Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

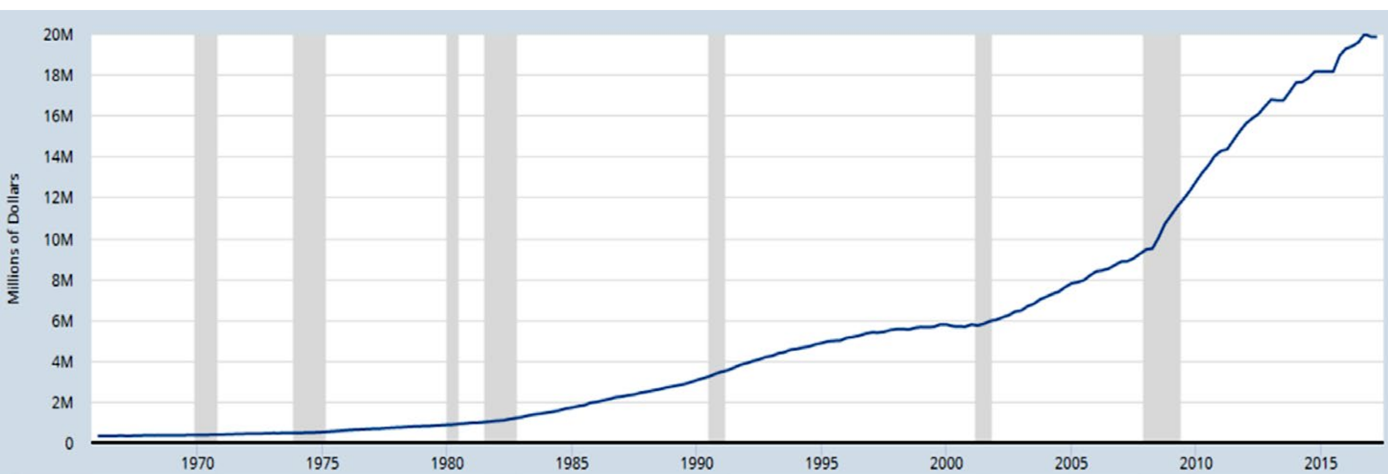
For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Debt Ceiling Crisis Averted (for now)

The media has latched onto the debt ceiling as one of its top news stories in the late summer, pushing it to the forefront of their coverage. I was asked about the debt ceiling in my last **CNBC interview on August 24th**. In my interview, I stated that there was a very low chance that the government wouldn't raise the debt ceiling, citing that the government had raised it 74 times since 1962. I also explained that the last time that the government had not increased the debt ceiling it had dire consequences on the stock market. I was confident that, despite the political fighting, no one wanted to repeat the mistakes experienced in 2011 when our debt was downgraded on the rumor of not raising the debt ceiling, causing the stock market to drop almost 20%.

On September 8, 2017 President Donald Trump signed a bill suspending the debt ceiling for three months. This has given the government more time to find a better solution and to quickly release over $15 billion in funds to help the victims of Hurricanes Harvey and Irma. As a result, the U.S. government total debt just surpassed $20 trillion for the first time in history (see the graph below).

Total U.S. Debt



Source: U.S. Department of Treasury

Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

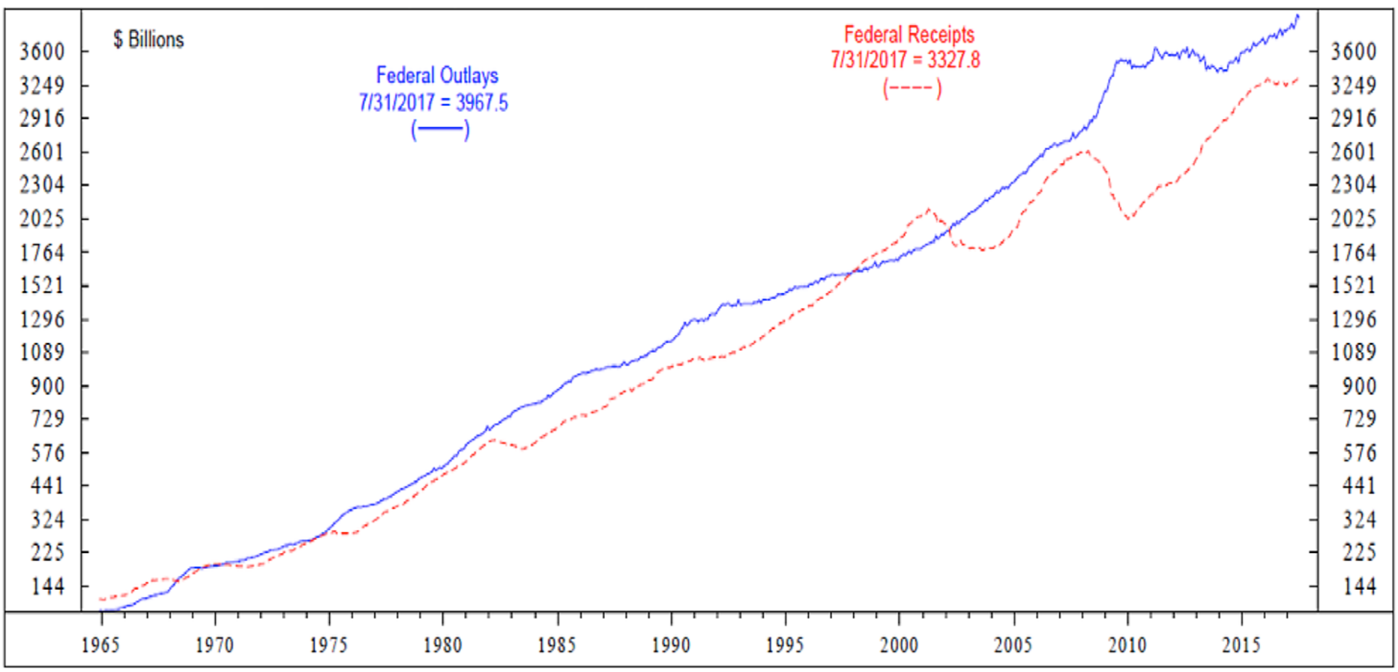
For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com | (800) 268-9046 | www.polarisgreystone.com

Deficit vs. Debt – how bad is it?

Let's get a little terminology out of the way. It is projected that our country will spend $693 billion more than it receives from all income sources this year. That is our annual "deficit." As a result of spending more than we have been making over four decades we have accumulated $20 trillion in "debt."

Deficit spending is a fairly new phenomenon is U.S. history. Prior to the 1980s, most short-term deficit spending was typically surrounding a war (e.g. War of 1812, World War I, and World War II), and was typically followed by a surplus budget to pay back the debt accumulated. As you can see from the chart below, the blue line is what the government is spending, in red is the income they are receiving. The only surplus run by our government was during the late 1990s under the Clinton administration. Other than those few years, we have had federal outlays far outweighing the receipts. Do you see the problem?

Federal Outlays vs. Receipts



Source: U.S. Department of Treasury

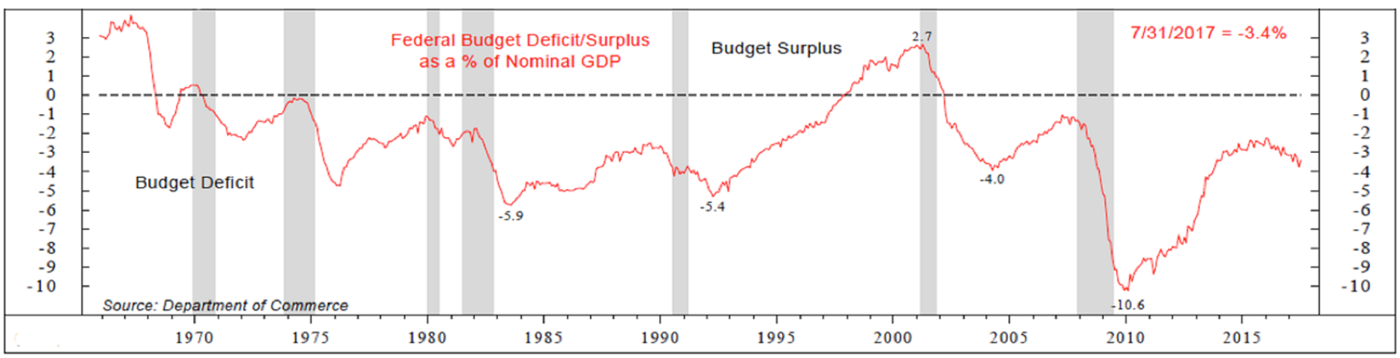
Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Another way of looking at the country's financial health is to see what the surplus or deficit is as compared to the country's gross domestic product (GDP – the size of our economy). As you can see from the chart below, we ran a surplus in the mid-1960s and the late-90s. The deficit to GDP was over 10% during the Great Recession, the highest rate since World War II. We fought our way back to a 2% deficit to GDP, only to have fallen back to 3.4% deficit to GDP.

Budget Surplus / Deficit as a % of GDP

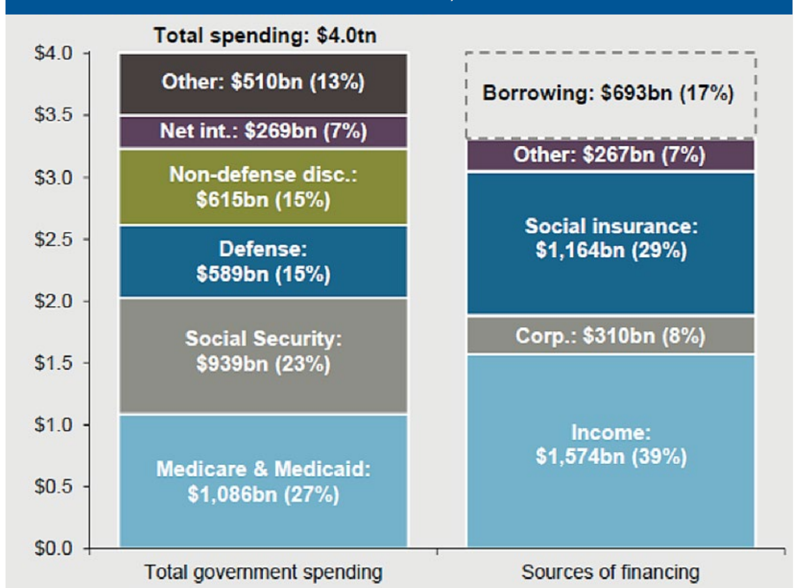


So how is our government spending our tax dollars?

Below you will see the break-down. You can see that 50% of our federal budget goes to Social Security and Medicare. Other entitlement programs take an additional 25% of the budget, leaving little discretionary spending. Those concerned about the size of the debt will see that only 7% of our budget goes to the servicing of our debt. This is a very reasonable number, for the moment.

The 2017 Federal Budget

CBO Baseline Forecast, USD Trillions



Source: Congressional Budget Office

Polaris Greystone
FINANCIAL GROUP, LLC

Polaris Greystone
Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

So Why All the Fuss?

First, it is $20 trillion dollars that we owe others. Despite common misinformation, only $6.1 trillion of our debt is owned by foreign investors, according to the Department of Treasury. It is widely known that China and Japan are the largest holders of U.S. debt, with $1.146 trillion and $1.090 trillion respectively, as of June 30, 2017. Foreign demand has been a net benefit to us lately, as this demand has been driving Treasury prices up and yields down. Our low interest rate environment, coupled with foreign demand, has kept yields down, thus making it easier to service our debt. If foreign demand were to wane, the cost of carrying so much debt could quickly become much more expensive.

Second, if we continuously run a deficit then we are adding to an already large pile of debt. If we keep adding to our already large deficit, the cost of carrying that debt will compound. Instead of the debt servicing being 7% as it is now, it could grow to 10%, 15%, or higher. That becomes much more challenging to balance a budget or limit the deficit without cutting other expenses like social security or Medicare.

Last, high debt loads slow an economy. Approximately 30% of our GDP is driven by government spending. Money going to servicing our debt is not being used to buy anything tangible, thus lowering your GDP.

What's The Impact to You?

Even a rumor that the U.S. government could default on our debt could be almost as bad as an actual default. Foreign and domestic investors view U.S. Treasuries as the safest investment that one can make. Any crack in that foundation of trust would have dire consequences. For example:

- There could be a mass exodus from U.S. Treasuries. This would cause significant losses for investors in these "safe" investments.
- Credit agencies would certainly lower our rating, making borrowing much more expensive for the U.S. government.
- Higher borrowing rates for the U.S. government most likely means a higher deficit.
- U.S. Treasuries are used as the benchmark borrowing rate for other bonds. Higher yields on Treasuries would increase the cost of borrowing for corporations, state and local governments, and for individual borrowers looking for mortgages and consumer loans.
- The value of the dollar could drop, increasing the probability of the dollar losing its status as the global currency.
- There is a much higher probability of inflation or worse, stagflation.

Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

What Should You Do?

For the past 40 years (minus a few years here and there) the government has been run with a deficit. To expect them to cut back spending, especially with all of the special interest groups today, is very unlikely. If the government can keep our deficit spending under the inflation rate, then we don't have a big problem. If our debt goes up by 2% but the inflation rate increased by 3%, then our ability to service debt just increased by 1%. The problem is you can't balance a budget based upon a perceived inflation rate that is constantly moving.

The easiest way for our government to afford our $20 trillion debt load is to devalue our currency, also known as inflation. Think about it… if a dollar is only worth 50 cents in ten or fifteen years' time, we've cut our debt in half. Don't think that's really going to happen? Well a dollar today would only buy you 70 cents worth of goods in 2000 or 53 cents worth of goods in 1990. That's a 2.12% and 2.38% compounded annual inflation rate, respectively. A 4.75% inflation rate over a 15 year time period would cut the dollar's value in half. If our debt remained at $20 trillion, but the dollar lost half of its value, then $20 trillion would really feel like $10 trillion to the government.

One way they could do this without too much opposition would be to recalibrate how inflation was calculated. This is not a conspiracy theory. The U.S. Government has changed how they calculate inflation multiple times in the past few decades. In each case, inflation rates were lowered as compared to how they would have been calculated in the past. According to the Bureau of Labor Statistics, the most recent change was made in January of 2015. Some economists estimate that our 1.7% current real inflation rate could be understated by as much as 3 to 5% as compared to how inflation was calculated in 1980.

The best way of combatting the negative effects of inflation is to grow your portfolio. This means rethinking your portfolio's allocation, with a higher concentration in stocks than you would hold in a traditional portfolio. We highly recommend that you sit down with your financial advisor and have them perform a review of your allocation and discuss ways to reposition yourself for a rising interest rate environment.

As always, I welcome your questions and comments.

Sincerely,

Jeffrey J. Powell
Managing Partner