

# The Week

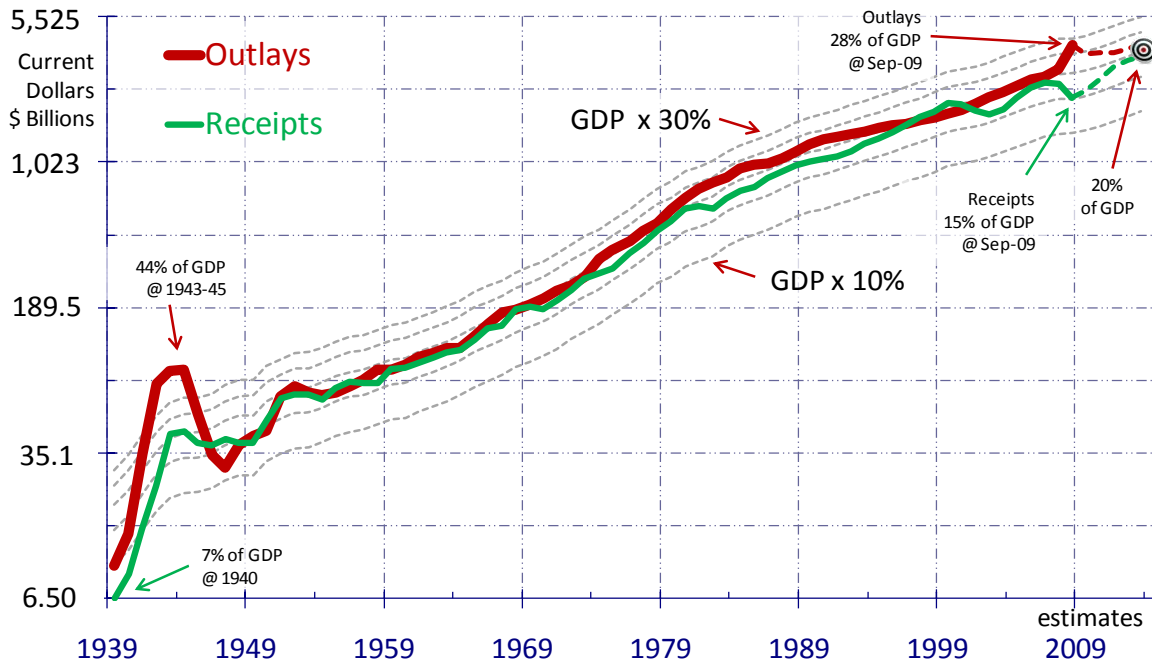
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*Tom McManus, Chief Investment Officer*

## **Going for Growth**

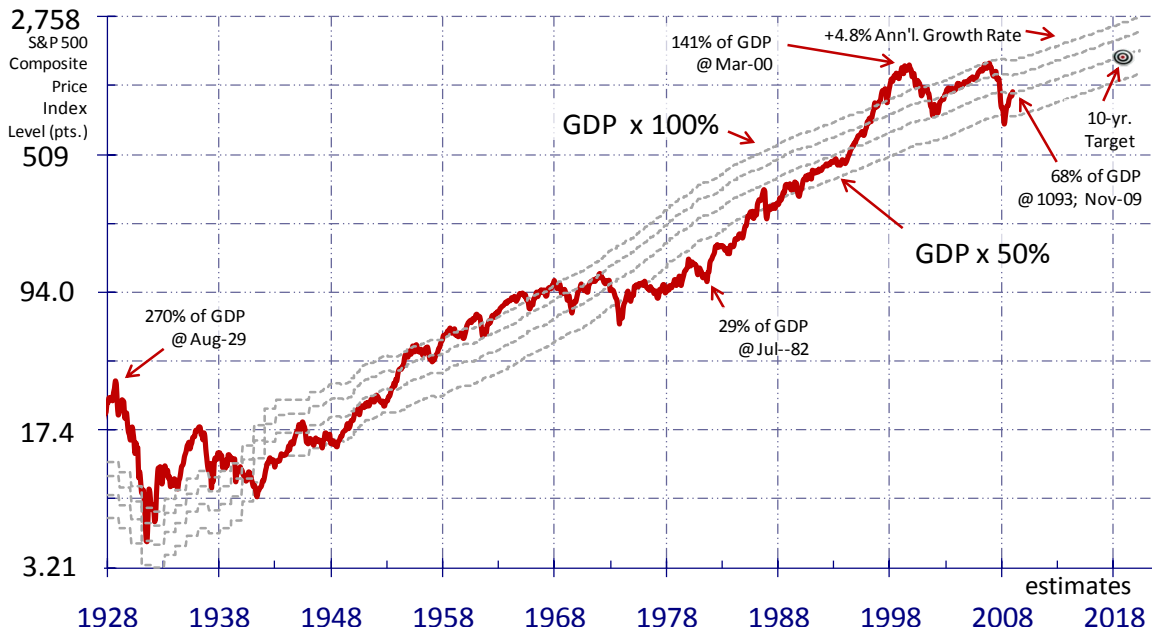
- In a speech to legislators after her recent reelection, German Chancellor Angela Merkel put her priorities on the line: their government's preeminent goal is to foster growth. "I want us to do everything we can do to create the conditions for new, stronger growth. Without growth, no investment; without growth, no jobs; without growth, no money for education; without growth, no support for the weak," Mrs. Merkel said. The story is no different in the US; our recovery and future standard of living depends on restarting economic growth.
- In the 56 years (that's 14 four-year Presidential terms from Eisenhower to George W. Bush) prior to the fiscal year just ended, total outlays (i.e. spending) of the U.S. federal government averaged 20% of Gross Domestic Product, and the total receipts (taxes, etc.) averaged 18%. Our first chart shows that both outlays and receipts tracked GDP closely; in fact, half of those years saw outlays within  $\pm 1.2\%$  of GDP around the average and receipts within  $\pm 0.5\%$  around their own average.
- The 2009 fiscal year was a big shocker as outlays soared to 28% of GDP and receipts plunged to 15% (see first chart). Spending jumped by \$1 trillion, boosted by bailouts and stimulus. President Obama's budget anticipates annual spending to remain below the 2009 level until 2013; by that time, if growth gets back on track, outlays will be back below 22% of GDP. Meanwhile, tax receipts should rise as a percent of GDP even without an increase in tax rates, as personal income and corporate profits rebound in the wake of the recession.
- The degree of government stimulus is shown by the budget deficit, the gap between outlays and receipts. Of course, the national debt is merely the accumulation of deficits over time, and many are concerned that 2009's \$1.4 trillion deficit — and more red ink anticipated over the next several years — will cause the debt as a portion of GDP to balloon. The number to track is "debt held by the public," currently a little higher than 50% of GDP. After WWII, this figure rose to 109%, but some post-war surpluses and many years of economic growth helped bring the ratio back to a more manageable level under 40%.
- Of course, the economy is sometimes stimulated by participants other than government. During the era of consumerism, debt owed by US households soared by +8.1% annually, rising from 50% of GDP in 1984 to nearly 100% now. By contrast, in the prior 25 years, household debt increased at a rate more in line with the broad economy, as it ranged between 40% and 50% of GDP. The effect of household debt reduction over the past two years has been a noticeable offset to the increase in government stimulus.
- Some may wonder about the relationship between government stimulus through deficit spending and consumer stimulus enabled by easy credit. Of course, the initial target(s) of their spending may be very different, as government may build bridges and roads while consumers may build homes and hot tubs. But each project requires materials and labor, and the providers of these items help the economy expand by purchasing other goods and services in turn — eventually, it is impossible to determine the origin of the stimulus.
- While the first order effects of these two types of expenditure are essentially indistinguishable, government stimulus — whether it arises from boosting spending or reducing taxes — typically involves a subsidy, or "gift." A county gets a new bridge or school, or a citizen gets a check in the mail or a smaller tax bill. It is not hard to see why so much time and energy is expended in determining who is the primary recipient. But growth depends more on how that benefit courses through the economy, spurring incremental activity. Whether or not the initial target of stimulus is a "good investment" is less critical.

### Largest Budget Deficit as a Portion (%) of GDP since the Second World War



Note: Log scale. Dashed grey lines represent 10%, 15%, 20%, 25% and 30% multiples of Gross Domestic Product (before adjustment for inflation). Budget deficit is the gap between outlays and receipts. Source: White House Office of Management and Budget.

### Our S&P 500 to GDP Ratio is Back to 68% ... the Middle of the Range Since 1940



Log scale. GDP is Gross Domestic Product before inflation adjustment. Stock index shows capital appreciation only. The S&P 500 is an unmanaged index and is unavailable for direct investment. Past performance is not a guarantee of future results. Source: Blue Chip Consensus, S&P, U.S. Commerce Dept.

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