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# Memo

**Date:** July 28, 2011

**To:** Investment Clients

**From:** Mark J. Pellegrino, Chief Investment Officer

**Subject:** The Twin Deficits: A Lack of Dollars and Sense

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### **The Twin Deficits: A Lack of Dollars and Sense**

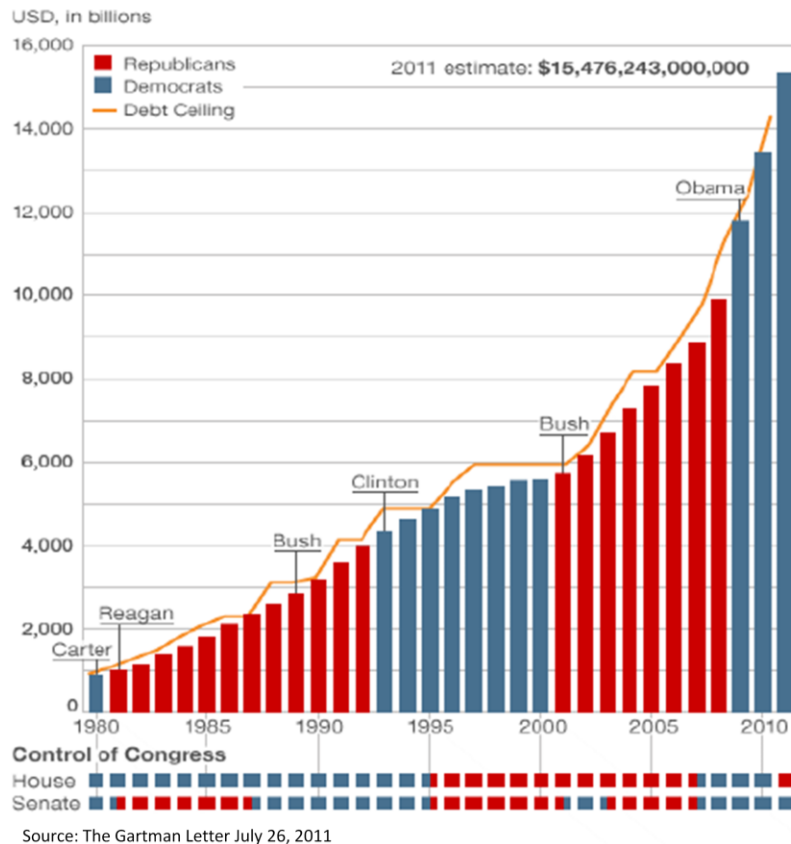
We, as consumers, have been deleveraging since the Great Recession of 2008, as has Corporate America. Even local and state municipalities have trimmed down. The federal governments of the developed world? Not so much... at least not yet, as the “stalemate”, “wrangling”, “partisanship”, “irresponsibility”, “negotiations”, “brinkmanship” – whatever word you might choose – has not yet brought us to a solution on the debt ceiling or the longer-term implications of an impending, gargantuan and long-lasting deficit.

And don't even get me started on the Greece situation! We see the latest solution cobbled together by European leaders as clearly temporary and simply buying time until the next round of decisions must be orchestrated in 12<sup>th</sup>-hour, behind-closed-door meetings. Meanwhile, Greece and the rest of Europe continue to cut government spending and raise taxes despite continued muted growth, while the ECB threatens to keep raising interest rates to fight the phantom of inflation. Once again, European leaders had the opportunity to do something meaningful and lasting, rather than “kicking the can down the road”, but came up short. Default is inevitable. It's just a question of when.

Turning back to the problem in the U.S., here's a bit of historical perspective.

The debt ceiling is a legislative construct, and therefore the crisis surrounding it is self-inflicted. (Some have argued whether we even need a ceiling, but that’s a conversation for another day.) It was created by Congress in 1917 with the Second Liberty Bond Act, which helped finance our entry into World War I. Since 1962, Congress has enacted, typically without much debate, 69 separate measures that have altered the limit on federal debt. And our short memories probably don’t have us remembering that not long ago – fiscal years 1998 through 2001 – the government actually ran budget surpluses, with U.S. federal debt held by the public falling by almost \$450 billion.

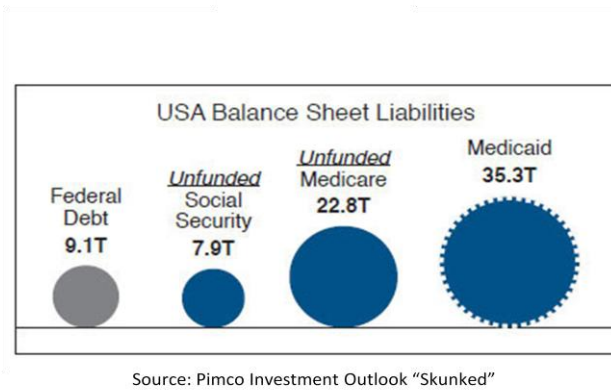
## US Debt Ceiling



Now, for a little math.

75% of the federal budget is non-discretionary and entitlement based. If we don’t attack entitlements – Medicare, Medicaid and Social Security (which make up 44% of total federal spending) – then \$1 trillion deficits will become an enduring reality. After Defense and interest payments on the national debt are excluded, remaining discretionary expenses for education, infrastructure, agriculture and housing make up at most 25% of the 2011 federal budget of \$4 trillion. You could wipe it all out and still end up with a budget shortfall of close to \$700 billion. Further, the Treasury and Health & Human Services have offered data on the net present value of entitlement liabilities. These are not estimates of future spending, but rather the discounted net present value of current spending should it continue at the projected demographic rate. The figure comes to \$65 trillion of entitlement liabilities!! (Anybody else

having trouble fathoming “trillions”?) In the past, it’s been suggested that we could grow our way out of our debt burdens, but can we really grow our way out of \$65 trillion?! Think about the interest on \$65 trillion of debt. Then think about that interest if the rating agencies were to cut the rating on U.S. debt from AAA to AA. Now you can see what a spiraling weight to economic health this can become.



So why hasn't this been dealt with yet? Politics, of course! There have been 3 “serious” proposals offered up thus far. One is the “Cut, Cap and Balance” proposal, which cuts total spending by \$111 billion in fiscal 2012 through discretionary and Defense cuts. This one scales back total federal spending over a glide path through fiscal 2021. It requires the passage of a Balanced Budget Amendment, which would require that federal revenues equal spending, as state governments do now. This bill died in the House, without any real debate.

Another was the McConnell-Reid proposal, which enables the President to request a debt ceiling increase of \$2.4 trillion in 3 increments before the 2012 election. The increase would automatically take effect unless Congress passes a resolution of disapproval with a two-thirds vote. This plan would create a 12-member Congressional committee that would craft a deficit-cutting package by the end of the year to be voted yea or nay by each chamber. It's likely the rating agencies wouldn't be comfortable with this proposal, since it seems to be a legislative maneuver to avoid dealing with the bigger issues. So, this plan appears to have been shuttered as well.

The proposal that's looked like it had the greatest promise is the Gang of Six plan. This plan cuts deficits by \$3.7 trillion over 10 years, 74% of which comes from spending cuts and the remainder from tax revenues. It also eliminates the AMT. It would lower corporate and personal income taxes, but eliminate many deductions, raising taxes by a net \$1 trillion from current levels. Each conference committee would be responsible for hitting a targeted value of cuts in the programs under their purview, including entitlements. If they failed to identify the cuts, a bipartisan group of Senators would be assigned to find them. This plan is born from, and mirrors, the proposal of the Bowles-Simpson Commission. We believe this plan would satisfy the rating agencies, and both sides will have moved considerably to get it done. However, the rub on this one is that it's very hard to draft such complex legislation by August 2<sup>nd</sup>. Also, Republicans in the House have voiced skepticism and many appear loathe to backpedal on their anti-tax

pledge. Think too about politically popular tax deductions coming “under the knife”, like the mortgage interest deduction, and how difficult it will be to get this through Congress . Is this plan dead, too? At the moment, it looks like it.

The sticking points on getting anything done on any of these proposals (and including those being crafted at the 12th hour behind closed doors) are these: (1) Republicans will not raise taxes – their sacred cow – and have demanded that spending must be cut by at least as much as the increase in the debt limit (2) The President has offered few specifics on spending cuts and (3) The President, who recently said there were no sacred cows, has plenty of sacred cows, including health care, high speed rail, green jobs and unspent stimulus dollars.

And make no mistake, the ratings agencies were criticized so strongly for their inability to warn of the 2007-2008 credit crisis that an obvious way for them to regain credibility would be to downgrade U.S. debt obligations. Moody’s earlier announced it expects to place U.S. debt under review for a possible downgrade due to 2 key factors: (1) the “degree of entrenchment into conflicting positions” within Washington and (2) the upward trajectory in debt that would remain should a credible debt reduction plan not be reached soon. This follows a similar warning from S&P. While not one of the big three rating agencies (including Fitch), rating agency Egan-Jones has already reduced U.S. Treasury debt to AA. It’s altogether likely that these rating agencies may act before August 2<sup>nd</sup>, and even more likely that the Treasury market will act before that.

In terms of what we see happening from here, our worst case scenario has some form of default occurring, causing a destabilization of the U.S. financial system and the following consequences:

- An immediate and precipitous fall by the stock market
- The yield on the 10-year U.S. Treasury, now about 3%, rising above 4%
- The dollar takes a hit, cushioned by the debt crisis in Europe, which perhaps becomes a bigger problem
- Business and personal credit become difficult to obtain
- The U.S. economy is thrown into a severe recession
- Housing prices continue to drop
- The volume of foreign participation in U.S. Treasury auctions diminishes

We’d put a relatively low probability on this scenario, but certainly can’t rule it out.

Our best case scenario has a “resolution” put forward that avoids all consequences, raising the debt ceiling by the deadline and reductions to spending and/or increases to revenue of at least \$2 trillion over the next 10 years – perhaps something like the Gang of Six proposal. We can’t rule this one out either, but assign a pretty low probability here too.

Our most likely scenario is somewhere in-between. There could very well be a compromise that provides a small “down payment” in cuts over 10 years, allowing Congress time to tackle the bigger issues, some prior to and some after next year’s election. However, this leaves some of the same issues still in play. If the rating agencies perceive that Congress has “kicked the can down the road” with

another 6-month increase in the debt limit and no real solutions, won't they believe this to be just one more game of partisan chicken? Room for bargaining under this scenario 6 months out is likely to be much narrower, making a resolution then even more difficult to achieve, especially in the more heated political environment present that much closer to the election. Will we look back at this moment in our history and see it as a period of global economic mismanagement of epic proportions? Time will surely tell.

How have we been positioning portfolios in response to these issues? First, it's important to ensure that the money market vehicles we employ as "parking places" aren't exposed to Greek sovereign debt in any meaningful way. We've, in fact, confirmed that to be true of the Fidelity vehicles we currently use.

Second, we've felt compelled to be much more tactical in the Income (more protective) portion of the portfolio this year than was necessary last year. Government bonds, for instance, are likely to be more volatile to decline in a debt default-induced environment, so we've limited exposure there. Floating rate securities are attractive to us given the unclear scenario for interest rates. We also still like exposure to Emerging Market Debt. We believe the emerging economies of the world will continue to carry global economic growth, meaning we'll see the greatest amount of credit upgrades from this part of the world. Additionally, we favor managers with flexible mandates or that hedge their portfolios, as these provide the opportunity to avoid risk and to go where opportunity resides.

Additionally, we've been overweighting the Diversifying segment of portfolios. That is especially true of the various Hedge Strategies we employ, since these absolute return approaches should hold up under both bullish and bearish scenarios. Ordinarily, you'd expect Commodities to be vulnerable to a big decline in the equity markets, and they are. However, our core Commodities positions are hedged, which gives us confidence in their ability to withstand a tough market environment. We're complementing these solid positions in Hedge Strategies and Commodities with exposure to Managed Futures and Global Real Estate, both of which are uncorrelated to traditional stocks and bonds.

Finally, we chose to remain underexposed in the Growth segment of portfolios, since this is where we see the greatest risks to significant decline. In most cases, that means being positioned about two-thirds into our agreed-upon strategic range for Growth exposure. Of the positions in place, we favor U.S. Large Cap over Small Cap – U.S. and overseas – and have actually gone naked in the Small Cap sub-segment. Our continuing belief in a declining U.S. Dollar will benefit the large multinationals that litter the U.S. Large Cap segment, while recent outperformance amongst Small Caps likely makes them the first to come "off the table" during a serious decline. We've also been willing to "look across the valley" in Emerging Market Equities, for the reasons shared above. These countries are growing at such a clip that they've sparked inflationary pressures, which has caused them to raise interest rates. This has triggered a recent decline in these markets, but one we feel provides a better entry point than an exit. Additionally, the uncertain investment environment of the moment also favors Opportunistic Investments. The tsunami in Japan and the recent developments in the Middle East, for instance, have thrown opportunity into our laps. With that in mind, you'll see targeted, thematic investments in Energy, Master Limited Partnerships (MLPs), White Metals (Silver, Platinum, and Palladium),

Agribusiness, Science & Technology and “Japan Reconstruction” moving into your portfolio. As in the Income portion of the portfolio, you can see we’re being equally tactical in Growth.

When we get defensive, to any degree, it’s for a reason. It’s not because we’re looking for ways to avoid making money, but because we’re looking to avoid losing a bunch of it – like when the “fat tail” risk of a global credit crisis is lurking, as it is today. While we believe a secular bull market is awaiting us somewhere “beyond the rainbow”, today’s economic and fiscal ingredients just don’t have us there yet.

On a final note, forgive me for not having written in a while. We’ve been fast at work on enhancements to our investment platform and service model, including, among other things, (a) the launch of our Opportunistic Fund, which will house thematic investments of many kinds, designed to produce outsized returns (b) a “Document Vault” that will allow you to securely house all of your important documents in one place (c) Investment Policy Statements (IPS) that more formally memorialize your goals and objectives. More to come on all of this... Nonetheless, I promise to be more “regular” going forward.

Our best to you for a healthy, happy summer!