MainStream Management
Creating Value, Driving Results

Spring 2013
MainStream Perspective

The 2013 Economic Outlook: As Unhealthy as a Jelly Donut

Our economy is like a living, breathing organism. Its health depends on factors it can control (inputs, exercise) as well its reaction to outside forces (genetics, environmental conditions) that are beyond its control. For the last 25-plus years this "living, breathing" economy was powered by unsustainable and unhealthy inputs — picture jelly-filled donuts and fattening fast food — in the form of increased debt and lower interest rates. Over that period of time (1982 – 2007) the economy caught a "cold" (minor recessions) only twice. Beginning in 2006, a substantial amount of the sugary, fat-filled, tasty-but-unhealthy stuff was taken away as consumers and corporations began to cut back and finally reduce their debt holdings. The result was the most dramatic recession in the United States and the first worldwide recession since the Great Depression (Figure 1).

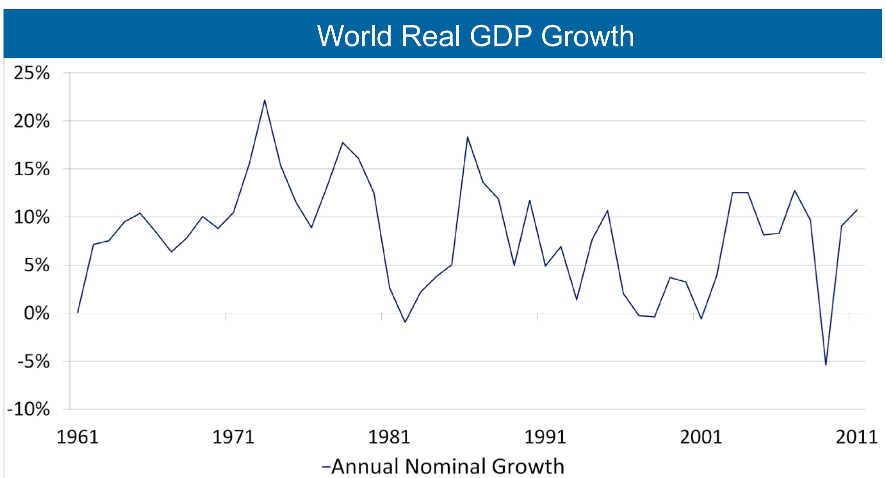

Figure 1. Source: World Bank

Governments around the world were not ready for the fast-food good times to end. In an attempt to support their struggling economies they started where consumers and corporations left off, with a steady IV drip of pure sugar in the form of deficit spending and reduced interest rates. That wasn't enough, so central banks got involved and injected sugar (money) directly into the system, further attempting to lower interest rates through direct purchases of debt and an expansion of their balance sheets (Figure 2, Page 2).

Sadly, but not surprisingly, consuming more junk food and sugar did not reduce economic ill-health. Slowly, some governments began the painful process of focusing on fitness (balance sheet strength) instead of taste (short-term economic growth). Putting away the jelly donuts was no fun for anyone in the short term, but it was necessary in order to experience healthy long-term economic growth.

Fast forward to January 2013, when Congress passed, and the President signed, the American Tax Payer Relief Act of 2012, thus delaying the so-called Fiscal Cliff. The law addressed the tax expirations associated with the Fiscal Cliff, but not the spending, deficit, debt, or economic growth implications that were the impetus for the

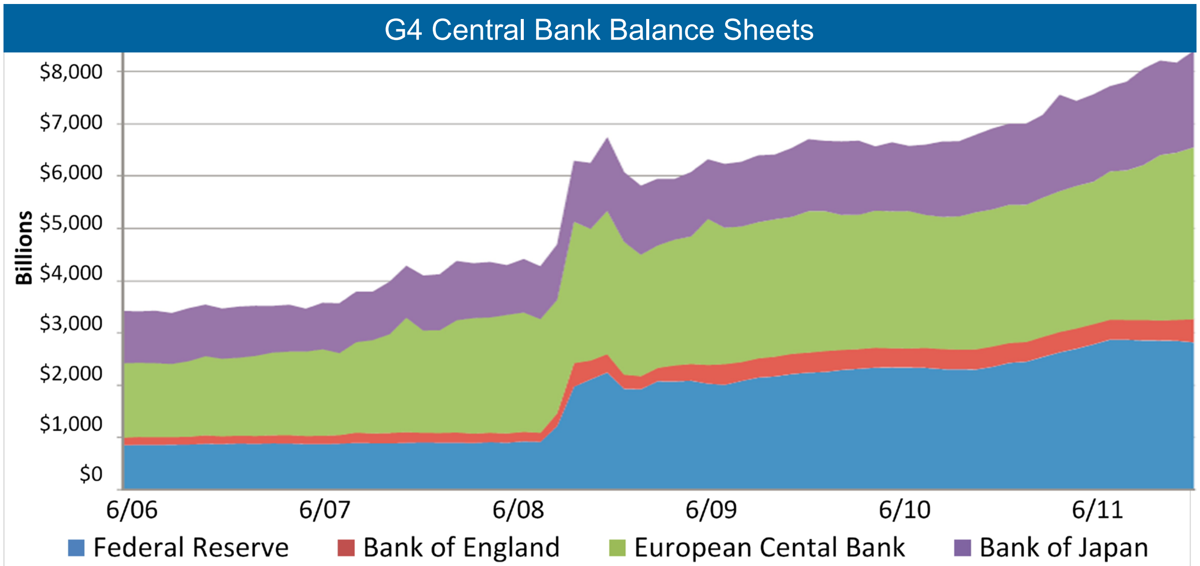

Figure 2. Source: Cumberland Advisors

Budget Control Act negotiations in the first place. Some of these issues still need to be addressed this year, while others will likely be postponed.

Deficit Spending and Debt

In an ideal world, an economy might be faced with only one macro challenge — high deficits, high debt or subpar economic growth. Despite the publicity surrounding the debt ceiling and sequestration, the increasing federal debt burden is the more pressing issue. The government has run a budget deficit in excess of $1 trillion for the last four years. As a result, outstanding government debt is larger than the GDP for the first time since the aftermath of World War II. Of particular concern, government spending is becoming increasingly structural (more skewed to mandatory as opposed to discretionary spending) and thus harder to decrease.

> "Despite the publicity surrounding the debt ceiling and sequestration, the increasing federal debt burden is the more pressing issue."

The United States electorate faces two fundamental questions, the answers to which will have a significant impact on long-term economic growth: How much financial assistance do Americans want in old age, both in terms of social security and healthcare benefits? And how much are they willing to pay for it in the present?

Everything else is secondary. Discretionary spending, the spending that is appropriated by Congress and therefore is subject to direct manipulation, is only 37 percent of total spending. Forty years ago it was 56 percent of total spending (Figure 3, Page 3). Cutting the entire discretionary budget ($1.3 trillion) would only result in a total budget surplus of $17 billion — but no military, government funding for roads, research, and the like.

Increasing revenues will also fall short. As an example, the American Tax Payer Relief Act will result in extra revenues of roughly 60 billion in 2013. This is roughly 0.4 percent of GDP or only 1.7 percent of total government spending. Doubling income taxes, or tripling corporate tax rates (impossible, considering current rates), would still result in budget deficits even when not considering the effect it would have on production, consumption, and growth.

The real costs lie in mandatory spending: Medicare, Medicaid, and Social Security. These costs will continue to increase as the population of the United States continues to age. We can't pay for them now; the taxes associated with each don't cover current spending, and there are no fail-safes to adjust this discrepancy going forward outside of assuming more debt – the exact thing that Congress will argue over when attempting to raise the debt ceiling next month.

Economic Growth

In an ideal world an economy would be faced with high deficits, high debt, or subpar economic growth. Today is definitely not ideal, as we are facing all of these problems simultaneously. Addressing any two problems together will lead to negative pressure on the third. In the short term, decreasing deficits and taking on less debt will mean less government spending and lower economic growth. Continuing to increase debt may be a viable option for several more years, but only if investors continue to purchase the issued debt at extremely low interest rates.

It seems as if this is what the current Administration is banking on. Current policy is aimed at gradually reducing the deficit through a combination of tax increases and cuts in government spending, in an effort to get by with low economic growth until that growth will pick up (magically) and allow for more aggressive debt reduction. The government has a crucial question to answer in 2013: How much in spending cuts and tax increases can the economy absorb while still growing? It is a very fine line to walk.

2013 Trends

For the remainder of this year, we're likely to face three ongoing challenges:

1. *Continued weak economic growth*
   Last year's 2 percent increase in GDP will be difficult to repeat in 2013. Tax increases will cut 0.5 percent to 1 percent from GDP growth mainly through decreased private consumption. Investment will remain subdued as Congress and the President continue to obfuscate their

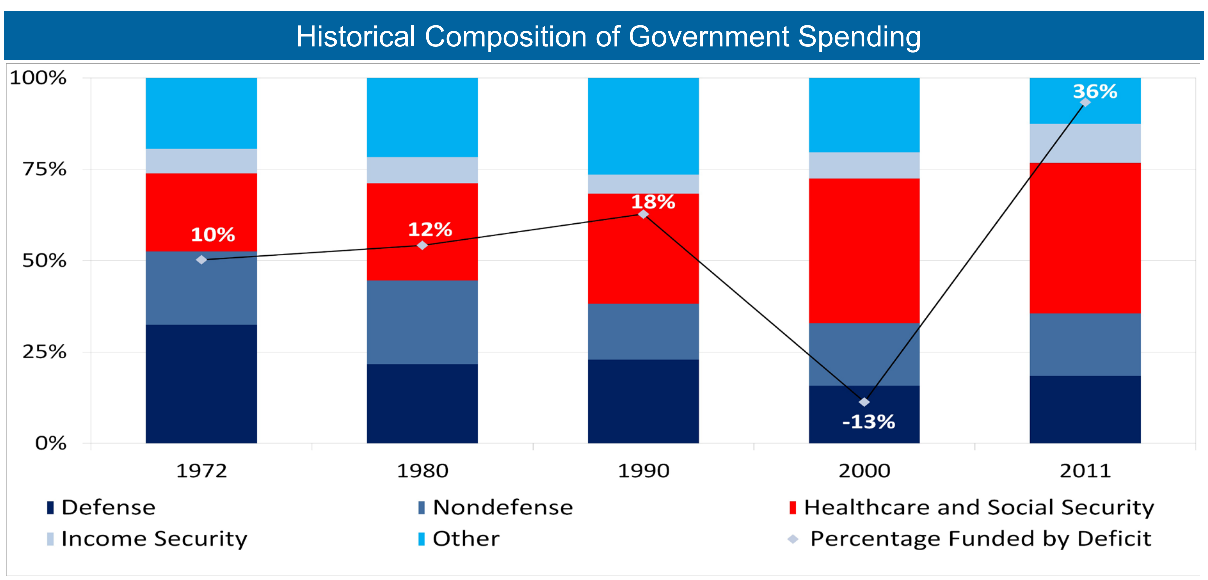

Figure 3. Source: Bureau of Economic Analysis

true spending intentions. Government spending will at best have no effect on GDP, and at worst have a mild negative effect, if any meaningful spending cuts are agreed upon.

2. *Top line growth and profit margins will both experience pressure*
   United States corporations had a good year in 2011, ending with corporate profits ($1.54 trillion) and profit margins (10.1 percent of GDP) at all-time highs. 2012 was not as forgiving. Through the third quarter of 2012 corporate profits (adjusted for inventory valuations and capital consumption) were $68 billion (-4.3 percent) lower than they were in the fourth quarter of 2011. Profits will continue to be constrained in 2013. Anemic economic growth is limiting top line revenue and already high margins are constraining further profit expansion.

3. I*ncreasingly interventionist government policy*
   The government has three problems: high deficits, high debt, and low growth. The American Tax Payer Relief Act sought to address the first two problems, but it exacerbated the third. Expect more of this kind of trade-off in 2013. Individual tax rates are likely to remain at current levels, but the government will focus on spending cuts and possibly corporate tax rates to reduce deficits. Government spending will be cut in 2013 by roughly $90 billion (0.6 percent of GDP) as a result of sequestration; the final amount of cuts will most likely be delayed and reduced, thus causing less of an impact in 2013, but this is only lip service in comparison to the changes that will occur after 2013.

Summary

All current measures continue to ignore the main problem that confronts the electorate: How much financial assistance do Americans want in old age, both in terms of social security and healthcare benefits, and how much are they willing to pay for it in the present? This issue will not go away. Therefore, the need for a combination of increased economic growth, decreased government spending, and increased government revenues will hang over the heads of consumers and corporations alike for the rest of 2013 and beyond.

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About MainStream Management

MainStream Management helps middle market business take a holistic view of their organizational performance from bottom-line financial management to top-line revenue creation. Our operational expertise in strategy formulation in addition to corporate turnaround and restructuring have enabled our clients to achieve improved profits and greater asset returns in uncertain times.

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