HAWK Talon

HAWK 100

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What if S&P Downgrades?

Standard and Poor's is one of several "Nationally Recognized Statistical Rating Organizations (NSRO)" that issue credit ratings that the SEC and other regulators require firms to follow. S&P and Moody's are the two most recognizable NSROs.

S&P's ratings on subprime loans allowed real estate financing to fester into a crisis. By issuing their highest quality AAA opinion on securities backed by the worst subprime mortgages, the NSROs enabled banks to buy untold sums of crappy loans and to push them on unsuspecting investors. Borrowers, banks, and investors assumed extraordinary risks and leverage, which regrettably transferred to taxpayers when the house of cards collapsed. The NSROs surely earned the public scorn.

S&P is trying to right its reputation and, on June 30, issued new sovereign government rating criteria. S&P ratings score five factors: political, economic, external, fiscal, and monetary. We suspect S&P will opine that the US is faltering on political, fiscal, and monetary factors.

An S&P downgrade may finally convey the risk of subprime lending. Since TARP placed those loans squarely on Fed books and Congress lacks the will to fix it, S&P likely will see fit to say as much. Then, the government that requires everyone to listen to NSROs will probably ignore S&P.

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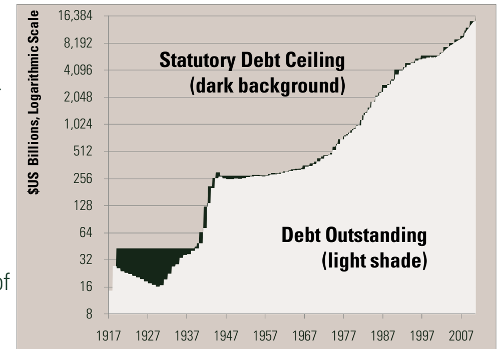
Give Me Liberty or Give Me Debt.

July closes with Congress and President Obama haggling over a crisis in the Federal debt, courtesy of four conditions. One, federal spending is huge. Two, federal receipts are small. Three, following from one and two, the federal deficit has accumulated unprecedented debt levels. Four, US law limits the debt it may issue, and we are above the legal limit.

After our 2nd Quarter letter, in which we explained the state of the US treasury, we continue following the debt negotiations and view them even more troubling now. Both political sides seem unable to comprehend the risks of staggering leverage on the liberty of 312 million US citizens (Census Bureau estimate).

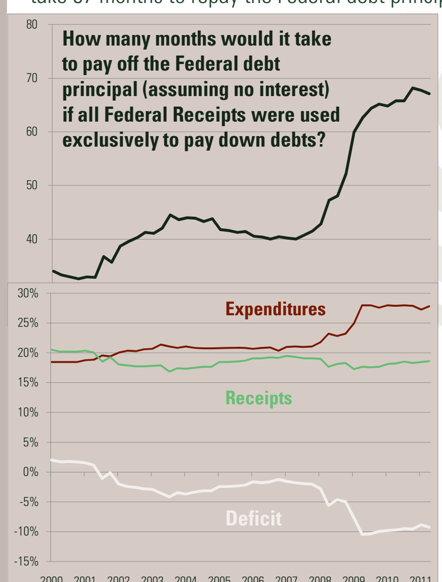


What purpose does debt ceiling serve if not to limit debt?
Source: US Treasury and Congressional Research Service.

Spending like there's no tomorrow. The Federal government comprises an increasing component of the economy. Medicare and Social Security are expected to ramp up while the first baby boomers turn 65 this year. Medicaid and social welfare roles are rising with a protracted economy. Even before future costs associated with Obamacare and Dodd-Frank, federal expenditures are 28% of non-government (i.e., private sector) GDP, a post-WWII high. The bottom chart presents the expansion of expenditures prosecuting the war on terror, TARP and Obama's shovel-ready stimulus.

Collection complications. Federal revenues have abated under a slow economy. Annualized receipts have slipped from Q4 2007 of $2.666 trillion (19.1% of GDP) to Q2 2011 of $2.565 trillion (18.7% of GDP). Receipts have persisted below 20% of GDP since 2001 and have failed to keep pace with the growth of expenditures during the same period.

At least the deficit and debt are growing. Fiscal deficits have averaged 9.7% of GDP since 2009 growing debt at the fastest pace since World War II, as the above chart shows. The Treasury now owes $14.343 trillion. Foreign holders control 31% of that balance which leaves the US with less autonomy in world affairs. At current levels, it would take 67 months to repay the Federal debt principal using all Federal receipts exclusively for debt service.



Fiscal policy as percent of private sector GDP from 2000.
Source: US Treasury and Bureau of Economic Analysis.

Congress's second liberty, borrow. The debt ceiling was first enacted with the Second Liberty Bond Act of 1917 which authorized Treasury to issue bonds to finance US involvement in World War I. It was enacted just four years after ratifying the 16th Amendment giving Congress the power to lay and collect taxes on incomes (Congress's first liberty). It took just two years for Treasury to raise debts five-fold from $5.7 billion in 1917 to $27.4 billion in 1919.

In 1939, Congress found the Second Liberty Bond Act confining when the Act "evolved into a general debt limit," writes D. Andrew Austin, an Analyst in Economic Policy, in a report for the Congressional Research Service. Since 1939, Congress has lifted the debt ceiling 76 times. Hawk100 wonders whether the Second Liberty Bond Act serves any purpose if it offers no borrowing restraint.

Excessive debt raises leverage risk and interest burden. Even with the 10-year treasury yield 3.8% below its historic average (Treasury reports average interest rate of 2.957%), we expect interest expense to be $424 billion this year. That takes 17% of all annual Federal receipts and costs $1,400 for every US citizen. If rates normalized, those costs would more than double. Hawk100 hopes Congress discovers a third liberty, restraint, before that burden befalls us.

6600 Perimeter Dr.
Suite 200
Dublin, Ohio 43016

614.791.HAWK

www.hawk100.com

By Richard Clemens, CFA, President