

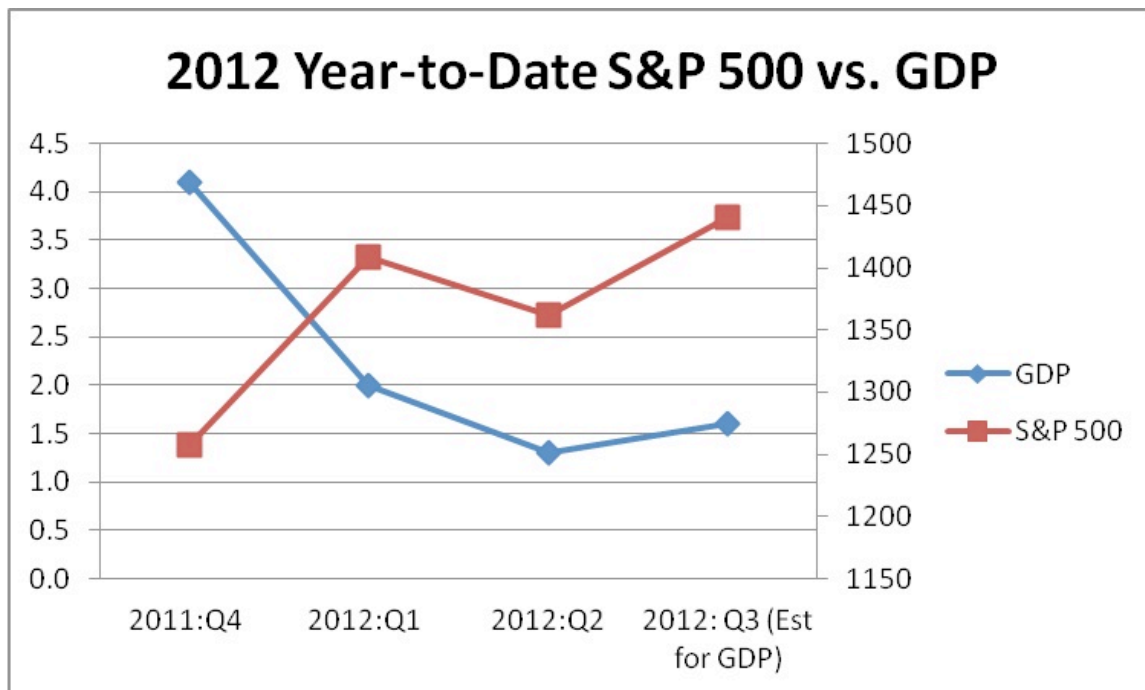
With 3 weeks left until the election, political rhetoric is in full swing, bombarding the public with explosive claims about the the economy and government spending. Trying to decipher facts from ambitious opinions is difficult and frankly makes me want to tune out the whole election campaigning. I just want to look at the facts and draw my own conclusions...

This past week I came across some charts on the economy and government spending that really made me pause and ponder. Setting all politics aside, these charts give a snap shot of current of GDP, Stocks, and Government cash flow. Draw your own conclusions....

### Chart #1 GDP and S&P

The first chart looks at the growth of economy and the S&P 500 (a barometer of US Stocks) performance this year. Since the end of the fourth quarter of 2011, the pace of growth of the U.S. economy has been contracting, and now sits at 1.3% as of the 2nd qtr. Projections for growth over the next year range from 1.7-2.5%. With interest rates at record lows for the last 4yrs, the impetus for GDP growth going forward must come from other sources. it takes at least 2.5% growth to get earnings to grow.

(Data Sources: MarketWatch, U.S. Department of Commerce/Bureau of Economic Analysis)



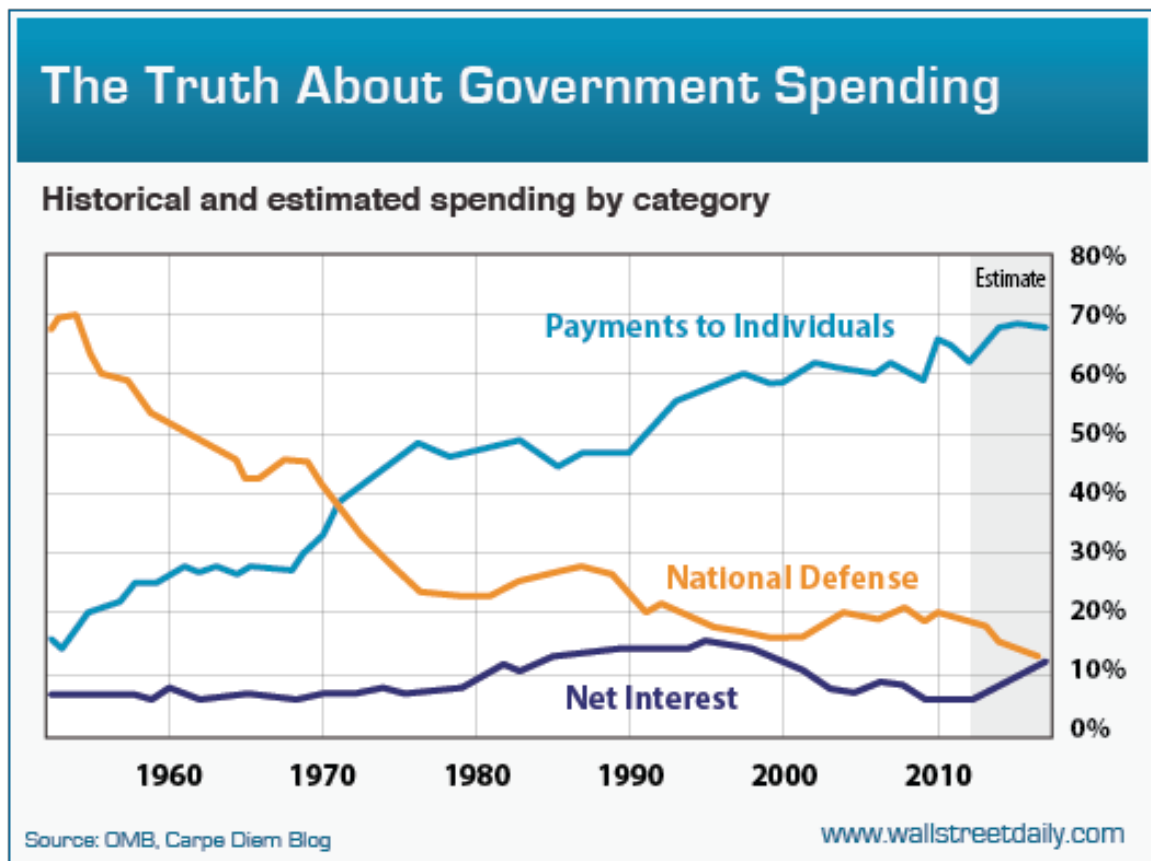
The U.S. Stock Market, as measured by the S&P 500 index, tells a completely different story with an opposite path of trajectory. Here, we have a pretty strong rally in the face of a struggling U.S. economy. Generally, it takes at least 2.5% GDP growth to enable private sector earnings to grow. So why is the stock market rising

in the face of slowing growth?

Two explanations: On the one hand, history has shown that stock market advances can be leading indicators of future advances in the economy by as much as six months. Hence, these stock market gains may be a precursor to a rebound in economic growth in early-mid 2013. On the other hand, the recent stock market rally in the midst of an economic contraction could be evidence of market growth that is being fueled by government intervention (i.e. QE3) as opposed to a building economic base.

### **Chart # 2 Allocation of Tax Revenue: Payments to Individuals, Defense, Interest Expense**

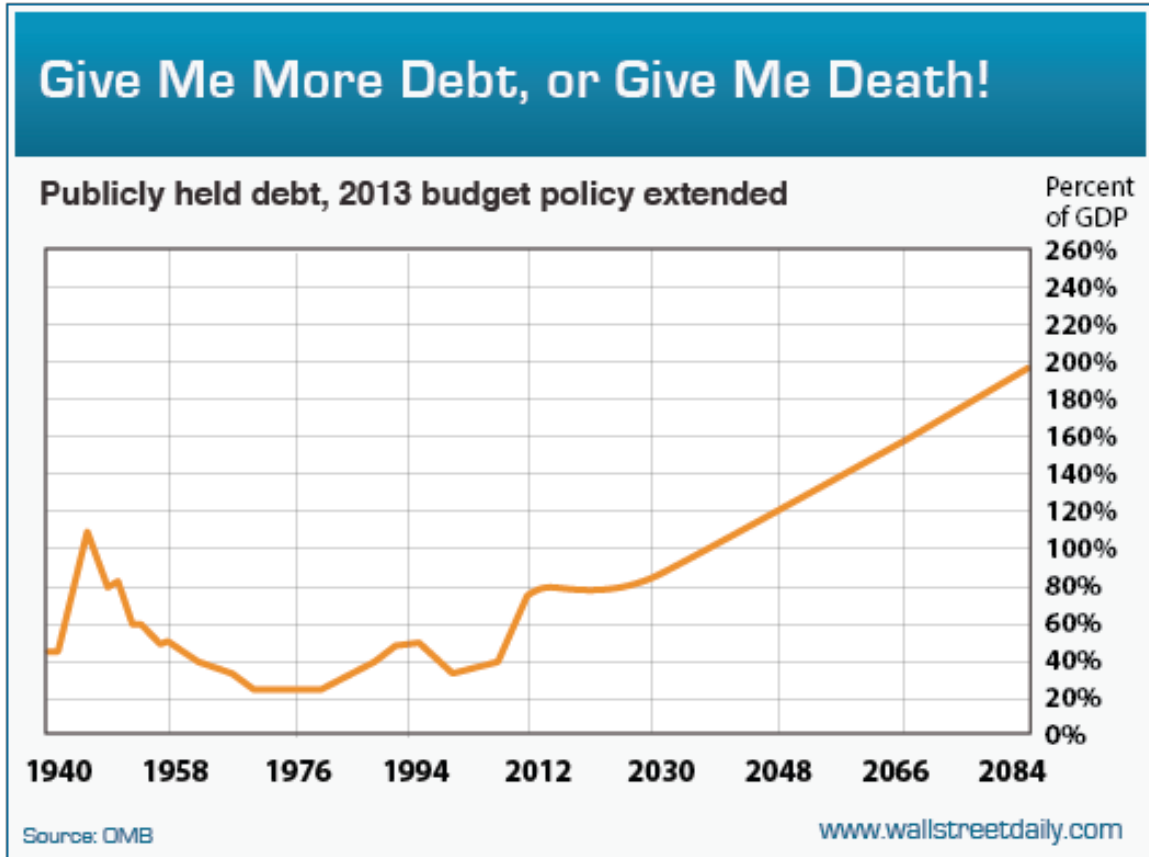
Almost two out of every three dollars spent by the federal government goes to individuals now, according to the Office of Management and Budget (OMB). That's up from less than one out of every six dollars in 1952. Politically, it is much harder to cut spending to individuals, than defense. Also keep in mind, net interest expense has benefited from 4 years of historically low rates. However, once rates begin to rise, which is still several years away, interest expenses will rise dramatically. (See Chart #3)



### Chart #3 Government Debt and GDP

This chart comes straight from page 58 of the OMB's Fiscal Year 2013 Budget of the U.S. Government: Analytical Perspectives.

In the government's own words, "publicly-held debt is projected to rise persistently relative to GDP." This could be a chart of Greece!

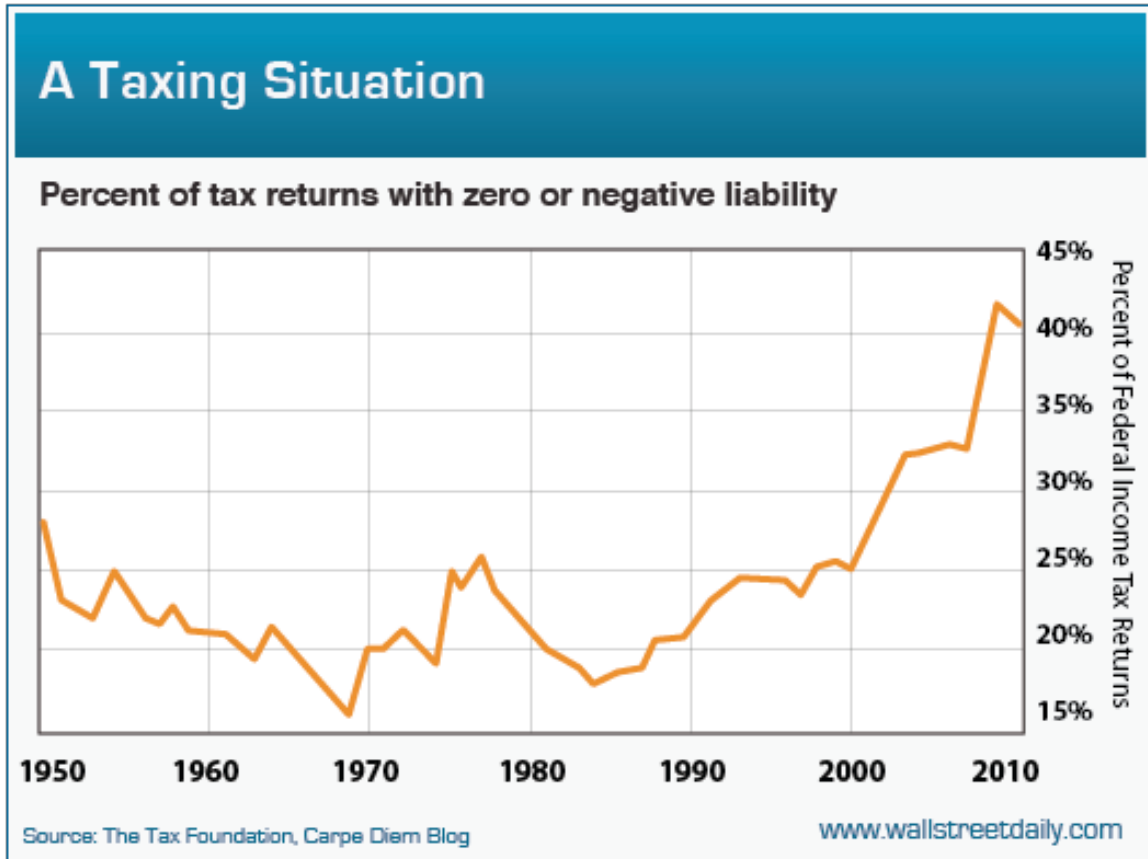


**Chart #4: Individuals contribution to Government Revenue:**

For 50 years (1950 – 2000), the percent of American’s paying no Federal taxes stayed range-bound between 20% and 25%. In the last decade, though, it’s almost doubled. According to the Tax Foundation, 41% of income tax filers in 2010 had zero or negative federal income tax liability.

Percent of Americans paying not paying any taxes

--



**Conclusion:** Both the markets and the economy are increasingly dependent upon huge increases in government spending and artificially low interest rates to sustain growth. The possibility of getting the federal budget under control is becoming increasingly difficult as the pool of those paying in is shrinking relative to those taking out. Any reduction of spending will invariably involve pitting those writing checks against those cashing them.

Bottom line: If federal spending is not curbed (the largest cuts must come from reduction in outlays to individuals-see chart #1), it’s not going to matter how much we tax the Americans that actually pay taxes. It will eventually become

mathematically necessary to tax everyone just to survive. Will we, the American people, keep kicking the can down the road? Can politicians stomach such a reality of addressing the problem now?

**Portfolio Strategy:** The markets are likely to remain in a tight holding pattern until after the election. Clarity and certainty of Fiscal policy will be key in building confidence for investors to drive the market higher. In the mean time, exceptionally accommodating Monetary policy is keeping a floor under prices. Risk positions are weighted in High Yield bonds, Large Cap stocks, but also have exposure to Global Infrastructure, Health, and Real Estate sectors.

As always, please contact me with any questions or concerns.