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The Debt Issue

Over the years, long-term investors have properly been advised to take a long-term view. Don't fret about short-term disruptions, weather effects, strikes or even the occasional bad policy decision. Don't even get overly worried about recessions - recessions happen and are always followed by recoveries. If you can anticipate them, you can enhance returns. But even if you can't, a diversified portfolio of long-term assets should serve you well.

However, over and above these short-term concerns are longer-term worries. What happens when the world runs out of oil? Will terrorists eventually strike us in a worse way than on 9/11? Will the U.S. dollar lose its ascendancy in the global economy?

Of all these long-term concerns, the most frequently cited by investors today is the issue of the federal debt. Many worry that we are drowning in a sea of government red ink that will eventually lead to a U.S. economic crisis. Some are worried that a too rapid attempt to fix the problem could lead to another recession. And while there is general agreement that something needs to be done about government deficits, there is an overall dread of the pain that fixing the problem will entail.

For investing, the single most important aspect of the debt issue is to see it in a balanced way. With that in mind, this article first outlines the current state of the federal finances and their expected path in the absence of remedial action. This is followed by an outline of some proposed solutions now on the table. The next section considers what should be done about the issue and what, given political realities, is likely to be done. Finally, we look at the implications of this likely path for investment strategy. We also include two brief boxes on the issues of the debt ceiling and the fiscal implications of the end of QE2. The bottom line is that while debt-related financial turmoil is possible, the most likely scenario is one in which Washington cuts spending and raises taxes enough to avoid a crisis but not so much as to stall economic growth or prevent an increase in market interest rates.

The state of the finances

The federal budget is, of course, immensely complicated in its details but the big picture is pretty straightforward. In recent years, we have been running huge deficits (that is, on an annual basis, spending has been exceeding revenues) and this is generating a fast-growing national debt. Moreover, even with somewhat smaller deficits over the next few years, the debt will continue to grow at an alarming pace.

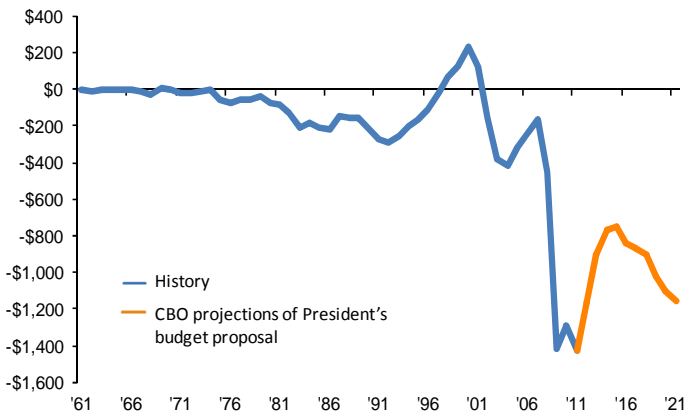
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including weekly insights from
Dr. David Kelly.

Chart 1 below shows the path of federal deficits from fiscal year¹ 1961 to fiscal year 2010 and the Congressional Budget Office's (CBO) estimate of deficits expected through fiscal year 2021, if the President's 2012 budget were fully enacted². Chart 2 shows what this would imply for the federal debt, which, of course, grows each year by the amount of the federal deficit.

Clearly, these are very sobering numbers with the federal deficit falling only to \$748 billion by fiscal 2015 (which would, incidentally, be higher than any deficit recorded prior to 2009) before rising to \$1.158 trillion in fiscal 2021. This contributes to very rapid growth of the federal debt, with the debt in the hands of the public³ climbing to \$20.8 trillion by the end of fiscal 2021 compared to an expected \$10.4 trillion at the end of this year.

Chart 1: Federal Deficit: 1961 – 2021

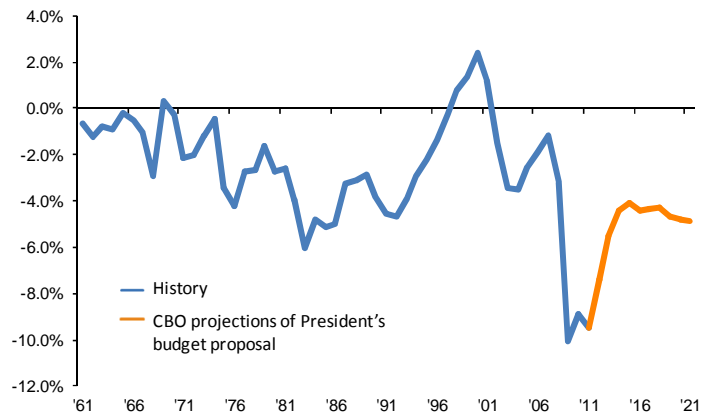
Billions, USD



Sources: CBO, BEA, J.P. Morgan Asset Management

Chart 3: Federal Deficit: 1961-2021

Percent of GDP



Sources: CBO, BEA, J.P. Morgan Asset Management

Chart 2: Federal Debt: 1961-2021

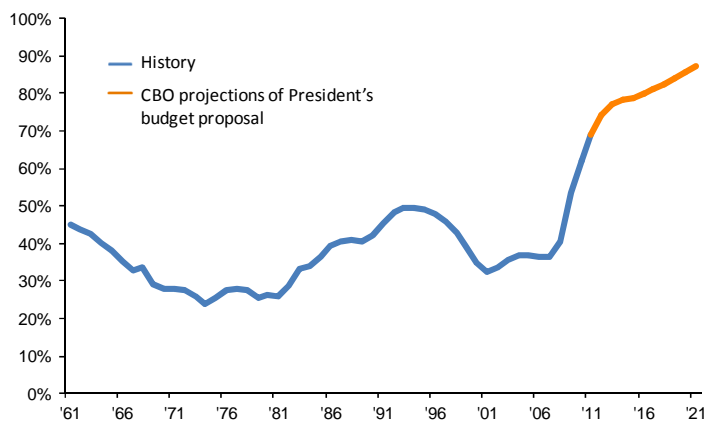
Billions, USD



Sources: CBO, BEA, J.P. Morgan Asset Management

Chart 4: Federal Debt: 1961-2021

Percent of GDP



Sources: CBO, BEA, J.P. Morgan Asset Management

¹ For the federal government, the fiscal year starts on October 1 and ends on September 30. So, for example, fiscal 2011 started on October 1, 2010 and will end on September 30, 2011.

² Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 2012 (April 2011)

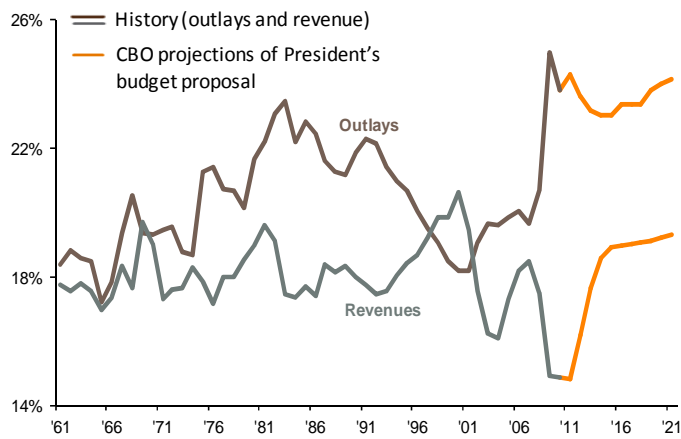
³ In this analysis, we generally focus on the "debt held by the public" which was \$9.0 trillion at the end of fiscal 2010 rather than "gross federal debt" which equaled \$13.5 trillion at that time. The former concept excludes money owed by one branch of the federal government to another and, as such, is a better measure of the strain on capital markets caused by running chronic deficits.

While these numbers are huge in raw terms, when thinking about their implications for markets, it is more important to look at them relative to the size of the economy overall. The previous two charts show the deficit and debt as a percentage of GDP from 1961 to 2021.

Although examining the numbers as a percent of GDP makes them look at least comprehensible, it by no means reduces the challenges posed to the U.S. economy by federal debt. Over the next decade, without some radical policy changes, the federal debt could climb to 87.4% of our GDP, from 69.1% this year.

Two other points should be made about the nature of the problem, which are illustrated in the charts on this page. First, over the past 50 years, federal revenues have averaged 18.0% of GDP but in the current year they are set to amount to just 14.8%. During the same period, federal spending has averaged 20.5% of GDP but in the current fiscal year it should amount to 24.3%. This strongly suggests that any honest approach to balancing the budget will require *both* revenue increases and spending cuts.

Chart 5: Revenues and Spending: 1961-2021
Percent of GDP

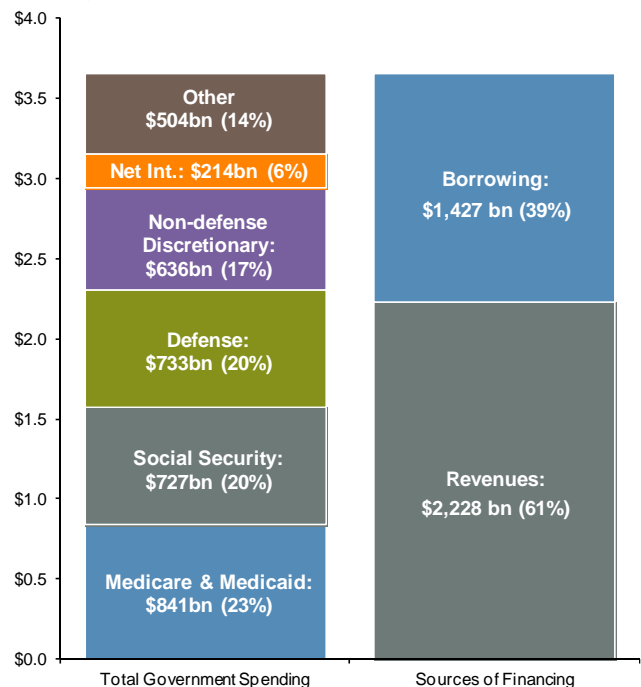


Sources: CBO, J.P. Morgan Asset Management

Second, the budget *cannot* be balanced purely by hammering discretionary spending. The cold reality is that we are currently borrowing almost 40% of total government spending or \$1.4 trillion. If we eliminated all non-defense discretionary spending, it would still amount to only half of the current deficit. As an alternative, if we eliminated all

spending on Social Security and defense, it would still just cover the deficit. ***As a practical matter, the federal budget cannot be balanced without increasing taxes and cutting spending on Medicare, Medicaid, Social Security and defense.*** With the exception of interest payments on the national debt, which are estimated at a still manageable \$214 billion this year, there can be no sacred cows on the road to fiscal reform.

Chart 6: Revenues and Spending, 2011
Trillions, USD



Sources: CBO, J.P. Morgan Asset Management

Two other points should be made about the budget math before proceeding, one rather sobering and the other a little reassuring.

First, an obvious goal might be to try to get both spending and revenues back to the 50-year average for spending which is, as noted earlier, 20.5% of GDP.

In fiscal 2011, the CBO estimates that net interest on the public debt will equal 1.4% of GDP, leaving federal spending on goods and services at 22.9% of GDP. By 2021, under the President's budget proposal (and the numbers are not much

different under some alternative proposals), net interest is projected to reach 3.9% of GDP due to significant increases in both total debt and Treasury rates⁴. Therefore, arriving at a spending target of 20.5% of GDP would mean cutting spending on goods and services to just 16.6% of GDP, a truly daunting target from here.

Second, on the positive side, the first critical goal of policy should be to stabilize the debt-to-GDP ratio. However, because of growth in nominal GDP, this doesn't quite require a balanced budget every year. As an example, the President's budget assumes nominal GDP growth of 5.2% in 2016 with a debt equal to 78.9% of GDP by the end of fiscal 2015. Mathematically this implies that as long as the deficit-to-GDP ratio is less than 78.9% of 5.2% (or 4.1%) then the debt-to-GDP ratio would actually fall. It almost goes without saying that we ought to aim to reduce the debt-to-GDP ratio, since just stabilizing it leaves it vulnerable to a reacceleration in any economic adversity. Still, it is important to recognize that dealing with the budget issue doesn't require an immediate move back to budget balance.

Dealing with the debt I: The deficit commission proposal

Such is the debt problem - now what do we intend to do about it? The good news is that we are now at least paying attention to the issue. In fact, the current focus on long-term budget issues can probably be traced back to early 2010 when the President established a bi-partisan commission charged with:

"...identifying policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run. Specifically, the Commission shall propose recommendations designed to balance the budget, excluding interest payments on the debt, by 2015. This result is projected to stabilize the debt-to-GDP ratio at an acceptable level once the economy recovers"⁵.

⁴ Most of the increase is coming from higher interest rates rather than a higher debt to GDP ratio. The CBO projections imply that the average interest rate on federal debt will rise from 2.2% this year to 4.6% in 2021 or a 109% increase, while the debt-to-GDP ratio will increase from 69.1% to 87.4% - an increase of 26%.

⁵ Executive Order -- National Commission on Fiscal Responsibility and Reform, February 18, 2010.

Early last December, the Commission issued its report⁶, although with the support of only 11 of the 18 members. In general, the Commission treated nothing as "off the table" but rather suggested reforms across a wide range of issues. Among the steps they proposed were:

- Hold discretionary spending in 2012 at 2011 levels and then reduce real spending to pre-2008 levels in 2013. Thereafter, hold spending growth to half the projected inflation rate through 2020. Apply this equally to "security" and "non-security" spending.
- Increase the gasoline tax by 15 cents from 2013 to 2015.
- Implement comprehensive tax reform lowering both corporate and individual tax rates but limiting tax breaks on mortgage interest, municipal bond interest, employer-provided healthcare, dividends and capital gains.
- A phased-in increase in the age of eligibility for Social Security starting in 2027.
- Reforms to Medicare and Medicaid programs to, among other things, reduce the incentive for states to game federal Medicaid transfers and to restrict supplemental Medicare coverage from dollar one.
- In 2015, the Commission's proposal would raise revenues by 3% compared to what it calls a "plausible baseline" while cutting spending across all categories by about 6%. It is worth noting, however, that this reduction in tax revenues is on top of an already assumed expiration of the Bush tax cuts for households earning over \$250,000 per year.

While very broad, many of these proposals are actually quite mild in their effects. In particular, there certainly is an argument for a more aggressive approach in increasing the eligibility age for Social Security and Medicare or increasing

⁶"The Moment of Truth", The National Commission on Fiscal Responsibility and Reform, December 2010.

the gasoline tax. Still, based on the Commission's numbers, this would be sufficient to cause the debt-to-GDP ratio to peak in 2013, before beginning a long and slow trek downward.

Dealing with the debt II: The Ryan proposal

Since the publication of the Commission's proposals late last year, Washington has seen two budget standoffs resolved.

In the first, on December 6, 2010 the President announced that he had come to a deal with Congressional Republicans to extend all of the Bush Tax cuts for 2011 and 2012, along with tax breaks on payroll taxes and business equipment spending, and a further extension of unemployment benefits. While these measures have likely helped bolster the economy in the short run, they have also put off the evil day when the federal government engages in an actual budget restraint.

In the second, on April 8 of this year, the Administration came to a last minute agreement with Republican lawmakers to avoid a government shutdown. This agreement included \$78.5 billion in cuts to discretionary spending for the 2011 budget relative to the President's 2011 budget proposal, but did not address longer-term budget issues.

Meanwhile, that longer-term debate returned to the center of the political arena on April 5, when Representative Paul Ryan, the Chairman of the House Budget Committee, laid out a proposal to cut \$4.4 trillion over 10 years.⁷

This plan, perhaps predictably, attempts to do most of the heavy lifting on the budget from the spending side, cutting federal spending from 24.1% of GDP in the current fiscal year, to 19.7% by 2018. Revenues would rise from 14.8% of GDP this fiscal year to 17.9% of GDP by 2018, leaving the nation with a federal deficit that year of 1.8% of GDP.

The most notable parts of the Ryan proposal are his attempts to control spending on both Medicaid and Medicare. For the former, he proposes block grants to the states, putting the onus on state governments to improve efficiency. For the latter he suggests a phased-in scheme of subsidized health care premiums for senior citizens rather than direct payments to health care providers. On the revenue side, Representative Ryan's budget proposes broad tax reform with reductions in both individual and corporate tax rates but also reductions in tax breaks such as the mortgage interest deduction. His budget leaves the growth in defense spending and Social Security largely untouched, although it acknowledges the need to consider both means testing and increases in the age limits for eligibility going forward.

Dealing with the debt III: The President's proposal

Eight days after Representative Ryan outlined his proposal, the President announced one of his own⁸. Starting with his own 2012 budget as a baseline, he proposed to cut a further \$4 trillion from cumulative deficits over the next 12 years with roughly \$1 trillion of this coming from tax increases embedded in a broad tax reform, \$1 trillion coming from lower interest costs and the remaining \$2 trillion coming from spending cuts in defense, non-defense discretionary programs and medical programs. It should be noted that the President's budget already assumed the end of the Bush tax cuts in 2013 for individuals/households earning over \$200,000/\$250,000 per year and further cuts in defense spending. His proposals for Medicare and Medicaid largely mirror those already in the health care act signed into law last year, while, like Representative Ryan, he does not propose any changes to Social Security.

⁷The Path to Prosperity: Restoring America's Promise, Fiscal Year 2012 House Budget Resolution, April 5, 2011.

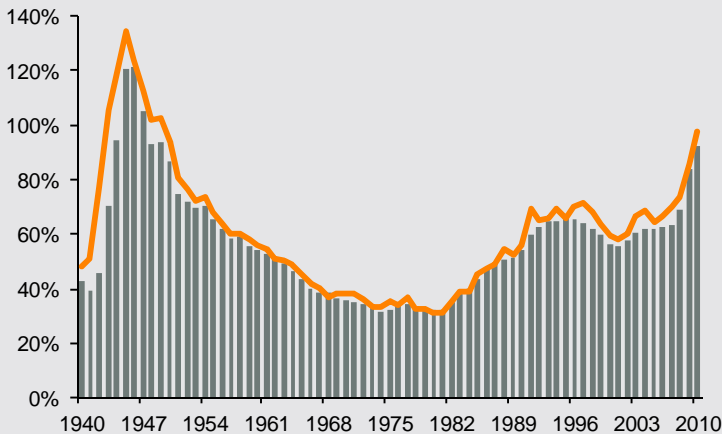
⁸Remarks by the President on Fiscal Policy, George Washington University, April 13, 2011.

The debt ceiling sideshow

Some of the drama in the current debate on deficits and debt comes from a threat by some lawmakers that, in the absence of progress on the long-term issue, they will refuse to raise the federal debt ceiling. By way of background, the concept of a debt ceiling was first introduced back in 1917 when Congress authorized the Federal Government to borrow up to \$11.315 billion to fund U.S. participation in World War One. Since then it has been raised many times and often with accompanying political theatre. The current legal debt limit is \$14.294 trillion⁹ a limit which we essentially hit in mid-May. Even after reaching the limit, there are some technical adjustments that the Treasury Department can employ to postpone actual default. However, Treasury now estimates that they will reach the limit of these adjustments by Tuesday, August 2, 2011, at which point, without an increase in the debt limit, or alternatively, immediate truly massive tax increases or spending cuts, the U.S. will default on its debt.

No one can predict all of the ramifications of a default - but it is easy to see how it could trigger a worse financial crisis than the one that followed the collapse of Lehman Brothers. It would also add a much larger credit risk premium to Treasury bonds going forward, increasing the cost of servicing the federal debt for decades to come.

Chart 7: The National Debt and Debt Ceiling
Percent of GDP



Sources: CBO, BEA, J.P. Morgan Asset Management

The alternative, raising taxes and cutting spending enough to pay our bills on a day-to-day basis immediately is also completely untenable at this time. According to the Congressional Budget Office, we will run a deficit of approximately \$1.4 trillion this year, with revenues of \$2.2 trillion falling far short of spending of \$3.6 trillion. To put this in perspective, \$1.4 trillion is roughly equal to spending on defense and Social Security combined. If you think it is politically difficult to raise the debt ceiling, consider how impossible it would be to cut spending or raise taxes enough to achieve budget balance immediately.

Equally relevant, from an economic perspective, is that the current budget deficit amounts to about 9% of GDP. However much we dislike deficits, the reality is that a deficit amounts to extra demand for goods and services in the economy since it equals the money the government puts into the economy in the form of spending less what it takes out in the form of revenues. If the U.S. were suddenly, overnight, to balance its budget, it would remove 9% of the total demand in the economy, triggering a recession which would make the last one look mild by comparison.

It is because of this reality, that we believe any threat to not to raise the debt ceiling is irresponsible. But it is precisely because the consequences of not raising the debt ceiling are so awful that, in the end, it is unlikely that a majority in the House or the Senate would want to explain to the voters why they visited this calamity upon them.

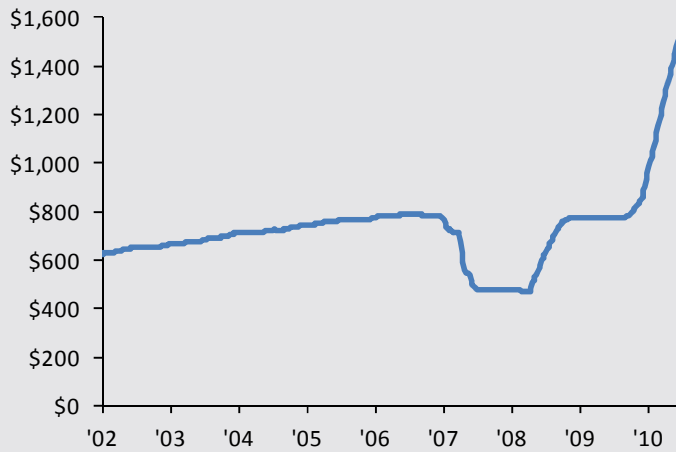
⁹Note that the debt ceiling limit includes roughly \$4.6 trillion in debt owed by one branch of the government to another.

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The QE2 sideshow

One complication in the federal debt debate and one that ought to add urgency to the issue, is the impending end of what is popularly known as “QE2”. Since the start of the financial crisis, the Federal Reserve has taken a number of innovative steps in an attempt to both mend the financial system and stimulate the economy. This has included a federal funds rate set at a range of 0-1/4% since December of 2008. However, last summer, with the economy still plagued by very high unemployment and very low inflation, the Fed decided to take further steps to attempt to stimulate the economy by reducing long-term interest rates. This program, which officially kicked off following the Fed’s early November meeting, involved purchasing between \$800 and \$900 billion in Treasury bonds between November 2010 and June 2011.

Chart 8: Federal Reserve Holdings of U.S. Treasury Securities
Billions, USD



Source: Federal Reserve H.4.1 Report

This program is essentially on track. On November 3, 2010, the Federal Reserve System owned \$842 billion in Treasury bonds. By May 19, 2011 these holdings had risen to \$1.495 trillion – an increase of \$653 billion with six weeks to go in the program. It is debatable whether this program really did stimulate the economy. The stock market has rallied nicely

since the start of the program. However, the newly minted cash used to buy most of these bonds has piled up as “excess reserves” held by banks at the Federal Reserve and so has done nothing directly to increase lending.

However, as of June 30, the buying stops. Moreover, over the next few years, according to the minutes of the latest FOMC meeting, the Federal Reserve wants to gradually return to a more normal monetary policy where banks presumably will not hold bloated excess reserves. If they follow through on this, then not only will the biggest buyer of the last year no longer be buying but over the next few years will actually be a big seller, adding to the distress of the Treasury department as it tries to find private sector homes for its ever-increasing stockpile of debt.

What should be done

Economics is the science of making choices recognizing limited resources. Bearing this in mind, and regardless of political affiliation, a few obvious points should be made.

- (1) The debt problem is a critical problem but one that is best dealt with by means of a disciplined plan implemented over a number of years. We don’t need to get the deficit from 9% of GDP to 0% of GDP in one year. Rather, a plan over 3-5 years to get from 9% of GDP down to roughly 4% of GDP and, thereafter, more slowly to budget balance is probably the right approach.
- (2) The Deficit Commission is completely correct in saying that all issues need to be on the table. For example, on the tax side, they raise the issue of tax reform which will be critical in reducing the sting of higher taxes on the economy. Higher gasoline taxes, while unpleasant, can help reduce U.S. oil consumption and thereby reduce both the quantity of crude oil we import as well as global oil prices. Lower corporate tax rates could encourage American firms to repatriate foreign profits and try to earn more of their profits in the United States.

- (3) Federal spending on Medicare and Medicaid will need to be controlled. Within the last decade, the federal government has added a Medicare drug benefit program under the Bush Administration and agreed to a huge increase in Medicaid participants as part of the President Obama's health care reform. While there is almost no limit to the amount of money that *could* be spent on health care for every American over their lifetime, there is urgent need to impose discipline on the system, through steps such as increasing the age of eligibility for Medicare and forcing all recipients of medical benefits to face more of the upfront costs of purchasing services.
 - (4) Social Security may not be part of the problem as the President and Representative Ryan have stated but it ought to be part of the solution. As in the case of Medicare, we are all living longer and we will all need to work longer.
 - (5) Defense is another area that cannot be held sacrosanct. There is no doubt that we live in a dangerous world. However, given the current day threat from terrorism rather than large standing armies, it would make sense from a strategic perspective to continue to draw down our troop presence in Afghanistan and Iraq and ask very serious questions about the large American military commitment in Europe as well as Japan and Korea.
- (2) In a political stalemate the deficit will fall from about 9.0% of GDP in the current fiscal year to about 7.5% of GDP in fiscal 2012. This assumes a reasonable 5.0% year-over-year gain in nominal income and the end of some one-year tax breaks introduced last December.
 - (3) It is possible, but unlikely, that a grand compromise will be enacted before the 2012 elections, involving both revenue increases and spending cuts. More likely, the central issue of the budget will be used as a punching bag in political commercials throughout the 2012 election season.
 - (4) Once elections are over, should President Obama be re-elected, a grand compromise might emerge in December 2012. The President will have the bargaining power of a veto pen that could allow all the Bush tax cuts to expire, and, if re-elected he will have some popular mandate to agree on an overall plan with Congress. This probably will include some further cuts to defense, some methods to rein in the growth of medical and Social Security spending and tax reform that, while simplifying the code, will also increase the tax take from individuals. Barring an economic relapse, this should allow the U.S. to hit the President's estimated 5.5% of GDP budget deficit target for 2012, but crucially with a plan for further meaningful reductions in the following years.
 - (5) If, on the other hand, the Republicans take the presidency, they would likely still try to do something about the budget in the form of tax reform and spending cuts. While this would likely involve more spending cuts than tax increases, a new President would likely feel that he/she would have a mandate to attack the debt issue and would also likely want to get the most unpleasant part of the budget out of the way as early as possible, again likely setting us on a path to get the deficit low enough to stabilize the debt-to-GDP ratio by the middle of the decade.

No doubt someone will be offended by each of these ideas. The decision on which ones to adopt will be made by elected representatives. However, it is vital that both politicians and the people who elected them consider these ideas with clear eyes.

The most likely scenario

Predicting political outcomes is at least as tricky as predicting economic ones. However, as of early June, a few assumptions can be made.

- (1) The debt ceiling will be raised before the government defaults in early August. However, the increase will be tied to budget cuts that will limit its size, suggesting that we will have to go through the same dance again in 2012.

Investment implications

Given all of this, what are the implications for the average investor?

- (1) Despite all the current concern about the budget and indeed to some extent because of it, the most probable outcome will be a compromise that brings the budget closer to balance over the next few years. As tax law is currently written, we will see significant progress on this in 2012, and a grand compromise enacted at the end of 2012 or early 2013 could bring us much closer to a 3%-4% deficit/GDP ratio by 2015 - at which point the debt-to-GDP ratio will stop rising. So don't bet on a financial crisis in the U.S. in the next few years - it is still possible rather than probable.
- (2) Particularly if the President is re-elected, expect higher taxes for upper-income individuals including higher taxes on dividends and capital gains.
- (3) Expect higher interest rates. A recovering economy combined with still massive federal debt issuance and an end of QE2, ought to push Treasury rates higher after almost 30 years of decline.
- (4) Expect budget cuts. While no area of the budget is likely to be spared, older Americans may bear the brunt of spending cuts in the form of cuts to Medicare and restrictions on Social Security simply because it is spending in these areas that, if left unchecked, will pose the greatest budget challenge.

The bottom line is that while some look at the federal budget as a mortal threat and use it as a reason not to invest, the more likely outcome is that it will be fixed - but fixed at the expense of those who are richer than average, older than average and who are invested in long-term bonds. This being the case, the appropriate response to the debt issue is not to panic, but rather to ensure that your portfolio is large enough and protected as much as possible from both higher taxes and higher interest rates.

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