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CLIENT BULLETIN

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➢ *Truly Emerging Markets*

We have all heard about the growth of "emerging markets" such as China and India. There are some myths about that emergence but there is also a lot of substance. The chart at right shows that as of December, 2010, for the first time ever, more than half of United States exports go to developing countries vs. developed markets. Quite a milestone. Wal-Mart, which has over 70% of its international stores in emerging markets, certainly understands this shift.

Sources: U.S. Census Bureau and FactSet.

➢ *Inflation – Two Measures.*

There are two inflation reports that you will hear about in the media. The first is the Consumer Price Index (CPI). This is a measure of change in prices for an index of goods and services that people buy for day-to-day living such as food, clothing, shelter and transportation. The increase in food and fuel prices over the past six months has pushed up the CPI to an annual rate of 4.2%, faster than in a long time and higher than the Federal Reserve (the Fed) considers acceptable.

➢ *Don't These Guys Eat or Drive?*

The Fed, however, is not concerned with inflation right now because they look at a "core" inflation rate that strips out food and energy prices. The core inflation rate over the past six months showed only a 1.4% annual rate of increase. So what gives? Why are we all getting socked at the grocery store and the gas pump and the Fed doesn't see any inflation? The answer lies in the Feds purpose and time frame. All at the Fed are aware that food and fuel are essential and that households get squeezed when these prices rise, but they also recognize that these prices are more volatile than most. The Fed's job is to set policy in response to fundamental inflation trends, not to react to temporary monthly swings in prices. The Fed removes food and fuel price swings from its calculation not because they are insignificant but because their inclusion might disguise underlying basic inflation trends.

- ***The Politics of Debt***

As we discussed last month, the United States government is on an unsustainable fiscal path. For 2011, the administration is projecting an all-time high deficit of ***$1.6 trillion*** which will add to the existing ***$14.1 trillion*** of debt that has already been accumulated. Politically, the potential remedies to this universally recognized problem fall largely along philosophical lines – bigger government vs. smaller government. Is the solution to raise taxes (bigger government) or reduce spending (smaller government)?

- ***Yes and Yes***

Given the severity of the situation and limitations on the effectiveness of each strategy, the answer to this question is most likely "both". On the spending side, 87% of federal spending either cannot be changed or, based on past practice, will not be changed. Even if Congress were to cut the discretionary portion of its budget by 1/3rd, the savings would only amount to $150 billion – a figure that would not make a dent in a $1.6 trillion deficit. On the taxing side of things, raising taxes to a high enough level to move the deficit-reduction needle would most likely damage economic growth in the long run, thereby making the deficit bigger.

- ***Some Movement***

This fiscal debate has dramatically changed character and emphasis in just the past few months. In his state of the Union address in January, President Obama only hinted at tax reform and spending cuts and his original budget offered what can only be described as perfunctory efforts at spending restraint. Now he proposes to cut a cumulative $3 trillion from federal spending over the next 12 years. This figure still falls far short of the Republican proposals, which would cut almost $6 trillion off the deficit over the next 10 years, but the President's proposals have changed significantly in a remarkably short time. Clearly the fiscal goal posts have moved.

- ***The Elephant in the Room***

Any honest effort at a fiscal solution must address "entitlement" programs. This is the misnomer given to Social Security, Medicare and Medicaid. They are by far the largest part of the federal government's spending (58%). Amazingly, in 2011, outlays for these programs will equal almost exactly the total revenues of the federal government. In other words, the government will use every tax dollar it receives to pay for Social Security, Medicare, Medicaid and a few other programs. The government will finance wars, pay for courthouses, government buildings and every government agency such as Homeland Security, Amtrak and the Center for Disease Control, by borrowing money.