confidence in our forecast of a slow, continuing economic recovery, we recognize that a number of serious economic and financial market challenges remain. The European Sovereign Debt crisis remains very dynamic and subject to market sentiment. Should this situation actually come to a "make-or-break" crisis momentum, we are somewhat confident the European Central Bank would step in as a lender of last resort, but such support is far from guaranteed.

Government debt loads are exceptionally high in many of the world's developed economies. The hard choices associated with correcting these imbalances is likely to weigh on economic performance for some time; but allowing debt levels to continue higher would ultimately be much worse.

Additionally, we are in unchartered territory in terms of potential policy response should the economic recovery falter. Monetary and fiscal policy, the traditional levers of stimulus employed to counter a downturn, are largely exhausted. Interest rates have very little room to go lower and government debts are already on an unsustainable path. Should another adverse global economic shock occur over the intermediate-term, there is little government officials could do to directly counteract the results.

Oil and other commodity prices also pose a risk to the economic outlook. Crude oil prices have the potential to place a ceiling on global growth prospects as prices seem to rise with every sign of economic life, as would potential spikes related to tensions with Iran.

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