November 2012 | Vol. 2 No. 11 | Wealth Management Update

In Debt We Trust?

By Louis E. Conrad II, CFA

- With the election over, the "fiscal cliff" is getting quite a bit of attention now.
- As we wrote in the June issue of The COMPASS Chronicle (see the library page of our web site), the "fiscal cliff" is a combination of federal tax increases and spending cuts scheduled to take effect on January 1 unless new legislation is passed.
- The article to the right addresses how we reached our current financial predicament.

Our federal government is drowning in debt. The numbers are astounding and growing larger every day. The U.S. national debt, which totals over $16 trillion, amounts to over $51,500 for every man, woman, and child in the U.S. or more than $141,000 for each taxpayer. Though politicians prefer to ignore the debt problem, the longer they wait to address the issue, the harsher the fix will be.

Budget Deficits

Our national debt is the cumulative effect of incurring annual budget deficits; that is, when federal government spending exceeds federal tax revenue. The federal government has incurred annual budget deficits nearly every year for decades. In only four fiscal years out of the last 40, from 1998 through 2001, has the federal government run a surplus.

Deficit Spending

According to the Congressional Budget Office's (CBO's) baseline forecast for just-ended fiscal 2012, the federal government was expected to spend $3.563 trillion, but only receive $2.435 trillion in tax revenues, leaving a staggering $1.128 trillion deficit for fiscal 2012 alone. In other words, the federal government was projected to borrow $0.32 for every dollar it spent. Consider this analogy: you spend $100,000 per year, but only earn $68,000. To support your spending level, you borrow $32,000 on your credit card. You are effectively borrowing from your future consumption to live more extravagantly today.

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Advisor Corner

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In Debt We Trust? continued

Though the federal government has had a history of spending more each year than it receives in revenue, the past few years have seen a dramatic increase in federal outlays and a dramatic decrease in federal receipts. For the past 52 fiscal years, the federal government's spending has averaged 20.5% of our gross domestic product (GDP), while revenues have averaged 17.9% of GDP. In fiscal 2012, the gap widened with spending spiking to 24.3% of GDP, while revenues declined to 15.8% of GDP, based on CBO forecasts, resulting in the more than $1 trillion deficit for fiscal 2012 cited above.

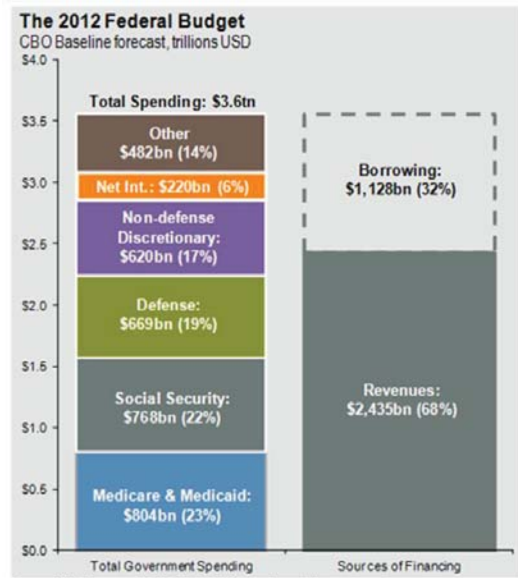
Debt Financing

This deficit, and the ones that came before it, are financed by the issuance of U.S. Treasury securities. The largest holder of such securities is actually the Federal Reserve and intragovernmental holdings, such as the Social Security and Medicare trust funds, with over $6 trillion or roughly 40% of total Treasury debt outstanding. Outside of the U.S. government, China is the largest holder of U.S. debt with $1.2 trillion or 7% of the total, followed closely by Japan with $1.1 trillion.

Tax Increases or Spending Cuts?

While politicians may bicker about whether tax increases or spending cuts are needed, the reality is that both will be required. In the future you will pay more for reduced services and programs from the federal government. Many taxpayers believe that since they paid taxes to support various federal government programs, especially Social Security and Medicare, that they are entitled to the benefits those programs now offer. However, the taxes paid to support Social Security and Medicare have fallen short of the actual cost of these programs. For example, according to the Social Security and Medicare Boards of Trustees, "Both Medicare and Social Security cannot sustain projected long-run program costs under currently scheduled financing, and legislative modifications are necessary to avoid disruptive consequences for beneficiaries and taxpayers." The trustees indicate in their 2012 annual report that expenditures will exceed revenue for both Social Security and Medicare Part A for each year over its 75-year projection period unless meaningful adjustments are made.

Though much has been made of the European debt crisis, the seeds of our own debt crisis are being sown. In fact, in just the time it took you to read this article, the U.S. national debt grew an estimated $4 million.



Source: U.S. Treasury, BEA, CBO, J.P. Morgan Asset Management.
2012 Federal Budget is based on the CBO's August 2012 Baseline Scenario.
Data are as of 9/30/12.