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The Right Way
to Invest

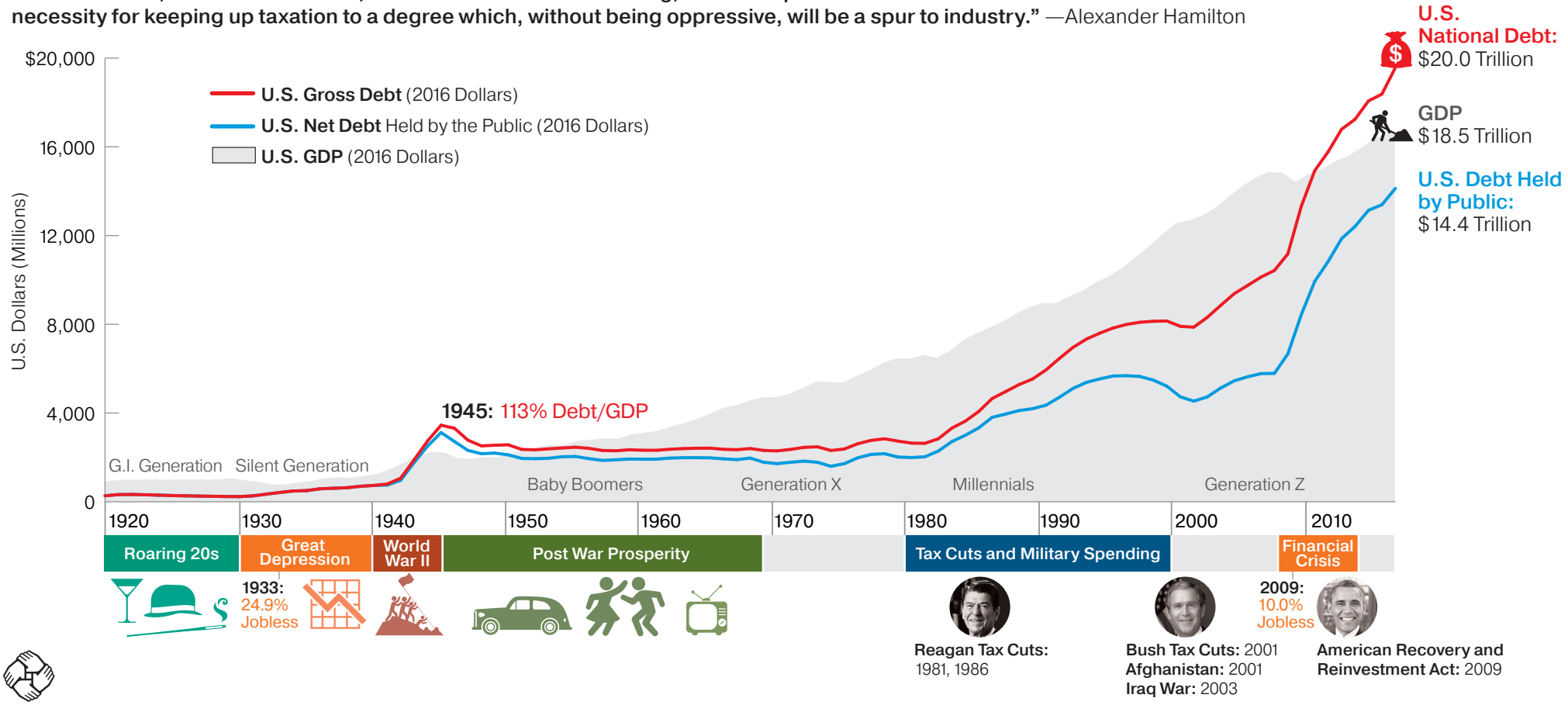
The Truth About Debt

2017

Not FDIC Insured
May Lose Value
Not Bank Guaranteed

The History of U.S. Debt

"A national debt, if it is not excessive, will be to us a national blessing; it will be a powerful cement to our union. It will also create a necessity for keeping up taxation to a degree which, without being oppressive, will be a spur to industry." —Alexander Hamilton



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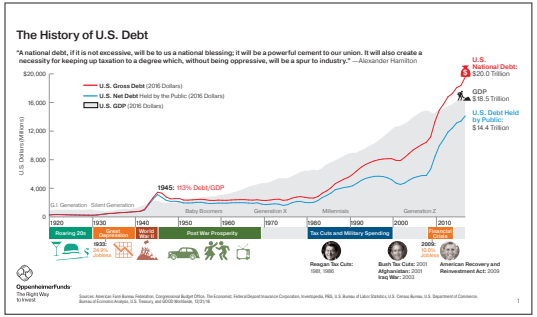
Sources: American Farm Bureau Federation, Congressional Budget Office, The Economist, Federal Deposit Insurance Corporation, Investopedia, PBS, U.S. Bureau of Labor Statistics, U.S. Census Bureau, U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Treasury, and GOOD Worldwide, 12/31/16.

Speaker Notes



As of today, the U.S. debt now stands at over $20 trillion, representing over 105% of U.S. gross domestic product. $20 trillion! It's almost incomprehensible. The media's attempt to illustrate it has only made it more frightening:

- If you had spent $1 million per day since Jesus was born you would not have even spent $1 trillion yet!
- If the $20 trillion national debt was laid in a single line of $1 bills, the pile would stretch from the Earth past Planet Uranus!

That's scary imagery, but as Arthur Clarke told us, "Only small minds are impressed by large numbers." The hysteria over the $20 trillion debt is misplaced.

1. The assets and taxing power of the U.S. Government dwarf the country's liabilities.
2. Fully 27% of the debt is money that the government owes to itself. The debt held by the public is equal to 77% of GDP and has been relatively stable since 2013.
3. A large percentage of federal expenditures and the future "unfunded liabilities" are spending for Social Security and Medicare benefits. The numbers are staggering but our politicians can make changes to the programs without damage to the credit rating of the federal government. It's happened before.

Myth: The U.S. is a bad credit risk

Liabilities: $20 Trillion

Assets: >$200 Trillion

Land, Buildings, and Commodities

640 million acres of land representing 28% of the country and 47% of the west coast

$119.4 trillion of oil

$8.6 trillion of natural gas

$22.5 trillion of coal

$3.3 trillion in government buildings and other property

≈ **$6–$10 trillion** in military assets

Financial Assets

$2.0 trillion in stocks, bonds and other financial assets (ex. gold)

$320 billion in bullion gold reserves

Present Value of Future Taxes

2016 Tax Revenue
$3 trillion

2066 Tax Revenue
$22 trillion
(17% of $131 trillion GDP)

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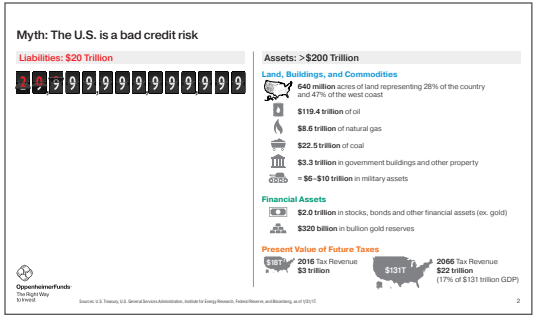
Sources: U.S. Treasury, U.S. General Services Administration, Institute for Energy Research, Federal Reserve, and Bloomberg, as of 1/31/17.

Speaker Notes



When the bank lends you money, the loan officer considers the assets against which you are borrowing. Well, what are the assets of the federal government?

A. **Land:** The U.S. Government owns 640 million acres of land. That's 28% of the nation's total surface and includes 47% of all the land in the west. What's it all worth? A lot.

B. **Commodities:** It is estimated that the United States sits atop $119 trillion in oil, $22 trillion in coal, and more than $8 trillion in natural gas.

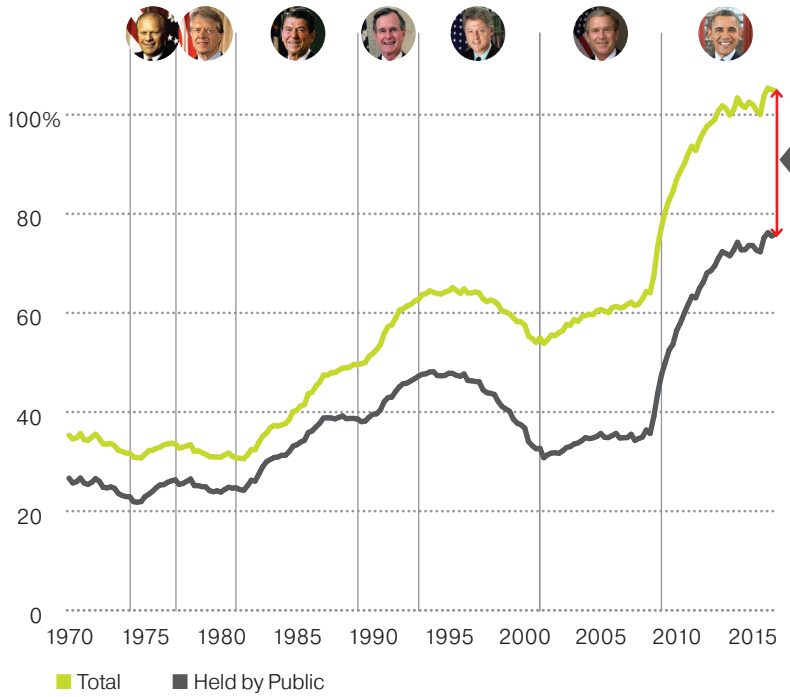
C. **Military equipment:** What are the P-8A Poseidon and F-35 Lightning aircraft, the CVN-78 aircraft carriers, the Arleigh Burke DDG 51 destroyer warships and the Trident II submarine-launched ballistic missiles all worth? All U.S. military equipment is estimated at $6–$10 trillion.

D. **Present value of future taxes:** The average nominal growth rate since 1980 has been 5.5% annually. If the economy grows at a rate of only 4% for the next 50 years, the economy will grow to be $131 trillion. The United States, on average, collects tax revenue equal to 17% of gross domestic product. In this scenario, by 2066, the country will be collecting $22 trillion per year in tax revenue.

In short, the assets and taxing power of the U.S. Government dwarf its liabilities, which aren't even close to threatening the country's solvency.

Myth: U.S. debt is predominantly held by foreigners; the system will collapse when the Chinese begin reducing their exposure to U.S. debt

Debt: Total and Held by Public as a Percent of GDP



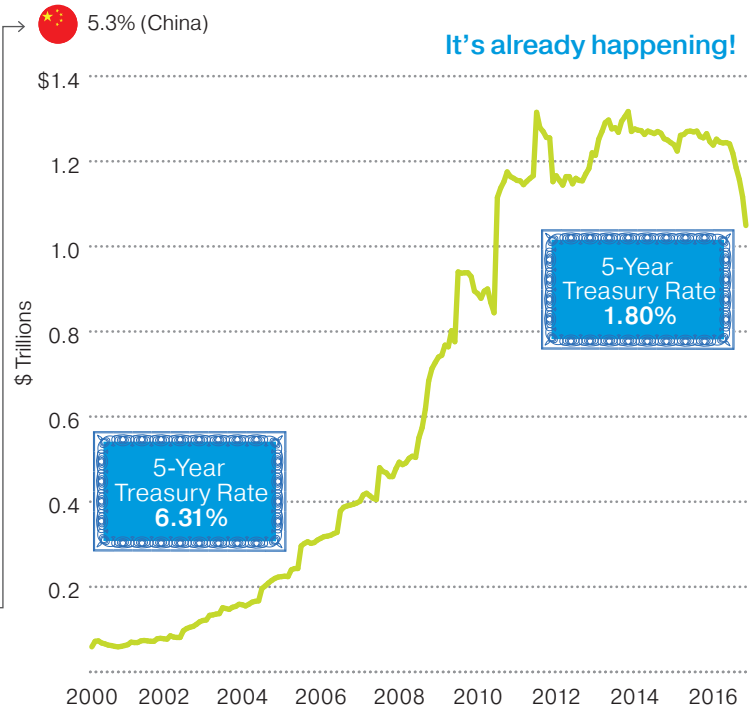
27.7% is money the government owes to itself

- **13.9%** (Social Security Trust Fund)
- **12.3%** (Federal Reserve)
- **1.5%** (Disability insurance fund, other)

An additional **42.6%** is bonds held by U.S. savers, U.S. pensions, and U.S. financial institutions

- **16.1%** (All world, excl. Japan, China, UK)
- **5.6%** (Japan)
- **5.3%** (China)
- **1.1%** (United Kingdom)

U.S. Treasury Securities Foreign Holders: China



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Source: U.S. Treasury, 1/31/17.

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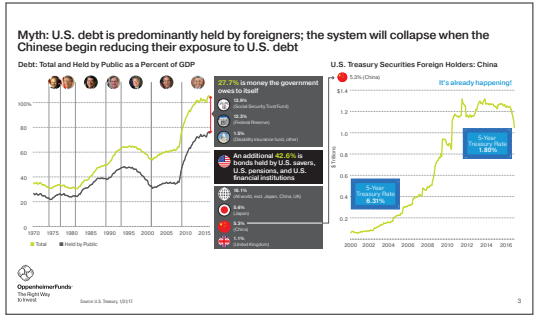


Isn't the U.S. reliant on foreign investors to fund the debt? And what happens when the Chinese decide to reduce their exposure to U.S. Treasuries?

- The biggest holders of U.S. debt are entities of the federal government, including the U.S. Federal Reserve and the Social Security Trust Fund. Fully 27% of the debt outstanding is money that the federal government owes to itself.
- The remaining $14.5 trillion is the debt held by the public and represents 77% of GDP. This is the more-widely quoted measure. Roughly 25% of the debt held by the public is owned by U.S. households and corporations, including chartered banks and insurance companies. U.S. state and local governments also own U.S. Treasuries.
- Fully 29.7% of U.S. debt is held by the rest of the world, including China and Japan, which hold over $1 trillion each. So what happens when foreign governments begin to reduce their exposure to U.S. Treasuries? It's already happening! Chinese ownership of U.S. Treasuries peaked in 2013 at $1.3 trillion and as of the end of 2016 stands at close to $1.0 trillion. Over that time, the borrowing costs of the U.S. Government has actually fallen, not risen!

Myth: The government spends most of your money on pork projects and random programs

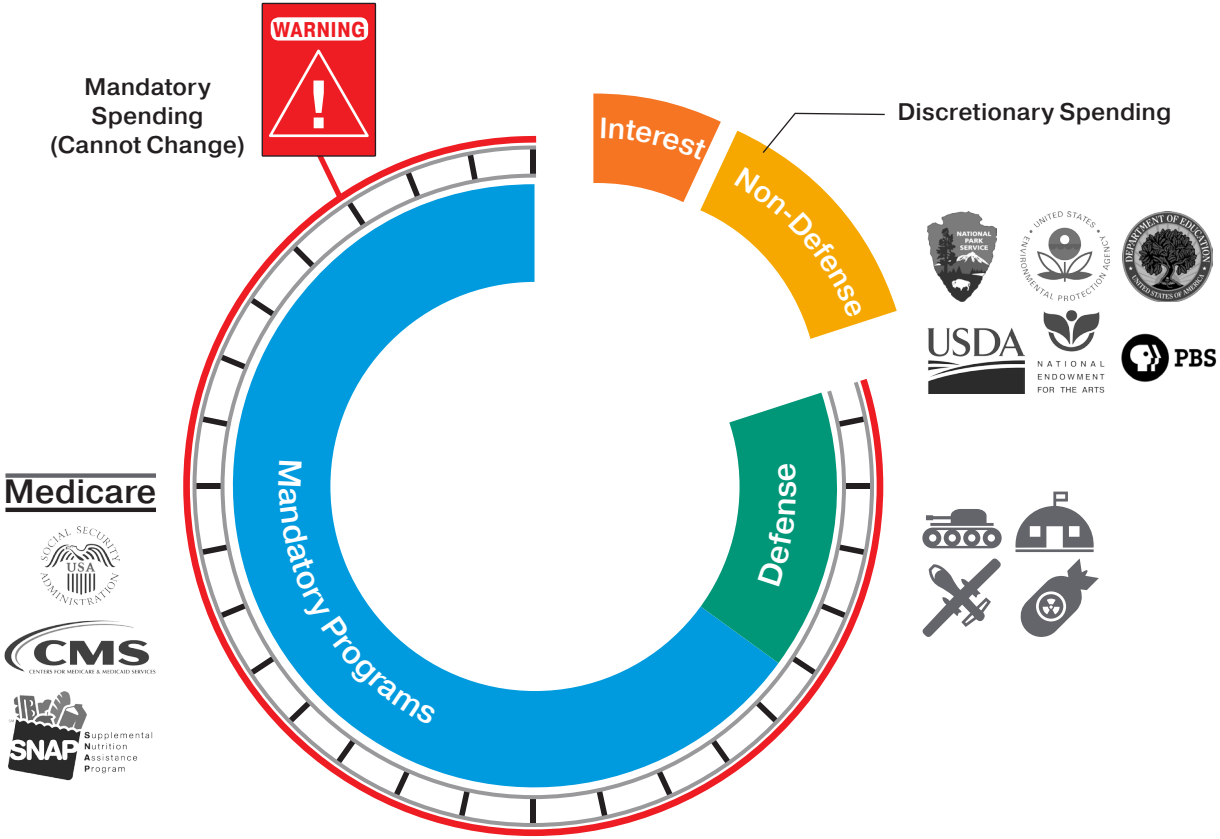
"If you look at how the federal government spends our money, it's an insurance conglomerate protected by a large standing army." —Ezra Klein

Expenditures

87%

of 2016 U.S. expenditures went to:

1. **Mandatory Programs**
2. **Defense**
3. **Interest**



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Source: U.S. Treasury, 1/31/17.

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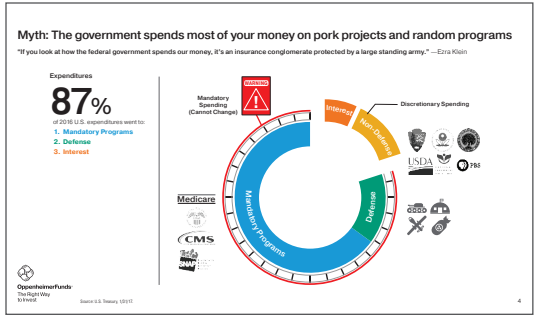


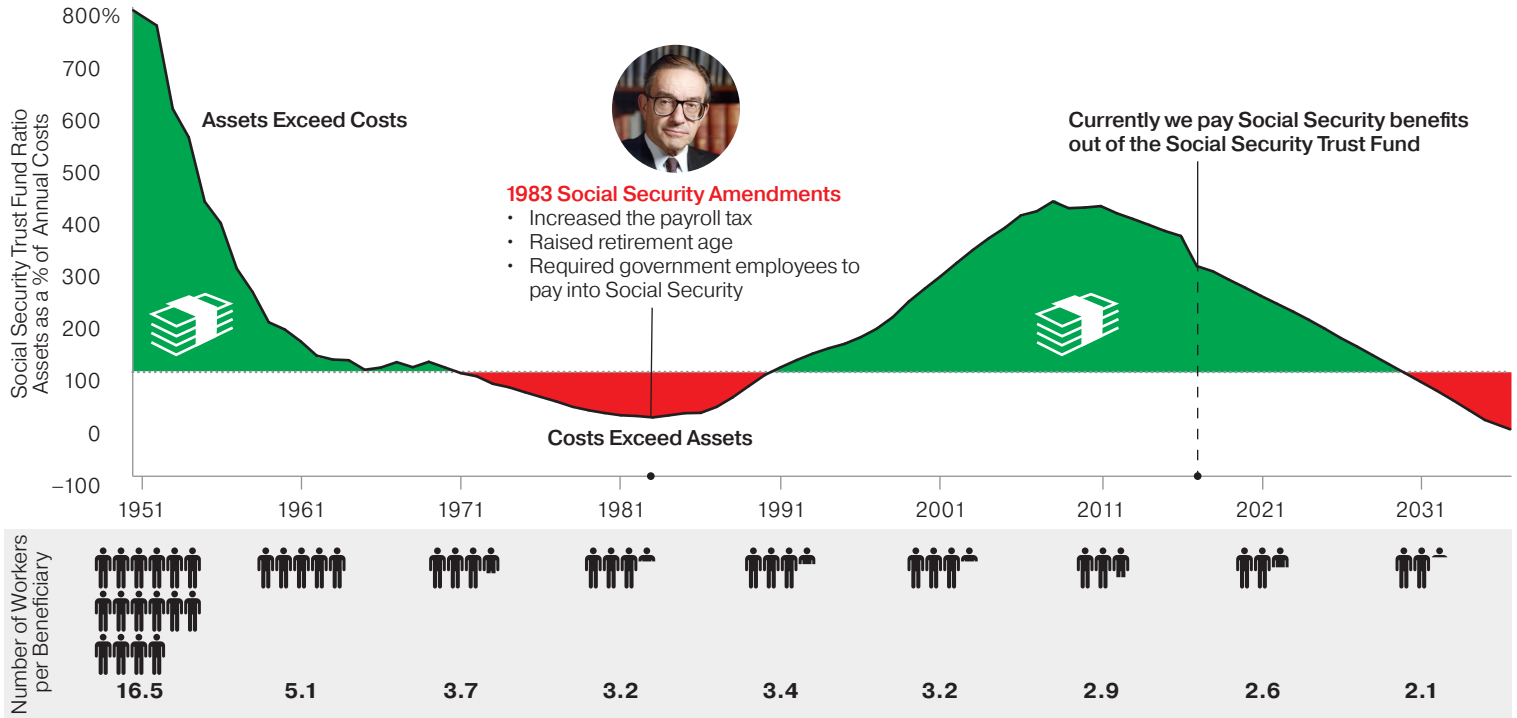
Ezra Klein said it best: "If you look at how the federal government spends our money, it is an insurance conglomerate protected by a large standing army."

Contrary to popular opinion, the annual deficits are not the result of pork spending and random projects. In a given year, roughly 80% of federal spending is allocated to mandatory entitlement programs like Social Security, Medicare, and the Supplemental Nutrition Assistance Program (formerly known as the Food Stamp Program), and to military spending. Most of that spending is considered the "third rail of politics" in that they are untouchable… for now. Add in the interest on the debt and you're closer to 85%–90% of all federal spending.

Politicians can cut discretionary expenditures like the National Endowment of the Arts or Public Broadcasting and it will not make a dent in the total spending.

Myth: When the Social Security Trust Fund runs out of money then the program collapses

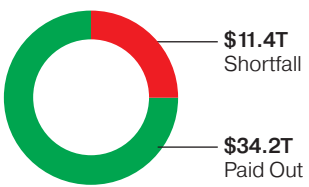
"This bill demonstrates our nation's ironclad commitment to Social Security. It assures that America will always keep the promises made in troubled times a half a century ago." —Ronald Reagan, April 20, 1983



What happens from 2034 to 2090?

1. Payments are no longer made from the depleted trust fund.
2. Payments paid directly from the payroll taxes being collected.

3. Unless changes are made, the federal government will collect only 75% of scheduled retirement benefits.



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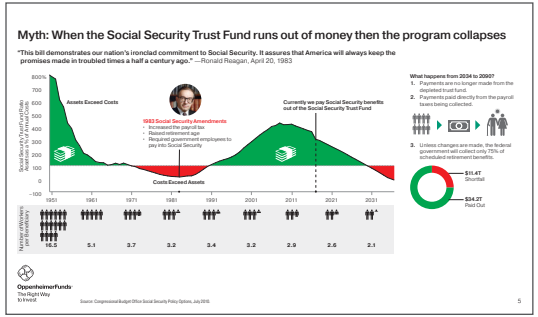
Source: Congressional Budget Office Social Security Policy Options, July 2010.

Speaker Notes



The Social Security Trust Fund exists because, for much of the last three decades, contributions made by workers and employers has exceeded the amount currently needed to fund the Social Security system and those retired workers currently collecting Social Security benefits.

It hasn't always been this way. In the late 1970s and early 1980s, the costs of funding Social Security benefits exceeded the assets in the trust fund. The Greenspan Commission, chaired by future Federal Reserve Chairman Alan Greenspan, proposed a series of amendments to rebuild the Social Security Trust Fund including increasing the payroll tax, raising the retirement age, and requiring government employees to pay into Social Security. President Ronald Reagan signed the bill into law and the trust fund was rebuilt.

It is now estimated that by 2035 the costs of funding Social Security benefits will once again exceed the assets. This is the direct result of the aging population and the nation's low birth rate.

Is this a looming catastrophe? No. First, when the Social Security Trust Fund is depleted, payments will be made directly from payroll taxes being collected. Unless changes are made, those tax revenues are likely to cover roughly 75% of scheduled retirement benefits between 2034 and 2090. That's not great news, but to suggest that it is the event that will cause the American empire to fall is hyperbole. Second, it is very likely that the nation's politicians will respond similarly to how they did in 1983 to shore up the Social Security Trust Fund for decades to come.

Myth: Draconian measures are required to "fix" Social Security

"While it is clear that we need to make adjustments to protect Social Security for the long term, it is disingenuous to say that the trust fund is facing a crisis." —Carl Levin

"We need to strengthen and save Social Security for today's workers. If we don't act now, this system, born out of the New Deal, will become a bad deal." —Mitch McConnell

I. Eliminate the taxable maximum

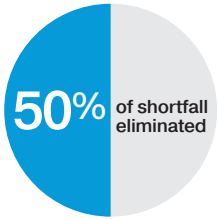
Social Security is financed by a 12.4% tax on wages (half paid by workers, the other half paid by employers) up to the taxable-earnings cap of $127,200.

A 12.4% tax on all earnings would eliminate 100% of Social Security's shortfall over the next 75 years with all else being equal.

II. Combine a series of changes to the program

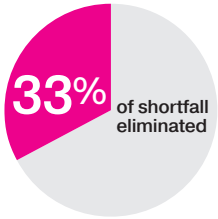
A +
Change the Taxation of Earnings

Increase the Payroll Tax by 1% Today



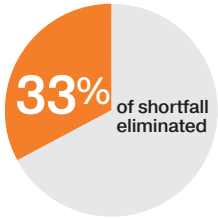
B +
Change the Benefit Formula

Index Initial Benefits to Changes in Longevity



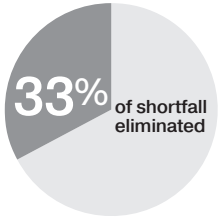
C +
Raise the Full Retirement Age

Index Retirement Age to Changes in Longevity



D
Reduce Cost-of-Living Adjustments

Base COLA on the Chained API



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Source: Congressional Budget Office Social Security Policy Options, July 2010.

Speaker Notes

Over the next 75 years, the federal government has promised benefits to Social Security recipients in excess of anticipated payroll tax revenues.

Social Security benefits are promises to be paid in the future which allows us to make adjustments in the present. Potential combination of options include:

A. Changing the taxation of earnings

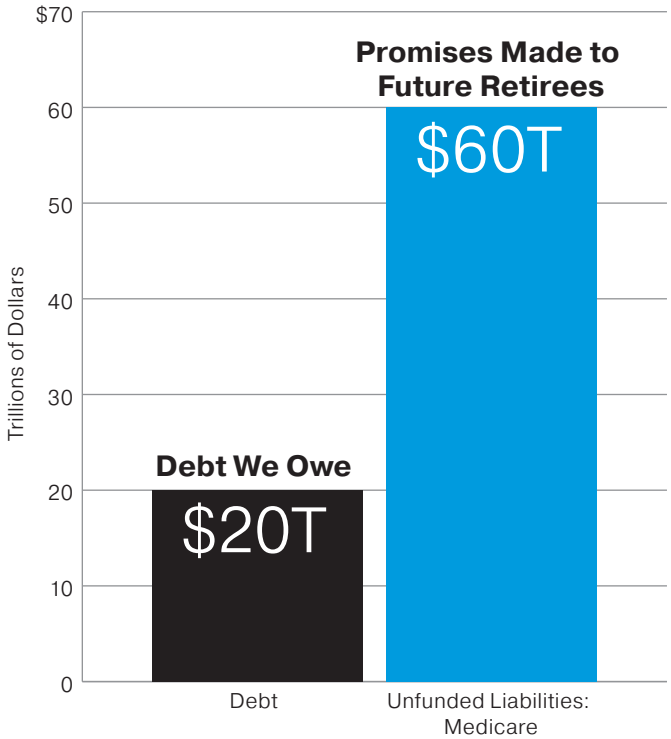
B. Changing the benefit formula

C. Raising the full retirement age

D. Reducing cost-of-living adjustments

Or, for example, the government could eradicate the shortfall today by simply eliminating the taxable maximum.

Myth: The $60 trillion of unfunded Medicare liabilities is catastrophic for the country and signals that the country is insolvent



Addressing the Medicare Shortfall

Adjustments to the program

Raise the retirement age

Raise Medicare premiums

Raise the payroll tax

Slow health care costs growth rate

Pay for service, not tests

Personalized medicine

Higher deductibles

Grow the economy

2016
Nominal GDP

2066
Assumes 4% nominal GDP (2% real GDP, 2% inflation)

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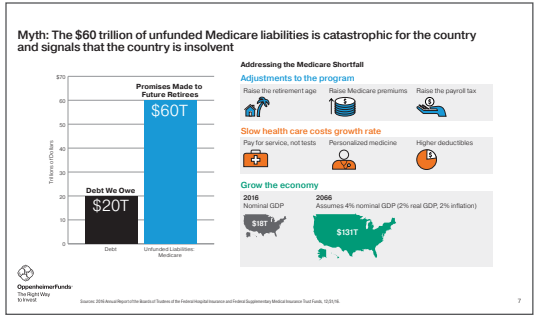
Sources: 2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, 12/31/16.

Speaker Notes



The U.S. has $100 trillion in unfunded liabilities. The country is insolvent, right? End times are here, right?

Fortunately the answers are an emphatic, “No!”

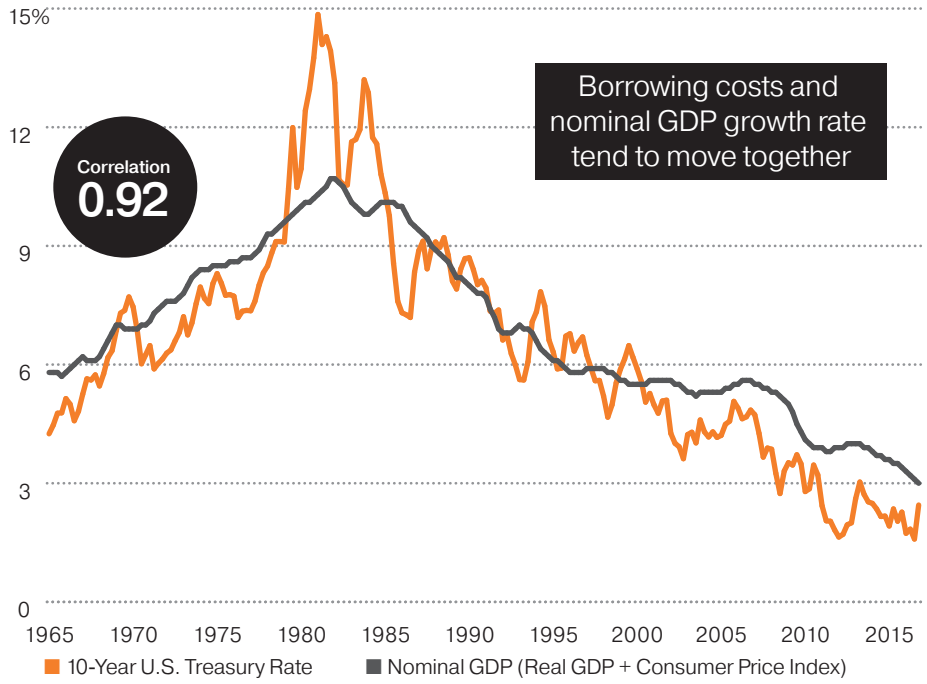
Unfunded liabilities are simply an accounting entry that attempts to forecast the future monetary obligations for health care and Social Security. If you add up all the U.S. Government’s promises to pay retirement and health care benefits and subtract the project tax revenue dedicated to those programs over the next 75 years, there is a gap. A $100 trillion gap.

Unfunded liabilities are not the debt. We have to pay back the debt. Unfunded liabilities are promises made to future retirees. The good news is that we can change those promises whenever we want without damage to the credit rating of the federal government.

- The Medicare Trustees reported in 2016 that the present value shortfall for future healthcare spending could be entirely covered if Medicare payroll taxes were increased from 2.9% to 3.6%.
- Projections can change fast. Unfunded liabilities are calculated by extrapolating the current growth rate of health care costs forward. It assumes that seven decades of innovation will do nothing to change the rate of health care inflation. Ongoing advancements in personalized medicine have the potential to forever transform healthcare and the costs associated with it.
- If the U.S. economy grows at a modest 4% nominal rate over the next 50 years, the economy will be $131 trillion. That’s 2x the size of the total “unfunded Medicare liabilities” over that period.

Myth: If interest rates go up then the U.S. will not be able to make its debt payments

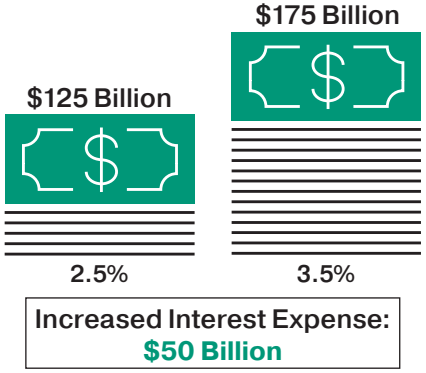
10-Year Treasury Rate and Nominal Gross Domestic Product (GDP)
Y/Y Percent Change (10-Year Moving Average)



Example

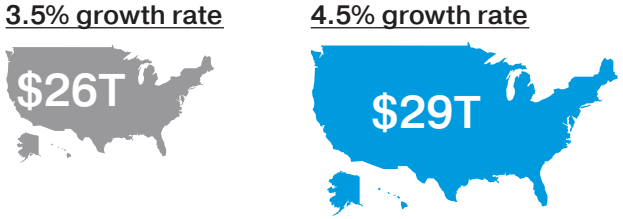
Treasury issues $5 trillion in new debt over next 10 years.

A one-time sustained increase in the 10-Year Treasury rate from 2.5% to 3.5%.



Nominal GDP growth rate also increases by 1%

U.S. GDP in 2026 at



Tax Revenue = (17% of GDP) **$4.4T** **$4.9T**

Increased Tax Revenue:
$500 Billion

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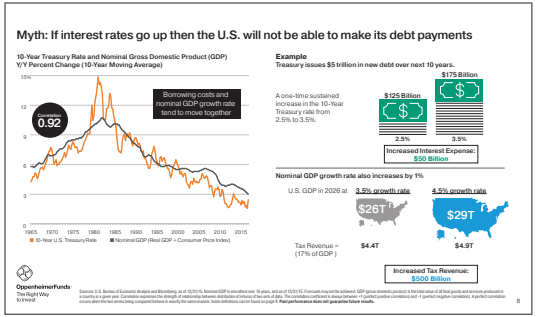
Sources: U.S. Bureau of Economic Analysis and Bloomberg, as of 12/31/15. Nominal GDP is smoothed over 10 years, and as of 12/31/15. Forecasts may not be achieved. GDP (gross domestic product) is the total value of all final goods and services produced in a country in a given year. Correlation expresses the strength of relationship between distribution of returns of two sets of data. The correlation coefficient is always between +1 (perfect positive correlation) and –1 (perfect negative correlation). A perfect correlation occurs when the two series being compared behave in exactly the same manner. Index definitions can be found on page 9. **Past performance does not guarantee future results.**

Speaker Notes



What happens if interest rates go up? Won't the interest on the debt alone be too large of a burden to bear?

Consider this example:

Let's assume the U.S. Treasury issues $5 trillion in new bonds over the next 10 years.

A one-time sustained 1% increase in the 10-Year Treasury rate today, all else being equal, would add approximately $50 billion ($5.0 trillion times 1%) in interest expenses to the federal government over the next 10 years. At first glance, the figure is disconcerting.

But why are rates rising? As the chart shows, interest rates tend to track the nominal growth rate of the country. It stands to reason that nominal GDP will have also increased by 1%. At the current 3.5% nominal growth rate, U.S. GDP will be $26 trillion by 2026. At a 4.5% nominal growth rate, the U.S. GDP will be nearly $29 trillion by 2026.

The U.S. Treasury collects tax revenues on average equal to 17% of GDP. 17% of $3 trillion in additional GDP is $510 billion. In this example, the additional $510 billion in tax revenue collected would more than offset the $50 billion in additional interest example.

Index Definitions

GDP (gross domestic product) is the total value of all final goods and services produced in a country in a given year.

BO0214.002.0217 September 8, 2017