February 8, 2010

The Week

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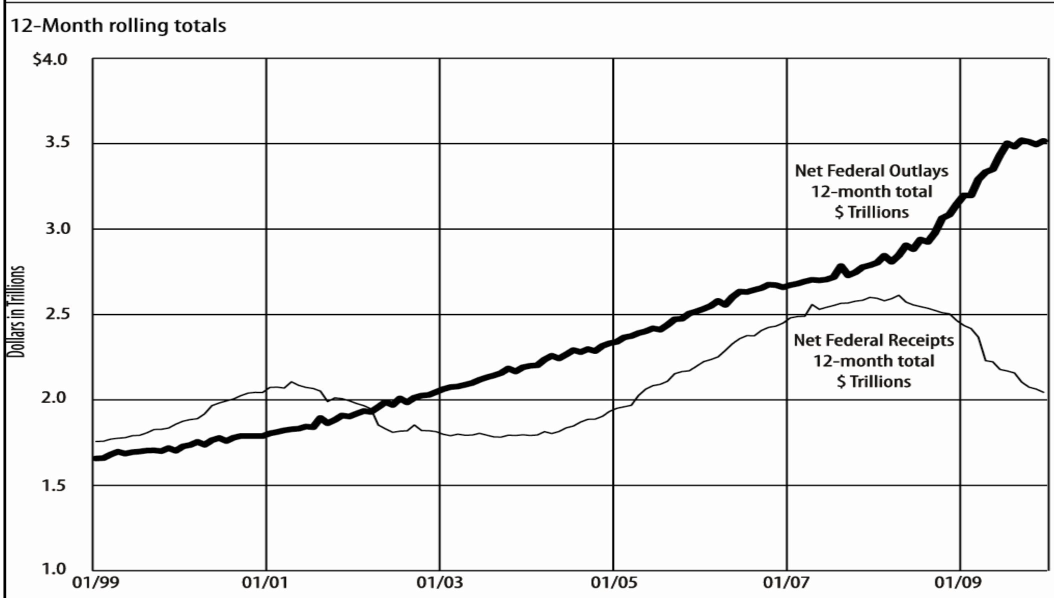
Can we grow out of this one?

- Last week, the government released its budget projections for 2011 and beyond. Unfortunately, there is red ink as far as the eye can see. This bad news comes at the same time when investors are worried about the sovereign debt of several European countries, including Greece and Spain. To top it off, Moody's, the credit rating agency, warned that the U.S. triple-A sovereign credit rating could come under pressure, if the U.S. economy does not perform well or U.S. policymakers do not take action to reduce the deficit.
- One of the themes from our 2010 outlook was to expect higher taxes after the Congressional elections this fall. The new budget projections suggest that higher taxes are indeed likely. The Bush tax cuts are set to expire at the start of 2011, and other tax increases are possible if Congress cannot cut spending.
- A review of the U.S. budget situation shows that the federal deficit has increased because of a decline in net revenue during the recession as well as an increase in net spending. Revenues declined because many workers lost their jobs and no longer paid taxes. At the same time, spending surged because of the government's rescue of the financial system along with the increased expenditures for benefits to unemployed workers. In the 12 months ended in December, the yearly deficit stood at almost $1.5 trillion or 10.2% of current U.S. economic output as measured by gross domestic product (GDP).
- So the big question is can the U.S. economy grow out of this deficit? Looking ahead, revenues are likely to increase when the unemployment rate begins to decline and tax receipts increase. If the government can reduce spending, then it would be possible to grow out of the deficit problem. Unfortunately, that does not appear likely. The government still wants to spend money on many projects that it considers investments. The key issue is whether the United States can afford these investments given its high debt level and the large percent of U.S. government debt held by foreign governments. Increased spending, even on public investments, means that the deficit is unlikely to decline significantly in future years unless taxes go up considerably.
- Recent market action indicates that investors are becoming increasingly concerned about the U.S. budget situation as well as the prospects for less global monetary stimulus. The decline in the U.S. equity market in January was similar in scope to the short-term market corrections this past June and October. However, the reversal in market sentiment discussed in last week's report and follow-through selling in early February suggests that the character of the equity market may be changing. If the S&P 500 trades below the 1039 level and stays there for several weeks, this would be an important signal to us that the U.S. equity markets are probably in for an extended period of weakness not just a short timeout similar to corrections in June and October.
- The rally in the U.S. equity markets during the past year was one of the longest advances without a major correction since 2000. Therefore, an extended period of consolidation or weakness is possible. This is consistent with our 2010 outlook which said that during the year after a strong market advance the equity markets are often more volatile and gains are more modest.

- During the 1990s, the U.S. equity market had several rallies that were longer than the most recent rally. But that was when the budget deficit was declining, eventually turning into a surplus by the end of that decade. The healthy economy and the declining deficits in the 1990s made investors more optimistic about future economic prospects, pushing price/earnings multiples to high levels. Unfortunately, the deterioration in the budget situation during the past decade has had the opposite effect.
- This week's chart looks at the trends in federal spending and revenues. The gap between rising net expenditures and declining net revenues has increased dramatically during the past two years because of the recession. The revenue line is likely to increase once employment begins to expand. Unfortunately, the expenditure line is unlikely to come down substantially if the government uses the temporary financial rescue funds to finance other spending instead of reducing the deficit as originally planned.
- Recent economic reports have been more positive than negative. This helps support the equity markets during periods of weakness. Alternatively, during the recession, the economic news was more negative than positive. Consequently, the equity markets dropped dramatically during periods of weakness. As long as the economy continues to grow, equity market corrections this year may be substantial but are unlikely to be as severe as the steep declines during the recession.

Federal receipts and outlays



Source: Haver Analytics