WEBB ASSET MANAGEMENT

October, 2009

Monthly Commentary

SYSTEMATIC, PROVEN & RELIABLE

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The global economy continues towards recovery concurrent with secular declines in the balance sheets of corporate America and nations alike. Being opportunistically bullish short term as the economy and earnings accelerate can and will provide investors with significant potential gains.

Specifically, this month's comments will focus on the secular degradation of the US Treasury's balance sheet. The GDP of the US is currently $14 trillion. Treasury revenues are $1.7 trillion and expenditures are $3.1 trillion. The deficit is $1.4 trillion or 10% of GDP. This is the largest deficit to GDP since World War II. Proponents argue that, like post-WW II, it is necessary to run significant deficits to combat this crisis.

This is a fallacious comparison. The World War II deficit was temporary while the current deficit is permanent. When WW II was over, the economy shifted back to being consumer driven. There were five years of pent up demand and the world needed rebuilding. This is not the current scenario. When this economic crisis is over, GDP will be stronger but not torrid. More importantly, with 60% of federal expenditures as entitlements (Medicare/Medicaid, social security, and welfare) there are few easy choices to reduce expenditures. Defense is the one area that could be cut at 24% of expenditures. Interest is already 10% of expenditures.

The Congressional Budget Office (CBO) recently published the deficit projections for the next ten years. The projections show the deficit at 10% of GDP in this fiscal year declining gradually to 5% of GDP in 2019. THIS IS THE WAKE UP CALL THAT DEFICITS ARE BECOMING STRUCTURAL. The USA cannot continue its profligate ways.

Treasury debt currently amounts to approximately $12 trillion or 86% of GDP. $1.4 trillion of debt will be added this year and $9 trillion added over the next ten years. Thought the CBO's projections call for the deficit to GDP to decline, the relative levels of debt to GDP will increase. If one assumes GDP grows at 3% annually, debt to GDP will increase from the current 86% to 125% of GDP in 2020.

There are four ways to reduce the debt burden: 1) raise taxes, 2) reduce expenses, 3) default, or 4) monetize the debt. There is no magic fix and the solution will most likely come from all four.

The question is how long can this continue without negatively effecting the economy. There are currently no solutions to effectively control Federal deficits. In fact, there exists a real danger that the Obama government may be trying to remedy the nation's crisis with a printing press solution.

By 'printing press' I mean to say the Federal Reserve buys the debt that the Treasury is issuing thus expanding the supply of dollars into the economy. In the past, during deficit periods, the debt issued by the Treasury was purchased by private capital and not by the Fed. Remember the old war posters 'Buy US Savings Bonds'? This kept the money supply and interest rates in check. This period marks a dramatic change, as the Fed is purchasing massive amounts of debt. This is referred to as 'quantitative easing'. Effectively, the Fed is purchasing debt to hold down interest rates, but this doesn't provide a stable, long-term solution.

Eventually, structural deficits will lead to higher interest rates and a lower dollar. If the Fed keeps buying treasuries there will be monetary inflation and ultimately higher interest rates. If the Fed stops buying treasuries, rates will rise naturally. Until there is significant strategic change from the current Administration, the balance sheet of the federal government will continue to erode.

Beyond the economic argument, there is a much larger 'moral hazard' issue at hand. How can a humane society create a stable and prosperous future by mortgaging away the economic well-being of their children today? Pete Peterson said it the best: 'You can only judge the worth of a society by what they leave to future generations'.

Predicting a tipping point that will push rates substantially higher is difficult. It is possible we may already be there. However, while the Fed continues to inject money and inflate the economy, we want to stay long. For the longer term, significant political and strategic changes need to occur for the U.S. recovery to have a chance at creating a sustainable and prosperous future for all Americans.

– Derek Webb

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