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Financial Briefs

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Are Federal Deficits a Concern?

A federal deficit occurs when the government's expenditures for the year exceed its income. The government then pays for those excess expenditures by borrowing money, adding to the national debt. After a brief period of budget surpluses, the federal government is again running up substantial budget deficits. Are these deficits a cause for concern? It's tough to decide, since opinions range from they don't matter at all, to they will ultimately result in federal bankruptcy. It might help to put the federal deficits in perspective.

In 1998, for the first time in 28 years, the federal government ran a budget surplus. Those surpluses lasted for four years. During that time, concerns about the viability of the Social Security system seemed less urgent, and there was talk about what would happen to the bond market if the federal government paid off all its debt. These concerns were short-lived. Following two tax cuts, the September 11 terrorist attacks, the Afghanistan and Iraqi wars, and a recession, the federal deficits were back.

The fiscal year 2004 (the government's year-end is September 30) budget deficit was $412 billion, while fiscal year 2005 is expected to be in the $325 to $350 billion range (Source: Associated Press, July 8, 2005). A recent Congressional Budget Office report projects federal deficits over the next 10 years to total $3.5 trillion.

Of course, a federal deficit results in an increase in the national debt. As of July 18, 2005, the national debt was $7.855 trillion. A significant portion of that debt is owed to the Federal Reserve and other government accounts. As of March 2005, the public held 59% of the national debt (Source: *U.S. Treasury Bulletin*, June 2005).

While the dollar amounts of the current and projected deficits and national debt are enormous, these numbers are often presented as a percentage of gross domestic product (GDP) to show that they really aren't out of line with past deficits and debt levels. For instance, in 2004, the deficit as a percent of GDP was 4.5%, which was not dramatically out of line with past figures. But does that mean that we don't need to be concerned about the deficit or the level of the national debt? Some of the more significant concerns include:

Higher interest rates — Deficits are generally believed to increase interest rates, due to their impact on

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Why Is the Fed Raising Interest Rates?

After bringing short-term interest rates down to the lowest levels in decades, the Federal Reserve (Fed) started increasing the federal funds rate in .25% increments in June 2004. As of November 1, 2005, the fed funds rate has increased 12 times to its current level of 4%. Why is the Fed raising interest rates?

One of the Fed's main duties is to implement the nation's monetary policy. The Fed's goals when setting monetary policy, as detailed in the Federal Reserve Act, are "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." The Fed has three main tools to implement monetary policy:

- **Purchasing or selling U.S. Treasury securities in the open market.** If the Fed wants to increase reserves at member banks so more funds are available to lend to customers, it purchases government securities in the open market, paying for the securities with a Federal Reserve check. Since this check is not issued by a commercial bank, the entire banking system has more funds available when the check is deposited in a commercial bank. To reduce the supply of funds, the Federal Reserve sells government securities, getting paid with a check drawn on a commercial bank. When the check is

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How Do We Measure Inflation?

The most commonly cited measure of inflation is the consumer price index (CPI). However, the government releases not one, but three, versions of the CPI:

- **CPI-U** — The CPI for all urban consumers, the most commonly cited of the three indexes, is based on expenditures of almost all residents of urban or metropolitan areas, including urban wage earners and clerical workers, professionals, the self-employed, the poor, the unemployed, and retired individuals. It represents about 87% of the U.S. population and does not include individuals in rural nonmetropolitan areas, farm families, persons in the Armed Forces, and those in institutions such as prisons and mental hospitals (Source: Bureau of Labor Statistics, 2005).
- **CPI-W** — The CPI for urban wage earners and clerical workers is based only on expenditures of wage earners and clerical workers in urban or metropolitan areas, representing approximately 32% of the U.S. population (Source: Bureau of Labor Statistics, 2005). This index is typically used to make cost-of-living adjustments for labor contracts and Social Security benefits.
- **C-CPI-U** — The chained CPI for all urban consumers, released in July 2002, covers the same expenditures as the CPI-U, but is calculated in a different manner. Started during the 1990s, the CPI-U and CPI-W allow for modest consumer substitution of items within the same categories to compensate for price changes. The C-CPI-U, on the other hand, also allows for consumer substitution between categories. These calculation differences typically mean that the C-CPI-U will show a lower inflation rate than the CPI-U.

All three CPIs measure the average change in prices paid by consumers for over 200 categories of goods and services in eight major categories — food and beverages, housing, apparel, transportation, medical care, recreation, education and communication, and other goods and services. The CPIs are weighted averages, reflecting the importance of each category in the average consumer's overall expenditures. For the CPI-U and CPI-W, the weightings are based on consumer expenditure surveys and stay fixed for a two-year period. The C-CPI-U index, on the other hand, uses contemporaneous monthly expenditure estimates. The CPI-U and CPI-W are calculated for the entire nation, for broad geographic regions, and for large metropolitan areas, while only a national C-CPI-U is calculated.

In addition to these three indexes, references are often made to core inflation, typically when monetary policy decisions are discussed. Core inflation typically means the CPI-U index excluding food and energy prices, which represents approximately 23% of consumer spending in the CPI. Food and energy prices are excluded because their prices tend to be more volatile and often change significantly over short time periods due to outside factors.

Federal Deficits

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the supply and demand for loanable funds. Deficits reduce national saving, causing interest rates to rise and investment to fall. A 2003 study by a Federal Reserve economist found that a one-percentage-point increase in the projected deficit-to-GDP ratio was estimated to increase long-term interest rates by .25% (Source: Federal Reserve Bank of San Francisco, 2004).

Interest payments on the debt — During periods of budget deficits, the national debt increases every year. Thus, even if interest rates remain constant, interest costs will increase. But interest rates do not remain constant and are now increasing. Thus, interest costs will increase due to a general increase in interest rates and an increase in the total amount of debt.

For fiscal year 2004, interest was the federal government's sixth largest expenditure, accounting for 6.7% of total expenditures (Source: Council of Economic Advisors, 2004). And that was during a period of very low interest rates. One study looked at what would happen to interest costs if the effective interest rate on the national debt rose from 3.54% in mid-2004 to the average level of 6.36% for the period 1992–2001. That increase would cause interest expenditures to rise to the fourth largest government expenditure and would likely move to third place, behind Social Security and national defense, if debt levels increased as well (Source: *Business Economics*, January 2005).

The government's ability to contain spending — While projected budget deficits of $3.5 trillion over the next 10 years seem overwhelming, there are concerns that the deficit could exceed even those figures. For instance, the projections do not include the costs of additional Medicare benefits that were recently enacted. Also, these estimates are based on an assumed GDP growth rate of 4.62% per year for the entire 10-year period, an event that has never occurred before in U.S. history.

What impact on our economy will deficits of this size have if they continue into the future? No one knows for sure. For years, we have heard dire predictions about how difficult it will be for future generations to fund Social Security and Medicare benefits for the baby boomer generation. It may be even more difficult if we have years of budget deficits rather than budget surpluses.

Interest Rates

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deposited in the Federal Reserve, the money is essentially taken out of circulation.

- **Changing the reserve requirements.** Each bank is required to keep a certain percentage of deposits on hand, which cannot be loaned out. Changing the requirements allows the Fed to change the amount of money available on a large scale. These requirements, however, are not frequently changed.
- **Raising or lowering the fed funds rate and discount rate.** The fed funds rate is the interest rate that banks charge each other for overnight loans, while the discount rate is the interest rate the Fed charges on loans it makes to banks. Lowering these rates makes it less expensive for banks to borrow money and loan it out, while raising the rates has the opposite effect.

Typically made at Federal Open Market Committee (FOMC) meetings, changes in these rates are widely reported and are viewed as a public signal of the Federal Reserve's monetary policy. While these rates apply to a relatively small volume of borrowed reserves, other interest rates change in response to changes in these rates.

The Fed typically lowers rates when it wants to stimulate the economy and reduce the threat of recession. Lower interest rates increase demand for items like housing and automobiles, increasing production and helping to reduce the threat of recession. It also makes it less expensive for businesses and consumers to borrow money.

Interest rates are typically increased when the Fed wants to slow the economy to prevent significant increases in inflation. Increased interest rates reduce demand for items like housing and automobiles, which consumers typically need to borrow money for in order to purchase, reducing production. This lowers inflation but can also decrease economic growth. It also makes it more expensive for businesses to borrow money for operations, lowering earnings.

But with inflation at fairly low levels, 3.3% in 2004 and 1.9% in 2003 (Source: Bureau of Labor Statistics, 2005), is there really a need to increase interest rates? With interest rates at such low levels in June 2004, increasing them was not meant to restrict economic activity, but to keep monetary policy neutral. If interest rates remained at such low levels, it was feared that the economy would grow too fast, causing inflation to increase significantly.

It is difficult for the Fed to determine what level of interest rates will achieve their goals of maximum employment, stable prices, and moderate long-term interest rates. First, since so many economic statistics are calculated after a significant time lag, the Fed often has to make key decisions with less than precise information. Second, the Fed does not know precisely how a given change in the fed funds rate and discount rate will affect the economy. The relationship is not stable and will change depending on the economic situation at that time. Third, other factors, besides those at the Fed's disposal, impact economic output, employment, and prices.

How Is Employment Measured?

Employment statistics are some of the most timely statistics generated by the government — figures are typically released within three weeks of month-end. This timeliness, coupled with the fact that employment figures signal broad-based changes in the economy, make it a closely watched statistic. The Bureau of Labor Statistics publishes two major monthly employment data series:

- The **establishment** or **payroll survey** is based on a survey of approximately 400,000 business establishments accounting for approximately one-third of all jobs in the United States. This series excludes agricultural jobs. In addition to overall payroll figures, the series also shows employment by industry classification.
- The **household survey** is based on a survey of 60,000 households, including agricultural jobs. The widely quoted unemployment rate is derived from this survey.

There are several differences between the two measures of employment. First, the payroll survey counts jobs, while the household survey counts people employed. So, an individual with two jobs would be counted twice in the payroll survey and once in the household survey. Second, the payroll survey only counts non-farm wage and salary workers, while the household survey also includes agricultural workers, the self-employed, workers in private households, unpaid family workers, and workers on unpaid leaves. Third, the payroll survey includes employed individuals under age 16, while the household survey excludes them.

The payroll data series tends to show smoother shifts in employment figures and is typically considered the more accurate of the two series. In fact, the payroll data series is one of the key economic statistics that the National Bureau of Economic Research considers when determining whether the economy is expanding or contract-

Business Data

Indicator	Month-end Aug-05	Sep-05	Oct-05	Dec-04	Oct-04
Prime rate	6.50	6.75	6.75	5.25	4.75
3-month T-bill yield	3.50	3.44	3.89	2.23	1.86
10-year T-note yield	4.24	4.23	4.46	4.21	4.03
20-year T-bond yield	4.50	4.56	4.75	4.84	4.79
Dow Jones Corp.	5.02	5.24	5.39	4.97	4.78
GDP (adj. annual rate)#	+3.80	+3.30	+3.80	+3.80	+4.00

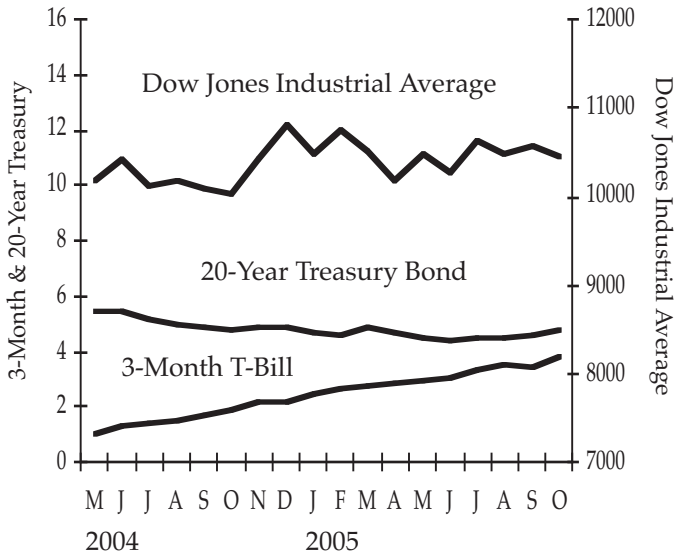
Indicator	Month-end Aug-05	Sep-05	Oct-05	% Change YTD	12 Mon
Dow Jones Industrials	10481.60	10568.70	10440.07	-3.3%	4.1%
Standard & Poor's 500	1220.33	1228.81	1207.01	-0.5%	6.8%
Nasdaq Composite	2152.09	2151.69	2120.30	-2.7%	7.4%
Gold	433.25	473.25	470.75	8.1%	10.6%
Money supply M2 (bil.)@	6523.30	6554.40	6587.90	2.7%	3.8%
Consumer price index@	195.40	196.40	198.80	4.5%	4.1%
Index of leading ind.@	138.30	137.60	136.80	18.5%	18.9%

— 1st, 2nd, 3rd quarter @ — Jul, Aug, Sep

Sources: *Barron's, Wall Street Journal*

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

May 2004 to October 2005



News and Announcements

Refer Your Friend

We have worked together to create a financial strategy and investment portfolio designed to help you pursue your long-term investment objectives. During this time, I am sure you realized the importance of professional advice when it comes to understanding the different securities available, portfolio diversification, risk tolerance, and how economics relate to your financial situation.

I am always happy to help guide you through this complicated world of financial management strategy, and I value the confidence and trust you place in me. My top priority is to help assure you are pleased with the service I provide you, and I hope you are so delighted with my work that you want your friends and family to benefit from my services too.

If you have friends or family members who you think could benefit from my services, please refer them to me. Be assured I will treat your referrals with the same degree of confidentiality and respect you are accustomed to. I value you as a client and thank you for allowing me the opportunity to help more people along the road toward their financial goals.

Your 401(k) Questions

Do you have questions about 401(k) plans? I can help with the following:

- How you can allocate your contributions. Don't make choices based on the past performance of the various investment choices. You should also consider your spouse's retirement plan, any investments you own outside company plans, and the amount of time you have until you retire. All of your investments should fit together like pieces of a puzzle.
- If you are leaving your employer, should you roll over the 401(k) plan to an IRA, leave it in your old plan, or roll it into your new employer's plan? The same decision is not right for everybody.
- What are the tax ramifications if you are retiring and want to begin receiving payments from your 401(k) plan, if you leave your employer and feel you must take out some funds for personal use, or if you leave the company and have an outstanding loan?
- Are you self-employed? If you are, you should contribute to your own retirement plan such as an IRA, a money-purchase or profit-sharing plan, or an SEP.

The important thing is to take action now to help assure your retirement money is working as hard as you are. If you have questions regarding 401(k) plans, please call.

Rick