

Quarterly NEWS

GHP Investment Advisors, Inc.

Fourth Quarter 2010

Deficits, Debt and Economic Growth

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Intermittent declines are a regular feature of investing even in good times. Of course, the recent financial crisis was anything but good and the declines were truly jaw dropping. Perhaps equally remarkable, however, has been the stock market recovery over the past two years. The S & P 500 Total Return Index rose 15.1% this year on top of a 26.5% gain in 2009. The gain this year came despite moments of stress and volatility.

Once again the volatility began in the debt markets, in particular European government bonds and their potential impact on a fragile global financial system. Government debt will continue to worry investors in 2011. We believe the bond market, however, can ultimately help guide the United States to a healthier financial position despite political inertia and continued financial market volatility.

The “Bond Vigilantes” are Back in Europe

Over the past 25 years bond market investors became society’s watchdogs and guardians against policies that threatened to stoke inflation or degrade government credit. In the 1980s and early 1990s these investors came to be known as “bond vigilantes.” Their hair trigger reactions often forced the government to change policy direction.

When President Clinton proposed new spending initiatives early in his first term, bond prices declined, pushing interest rates higher and forcing the President to abandon his plans. Conversely bond prices rose and interest rates fell when President Clinton shifted away from spending toward a balanced budget. These policies, combined with a hawkish Federal Reserve and rising productivity, produced nearly two decades of very low inflation. The bond vigilantes were quiescent for most of the late 1990s and 2000s, but they returned with a vengeance this year in Europe.

Credit Quality is the Problem, not Inflation

This time the vigilantes are less focused on inflation but more concerned about the credit worthiness of European governments. Governments all over the world responded to the recession and financial crisis with standard Keynesian macroeconomic policies, insisting that short-term deficits were necessary to stem the economic slide. On top of this governments made expensive commitments to backstop their banking systems to prevent financial collapse.

In Europe these policies were implemented despite already high levels of debt and unsustainable long-term financial commitments for pension and health programs. Eurozone countries, in particular, faced greater pressure because their economies grew more slowly than the U.S. economy over the past twenty years due to lower productivity, heavier regulation, higher taxation, and more limited business competition.



At first glance a number of European countries appear to be less indebted than the United States. As you can see in **Exhibit 1**, French government debt amounts to 57% of Gross Domestic Product (GDP) and German debt is 51% compared with 68% in the United States. Most European governments, however, pursued a social welfare model based on generous health care programs, early retirement pensions and high unemployment benefits (to name only a few of the myriad social programs). This expensive system is already insolvent based on the promises European governments made to their people.

In addition to these various forms of social insurance, European governments actively regulate their economies to create a more “orderly” (in their view) marketplace. Most European governments impose regulations to limit business competition and protect jobs. By protecting existing jobs and employers, however, they reduce incentives to start new companies, innovate and hire additional employees. As a result of these policies, European countries suffer from chronically high unemployment, low productivity growth and sluggish economies.

While all European governments pursue these policies, not all of them pursue them to the same extent. Britain, which is not a member of the Euro currency zone, is generally more free market oriented while France leans toward government intervention and regulation. Germany tends to sit somewhere in-between. Economic growth was generally more robust in Britain over the past 20 years, followed by Germany with France lagging behind. Following even more distantly are the now troubled countries of Greece, Italy and Portugal.

Although Spain and Ireland pursued more free market oriented policies in recent years, they now find themselves in financial hot water due to over-investment and excess capacity. These are the more traditional maladies of the boom and bust economic cycle. All of these countries are now lumped together by the media under the inglorious title: PIIGS (Portugal, Italy, Ireland, Greece and Spain).

European Government Finances are Between a Rock and a Hard Place

The bond vigilantes are lining up each highly indebted country in Europe and shooting them one by one. Greece was targeted first. Not only was its budget deficit and government debt high, but repayment was required very soon. Other European governments watched in horror as Greek government bonds plummeted and interest rates rocketed from 4.3% to 13.1% in a very short period of time. Investors then turned their attention to Ireland, Portugal and Spain, forcing government bond prices lower. The financial markets even placed modest pressure on Britain, France and Germany by initially selling their bonds as well.

Britain, France and Germany as well as other European governments got the message and rapidly shifted from stimulus to fiscal contraction. Like most governments the Europeans would probably like to maintain their generous programs by imposing higher taxes. Their options are limited in this regard because Europeans are already among the most highly taxed people in the world (see **Exhibit 2**). They face a classic dilemma laid out by American “supply-side” economists in the high-tax 1970s and 1980s - onerous tax rates threaten to reduce government revenues by shrinking the economy.

The bond vigilantes have European governments boxed in and sacred cows are being sacrificed for the first time. While the initial cuts are modest in most cases (with the exception of Greece and Ireland) the inability of European governments to increase taxes or debt will change the direction of welfare state policies for many years to come. Stingy lenders will likely accelerate existing European government policies to boost productivity and economic growth by relying more on markets and less on insolvent governments.



The Bond Vigilantes are Coming to the United States

So far the United States government has largely escaped bond market turmoil. In the U.S. high inflation is a distant threat (please see our Second Quarter 2009 newsletter at www.ghpia.com for our analysis of why the bond market does not perceive a risk of high inflation), our borrowing capacity is vastly larger than Europe, and, ironically, our financial system is in better shape due to the generally effective policies of the Federal Reserve and the government during the financial crisis.

Despite their absence we believe the bond vigilantes are likely to reappear in the near future. While not nearly as severe, our long-term fiscal issues are similar to Europe. As you can see in **Exhibit 3** the federal government budget deficit is truly eye popping - more than double the percentage that aggravated bond investors in the early 1990's. If left unchecked, the Congressional Budget Office (CBO) estimates that current fiscal policies will produce government debt equal to 100% of GDP in five years.

As you can see in **Exhibit 2**, the U.S. government (state and federal combined) collects about 25% of GDP in tax revenues compared with approximately 40% in France and Germany. Tax revenues were also higher in the United States during the booming 1990's, approaching 33% of GDP. Unlike Europe, we are arguably not taxed to the "supply-side" maximum and higher taxes are most likely in the offing.

Higher Taxes (but not Very High Taxes) are Required to Fix our Problems

Despite political rhetoric to the contrary the United States probably does not face draconian tax hikes or radical policy changes. Modest, but periodic, tweaks to both tax rates and entitlement programs should be sufficient to prevent short and long-term government insolvency. Even with more rapid deregulation in Europe, the U.S. remains a free market economy likely to produce more robust economic growth. Economic growth alone should cut the budget deficit in half over the next five years. Tax rates equivalent to 1990's levels would then bring deficits back to manageable levels over time.

Similar to Europe, simply reducing the deficit over the next five years is not enough because our government also made very expensive promises for health care, social security and other entitlement programs. While the U.S. has the capacity to solve short and medium-term fiscal problems with modest tax increases, raising taxes much beyond these levels, however, would potentially induce a "supply-side" reaction of slower growth and lower government revenues.

Over the last two decades Europe proved that tax rates approaching 40% of GDP are a significant drag on an economy. The U.S. government is not yet cornered between bond vigilantes on one side and "supply-side" tax effects on the other, but when the time comes the only response available will be a restructuring of the social welfare system similar to the process now underway in Europe.

The Bond Market Can Motivate Politicians Faster than the Voters

We believe the bond markets will force change faster than many people realize. At the moment the U.S. government is only paying an average interest rate of 2.25% on its debt. Record low interest rates will eventually give way as the economy recovers, but the debt will remain. Over the next several years each percentage point hike in interest rates could increase the government's tab by \$150 billion.



A U.S. Treasury bond maturing in two years currently yields 1.0% and the five-year bond pays only 2.0%. Interest rates could easily rise by two or three percentage points and still remain low by historical standards. In fact this scenario is highly probable and could add \$400 billion per year to the budget. To put this in perspective, the federal government spent around \$450 billion on Medicare this year. Rising interest rates will cause bond prices to fall even in the absence of vigilante pressure, and these staggering numbers will make the costs of rising debt highly visible to bond investors.

Given these large numbers, why is more radical change not required in the short run? Most entitlement promises are payable over many years as our population ages and requires more medical care and social security. Moreover, economic growth will eventually accelerate despite current fears to the contrary. If the economy returns to its historical growth pattern, an extra \$1 trillion could flow into government coffers annually over a period of time.

Small Reforms Every Few Years Can Add Up to a Big Change

Modest changes to our entitlement programs could also yield significant cost reductions without radical change. Contrary to popular cynicism a number of tweaks have, in fact, been enacted in the past. The most notable example is the 1983 political compromise that raised the retirement age to 67 (and is still in progress more than 25 years later). Similarly, a law was enacted in 2007 charging an additional small premium to Medicare Part B beneficiaries with high incomes. Medicare Part A still carries no premium despite its average cost per beneficiary of \$4,700. About 20% of Medicare beneficiaries have incomes that are more than sufficient to handle this level of premium or additional deductible (and perhaps as many as 50% in particularly tight budget circumstances) producing \$50 billion in cost savings per year, out of a \$200 billion program. Numerous examples such as these are available to preserve programs while avoiding national bankruptcy.

These are exactly the same types of solutions now being enacted in Britain, France and Germany. While Greece, Ireland, Spain and Portugal will be forced to make faster, more radical changes, the more stable countries will not. They will adopt a series of smaller changes to periodically appease their lenders that add up to a long-term policy shift.

The United States is in a better position than Britain, France and Germany despite our alarmingly large budget deficits at the present time. Bond vigilantes are forcing European politicians to tame deficits, albeit reluctantly and begrudgingly. We believe the same will eventually be true here as well. For now the bond vigilantes are busy in Europe, but when their work is done they will return to America creating a great deal of sound and fury. We will all be better off when they arrive. ☞



Exhibit 1

Debt and deficits

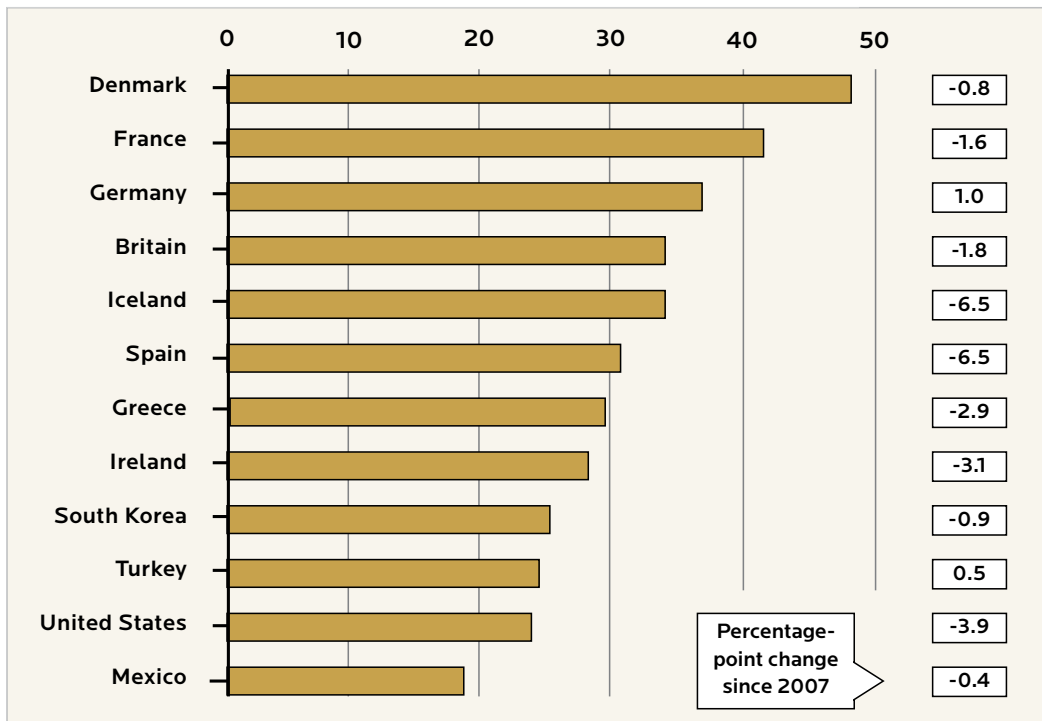
	Debt / GDP (%)	Deficit / GDP (%)	Unemployment (%)
Japan	114.0	-7.7	5.1
Italy	103.3	-5.0	8.6
Greece	97.3	-8.3	12.2
Belgium	82.4	-4.9	8.6
United States	67.8	-10.5	9.7
Portugal	63.2	-7.3	10.7
Hungary	61.6	-4.2	11.3
Ireland	61.5	-32.3	13.6
France	57.1	-7.4	9.3
United Kingdom	51.3	-9.6	7.9
Germany	50.5	-4.0	6.9
Iceland	45.2	-6.3	7.5
Spain	43.4	-9.2	19.8
Austria	41.7	-4.4	4.5
Netherlands	34.7	-5.8	4.1
Canada	31.4	-4.9	8.1
Poland	29.0	-7.9	9.6
Slovak Republic	24.5	-8.0	14.1
Switzerland	5.7	-0.7	4.4
Slovenia	5.4	-5.7	7.2
Czech Republic	3.5	-5.2	7.5
Australia	0.4	-3.3	5.2
Denmark	0.3	-4.6	7.2
New Zealand	-4.4	-5.3	6.5
Sweden	-21.1	-1.2	8.4
Korea	-36.6	1.6	3.7
Luxembourg	-41.6	-2.2	6.0
Finland	-56.6	-3.3	8.6
Norway	-157.0	9.5	3.6

Source: 2010 data, OECD Economic Outlook 88 database, www.oecd.org



Exhibit 2

Total tax revenue as % of GDP, 2009*

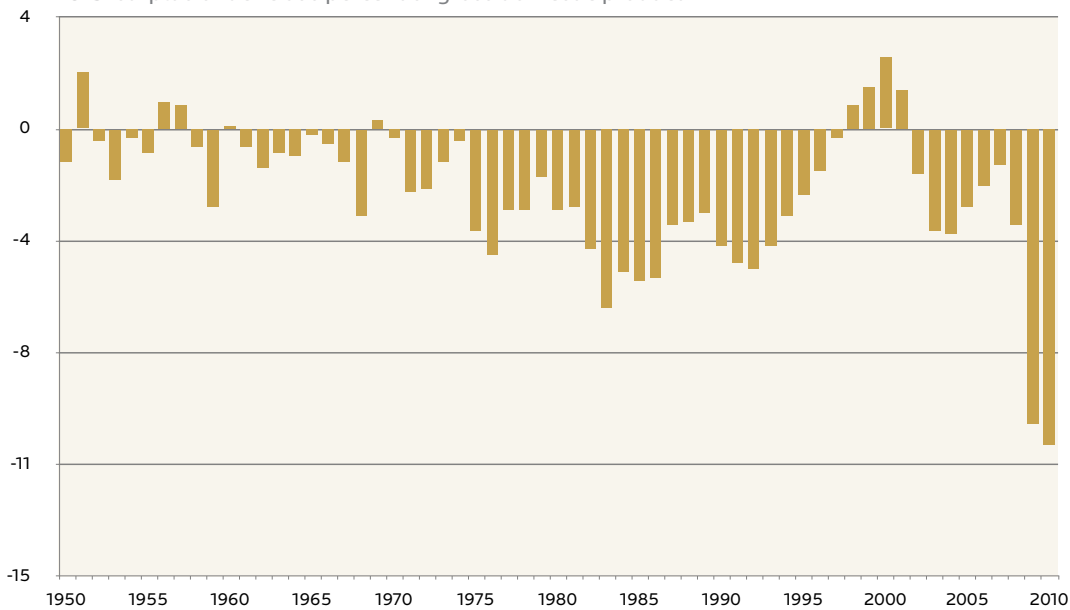


Source: OECD and www.economist.com

*Estimate

Exhibit 3

U.S. surplus or deficit as percent of gross domestic product



Sources: Department of the Treasury and Office of Management and Budget. 2010 Estimated.



Market Summary

Key Financial Ratios for Domestic Asset Classes

Asset Class	Price/Earnings 2010:Q4	P/E Benchmark	Over/Under Valuation	Price/Book Value 2010:Q4	P/BV Benchmark	Over/Under Valuation
Large-Cap Growth Stocks	17.3	27.0	-35.9%	3.5	5.7	-38.6%
Large-Cap Value Stocks	14.4	20.2	-28.7%	1.6	2.5	-36.0%
Mid-Cap Growth Stocks	23.5	24.8	-5.2%	3.2	4.5	-28.9%
Mid-Cap Value Stocks	20.2	19.1	5.8%	1.6	2.2	-27.3%
Small-Cap Growth Stocks	23.2	23.2	0.0%	2.6	3.5	-25.7%
Small-Cap Value Stocks	33.6	18.2	84.6%	1.5	2.1	-28.6%

*Please note that the P/E data reported above are based on "as reported" earnings information rather than "operating" earnings. "As reported" earnings include one time write-offs whereas "operating" earnings reflect the profitability of a company as a going concern. We believe P/E's based on operating earnings are a better long-term valuation indicator, but Standard and Poor's does not report this information for the style indexes used in our calculations. Amid economic recession, declining earnings impact price-related ratios and "as reported" earnings can be significantly lower than "operating" earnings (particularly in the Value segment of the market) due to large write-offs. As a result, the P/E ratios listed above are higher than they would be using "operating" earnings for the denominator. To address this issue we have included Price to Book Value (P/BV) data, which are less affected by the impact of declining earnings and large write-offs.

GHP Investment Advisors, Inc. benchmarks are based on proprietary discounted cash flow models. P/E and P/BV data provided by Bloomberg L.P. as of 12/31/10.

Returns by Index

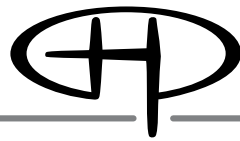
Index	2010:Q4*	YTD*
DJIA Total Return	8.04%	14.06%
NASDAQ	12.34%	18.14%
S&P 500	10.76%	15.06%
S&P 500/Value	10.51%	15.10%
S&P 500/Growth	11.02%	15.05%
S&P MidCap 400/Value	12.38%	22.78%
S&P MidCap 400/Growth	14.55%	30.57%
S&P SmallCap 600/Value	15.97%	24.72%
S&P SmallCap 600/Growth	16.52%	27.99%

DJIA & NASDAQ: Bloomberg L.P. as of 12/31/10.

S&P Returns: Standard & Poor's (January 3, 2011) Standard & Poor's Reports December Index Returns. Press Release.

*Dividends Reinvested.





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