

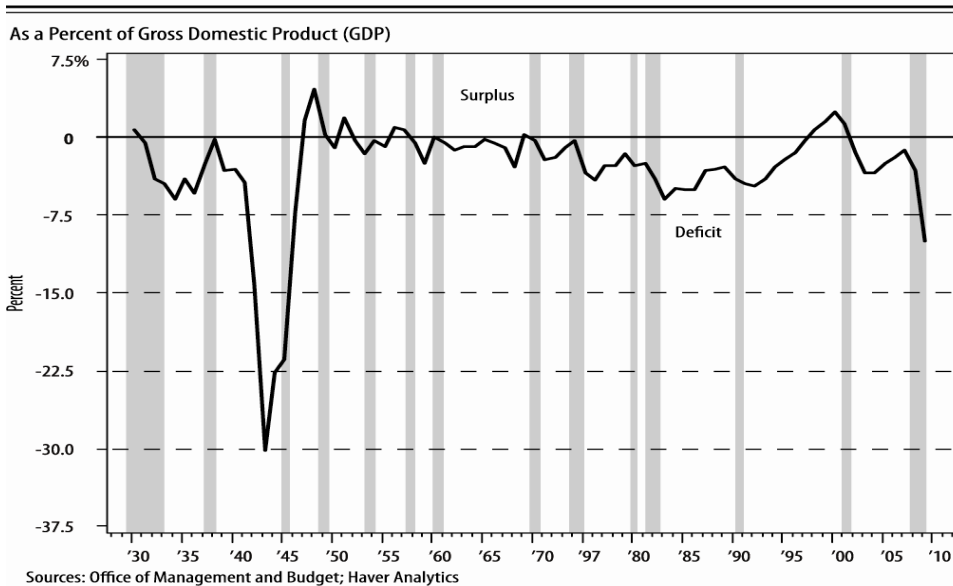
# The Week

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## Health care, deficits and the role of government

- The U.S. stock market, as measured by the S&P 500, has moved higher, surpassing its January high. In doing so, the market is near our equity strategy team’s year-end target range of 1175-1200 on the S&P 500. That does not mean that the market cannot advance further. It just means that the market is getting close to what we consider a fair value for our expected earnings this year. The market advanced during the past few weeks despite investor concerns that passage of health care reform could lead to financial problems for the government in coming years. This week’s report will look at some of the long-term implications of health care reform that could affect the market at some point.
- The new health care reforms are designed to expand health care coverage without increasing the deficit. Only time will tell if this actually happens. If medical care inflation remains high, as we expect, the government may need to raise additional revenue to prevent the deficit from rising. Therefore, investors probably need to prepare for higher taxes in the years ahead. This report discusses how a large deficit can result in a significant shift in government policies and why health care reform may be the impetus for higher taxes in the years ahead.

### Federal Surplus / Deficit



- Deficits can threaten U.S. financial health. If the deficit remains high and the government accumulates too much debt, investors may not want to hold U.S. dollars or finance government spending through purchases of U.S. government bonds. Consequently, when the deficit increases, the government can use this situation to make long-term structural policy changes. This happened in the early 1980s, the early 1990s and is probably happening now.
- Back in the early 1980s, the Reagan Administration came to power, promising more deregulation and less government involvement in the economy. In order to accomplish this, President Reagan promoted tax cuts that would encourage businesses to expand output. Of course, the tax cuts worsened the deficits caused by back-to-back recessions in 1980 and 1981-1982. The President believed that cutting taxes first, pushing the deficit upward, would eventually force Congress to cut spending later.
- In the early 1990s, the deficit was increasing again. President Bush had been elected on a promise of no new taxes. Unfortunately, the deficit had remained stubbornly high throughout much of the 1980s, and something needed to be done. Therefore, President Bush abandoned his no-new-taxes pledge to get Congress to adopt a pay-as-you go budgeting processes. This was a major structural change that caused the deficit to shrink. Eventually, the deficit turned into a surplus, helped by reduced defense spending, as well as from increased taxes during both the Bush and Clinton's presidencies.
- Today, the government deficit is much larger than it was in either of those earlier periods. During the first Reagan term, the deficit increased to 6.0% of gross domestic product (GDP). Today, it is more than 10% of GDP. This big deficit means that the Obama Administration may use the deficit to make another structural change in the role of government. This time, President Obama appears to be doing the opposite of President Reagan. The administration may be increasing spending first, in order to force tax increases later. This appears to be a move back toward more government intervention in regulation of health care, banking, immigration and environmental policies.
- By expanding government programs when the deficit is already big, the administration will probably need additional revenue in order to bring the deficit down. The administration seems to be leaning toward a larger role for government similar to many European countries. History suggests, expanded government sets the stage for higher taxes.
- This week's chart looks at a history of the federal deficit as a percent of GDP. The deficits of the 1980s and the 2000s look small in comparison to the World War II deficit. Nevertheless, the current federal deficit is larger than the deficit in the 1930s depression and the largest in the post-World War II period. When the deficit becomes large and the line on the chart goes well below zero, the government often uses the deficit as a reason for a major change in policies.
- Looking ahead, the November Congressional election will be a critical referendum on the administration's bigger-government policies. Difficult decisions lie ahead for whichever party wins. By increasing spending and pushing the deficit up this past year, there will be fewer options for dealing with these problems.
- Finally, investors should prepare for more than just tax increases. Political rhetoric will be very contentious during the next few months with both sides claiming that the other side's policies could lead to the ruin of the United States. This negative talk may lead investors to become more cautious, and market volatility could increase.

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