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STANDARD & POOR'S

The Federal Deficit: Its Impact on Investment Performance

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Federal budget deficits are nothing new. In fact, the U.S. government has been operating in arrears nearly continuously since the early 1970s.[1] So what makes this deficit different? Its size. In 2009 and 2010 the deficit reached new highs in excess of $1.4 trillion, and it is expected to climb even higher this year. Some in Washington and on Wall Street blame years of wanton spending for the outsized debt we now face. Others point to the Great Recession and government's attempt to revive the economy through stimulus spending as a key driver.

It should be noted that the United States is not alone in this fiscal crisis. Governments across the globe are facing similar debt issues. Major industrial countries such as the United Kingdom, France, Germany, Italy, and Canada are carrying debt, on average, in excess of 89% of GDP. The United States' debt-to-GDP ratio is 91.55%.[2]

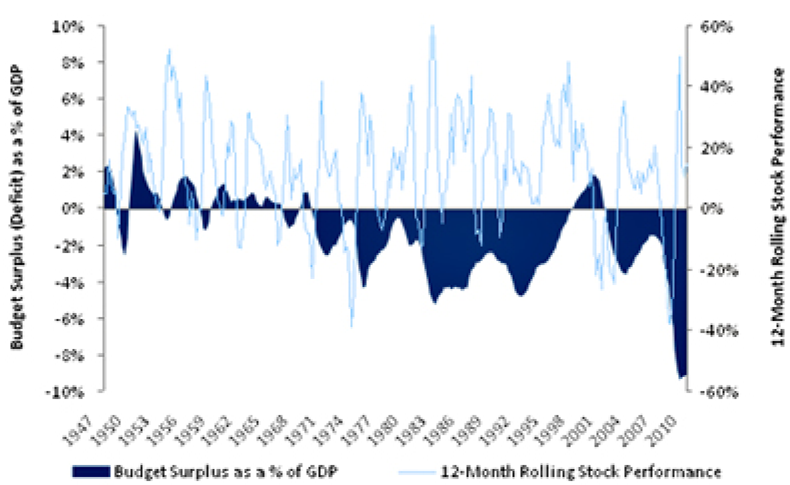
Indeed, the recent financial crisis has contributed significantly to historically high levels of borrowing around the globe. However, demographic trends are also at play. An aging world population, rising health care costs, and growing unfunded public pension liabilities are confounding the problem - and are likely to do so for decades to come.

Investment Perspective

With no quick fixes in sight, what do individuals need to know about the relationship between government debt and stock market performance that may affect their investments?

The first point to consider is that the realities presented by the current deficit (including the risk it may represent) are already factored into stock prices. The market treats the deficit - and news about the deficit - as information, nothing more and nothing less. The only time the market may react in relation to the deficit - or any other potential influence - is when the news is different (better or worse) than what is already known and anticipated.

The Federal Budget vs. the Stock Market[3]



The second point to keep in mind is that looking back through history, there is no discernable relationship between stock market performance and federal budget deficits. For instance, between 1947 and 2010, the correlation of stock market performance to the budget deficit (as a percentage of GDP) is 0.11, indicating a very weak relationship. The chart above illustrates this.

Further, stocks have actually performed better, on average, during periods when the federal government has run a budget deficit, earning 14.59% during all 12-month periods since 1947 with a budget deficit, as compared with 12.38% in all 12-month periods overall.

As for fixed-income investments, history shows that there is actually a negative correlation between government bond yields and budget deficits. From 1947 to 2010, government bonds returned only 3.14% during periods when the government ran a surplus greater than 1% of GDP, as compared with returns of 7.33% when there was a budget deficit. This outcome may be the result of less government borrowing putting downward pressure on yields.

Takeaways for Investors

Getting our fiscal house in order is essential for the long-term growth and prosperity of the nation. Yet doing so will take time and require sacrifice. There is no way to get the deficit down to acceptable levels without raising taxes and/or making large cuts in Medicare, Social Security, and defense, which together with the interest in the national debt represent more than $3 trillion in costs.[4]

With government debt continuing to increase here at home as well as around the globe, there are likely to be dire forecasts about the effects of deficits on stock and bond market returns. Yet historical evidence provides little support to indicate any significant relationship between the two.

For their part, investors should ignore the wind out of Washington and Wall Street and stay focused on their long-term investment plans, remaining confident in the notion that any future expectations about government debt levels is already accounted for in today's stock and bond prices.

[1]Source: The Bureau of Economic Analysis.

[2]Source: International Monetary Fund, *World Economic Outlook Database*,*2011*. Percentages shown are unweighted averages, and include all national, state, and municipal debt.

[3]Sources: Standard & Poor's; the Bureau of Economic Analysis. Stocks are represented by the S&P 500, an unmanaged index that is considered representative of the broad U.S. stock market. Performance is for the period indicated. Past performance is not a guarantee of future results. Indexes cannot be invested into directly.

[4] Source: Standard & Poor's, *U.S. Investment Policy Committee Notes*, April 20, 2011.