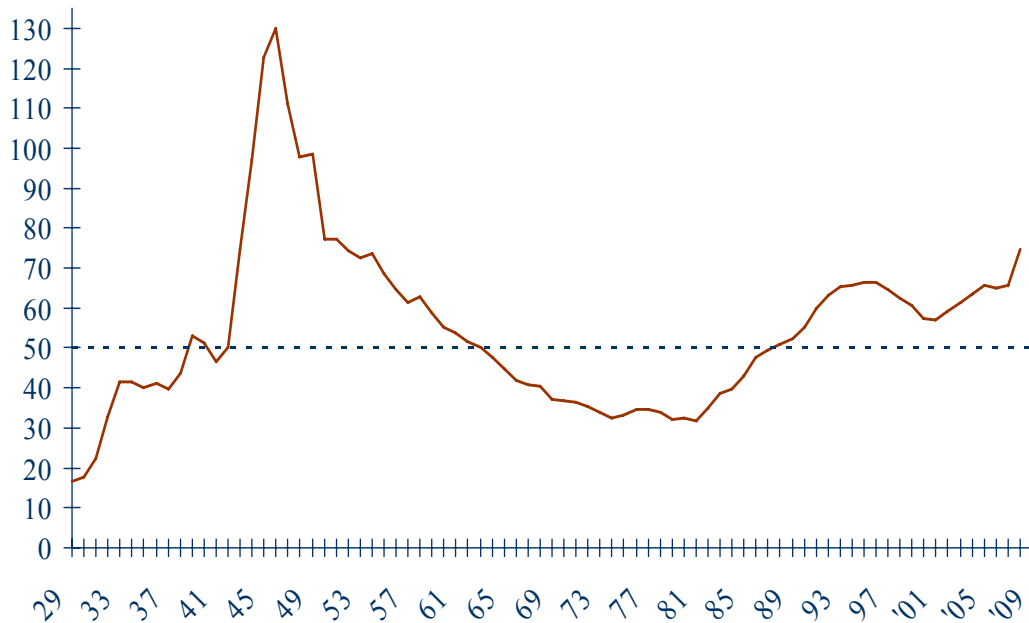


Will the Federal Debt Sink the U.S.?

Throughout the current recession, dizzying arrays of bailouts and stimulus packages have graced the headlines of media outlets worldwide. With billions of dollars already committed to help stabilize the global financial system, and billions more pledged through the administration's federal budget, many fear the U.S. government will eventually buckle from the mounting debt. While current and forecasted debt levels are high compared to recent history, such debt levels will not, as many fear, hamstring the U.S. economy in the immediate future.

The concern about the national debt is heightened due to the recent resurrection of the basic tenants of Keynesian economics. This economic school of thought argues that governments should stimulate demand in recessions through aggressive government spending (budget deficits) and/or tax cuts. The current federal budget is expected to produce record deficits and to cut taxes for 95% of the American public. While some of this spending will be funded by the 5% of Americans who will see their taxes increase, much of it will be financed through an increase in the national debt. The chart below depicts historical U.S. federal debt as a percentage of gross domestic product (GDP):

U.S. Federal Debt as a % of Gross Domestic Product



Through 2008, U.S. federal debt represents 74.8% of GDP, a level not seen since 1952. The 1950's presented a much different situation than the one being experienced now.

With the end of World War II, the need for financing diminished and the ratio fell from its highs as the economy grew. Looking forward the ratio is expected to increase as the U.S. adds to the national debt to stabilize the financial system and stimulate the economy. How much federal debt will be required in the coming years? The budget estimates that total federal debt will increase by \$2.7 trillion in 2009 and by another \$1.4 trillion in 2010. These estimated increases will bring U.S. federal debt as a percentage of GDP to 88.9% in 2009 and 94.5% in 2010 based on the budget's GDP forecasts.

Can the U.S. Sustain These Debt Levels?

Historically, increases in national debt have been due to recession or war. Currently, the U.S. is facing both. While concerns about debt levels blend into the background when the economy is growing, they tend to be pushed to the forefront during recessions when the future is unclear. To finance the national debt the government sells U.S. Treasury securities (bills, notes, bonds, TIPs etc.) to investors, including foreign governments. As long as investors and foreign governments are willing to buy and hold U.S. government debt, the government's financing needs are met and business continues as usual.

The current worry is that debt levels are high enough to dissuade foreign governments from buying U.S. Treasury debt. Additionally, there are fears that sovereign nations will take action to diversify current U.S. Treasury holdings. Such measures would hamper the U.S. government's ability to finance budget deficits, bailouts, stimulus packages and wars. Additionally, such actions would cause the U.S. dollar to plummet in value. With the U.S. dollar as the world's primary reserve currency, many nations, not just the U.S., have a tremendous amount at stake.

How much debt is too much? That is a question that academics and economists have grappled with for decades. No one really knows the answer, but the following points illustrate why the U.S. is able to sustain current and forecasted debt levels, at least for the immediate future:

1. The U.S. has Endured Higher Relative Debt Levels in the Past

While the forecasted debt to GDP ratios are high compared with recent history, the ratio was significantly higher during the years following World War II. In 1946, the federal debt was nearly 130% of GDP. Based on current budget forecasts, the U.S. would have to add \$7.5 trillion to the current \$11.0 trillion national debt to push the ratio to 130%. This would be a 68.2% increase in debt from the current level. Relatively speaking, the U.S. is in much better standing now than it was after World War II. While the world economy and geopolitical climate have changed dramatically over the decades, it demonstrates that the U.S. is able to bear significantly higher debt levels if absolutely necessary.

2. Demand for U.S. Treasuries is Strong

The recent financial crisis has reinforced the fact that U.S. Treasury securities remain the global instrument of choice when investors are faced with anxiety regarding the global economic system. In fact, the yield on the U.S. 10-year note shrunk to just over 2% as investors bid up prices in their "flight to quality" during the most worrisome days of the last 18 months. Even with the global financial crisis originating in the U.S., the global community flocked to U.S. Treasury securities in a massive vote of confidence. Additionally, recent U.S. Treasury

auctions have been met with solid demand. Even with the current elevated debt levels, the global community is willing to extend more credit to the U.S. if needed.

3. China is an Economic Ally

China is the largest creditor to the U.S. As of 12/31/08 China holds \$727.4 billion of U.S. Treasury securities equating to 23.5% of the \$3.1 trillion in debt held by all foreign nations. As China's importance on the world stage grows, many are concerned about the political and economic ramifications of having China as the U.S.'s largest debt holder. While unnerving for many, it is clear that without support from Beijing, the U.S. will have difficulty financing the budget deficit and other activities designed to stimulate the economy. It is important to keep in perspective that China is just as dependent on the U.S. as the U.S. is on China. If China were to stop providing cheap debt to the U.S., it would put upward pressure on interest rates and downward price pressure on their current U.S. debt holdings. Furthermore, if China were to suddenly diversify its holdings of dollars, the dollar would fall making Chinese goods more expensive for U.S. consumers which would slow the Chinese economic engine. The Chinese simply have too much at stake to take action that would be detrimental to both the U.S. and China.

4. The Current Crisis Might Not Cost as Much as We Think

While the administration is estimating that it will take billions to stabilize the economy and the financial system, it does not mean that all of these funds will necessarily be spent. When George H.W. Bush and Congress created the Resolution Trust Company in 1989 no one knew how much it was going to cost to stem the Savings & Loans crisis. In a 1990 Time Magazine article (J. Greenwald, "All Shook Up", 19 Oct.), it was estimated that the price tag could reach \$1 trillion. The FDIC later estimated that the true cost to the American taxpayer was \$124 billion. While still a large sum for the time, this example illustrates how estimates can dwarf reality in the heat of a crisis.

While this topic has garnered some media coverage already, we anticipate that it will be the subject of further debate in the near future. The focus will likely shift from how to stabilize the system to how to pay for the solution.

Looking Ahead

While seemingly unfathomable just a few months ago, discussion as to whether we have seen the end of the bear market and the beginning of a new bull market has moved to the forefront. Through May 31st, the S&P 500 has rallied 35.9% from the March 9th low. Such a move illustrates how quickly sentiment can change and propel the market forward. While this has offered a much welcome reprieve from the negative volatility experienced over the last 18 months, we expect the market to "seesaw" back and forth during the months ahead, a characteristic that is typical during the early stages of historical recoveries.

Looking forward, we anticipate the market will continue to build in fits and starts which may be extreme at times. From a strategic standpoint, we continue to assess and reassess our current positions as well as make adjustments where necessary. We are confident that our current posture is appropriate for the conditions that are ahead.

As always, if you have any questions about our strategy or the specifics of your portfolio, please contact us at your convenience.

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