

Profiles in Courage, 2011

“The time we have is growing short...there are serious questions, most immediately about the sustainability of our commitment to growing entitlement programs.” *Paul Volcker*

“As the largest buyer and holder of U.S. Treasury bonds, we need to seriously assess the risks”; “We hope that the U.S. government adopts a responsible policy to ensure the interests of the investors.” *China Cabinet Development Research Center, and the Chinese Foreign Ministry, after the Moody’s downgrade watch was announced, and S&P reportedly told lawmakers it might downgrade U.S. debt if payments were missed (even non-interest ones)*



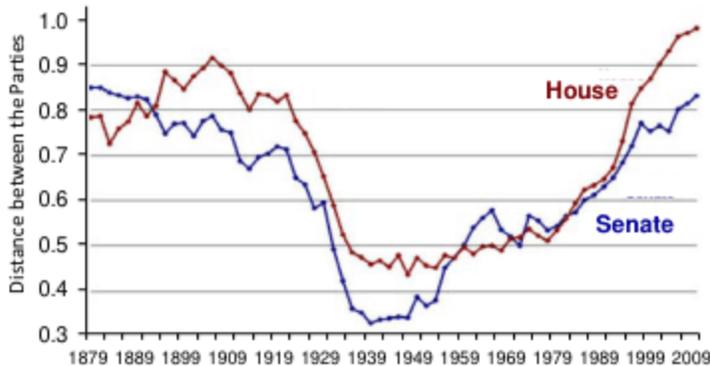
“The country is so totally given up to the spirit of party, that not to follow blindfolded the one or the other is an inexpiable offense. Between both, I see the impossibility of pursuing the dictates of my own conscience without sacrificing every prospect, not merely of advancement, but even of retaining that character and reputation that I have enjoyed. Yet my choice is made; I am at least determined to have the approbation of my own reflections.” *John Quincy Adams, on sticking to his principles and supporting the British embargo, knowing that it would harm his home state of Massachusetts and get him thrown out of the Federalist Party*

What would it take to put the US on a path to long-term debt sustainability? If it happened, it could be very bullish for financial markets. What might such a deal look like? A \$2.4 trillion increase in the debt ceiling combined with (i) payroll tax cuts to stimulate employment, (ii) \$3+ trillion in long term spending cuts and (iii) revenue increases. One of the most reliable relationships in the history of finance and economics is the inverse one between government spending and P/E multiples, and this kind of deal could put the US on a sounder footing, reduce concerns about the US\$ as the world’s reserve currency, etc.

Such a deal would take a lot of courage from members on both sides who would have to brave the fury and resentment of their own party for the good of the country. The John Quincy Adams quote above is from JFK’s *Profiles in Courage*, which chronicled Adams and 7 other senators willing to do exactly that, and pay the price. Unfortunately, the courage exhibited by the “political middle” has evaporated over the last 3 decades. We’ve shown the chart on the left before: how partisanship in the House and Senate has now eclipsed its post-Civil War high. On the right, a new look: **the disappearance of party “non-conformists” in the Senate.** The authors find a similar decline in the ideological diversity *inside* each of the parties, and a rising ideological distance *between* them. The Moderate Republicans (Durenberger, Hatfield, Kassebaum, Danforth) and Conservative Democrats (Johnston, Nunn, Heflin, Exon) of the 1970’s are gone, limiting the scope for ideological compromise.

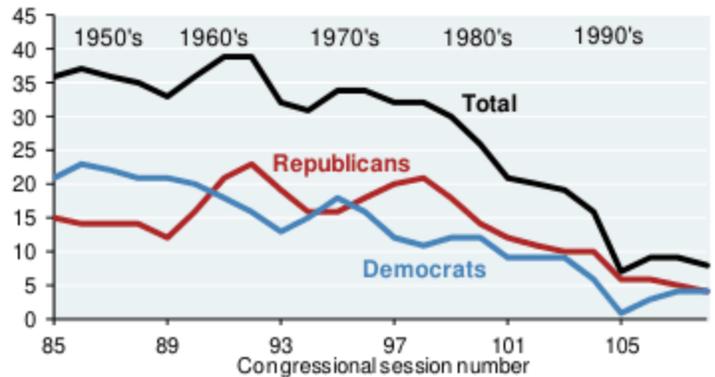
Party polarization at an all time high, 1879-2010

Degree of partisanship as measured through analysis of all Congressional roll calls



Source: Keith T. Poole, University of California - San Diego, January 2011.

Number of party non-conformists in the Senate 1953-2004



Source: *The Creation of an Endangered Species: Party Nonconformists of the U.S. Senate*, Richard Fleisher and Jon R. Bond, 2005.

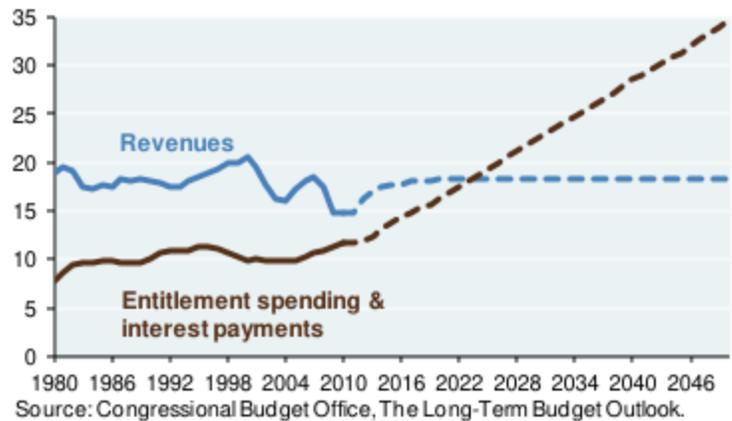
This all begs the question: what IS courage in the context of today’s deficit debate? After all, on entitlement reform, one man’s courage is another man’s cruelty. The answer may be a function of what period in history you’re discussing. When the healthcare entitlement system was set up in the 1960’s, more than a third of people aged 65+ lived in poverty. Around 50% of senior citizens were unable to get health care coverage because of their age, health and income status. At the time, **it took courage for politicians to vote in favor of these new entitlements**, given the entrenched opposition to them. When Medicare was introduced in 1960’s, it was described as “brazen socialism” in the Senate; one of the LP albums released in 1961 was entitled “*Ronald Reagan Speaks Out Against Socialized Medicine*”. When Truman proposed a national healthcare program in the 1940’s, the plan was called a Communist plot by a House subcommittee. And when President Roosevelt introduced social security in the 1930’s, he was branded as a Communist sympathizer by Alf Landon (Roosevelt’s GOP opponent in the 1936 Presidential election), Republican Senators from Ohio, Pennsylvania and Minnesota, and publisher William Randolph Hearst.

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However, a lot has changed since 1965. Healthcare entitlement programs now generate enormous operating deficits, and looking forward, are seen by some as a Leviathan threatening to swallow the country whole:

- According to the CBO alternative case¹, by the year 2024, entitlement plus interest spending will be equal to total government revenue. Just 12 years ago, in 1999, the CBO estimated that this would not happen until 2060. The crossing point has moved in by 36 years.
- The present value of future unfunded obligations ranges from \$64 trillion to \$99 trillion (depending on the source), which is 7 to 10 times the amount of existing Federal debt held by the public
- In 1967, the government estimated that Medicare expenses would grow by 7x by 1990 (unadjusted for inflation); they grew by 61x instead². In addition to the lack of cost controls on entitlements, demographic changes are a problem as well: the ratio of workers to Social Security recipients has declined from 17-to-1 in 1950 to 3-to-1 today.
- The entitlement issue is not just a question about future expenditures; entitlements are already having a big impact on government finances. In the table³, we look at some examples of this. What you will find: (a) healthcare spending has overtaken education spending; (b) entitlements have grown sharply compared to growth in population, household income and overall government spending; (c) price-sensitive medical spending (paid out-of-pocket) has collapsed; and (d) more “productive” forms of government spending have fallen to an all-time low. David Walker, the former Comptroller of the US, refers to this as the “crowding out” of important discretionary programs.

CBO alternative case: Entitlement Leviathan
Percent of GDP



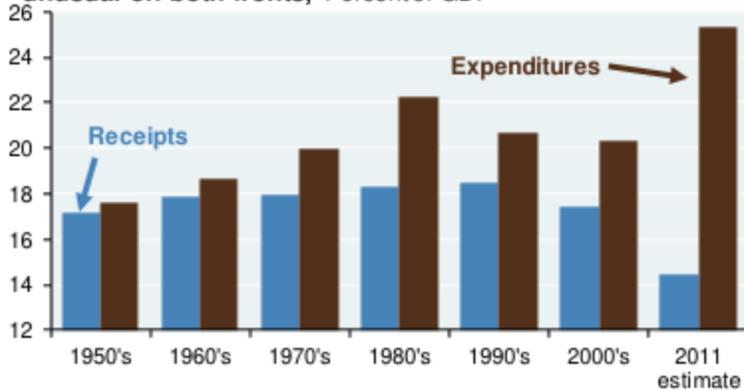
Indicative entitlement trends: 1960-2010		1960	1970	1980	1990	2000	2009/10
(a)	Healthcare spending (% of GDP)	1%	3%	4%	5%	6%	8%
	Education spending (% of GDP)	4%	6%	5%	5%	6%	6%
(b)	Entitlement program enrollment (% of population)	N/A	18%	22%	25%	27%	29%
	Entitlement income (% of avg. pre-tax income)	N/A	8%	11%	11%	12%	15%
	Gov. spending per HH (% of median HH income)	N/A	53%	60%	68%	66%	82%
	Social Security spending (% of total federal spending)	N/A	15%	20%	20%	23%	20%
(c)	Medicare spending (% of total federal spending)	N/A	3%	5%	8%	11%	13%
	Medicaid spending (% of total federal spending)	N/A	1%	2%	3%	7%	8%
	Price sensitive out-of-pocket spending (% of healthcare spending)	48%	33%	23%	19%	14%	12%
(d)	Medicare/Medicaid (% of healthcare spending)	N/A	18%	25%	26%	32%	35%
	"Productive" federal spending (% of total federal spending) Includes spending on defense, education, infrastructure and technology	N/A	68%	54%	46%	36%	32%

Source: Kleiner Perkins Caufield & Byers. 2009/10 reflects latest data point available.

As a result, while it took political courage to set up America’s entitlement system, it may take even greater courage to modify and rescale it so that entitlements are a sustainable percentage of US national income. Whether we have the elected representatives with the political courage to withstand the scorn of their own party and their constituencies remains to be seen. Their constituencies will be formidable opponents: while 80% of Americans favor balancing the budget, only 12% support cutting Medicaid or Medicare. Huxley’s quote about countries getting the leadership they deserve may apply here.

¹ e.g., tax cuts do not sunset as planned; AMT keeps getting indexed to inflation, no Medicare reimbursement cuts take place, etc.
² The government’s decision to not impose cost controls on Medicare dates back to 1965, when the American Medical Association insisted on “usual and customary fees” in exchange for their support. See “Republicans Repeat Medicare Mistake of 1965”, an editorial from Democratic Senator Bob Kerrey to the New York Times in 1995.
³ Many of these statistics are derived from “USA Inc”, a 468-page document from Kleiner Perkins which is to date the most comprehensive review of the current and future U.S. financial position on record.

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Government revenues and expenditures: 2011 is unusual on both fronts, Percent of GDP

Source: Office of Management and Budget.

adjusted gross income for joint filers, so we're not talking about modern-day Rockefellers here). As many economists have noted, tax rates that high might not work, since behavioral responses by taxpayers can result in substantial revenue shortfalls.

What happens next? Markets may react negatively to a deal that raises the debt ceiling, but does not offset that increase with an equal or greater amount of verifiable⁴ long-term deficit reduction. The latest news from DC is a complex proposal from Senator McConnell, that when you cut through all the mechanics, would allow only 1/3 of Congress to approve a debt ceiling increase (so much for 235 years of history requiring legislative majorities). It would then be incumbent on the President to propose tax increases and spending cuts to Congress. Confusing and uncertain, at best.

Perhaps the best option is not to hope for a *Profile in Courage* moment for the US Congress, but a legislative way around it. One of the most politically contentious things the Congress has to do is close military bases that are no longer needed. In order to reduce the political pressure on any one legislator, in 1988 Congress devised a process called "*Base Realignment and Closure*". An independent panel makes a recommendation that Congress either has to accept or reject in its entirety; more than 350 installations have been closed so far. Some have proposed that a similar process be used on the question of spending cuts and tax increases, which are politically even more sensitive than base closures.

As we watch the US and Europe struggle with their fiscal challenges, there are opportunities. In the midst of all the uncertainty, there are large cap stocks that trade at market P/E multiples (12x-13x in the US, and 9x-10x in Europe), offer 3%-4% dividend yields, and which generate 30%-50% of their revenues in faster growing economies. They look like good value to us. **But we don't expect to get paid in full until (and unless) the world's largest debtor economies find a way out, which is going to require more leadership than we have seen so far, and perhaps a crisis to bring it about.** I remain amazed at traditional market research that ignores these developments, and considers corporate profits as if they exist in a vacuum. [We will have more to say about Europe next time; we have written about our deep skepticism on the region all year. For now, note that a Spanish bank that passed last week's stress test is launching an IPO which values its existing assets at 0.26 times book value].

As the US debt ceiling is raised to over 100% of GDP, the following quote seems as distant as ever:

"As a very important source of strength and security, cherish public credit. One method of preserving it is to use it as sparingly as possible...avoid accumulation of debt, not only by shunning occasions of expense, but by vigorous exertions in time of peace to discharge the debts which unavoidable wars have occasioned, not ungenerously throwing upon posterity the burden which we ourselves ought to bear." *George Washington's Farewell Address, 1796*

Michael Cembalest
Chief Investment Officer

Additional sources

"*Desperately Seeking Revenue*", Tax Policy Center, January 2010 (Altshuler, Lim and Williams)

"*Storms on the Horizon*", Richard Fisher, Federal Reserve Bank of Dallas, May 2008

"*2011 Fiscal Summit*", Solutions for Americas Future, May 2011, Sponsored by Peter G Peterson Foundation

"*The Disappearing Political Center: Congress and the Incredible Shrinking Middle*", The Brookings Review

⁴ Any plan will be scrutinized for gimmickry by the Congressional Budget Office, the Committee For a Responsible Federal Budget, etc.

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