MID·CONTINENT CAPITAL

CONSILIUM *

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*advice; judgment; resolution; wisdom

Promising More Than Can Be Delivered

With seven trading days remaining in the first quarter, the S&P 500 equity index has generated a 4.9% total return thus far in 2010, and recently reached its highest levels in 18 months. Of greater interest perhaps – and certainly more indicative of the current investment environment – was the nature of this gain: a 3% rise, followed by a two-week 10% drop, and a subsequent 13% rally. We continue to believe that a period of modest rates of return is possible as investors vacillate between "hope" for a strengthening economic recovery and "despair" over the inevitable end to the Federal Reserve's loose monetary policy. For the moment, the "hope" camp has the stronger case, as nearly every important macro indicator, from corporate profits to retail sales to industrial production, is moving in a positive direction. We are also pleased with the business performance of the majority of the companies we hold in client portfolios. Still, we expect that making money in stocks will be a harder slog for the next few quarters.

The most noteworthy development of the New Year has been the renewed, widespread focus on the fiscal imbalances of the world's developed economies. The government debt crisis in Greece, resulting from profligate spending on social programs and public sector pensions, along with a dwindling tax base, has citizens and investors everywhere asking: could it happen here in the US?

To address that question, it's important to remember "how we got here":

- Late 1990s: budget surpluses emerged thanks to several years of disciplined spending and robust personal income tax receipts due to the booming stock market; long-term crises in Medicare and Social Security programs were not addressed.

- 2000s: government tax receipts dropped sharply even *before* the "Bush tax cuts" took full effect as capital gains dried up, yet spending soared post-9/11 on both discretionary programs and national security; long-term crises in Medicare and Social Security programs were not addressed.

- 2010: owing to significantly higher spending, especially on Medicare, prospective deficits stand to become materially worse, even as tax receipts recover. The currently proposed ten-year spending plan calls for outlays, on average, that are 58% higher than those in past administration's final year in office.

The magnitude of the problem is staggering: this year's $1.7 trillion deficit will be followed by a decade of cumulative deficits totaling $7.5 trillion. By 2020, the continued accumulation of deficits will raise Federal debt to $19 trillion, or 77% of GDP, compared to $9 trillion, or 63% today. If left unchecked, by mid-century government spending is projected to represent half of all economic activity in the US; the annual deficit alone will have reached $10 trillion, or 22% of GDP, compared to the post-war average of just 2%; and Federal debt will exceed $140 trillion, or 300% of GDP. It would be fair to say that at such a point in time, the US will have ceased to be a free-market economy.

Just as a worker cannot create more hours in a day in which to earn a wage, the federal government can only do so much to raise additional revenue; higher tax rates will eventually fail to increase tax receipts. Economic theory and empirical evidence indicate that as tax rates rise, taxpayers have decreasing incentives to work and generate income, negating the intended effect of the tax rate increase. Indeed, at some point tax rates can become high enough to encourage the kind of tax avoidance that has become an art form in Greece. Some might also argue that we can inflate our way out of our debt, although the resulting higher interest rates would depress economic activity and increase deficits in the short

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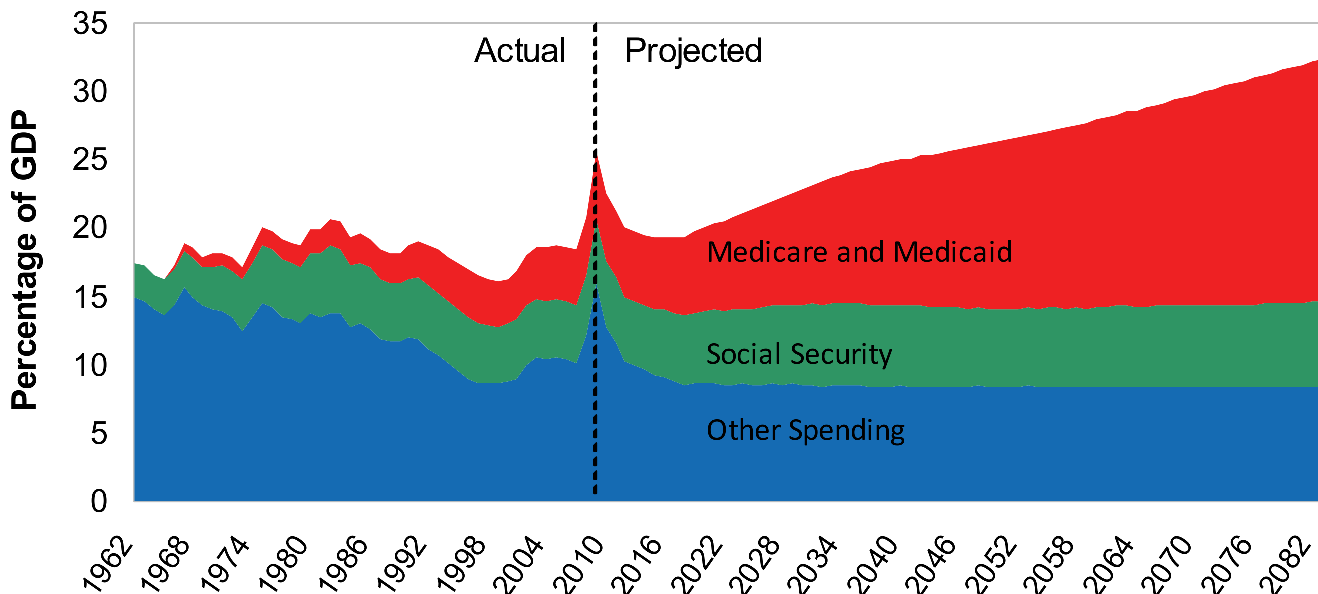
run as debt had to be rolled over. Therefore, a significant curtailment of the growth in federal spending, *especially* entitlement programs, is the *only* solution with a fair chance of long-term success.

Like Greece, our government has made promises that it simply cannot afford to keep. Greece's stagnant population growth, due to low birth rates, merely brought it to its current situation sooner. By waiting until the crisis was at hand, its government closed out options that could have been successful if implemented sooner, and the result is a painful retrenchment that has, predictably, led to social unrest. There is no reason to expect a different outcome in the other major, aging economies, especially Japan, the UK, France and Italy.

The US is equally vulnerable but our higher birth rate gives us some demographic "insurance" that might allow us to address our problems before the solutions become too painful to contemplate. Citizens from across the country are becoming intensely focused on the issue of fiscal responsibility and the unsustainable growth of government spending, for example, and there is widespread agreement that the earlier we address our deficits, the more palatable the "medicine" will be. *There is sufficient engagement on the part of the electorate that the time may be ripe for action.*

The consequences of inaction are clear: significantly higher interest rates (depressing the values of every asset class), permanent wealth destruction, reduced standards of living, a loss of US power and influence globally, social unrest, and perhaps even unprecedented political and cultural upheaval. We have not reached that point, fortunately. Nevertheless, Mid-Continent Capital believes this growing problem will become more relevant in future years, and inevitably will play a greater role in our efforts to grow and preserve our clients' assets.



Source: Mercatus Center/Veronique de Rugy's calculation based on Congressional Budget Office

References: *** The Budget of the United States Government, Fiscal Year 2011** http://www.whitehouse.gov/omb/budget/Overview/
*** A Roadmap for America's Future** http://www.roadmap.republicans.budget.house.gov/plan/
*** Baseline**

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