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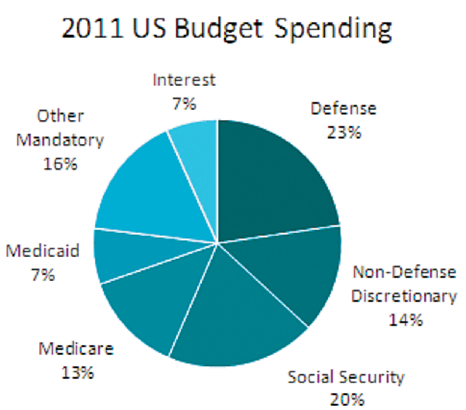
INVESTMENT OUTLOOK

Muddling through U.S. fiscal challenges

Recent headlines highlight the fiscal problems in the United States. This year's deficit is expected to reach $1.5 trillion or close to 10% of GDP. The total federal debt is about to breach the most recent ceiling of $14 trillion or close to 100% of GDP. To put it in perspective with some of the problem countries from Europe, Greece's debt is expected to reach 140% of GDP in 2011, while Ireland and Portugal owe 93% and 99% respectively. However, when you add on the future unfunded liabilities from Social Security, Medicare, and Medicaid the U.S. total jumps to $74 trillion, or 5 times the overall size of the entire U.S. economy. This has led some investors to sell their U.S. government debt and forecast inflation, currency devaluation and spiking long term interest rates. In this issue of INvested, we analyze the U.S. government debt situation and try to determine the potential impact for Canadian investors.



When looking at the deficit situation, it is important to try to separate the cyclical aspects from the structural.

For instance, payments for unemployment insurance are cyclical and apart from the 2007-09 recession this program has tended to operate with a surplus. Revenue from payroll taxes and income taxes have been quite depressed and are expected to rebound as employment improves and recent investment gains are realized. However, even adjusting for some of these cyclical effects, the structural deficit is still sitting at close to $800 billion per year. The main drivers of the structural deficits are the entitlement programs of Medicare, Medicaid and Social Security.

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Payroll taxes kept Social Security mainly at break-even until 1975-81 when expenses began to exceed revenue. Reforms that cut average benefits by 5%, raised tax rates by 2.3%, and increased the full retirement age from 65 to 67 restored the system's stability for the next 25 years, but the demographic outlook is poor for its pay-as-you-go funding structure. In 1950, 100 workers supported six beneficiaries; today, 100 workers support 33 beneficiaries.

Since Social Security began in 1935, American life expectancy has risen 26% (to 78), but the "retirement age" for full benefits has increased only 3%.

In light of these challenges, should investors sell their U.S. government bonds?

We would suggest caution from such extreme measures.

We believe that the current challenges are manageable in light of the positive factors behind the U.S. economy.

Social security can be reformed through three steps: reducing benefits to high income earners, increasing the cap on earnings subject to Social Security taxes, and increasing the retirement age gradually to 68 in 2050 and 69 in 2075.

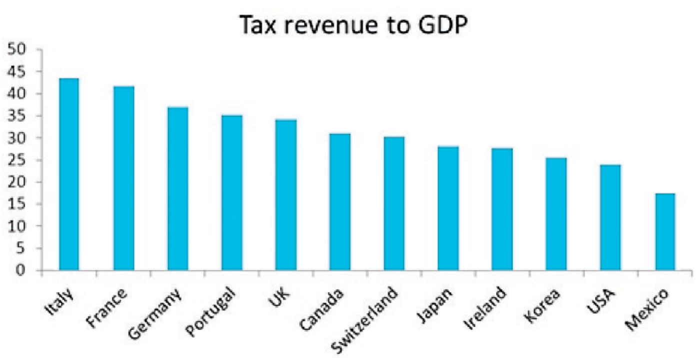
On another front, Medicaid and Medicare—the programs providing health insurance to low-income households and the elderly, respectively —now cost over 5% of GDP in the U.S.. Since their creation in 1965, both programs have expanded markedly. Medicaid now serves 16% of all Americans, compared with 2% at its inception; Medicare now serves 15% of the population, up from 10% in 1966. As more Americans receive benefits and as healthcare costs continue to outstrip GDP growth, total spending for these two entitlement programs is accelerating.

Medicare is the much larger problem. To close the funding gap, we would need to see a doubling of Medicare tax or a halving in benefits. The underlying problem is that healthcare spending in the U.S. (at 16% of GDP) is a much larger percentage of the economy than developed country peers at about 10%. Meeting this challenge will require more fundamental reform including improving efficiency of healthcare delivery and supporting healthier lifestyles for citizens in general. The current legal environment can incentivize over-testing and overly expensive treatments, as can individuals' attitudes about extending their own life at any cost. Correcting lifestyles and legal/societal forces will be an important part of reducing healthcare spending.

What is the likelihood that Americans have the political will to tackle some of these larger problems? While a hefty 80% of Americans indicate balancing the budget should be one of the country's top priorities*, only 12% of Americans support cutting spending on Medicare or Social Security**.

In light of these challenges, should investors sell their U.S. government bonds? We would suggest caution from such extreme measures. There are three main factors that give hope to the ability of the U.S. economy to weather some of these fiscal challenges.

First, despite debt levels being at historic highs, debt service has been close to historic lows as a percentage of GDP due to the lowest interest rates in 50 years. The power of the U.S. currency as a reserve currency and historically low interest rates have given enormous flexibility in timing some of these adjustments.



Secondly, the U.S. tax burden is very low especially when compared to other OECD countries. Total tax revenue in the U.S. is only 24% of GDP compared to 34% in other OECD countries and 31% in Canada. Though tax increases would be politically unpopular, this lower current level of taxation gives the U.S. more flexibility to raise revenue.

Finally, real GDP growth in the United States has been quite strong over long time periods and in fact has expanded by 3% annually over the last 40 years. When this is split out, approximately half comes from population growth and half from productivity. It is this productivity growth and net population growth that will be required to improve the fiscal situation in the United States.

Overall, it is clear that the United States will need to make some hard decisions on taxes and benefits. That being said, some analysts have used the current cyclical challenges as a motivation for extreme forecasts and radical portfolio shifts. We believe that the current challenges are manageable in light of the positive factors behind the U.S. economy.

In Canada, healthcare inflation is also a problem. The expansion of the scope and quality of services coupled with low rates of productivity growth have meant that the share of national income devoted to heath care spending has grown from 7 to 12 percent. On the other hand Canada's single-tier public healthcare system is a beloved service that taxpayers seem to want to support. Changes have been proposed on a number of fronts: the quality and quantity of service may have to go down and taxed and private costs may have to rise.

The Canada Pension Plan is a conservative program that offers an indexed benefit to workers that have contributed to the plan. While the number of retired people in Canada will grow as the boomer generation retires, a pool of assets has been accumulated toward this need. In fact, the CPP liability is fully funded and the assets are managed by a globally recognized team.

So, while the decisions faced by Canadian leaders and taxpayers bear similarity with those in the U.S. the magnitude of the problem here is far less acute. At the same time, Canada has only 34% debt to GDP (or about 65% including provincial debt) and a tractable path to balanced federal budgets within the next few years.

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Conclusion

This issue of INvested has argued that the U.S. situation is manageable. Like many difficult situations though it has the potential to get worse before it gets better. One question is whether Canadian interest rates can effectively decouple from U.S. rates should U.S. rates start to reflect a loss of confidence. There is no doubt that the economic damage of higher rates in the U.S. would be felt in Canada; however all things equal, this could put downward pressure on Canadian rates through slower growth and inflation. Yields have diverged significantly in the past. In the early nineties, when Canada's situation was worse than the U.S., the Canadian 10-year bonds paid 2.5% more than U.S. Treasuries. Foreign flows into Canada bonds have become significant since 2008 as a way to buy the Canadian dollar and Canadian credit risk. This capital flow might reflect a reallocation from U.S. Treasuries which, if sustained, could establish a wedge between the respective rates.

Canadian-based investors are fortunate at this point in history to have the majority of their fixed income assets at home. While U.S. savers face the prospect of costlier healthcare, reduced entitlements, and higher taxes, Canadians have relatively benign fiscal challenges. At the same time, these factors should mean that Canadian rates will only rise in sympathy with the economic cycle. The fixed income component that we manage will seek to find value in non-government bond positions that will appreciate into the recovery and by underweighting shorter dated bonds so we can take advantage of curve flattening – a situation where near term interest rates rise relative to bonds maturing further out. As a whole, fixed income returns will be limited as rates rise; however this part of the cycle will coincide with superior returns from equity investments.

We believe that the U.S. will find a way to muddle through and eventually turn the corner by addressing its giant entitlement spending and liabilities. Canadian fixed income investors are in an even better position because Canadian rates have the ability to outperform during the adjustment period.

Medicare/Medicaid statistics taken from A Basic Summary of America's Financial Statements, USA, Inc., Mary Meeker

*Peter G. Peterson Foundation survey in November 2009
**Pew Research Center survey from February 2011

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