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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

The Office of Management and Budget now forecasts the US economy to grow 1.7% this year and 2.6% in 2012.

Australia, Canada, Denmark, Finland and Sweden all regained their AAA ratings in recent years after losing them, but the shortest time any of them managed it was nine years – *International Business Times, Aug 8 , 2011*

The National Debt

On August 5th, Standard and Poors downgraded the credit rating of US with much fanfare. US treasury securities were most directly affected by the announcement yet their prices rallied in the immediate aftermath of the event. Most Americans with a passing interest in finance were aware of our longstanding AAA credit rating and had assumed it would last indefinitely. The downgrade raises questions. What is our fiscal condition now and how did we get there?

We should place our country's credit rating in some context. S&P actually downgraded the US to AA+ which is the same rating as Belgium, Spain, Australia, and Hong Kong. A handful of countries retain a AAA rating. The basis for the downgrade went beyond financial metrics to the country's political culture. The prolonged stalemate between the administration and congress over the debt ceiling contributed to the agency's doubts about the American political process. This excerpt from S&P's announcement illustrates:

> The downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned when we assigned a negative outlook to the rating on April 18, 2011

In additional to the political crisis, the county's financial health has deteriorated. One of the most common yardsticks of sovereign credit health is the ratio of a country's total public debt to its gross domestic product (GDP). It is analogous to a family's debts divided by its annual income

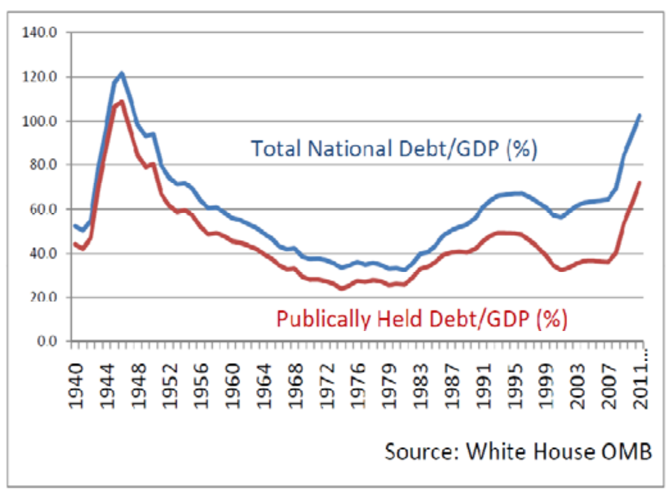
A couple of observations are in order. There are ***two*** major definitions of the public debt. The first is *total national debt* which is the sum of all the obligations issued by the treasury department. The second is *publically held debt* which excludes those treasury securities held by other US government agencies. Social Security is the biggest such holder. The second measure is roughly 2/3 of the first as government agency holdings of treasury securities are very substantial.

Unfortunately, the trust fund assets of the social security administration and other agencies are dissipating rapidly. The treasury will be asked to redeem these securities in a comparatively short period of time. And that takes us back to the definition of total national debt as the operative measure of fiscal health. The reader should be aware that both measures are used in the popular literature. As a practical matter, they correlate highly with one another as the chart below illustrates.

Our country has had a continuous debt balance since the administration of Andrew Jackson. What has varied is the size of the debt relative to the economy and what was being financed by that debt. Our current debt to GDP ratio does have precedent. In 1946 it reached 130% as a result of heavy wartime borrowing and a postwar recession.

After World War II, the debt obligations of the US were larger than they are now – relative to the size of the economy. Of course, the US had mobilized in an unprecedented fashion to fight a two front global war. Defense spending expanded to nearly 44% of the economy in 1943 and 1944. Even an expansive view of defense spending today would place it at less than 10% of the economy. Instead, modern America spends considerably more on federal entitlement programs such as Social Security, Medicare, and Medicaid.

Despite a large national debt 65 years ago, postwar America did not face the huge looming



deficits in its entitlement programs that we face today. Those World War II expenditures would be short lived. Not so, our retirement and health care commitments. Most economists are in general agreement on this issue and they estimate the present value of these deficits from $55 trillion to $110 trillion dollars! The annual output US economy today is only about $15 trillion.

What we have now is a debt burden that has precedent only in the context of a militarized American economy in the 1940s. Moreover, that debt burden is projected to increase dramatically because of promised transfer payments to a rapidly expanding senior population.

S&P continues to have a "negative" outlook on the US credit rating. The agency will be reviewing political developments in the United States with an eye towards efforts to reduce the size of its deficit. One of the products of the compromise over the debt ceiling extension was the creation of a bipartisan budget "supercommittee". Its mission is to create a plan before Thanksgiving to cut $1.5 trillion in federal spending over the next decade. Its recommendations must be voted on by Congress before Christmas.

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This will be the fourth commission tasked with addressing federal budget issues in the last two years. They've all come up with some good (if painful) ideas. The problem is that their recommendations have been ignored by either the President or Congress – or both..

One could argue that the stakes have been raised. The US credit rating has suffered and S&P has said that there is a significant likelihood of another downgrade in the next 18-24 months. So far the borrowing costs of the treasury have not been adversely affected. There appears to be no successor to the dollar as reserve currency on the horizon. The Euro has its own set of problems brought on by profligate spending by several of its members.

But no one will sound a trumpet to warn us when investors will exit dollar holdings. So far, the Federal Reserve has been able to prop up the prices of treasuries with its open market operations. Ultimately, the value of a currency is tied to its ability to purchase goods and services. The US is in the unenviable position of printing large amounts of currency in an economy which is expanding slowly. That's not a recipe for a strong dollar.

The Municipal Bond Market

The recent downgrade in the credit rating of the United States has had a cascading effect on the $2.9 trillion municipal bond market. Thousands of cities, school districts, public housing and transportation projects directly linked to federal funds saw their credit ratings reduced by S&P. The good news is that fewer than 1% of the outstanding issues were effected and that the municipal bonds market has continued to trade reasonably well.

Nevertheless, there is heightened concern of default risk in the municipal bond market. Numerous states have had well publicized fiscal crises in the last two years. Real estate values, which serve as key support to the property tax regime of local governments, have taken a plunge.

The demise of municipal bond insurers eliminated a key credit backstop for municipal bond investors. In early 2008, there were four major bond insurers underwriting about half the municipal bonds outstanding. Now there are only two left insuring about 10% of the marketplace, Well known municipal bond analyst , Meredith Whitney, caused a stir last December when she predicted "hundreds of billions" of dollars in municipal defaults in the near future.

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These fears have not yet been validated. In fact, default rates this year have fallen relative to 2010. In the first half of 2011, only 24 issues totaling $760 million have gone into arrears. This is an annual rate of about 0.05%. Historically municipal bonds have enjoyed default rates that are much lower than the corporate sector – and that trend has continued.

We must travel back in time to the Great Depression of the 1930s and the Long Depression of the 1870s to find significantly heightened default rates. 24.5% of the issues outstanding defaulted in the Long Depression and 15.4% defaulted in the 1930s. Notably, the recovery rates on defaulted bonds were quite high in the later depression. The total loss on all municipal bonds due to default was only a small fraction of the tax-free bond market.

The ratings agencies may have been unable to assess the risk of real estate derivative securities in the subprime crisis. So far, however, there ratings of municipal issuers have been stable and have correlated with actual default experience. No AAA bonds have defaulted within ten years. Even the lowest investment grade has only had a cumulative default rate of 0.16% after one decade. Ratings do count for something.

Default is the last option any municipality would choose in a financial crisis. Default effectively freezes the borrower out of the bond market for years to come. And there are no ready substitutes for bond financing. Debt service comprises less than 10% of the total budget for most issuers and this obligation is usually senior to most everything else. In other words, lots would have to go wrong for large scale defaults to occur in the near term.

However, there are longer term structural problems with the municipal market. Most are related to a looming unfunded liability of health and pension entitlements. In that sense, the problem is similar to that faced at the federal level. As states and cities cannot print their own money, they may be forced to take the lead on meaningful fiscal reform in advance of the Federal government.