

4th Quarter 2011

Portfolio Insight

“The Congressional Budget Office (CBO) projects a bright outlook for the federal budget over the next several years, assuming that current policies are maintained... Extrapolating from current policies, CBO projects growing surpluses over the next decade.”

This forecast is from The Budget Outlook of the CBO issued in January, 2000.

Implicit in the CBO forecast is the assumption that government macro policy was the cause of the strong economy and the resultant budget surplus of the late 1990s. The media often comments “the President is doing a poor (good) job of running the economy”. As an example, we have read many times over the past decade about how well President Clinton ran the economy during the 1990s. Observers point to the decade’s high rate of economic growth (4% annually); robust job creation; low inflation; declining budget deficits and eventual surpluses; and the rising rate of home ownership.

Some of Clinton’s policies, especially in the area of international trade, contributed to the good economic results of the 1990s, but it is not convincing that most were causative. Many political and microeconomic events occurred before and during his tenure which were none of his doing. Among them:

1. The end of the Cold War in late 1991 led to a reduction in defense spending—a “peace dividend” for the economy. As is often the case, the end of war also fostered a decade of optimism.
2. Inflation was low during the 1990s due to a continuation of Federal Reserve policies that began in the early 1980s. Low oil prices throughout the 1990s helped keep inflation expectations down.
3. By 1990, a large percentage of Baby Boomers were entering peak earning years, fueling growth in real estate, financial services, and other industries.
4. Perhaps most significantly, the 1990s saw steady improvements in workplace productivity. Innovation in information technology and the explosion of the internet drove significant increases in business formation and job creation.

5. Near the end of the decade, Y2K concerns led to a massive upgrade cycle in computers worldwide. The US high-tech industry was a major beneficiary.

The cumulative effect of these events created huge increases in tax revenue and budget surpluses. President Clinton and Congress acted wisely to pay down the national debt. This led to the rosy scenario mentioned in the 2000 CBO forecast.

However, these events also led to an overheated economy by 2000 and an overvalued stock market. The subsequent tech/telecom industry retrenchment led to significant job losses, and the downturn was exacerbated by September 11. These events, not caused by a change of fiscal policies, led to a recession, followed by the second Iraq war and the end of the peace dividend.

The point here is two-fold: (1) long-term government forecasts, no matter how accurate the current data and assumptions, may be wrong, due to unanticipated factors; and (2) microeconomic trends and events can have more impact on the economy than government policies. These factors are important to keep in mind as we consider the current and long-term economic challenges of large current budget deficits, high federal and state debt levels, and high unemployment.

Simply stated, our current budget deficit exists largely because tax revenues are too low and government spending is too high. In the past few years, fiscal policies of the Obama administration and Congress have been unsuccessful at stimulating the economy enough to significantly increase employment and tax revenues. The recent failure of the congressional Super Committee is testament to the difficulty politicians have in controlling spending. If the CBO’s official Alternative

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Fiscal Scenario plays out over this decade, debt will surpass 100% of GDP. Since the implications for the economy and investments are not encouraging, it is no surprise pessimism on Wall Street and on Main Street is high. There are three alternatives to a country which has reached unsupported levels of debt: default (not workable for the largest economy in the world); inflate (not palatable for many reasons); or growth.

Trends currently developing in energy, health-care, and manufacturing may have greater positive impact on our economic health in the long-term than changes in personal tax rates or new stimulus plans.

Energy

Innovations in horizontal drilling and hydraulic fracturing technology have enabled the US to develop large natural gas and oil reserves from unconventional shale resources. The adoption of shale technology has unlocked oil and gas deposits once thought unrecoverable or uneconomic. This technology enables increasing domestic reserves and growing production. According to a report published this December by the Institute for Energy Research, technically recoverable oil resources in the US now total more than 1.4 trillion barrels. Compared with our current proven reserves of 20 billion barrels of oil, shale technology has the power to dramatically increase reserves and reduce US dependence on imported oil.

Natural gas produced from shale has increased from almost nothing in 2000 to 13 BCF per day in 2011, making the US the world's leading producer of natural gas. The recent abundance of natural gas from shale discoveries has forced prices below their historical cost of supply. While this is not ideal for the average gas producer, it is attractive for many manufacturing industries which rely on natural gas. It is also a factor in encouraging manufacturers to locate in the US. Long term, low natural gas prices are also a potential source of new electric power generation, a positive for an economy largely centered on electricity dependent equipment and infrastructure.

The growth of shale oil recently reversed a nearly 25-year decline in US oil production. Starting in 1985, daily oil production declined from 10.5 million barrels to just under 7 million barrels in 2008. Domestic production will be about 7.5 million barrels in 2011. In 2010, the US imported

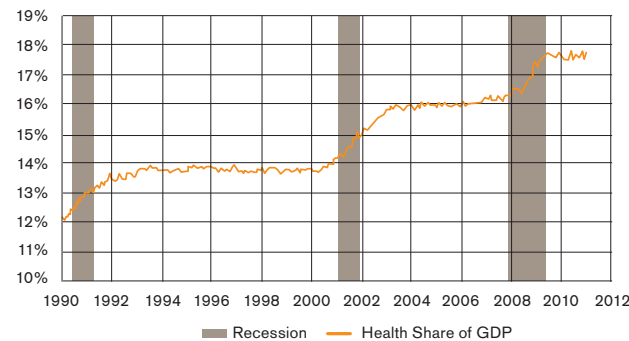
over 50% of its oil from OPEC or other countries considered risky or unfriendly to our interests. The increased domestic production of oil should allow the US to significantly reduce imports of oil. The economic implications of the change in oil production are material. We currently import approximately 10 million barrels of oil per day. This amounts to sending \$350-\$400 billion internationally each year, often to nations that do not have our best interests in mind. With the growth of US production, ExxonMobil recently estimated that we can conservatively reduce our oil imports below 7 million barrels per day by 2040.

Another benefit from the shale revolution is job creation. Several respected sources have provided estimates for domestic job creation ranging from 400,000 to 1,000,000. These estimates reflect direct and indirect job creation, meaning more people leaving unemployment, paying taxes, buying houses and contributing to economic growth.

Health Care

Recent headlines continue to capture the significance of future health care spending and its risks to our nation's fiscal well-being. The data show that healthcare spending as a percentage of US GDP has remained flat for long periods since 1990 with step ups from increased insurance mandates, large numbers of new devices and branded expensive drugs, and a longer lived population with increased numbers of chronic ailments. Recessions aggravate the percentage as GDP falls.

HEALTH SPENDING SHARE OF GDP



Focusing on areas to cut costs in health care is one effective method to address the nation's current and future budgetary issues. Approximately 87% of total health care spending is on providers and services, with the balance for medical

technology and drugs. CMS estimates the cost of waste, fraud, and abuse at \$150-\$250 billion annually or approximately 20% of total CMS spending. Medicare and Medicaid fraud alone, by some estimates, is between \$60 and \$120 billion. Increasingly, CMS is implementing sophisticated computer programs and billing algorithms to reduce wasteful spending and target fraud and abuse. These numbers are only part of the problem. The PriceWaterhouseCoopers Health Research Institute, a highly respected expert organization, estimated healthcare waste, fraud and abuse at \$1.2 trillion of all national health care spending in 2008.

A wave of recent generic drugs will reduce spending on branded drugs by over \$150 billion from now through 2018. In addition, innovative targeted therapies and diagnostic tests are in development. Getting medications to patients where the drug is known to have an effect will reduce ineffective health care spending.

Considerable investment is being made on healthcare information technology. Besides increasing efficiency, data made available from these systems can increase patient safety and reduce medical errors, potentially cutting costs by \$400-\$500 million annually. Wellness and prevention programs are producing a healthier workforce and population—a definite cost saver. Insurance plans that partner with patients to reward positive life style choices are improving therapeutic compliance and reducing costs.

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Finally, a shift in focus at Medicare to reimbursement based upon quality rather than traditional fee-for-service (volume based payments) may ensure the most efficient use of health care dollars to produce quality patient outcomes. Substantial savings may also come from innovative programs such as clinical integration, accountable care organizations, medical ‘homes’ and bundled payment programs.

The net result of these many efforts and initiatives should be an overall reduction in the rate of health care spending growth.

Manufacturing

The Boston Consulting Group (BCG) recently published a white paper entitled *Made in America, Again - Why Manufacturing Will Return to the US*. The report concludes that by 2015 many of the manufactured goods sold in North America will be just as economically produced in the US as they would be in China. BCG predicts many companies will choose to locate new manufacturing facilities in the US over the next five years.

China is becoming a less compelling choice for manufacturers. Wage and benefit costs have risen significantly for Chinese workers. Low productivity, transportation, supply chain issues, risks to intellectual property, and political unrest are just some of the other reasons companies may choose to leave or reduce their presence in China.

The implications for the US are clearly positive. BCG expects up to 800,000 manufacturing jobs to return to the US by mid-decade and, with a multiplier effect, they estimate 3.2 million total jobs may be created, many of which will be high-paying jobs. Again, these people will pay taxes, buy homes, etc.

The trends we present here are not near-term in impact but could have a long-term effect. In our base-case scenario, we believe the US economy will grow for the next couple of years, albeit slowly. That scenario assumes a European recession but that the Eurozone avoids a disaster, such as banking crisis or debt default by a major country, such as Italy. The fiscal and economic environment in Europe is clearly challenging but, according to J.P. Morgan, only 8% of S&P 500 earnings are from Europe. At current levels, we believe US equity prices largely discount a moderate European recession.

With monetary policy nearly ineffective in creating real growth and with more fiscal stimulus unlikely, we are going to experience an economy which will grow at a natural rate, uninfluenced by macroeconomic policy. Think of it as organic growth as opposed to illusory, patchwork growth. Organic is good for us.