



# INVESTMENT STRATEGIES

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## The Debt Bomb

*A detailed look at our government debt*

The debt limit political imbroglio and debates regarding spending and tax issues have led to more discussions about the level of our government's sovereign debt. The current level of sovereign debt is not a number we would call prone to being easily understood -- over \$16.4 trillion, or 164 followed by eleven zeroes.

What may make the number more meaningful for the average person is looking at that number on a per capita basis. At the start of 2012, the US census bureau pegged the US population at 312.8 million individuals. The population may have increased slightly since then, though our level of sovereign debt is increasing even more quickly, and essentially each individual in the US owes \$52,430.

A family of four's individual portion of sovereign debt amounts, astoundingly, to nearly \$210,000! Consider this is more than the median price of a house and the immensity of our debt comes more into focus. Also consider the median net worth of the average family is about \$110,000 and we can observe that more than half the families in the US would be considered to be underwater if the debt were divided equally. Fortunately, the *average* net worth amounts to just over \$500,000 per family, but even at that level, our government debt currently amounts to more than 40% of average family's net worth.

Even more troubling is the issue of unfunded liabilities, mainly Social Security, Medicaid, and Medicare, which are topics too large to cover in this publication. The current expected cost of these mandates dwarfs the level of sovereign debt. And while these are only potential future obligations, these expenses would basically more than equal our net worth. We note they are transfer payments that will come back to us.

What this really shows is the unsustainable course of these current mandates. While politicians may not want to broach the subject, at some point current levels of spending will have to be addressed. There are just too many people who are going to retire and likely live longer in relation to how many people who are working.

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Further, note that our sovereign debt is the equivalent of more than a second home mortgage for the average family. At just over \$210,000, the median home sale price in the US in 2012 was almost the same cost as the average amount of sovereign debt per family. However, the typical family does not mortgage their house by 100%; assuming a 75% debt to equity ratio on that average house, the mortgage debt would only be a little under \$160,000.

Let's look at this another way. What is the debt service on this sovereign debt? At the end of 2012 the average interest rate on our sovereign debt was 2.52%, meaning that the debt service for this average family on their portion of our debt would amount to \$5,285 annually, or roughly \$440 a month, almost like another rental or mortgage payment. Would this average family be able to afford an additional \$440 monthly payment for their portion of the sovereign debt? Probably not.

Currently the average interest rate on our sovereign debt is at a historically low level, and this may be the scariest part of the equation. In fact, the average interest rate has been trending generally lower for more than three decades, dropping to that level from well into the double digits at the start of the current downtrend.

How much further could this average rate drop? Not much, in our opinion, or for that matter on an actual basis with the current number only 2 1/2 points away from zero. As recently as the beginning of 2007, the average interest rate on our sovereign debt was **twice** the current level, or 5.04%, and at the beginning of 2001 the average interest rate was nearly 6.6%.

Should we go back to the level of interest rates in place as recently as 2007, you can double the debt service to \$10,570 or nearly \$880 a month. The average household income in the US is approximately \$50,000 annually, meaning that the potential cost of servicing our **current** sovereign debt amounts to more than 20% of the median family's annual income. This would seem untenable for most families.

However, at least through the next three to four years, the level of debt appears likely to grow beyond the current \$16.4 trillion, making the burden even higher. Spending has continued to move higher, well above the rate of inflation to pay for wars, stimulus, and various government programs.

Interestingly, if government spending had only grown at about the level of inflation since the early 1990s, we would have seen balanced budgets pretty much every year -- as tax receipts have generally exceeded the level of inflation growth -- and not the \$1 trillion-plus annual budget deficits we currently see. This is even in the face of the tax cuts initiated over the period before the just-enacted tax increases.

Unfortunately, government has increased its spending well beyond the level of inflation, something likely to continue, resulting in more and more debt.

Moreover, due to politicians' relatively short tenure in government, the lack of accountability that results, and the fact that most of the negative impact of the excessive spending and ill-conceived legislation is likely to occur well after they leave office, we believe the recipe exists for further increasing debt. There is little to no accountability in the system, in our view.

Let's look at what this means. First, we never expect to see our sovereign debt eliminated entirely. In general, prior to the past five years or so and subsequent to our big debt build-up coming out of World War II, our sovereign debt ranged from roughly 30% to 60% of our GDP. Currently, excluding unfunded mandates and intra-government debts this ratio is in the area of 100%. Thus, we would posit that the current level is about twice where it should be and we will need to reduce our level of debt by about a half. Government spending

will need to be reduced and taxes raised or else economic growth will need to accelerate to allow for such a reduction.

Hopefully we will see the latter account for most of this, as unfortunately the other two tend to reduce the latter, with an increase in taxes most likely to hold back economic growth as a reduction in dollars to be invested in the free economy often naturally reduces growth. In our view, government has never been able to allocate capital as efficiently as the free market.

This de-leveraging will result in slower growth, much as if you took on an excessive amount of debt on your credit cards. Eventually, you will need to pay that off, which will lower your current spending and standard of living. Also, as debt increases, the risk of non-payment (bankruptcy) increases, resulting in creditors demanding higher interest rates. When considering their willingness to fund our debt and at what cost, our creditors will also take into account our untenable unfunded mandates and what is done on the political front.

Further, the deficit spending, which is typically accomplished through money printing and an increased monetary base, would be expected to -- all things being equal -- result in inflation. Due to slack in the economy, that has not been the case up to now. However, as economic activity and the employment picture improves, demand will increase and with all of the excess cash in the system, we are likely to see inflation kick in at some point. We believe this is probably a ways off, but inflation will eventually arrive.

In light of this, what should investors do? Understand this is a long-term trend. The impact is something we will not incur in the next week, next month, or next year most likely. However, the impact will almost surely occur at some point. The Federal Reserve can likely mitigate some of it, but not all. The magnitude of the issue is unknown at this point, but there are a lot of assumptions we can make when portfolio planning.

We expect interest rates to rise at some point in the future, potentially significantly. The last time we were faced with a heavy inflationary environment, we saw double digit Treasury bond yields. Could that happen again? Only time will tell, but we cannot rule it out.

We hope, though there are no guarantees, that our creditors will not abandon us due to our high level of debt as they have done with Greece, Ireland, and other European countries with high levels of sovereign debt. Even assuming our creditors do not abandon us, interest rates may increase back towards the level seen last decade. Things could get truly difficult -- remember that double digit yields were common in a number of European countries hit by high debt-to-GDP levels.

As far as investments go, bonds are likely to be extremely hard hit in any such scenario, in our view. This is especially true of longer-dated bonds. When interest rates were peaking in the late 1970s and early 1980s, long-duration low-coupon bonds issued in the late '50s and early '60s were trading at a half or less of face value. This could occur again if rates rise sharply. We suggest being careful to ladder bond portfolios to have a majority of bonds with a remaining maturity of 5-8 years or fewer to limit potential capital losses on bonds and to allow for significant capital for reinvestment at higher rates.

Hard assets tend to do better in rising rate/inflationary environments. Direct investments in precious metals are one way, although we would suggest such metals that have industrial rather than luxury uses. We believe investments in equities in companies involved in such areas are also important. These can be energy, raw materials, precious and other metals, etc.

In general, equities also offer a degree of inflation protection, as companies typically increase dividends at above inflation rates and can pass on inflationary pressures through higher prices.

However, while these are the most traditional means of looking at investing in such environments, we would emphasize another, less traditional investing methodology, and that is investing internationally. By investing in stocks (and for that matter bonds) in international markets investors can get a measure of protection from the likely impact of these domestic problems. Typically, we might suggest investing in multi-nationals headquartered in the US to get international exposure. In this case we believe that would not be as good a strategy since these domestic companies could still see the negative impact through higher taxes, debt costs, etc. We stress and recommend adding direct international investing in both developed and international markets to gain some protection from this domestic-centered issue as well as for a measure of diversification. We suggest such investments be made on a cost efficient and diversified basis through ETFs. Consult your Financial Consultant for investment choices most appropriate for you.

*Additional information is available upon request.*

*We recognize each client's investment needs and goals are different. Opinions expressed here are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors.*

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**Buy** - We believe the stock has significant total return potential in the coming 12 months. **Long-term Buy** - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues. **Neutral** - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise. **Underperform** - We believe the stock is vulnerable to a price decline in the next 12 months.

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**1** - A large cap, core holding with a solid history. **2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks. **3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage. **4** - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base.

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# of <u>Stocks Covered</u>	% of <u>Stocks Covered</u>	<u>Banking</u>	<u>No Banking</u>
<b>Rating</b>				
<b>Buy</b>	57	42%	12%	88%
<b>Hold/Neutral</b>	73	54%	11%	89%
<b>Sell</b>	4	3%	0%	100%
<b>Restricted</b>	2	1%	100%	0%

*As of 6 February 2013*

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