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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Ballooning Government Debt—The Good, The Bad and The Ugly

Recently, Moody's Investor Services knocked the U.K.'s credit rating down a notch from its triple-A status. What's most interesting to us about this downgrade is that it happened despite the British government's commitment to austerity the last couple years – in fact, one could argue that it happened because of it. This is a bit different than the U.S. downgrade by S&P in August of 2011, which happened as a result of discouraging debt and deficit trends and Congress' inability to deal with the reality of the issues we faced (and continue to face). This damned if you do, damned if you don't scenario creates a bit of confusion around how to interpret future downgrades – and more importantly, how to act on them.

The one thing that both the U.K. and U.S. downgrades did have in common was that the underlying reason for them was the increasing amount of public debt and large deficits that both countries possessed. Unfortunately, these aren't the only two developed countries that suffer from large deficits and increasing debt loads - there are many others on the list as well. Some have already experienced a credit downgrade while others are working hard to avoid it. This is one of the largest issues of the day in our opinion and one that poses the greatest potential risk to growth going forward. Some potential effects of high public debt levels include:

<u>The Good (Developing Nations)</u>

When debt is on the way up and still at a reasonable level, money is typically being spent and is circulating within the economy – more than otherwise would be. People are working as jobs abound and typically there are tangible benefits of this spending.

If returns on debt are greater than the cost of the debt, then it can be beneficial. In other words, if debt is used in moderation as an investment that returns lasting growth and wealth to a country, then it can be justified so long as that economic growth and resulting income doesn't sputter out leaving only the debt.

<u>The Bad (U.S.)</u>

As a country accumulates more debt, interest costs rise and begin to pull money away from other important public services and programs, i.e. Instead of paying $264

billion of interest in 1990, the U.S. paid $359 billion in 2012. (This figure is a bit misleading since treasury rates in 1990 were over 8% compared to less than 2% currently. When we adjust for this rate difference, we find our debt servicing costs would be closer to $1.4 trillion today – more than a five-fold increase over 1990).

The Ugly (Europe)

As debt levels rise and reach potentially problematic levels, investors and lenders may require higher interest rates on government bonds to reward them for the increasing risk of interest payments not being made in the future. Coincidentally, these higher rates lead to higher debt servicing costs and begin taking away from more productive uses of money within the economic system. (This hasn't yet happened in the U.S., but if or when it does, the interest expense portion of the annual budget will be on the rise. Unfortunately, so will quite a few other items, most notably Social Security, Medicare, and Medicaid costs.)

If a country's debt levels get to the point where investors deem them to be problematic, there are really only a couple of options (excluding outright default). The first is to do whatever is necessary to turn the deficit around to a surplus so that debt can be retired and paid off over time. The second is to throw up one's hands and to say, "there's no way we're going to get out of this mess without taking a step back, so let's make more money and pay our debt with that". Although we favor the first, both options have consequences to a country's economy and its people's standard of living.

In our opinion, one of the reasons this high debt issue is currently a real risk to global economic growth is because a good deal of Europe is currently faced with the last and ugliest of these situations. Investors have taken note, national budgets are tight and getting tighter, and so the issue has to be dealt with. Although the U.S. is still enjoying low interest rates, that could change soon if something precipitates a crisis of confidence around the country's ability to meet its financial obligations. As we learned in watching the European crisis unfold, problems are overlooked until the day they aren't. As most of us here in New England can relate to since the Blizzard of 2013, the roof doesn't slowly sag to the floor, it holds until the moment it snaps – and what makes it finally give up the ghost is usually the smallest of things. Literally the straw that broke the camel's back.

The way we see it, the developed world has two choices in backing away from this ledge. First, it can dig in and start the slow, somewhat painful process of cutting unnecessary expenses while simultaneously doing what is reasonable and responsible to maximize revenue. Care has to be taken not to dis-incent entrepreneurism and risk-taking in the process, so our hope would be that initial revenue pushes be focused on closing gaps, minimizing losses due to tax fraud, and making tax code simpler and fairer – not necessarily higher. This process would most likely be painful initially as excesses are removed from the system, but much like a household that works hard to get out of debt, the eventual reward would be well worth the battle.

The second policy solution for paying down high debt levels would be inflating one's currency, providing more money with which to pay down debt. Although this choice has the appearance of being effective, we question its long term legitimacy. The cost of "printing" money to keep up with rising debt levels is felt most significantly by those who are already struggling to get by as prices for basic needs rise – milk, bread, energy prices rise faster than those of televisions and computers. In addition, there's little incentive to deal with the problem if one feels the painful day of reckoning can be delayed or avoided altogether. There's always a cost, it's just a question of who's paying it and when. Our feeling is that our national money matters should be handled much like our personal household finances – responsibly over time, with hard work and some sacrifice. If that path leads to a debt downgrade, well then so be it. In all likelihood, it would prove temporary.

Now that we're left questioning the health of the global economy and our ability to benefit from it, let us say that the show will go on. Even if growth is slower and adjustments are felt, there will continue to be jobs, technological innovations that make our lives easier and better, and opportunities for success. Our approach moving into this new environment will be to help you avoid unnecessary risk while capitalizing on opportunities as they arise. Even if markets are flat over longer periods of time – and we know what that feels like - they will continue to move up and down along the way. By taking a

fully diversified approach with a blend of traditional asset allocation (good old fashioned spreading your money around between stocks and bonds) and more active and technical asset management, we stand a good chance of capitalizing on some of the larger more well-defined up and down trends over time. Our goal is to achieve rates of return necessary for our clients to reach their long-term financial goals regardless of what the economy or markets serve up in the meantime. If we face more downgrades from the rating agencies in the coming months or years, let's just hope they're for the right reason – things are finally being dealt with and the future looks brighter.

2013 Tax Law Change Highlights

Now that most people have begun to get their 2012 tax returns in order, they begin turning their attention to the new tax law changes taking effect in 2013. Many are under the assumption that the new tax law changes only effect High Income Earners – individuals filers earning above $400,000 and families filing joint above $450,000. However, that is not the case. Here are several tax law changes to keep in mind when talking to your tax professional for 2013:

New Tax Bracket

If you are a household making more than $400,000 (single) or $450,000 (married filing joint), your tax bracket will be up to 39.6% from 35%. Those in the new high tax bracket will also be subject to a capital gains rate of 20% - up from 15% as well as the 3.8% surcharge from the Affordable Care Act. The 3.8% surcharge to net investment income kicks in once adjusted gross income tops $200,000 for individual filers and $250,000 for married filing joint.

Social Security and Medicare Tax

Starting January 1, the full 6.2% of Social Security will now be withheld from your pay – unlike the 4.2% that was withheld for the past 2 years. The wage ceiling on which Social Security is taxed has been increased to $113,700. Medicare tax is unlimited, but if you earn more than $200,000 as an individual or $250,000 for married filing joint, an additional 0.9% will be withheld.

Itemized Deduction Phase-Out

For 2013, the itemized deduction phase-out is reinstated and the personal exemption phase-out will be reinstated. The thresholds are:

$300,000 for married filing joint
$275,000 for head of household
$250,000 for single

If you fall into these categories, you will not be allowed to take all of your itemized deductions. Your personal exemptions, another subtraction from your income before taxes are calculated, will be reduced.

*This 2013 Tax Law Change article is not intended as tax advice. Please consult with your Tax Professional to review how these changes may affect your specific situation and before implementing any strategy.

Source: http://www.irs.gov/

St. Patrick's Day Fun Facts

- Boston, USA holds the honor of holding the first St Patrick's Day parade in 1737.
- Some 23% of Boston's population is of Irish descent – the largest ratio in America.
- According to the Guinness Book of World Records, the highest number of leaves found on a clover is 14.
- One estimate suggests that there are about 10,000 regular three-leaf clovers for every lucky four-leaf clover.

Sources: www.parkrideflyusa.com & www.WSAW.com

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