

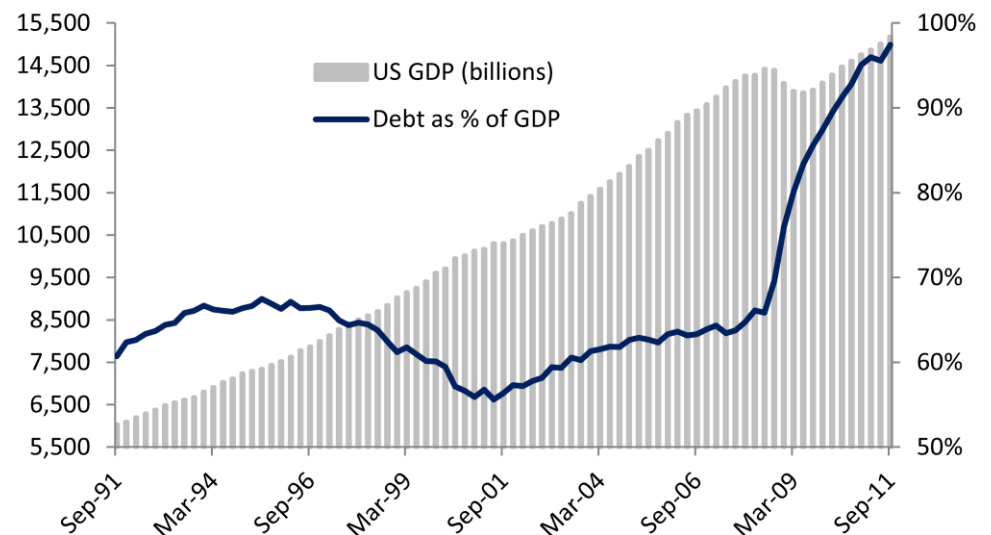
# RIVERPOINT

CAPITAL MANAGEMENT  
INVESTMENT ADVISORS

## RECENT HISTORY OFFERS SOLUTIONS FOR AMERICA'S FISCAL WOES

*Washington debates whether to cut spending or raise taxes in order to fix our country's fiscal woes.*

With the 2012 Presidential race heating up, the economy and federal budget are in the limelight. Of course, it could be argued that these topics have been in focus for the past few years. Either way, it doesn't seem that too many Americans are satisfied with our current fiscal situation: a sluggish economy is hindering tax receipts, the employment situation isn't great, and government debt balances continue to grow.



Source: Bloomberg

As you can see from the chart above, government debt levels have been creeping up for years. Going back into the early 1970s, total US debt outstanding was only 33% of US GDP. Now, we are heading towards debt levels that will exceed our country's GDP – an undesirable situation that will need to be rectified in the future.

How can we solve this problem? At this point in the election cycle, opinions on the subject are a dime a dozen. However, looking back to recent history, we can find three examples of countries that overcame a similar situation of excessive government debt: Ireland, Sweden, and

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*Before the financial crisis, Ireland's economy improved primarily due to spending cuts from new leadership.*

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Ireland has had its troubles recently – the government had to bail out its three largest banks during the financial crisis. But that had more to do with human greed – Ireland's real estate bubble dwarfed our own – than government policy. What people forget is that prior to the financial crisis, Ireland was the model economy for the “new” Europe – the “Celtic Tiger.” How did Ireland turn it around from the early 1980's, when GDP grew by just 1.5% per year, unemployment registered 17%, and the ratio of government debt-to-GDP stood at 109%? The Irish tried several solutions (including raising taxes), but nothing seemed to work until around 1987 when a new government took charge. Due to the country's poor financial condition, the new government was unable to raise new money in capital markets, forcing them to look internally for solutions. In response, the new regime cut government expenditures across the board (except for only education), focusing especially on health care, social security benefits, and pensions. Within two years of implementing the changes, the Irish deficit fell to 2.9% of GDP from 10.6%, and debt fell to 91% of GDP from 109%. GDP growth also picked up, averaging 5.5% per annum following the changes.

In the 1990's, Sweden and Canada both went through periods of soaring debt burdens and expanding budget deficits. Like Ireland in the late 1980's, new leadership took control in Canada and Sweden and got government spending under control. As can be seen in the table below, all three countries experienced similar results:

	<u>IRELAND</u>	<u>SWEDEN</u>	<u>CANADA</u>
	<b>BEFORE</b>	<b>BEFORE</b>	<b>BEFORE</b>
Debt as % of GDP	109.0%	72.0%	102.0%
Budget Balance as % of GDP	-10.6%	-11.2%	-9.1%
GDP Growth	1.5%	3.8%	1.5%
	<b>AFTER</b>	<b>AFTER</b>	<b>AFTER</b>
Debt as % of GDP	91.0%	64.0%	82.0%
Budget Balance as % of GDP	-2.9%	0.9%	0.2%
GDP Growth	5.5%	6.1%	2.5%

*Source: Bloomberg, The Ten Trillion Dollar Gamble by Russ Koesterich*

Importantly, these three countries righted their ships in the context of modern financial markets, giving more validity to their solutions than if their turnarounds took place in the 19<sup>th</sup> century.

What does this mean for the United States of America? For starters, it points to the fact that right-sizing government spending should be at the top of the list when it comes to proposed fiscal reforms. Since US Treasury bonds are the safest and most liquid investments in the world, America is in a nice position to be able to access funding markets while undergoing budget cuts – the Irish, Canadians and Swedes weren't so fortunate. But this security blanket shouldn't be abused as it has been over the past decade. Hard choices will have to be made in the coming years, and it's up to leaders in Washington to do the right thing for our country.

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*Investor sentiment is improving as concerns over a European banking crisis have abated.*

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In spite of such concerns, stocks have started fast out of the gates in 2012. The S&P 500 returned 4.5% in January, its best January performance since 1997. Why have stocks gone on such a tear? The European Central Bank mitigated the risk of a banking system meltdown by introducing a low-cost, three-year lending program to its members. Banks are using these loans to cover their funding needs for the foreseeable future, calming investor fears that the sovereign debt troubles might cause widespread bank failures. Secondly, fourth quarter earnings have been decent thus far. Roughly 40% of the S&P 500 has reported earnings, and three out of four have either matched or topped Wall Street's expectations. While this is not a historically large percentage of companies meeting or beating estimates, many analysts were worried that this "earnings season" would be a major disappointment. Also of note is the Federal Reserve's recent announcement that they intend to keep interest rates "exceptionally low" until late 2014, an extension from the previous mid-2013 target. Bond yields fell on the news, increasing the relative appeal of riskier assets like stocks for the next couple of years.

So, investor sentiment has perked up in the early going of 2012 – but with the Euro Zone debt crisis and political uncertainty in the US still looming, we remain fairly conservative. High-quality corporate bonds continue to offer the best value for fixed-income investments, and our focus on dividend-paying stocks has not wavered.

## MILESTONES OF NOTE:

Congratulations to Vic Lassandro, RiverPoint Managing Director and Director of Research, for winning the *Cincinnati Business Courier's* 2011 Stock Picking Contest!

We are also proud to report that Valerie Newell, RiverPoint Chairman and Managing Director, has been named as one of the Top 50 Women Investment Advisors in America by *Registered Rep* magazine!

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*Congratulations to Valerie Newell and Vic Lassandro on their outstanding achievements!*

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