

## Macro Economic Issues with Debt Ceiling Extension

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### 2011 Outlook

**GDP GROWTH:**  
2.5%

**UNEMPLOYMENT:**  
9.0%

**INFLATION:**  
1.75%

**FED FUNDS RATE:**  
0.35%

### Background

1. Let us begin by saying what is happening regarding the debt/spending/taxation question in the U.S. is part of the dialogue which we have been classifying as “The Long, Hard Slog”. We first wrote on this concept in the 4<sup>th</sup> quarter of 2007, believing debt structure and excessive leverage would eventually lead to economic changes which, would prove to be profound in their magnitude and duration. Part of the “Long Hard Slog” centers on the basic question of “what do we as a society expect from our government”. What are we willing to pay for, what is the role, in general, of our government? We are not alone in asking and attempting to answer this question. Many societies in Western Europe are actively asking this question. Japan is asking this question. The issue of too much deficit spending by our government is not a disease in and of itself. It is a symptom of the real problem. That problem resides in the fact that most western societies have been losing “market share” of the world’s economy since 1985. Over that period, we as a society have been leveraging our balance sheet, nationally. Now, we as a people are attempting to “de-lever” our balance sheets. Consequently, our government is now being asked to justify spending/debt levels.
2. We believe the outcome of highest probability is the debt ceiling will be increased. We believe our leaders in Washington will come to some sort of compromise, be it short term in nature. **WE DON’T BELIEVE THE U.S. GOVERNMENT DEBT MARKET IS IN JEOPARDY OF DEFAULT.**
3. We suggest the more likely scenario is the debt ceiling will be raised, enough spending cuts and tax increases will occur to allow the passage of a debt ceiling extension. However, even if this were to occur, the risk of a credit rating cut may remain on the table. If this were to happen, we would expect consternation to occur in the bond market.

### Potential Economic Impact

1. We need to understand that all which is being said regarding economic impact is what MAY happen – not what WILL happen. Economic forecasting is the science/art of using past relationships and economic outcomes to certain events/stimulus to project what may happen in the future. In more than

100 years we have never had a credit quality downgrade on Treasury debt, nor experienced an outright default on our obligations. So, we have no real comparables to use when making this analysis. Consequently, much of what will be said is speculative in nature.

2. If the debt ceiling is NOT raised, it is highly unlikely an actual “default” on Treasury debt obligations will occur. Roughly 60% of federal government spending is financed through tax receipts. So, upwards of 60% of current spending can take place without borrowing another dollar from the debt markets. Consequently, we believe interest payments, most forms of transfer payments (Social Security, Medicare) should continue without interruption. Military payments of most sorts should continue. Beyond that, a “pecking order” will need to be established regarding payment.
3. Regarding direct economic impact, a full 24% of economic activity annually is generated through government spending. This is about \$3.4 trillion per year. IF no more borrowing were to occur over a 30 day period, representing roughly \$113 billion of government spending would be curtailed over a 30 day period. This spending cut would probably take some time to “ramp up” – perhaps up to 30-60 days. Consequently over the first 60-90 day period, government spending would decrease by roughly \$170 billion. GDP would slow by over 4%. Currently, GDP growth is coming in around a 2% rate. Consequently, THE GROWTH IN THE ECONOMY MAY RAPIDLY SLOW. ECONOMIC RECESSION MAY BE IN THE CARDS IF GOVERNMENT SPENDING WAS TO SLOW TO THIS DEGREE THIS RAPIDLY, AND THE PROBLEM WAS TO PERSIST FOR AT LEAST A TWO QUARTER PERIOD OF TIME. We don’t believe economic recession to be a “base case” outlook, but the risk of an absolute economic contraction appears to be present, if government spending is curtailed long enough.
4. Within this analysis, it is assumed that most of the lost economic activity due to the delay in payments by the federal government would eventually be paid. Consequently, we believe the pure economic damage done by these delays will primarily be a growth “transfer” rather than a growth “sacrifice”. That is to say, if the economy slows significantly during the 2<sup>nd</sup> half of 2011 due to these cuts, much of that growth will be made up during the 1<sup>st</sup> half of 2012 as government programs are reinitiated.
5. As we proceed through this difficult, anxious period, it is our opinion, once again, that we as a people are answering the needed question “what do we expect from our government”. This question has been ongoing now for years, some would say centuries. We appear to be at a crossroads regarding this question. We firmly believe the U.S. people will answer this question, and move forward productively as a people and society.



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