



PERSPECTIVES

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Deficits, Debt Ceilings and Your Investments

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America's Ticking Bankruptcy Bomb – Fox News

Economic Outlook Grim, Budget Watchdog Says – USA Today

Obama Warns of 2nd Financial Crisis – CBC

Recent headlines only reinforce that the United States has a staggering deficit problem. Let's look at some basic numbers. For 2011, U.S. revenues are slated to be 18% lower than the 50-year average, while spending is expected to be 19% higher. In order to maintain a 2011 balance sheet, the U.S. will be required to increase its borrowing by 37%.

This means that the U.S. deficit — if we continue along the same path — could easily rise to 87.4% of our GDP (Gross Domestic Product) within the current decade, a significant increase over this year's debt-to-GDP ratio of 69.1% and a complete departure from the 50-year average. GDP refers to the market value of all final goods and services produced within a country in a given period.

The numbers are not good. The most probable solution will involve program cuts, reduced spending and higher taxes. Simply stated, government revenues must increase *at the same time* its expenditures decrease. Reining in discretionary spending can no longer achieve a balanced budget. In fact, eliminating all non-defense discretionary spending would eradicate only half the current U.S. deficit. To make matters worse, increasing the debt ceiling has become a political football.

How will this rising indebtedness impede our economy? How will this impact the investment returns on your savings? These questions are of foremost concern and weigh heavily on the

minds of most investors today.

Will interest rates rise?

In a word — yes. Growing deficits cause interest rates to rise for a number of reasons:

1. As a country's borrowing needs escalate, a government must offer higher interest rates on its debt in order to remain competitive for capital.
2. As the public sector absorbs a greater portion of investment resources, the revenue pool that would otherwise be available to fuel private sector growth is diminished significantly.
3. As debt levels rise, so too do market concerns regarding higher default and inflation risks.

Each of these risk factors increases the upward pressure on interest rates. In order to move forward, in a competitive and sustainable fashion, U.S. interest rates must rise.

What does this mean for you, the investor? An interest rate increase introduces the potential for diminished return for any and all long-duration bonds within an investment portfolio. Consistent with long-standing advice from Mercer Advisors, the purchase or holding of long-duration bonds continues to be discouraged. On the other hand, short-term bonds will produce favorable and increased returns as they roll over into higher prevalent rates upon maturity, increasing your return on investment.

How will a rising deficit impact your portfolio?

While the impact is certainly negative for long-duration bonds, contrary to what the financial media is reporting, the effect of a skyrocketing government deficit on the rate of return on your stock investments should be minimal.

It is important to understand the distinction between a government's fiscal fate and that of the same country's stock market returns. As implausible as it may seem, a country's deficit and debt levels have not shown to have had adverse impact on stock market returns. **In other words, the state of the U.S. federal economy is not indicative of the state of corporate America.** The relationship between the value of corporate America (rate of return on stock investments) and the rate of the government's economic growth (GDP) is not as inextricably linked as the press infers. It certainly is an issue of nationalistic pride, a disappointment as a citizen, but should not be made into an investment problem. While a combination of high debt and deficits may hamper a country's economic expansion, this slower growth has not

translated into lower corporate earnings.

In fact, a DFA study, using World Bank data from 1991 to 2008, compared current deficits with future GDP growth in 67 countries and determined, as you would expect, that high-debt countries running a deficit are more likely to experience lower economic growth over several years.

Yet, further analysis verified that low economic growth does not result in diminished stock investment returns. The GDP growth of each developed country was measured against its stock market performance in subsequent years. The results were used to designate high-growth and low-growth countries, based on their annual growth in real GDP. There was **no statistical difference** between the annual stock market returns in high-growth versus low-growth countries. In fact, low-growth countries had slightly higher average stock returns than high-growth countries.

Corporate America is currently strong in its recovery and growing — most importantly, it is better positioned to be prepared for the future than it has been for nearly a decade. Many healthy companies have been anticipating and planning for tougher economic times ahead — increasing their reserves of on-hand cash, limiting the hiring of new employees, minimizing inventories and capital expenditures as well as postponing expansion strategies.

What can we expect in the near future?

Unfortunately, we will continue to see misfortune around us. Those who have taken on additional risk by over-extending themselves and over-leveraging their assets will continue to struggle. Foreclosures will continue to occur and poorly run businesses will continue to fail.

Real estate prices are not expected to have a miraculous recovery. We may see more people join the ranks of the unemployed. The lives of many around us will change. In the face of this continuing misfortune, it is vital that we remain resolute in our commitment to making good investment decisions.

While difficult to live through these times of debt-related financial turmoil within a struggling economy, it is imperative for investors to bear in mind the following foundational market premise:

Risk and return are related — it has to work that way. Investors will be rewarded for the systematic risk that they take by providing capital to the market.

The U.S. government deficit has skyrocketed; interest rates are destined to rise. Yet, remember this — corporate America is not inextricably tied to the fate of our government's poor spending policies.

References:

DFA, Deficits, Debt and Markets. December 2010.

MSCI Barra Research Bulletin, Is There a Link Between GDP Growth and Equity Returns?, May 2010.

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