John Dessauer Investments, Inc.

John Dessauer's Outlook

August 2013

Stock Prices and the Economic Cycle

Looking back at the last several decades we can see that the greatest threats to stock prices and our portfolios have been abrupt changes in the economy. In the 1970s, stocks and bonds were crushed by a destructive rise in inflation. More recently, portfolios were battered by the 2008 financial crisis and deep recession. Our Federal Reserve has responded with an unprecedented expansion of its balance sheet. Pessimists have been arguing that the inevitable consequence of the easy money policy would be inflation, worse than that of the 1970s. Instead, the economy has teetered on the edge of deflation. For the pessimists, this means the underlying economy is so weak that trillions of Fed dollars have not been able to fend off the downward pull. One way or the other, according to the pessimists, the stock market is out of touch with reality and headed for another plunge. In defiance, stocks have continued their march to higher ground. Will the pessimists finally have their day? A few hedge fund managers say sell into this rally. Or, will corporate profits continue to grow, providing support for still higher stock prices? No one knows the future, but the fundamentals for the economy and corporate profits remain positive.

It has been five years since the financial crisis of 2008, long enough provide lots of detail about the underlying economic trend. We can now get reasonable answers to the pessimists' questions. Why hasn't the massive increase in the monetary base resulted in a much higher inflation rate? And, has the unprecedented Fed policy merely temporarily fended off a new recession?

The answers are that the economy has been too weak to generate inflation, and too strong to fall back into recession. The result of the

lackluster recovery from a nasty recession has been a longer than usual economic recovery cycle. Present conditions indicate this recovery cycle has a few more years to run. Businesses - especially large businesses - have adapted. They have been able to grow earnings at a significantly faster rate than the underlying rate of economic growth. That too is likely to continue. Before it winds down, this may become the longest positive cycle for growth in corporate profits in decades.

Richard Hoey, chief economist for BNY Mellon, when talking about the U.S. economy, likes to say: “Two for four and then three for three.” He means we are in the fourth year of slow growth - about 2%. That’s the two for four part - 2% growth for four years. He now expects growth to pick up. He sees the economy growing at about a 3% rate for the next three years. If he is right (he has an excellent record), the U.S. economy will have seven years of sub-par growth - a very long recovery cycle. Growth at a 3% rate is enough to stimulate growth in final demand, but not so much as to raise inflation or interest rates very much. There is no threat to stock prices in Hoey’s expectations. In fact quite the opposite: modest U.S. growth combined with globalization and new technologies favor continued robust growth in corporate profits.

It is astounding, far from what even optimists expected back in 2009 when the recession ended. Analysts understood that corporate profits would benefit from cost cutting as businesses adapted to the post recession slow growth environment. But no one expected corporate profits to grow at a multiple of the underlying U.S. economic growth rate. Analysts at Argus Research looked at operating earnings for the companies in the Standard & Poor’s 500 stock Index. The companies in that index are U.S. multinationals, mostly domiciled in the United States. Market pundits logically worried that slow U.S. economic growth would mean slow growth in demand and therefore slow growth in U.S. corporate profits. They have been very wrong.

According to newly released data from the BEA (Bureau of Economic Analysis), in four years - 2009 through 2012 - the U.S. economy grew, on average, at a 2.5% annual rate. Argus research calculated that earnings from operations for the S&P 500 companies grew on average at a 15.3% annual rate, or 6.4 times the underlying U.S. economic growth rate. There are explanations for this incredible earnings power. Argus Research says: “The key reasons include more efficient and flexible corporate earnings structures; productivity; globalization; currency trends and the zero-sum game in which

mega-cap companies chip away at smaller companies' market shares." They go on to add: "While the relative contribution from each factor moves around a bit, on a net basis we expect S&P 500 earnings power to sustain (and perhaps expand) its advantage over U.S. GDP growth."

This means corporate profits are likely to keep growing at a solid rate even if the U.S. economy stays in a slow growth mode. It also means that corporate profits are not as vulnerable to a setback in the U.S. economy as many investors fear. Remember a few weeks ago when Fed Chairman Bernanke talked about a possible slowing in the Fed's bond buying? Investors trembled and stocks fell on fear that a reduction in Fed monetary support would slow the economy. The Argus research says that fear was way overblown.

What if, as Richard Hoey expects, the U.S. economy grows at a somewhat faster pace? The Argus research does not provide a full answer, but logically an increase in growth anywhere - the U.S., China, Europe or the global economy - would be good news for demand and corporate profits.

The outlook for U.S. economic growth

Government reports on second quarter economic activity confirm that 2013 will be the fourth consecutive year of slow (about 2%) growth. On July 31, the BEA reported that second quarter growth was better than first reported, but still only at a 1.7% rate. The first quarter was also revised to show growth at a 1.1% rate. With six months left, the 2 for 4 looks pretty good. Now the question is: will the pace of U S. economic activity increase enough to give us the 3 for 3? Or, will this recovery cycle be extended by a fifth year of slow (2%) growth? Recent data on jobs points in the slow growth direction. But, along with the second quarter data, the BEA issued revisions dating back to 1929. For the years 2009-2012 - the post 2008 financial crisis recovery - the BEA found the actual annual growth rate of real GDP was 2.5%, 0.3% better that the previously reported rates. In other words, the post recession recovery has actually been stronger than believed, meaning reaching a 3% rate is not as big a stretch as some assume.

In the last week of July new claims for unemployment benefits fell to the lowest level in five years. On that news a cheer went up, hoping that this meant the economy was creating lots of new jobs. Days later came the Labor Department's monthly job creation and unemployment news. Hopes were

dashed. It turns out that the decline in claims for unemployment most probably was due to people giving up, dropping out of the labor force. The economy created only 162,000 new jobs in July, down from 188,000 in June and far below the 332,000 created in February. Economists expected 181,000 new jobs in July. The unemployment rate fell to 7.4%, but that was because 37,000 people dropped out of the labor force. The employment to population ratio fell slightly in July. Temporary or part time employment increased in July to 2.7 million, a new record high.

The jobs news points to continuing slow growth in the months to come, but there are signs of strength.

The Bloomberg Consumer Comfort Index rose in July to the highest reading in more than five years. Purchases of new homes rose 8.3% in July to the highest level since May 2008. Manufacturing expanded at the fastest pace in more than two years. In June (the latest data), orders placed with U.S. factories rose 1.5% to the highest level since records began in 1992. Service industries, which make up almost 90% of the economy, expanded in July at the fastest pace in five months.

The bottom line on the U.S. economy is that, as has been the case throughout the recovery, the signs are mixed. Jobs data point to slow growth. Sustained strength in motor vehicles and housing point to a modest increase in the rate of growth.

China

China is dealing with the consequences of a credit expansion. Pessimists talk about China heading for a Lehman Brothers moment. The talk has scared some investors, but only those that don't know much about China and have forgotten Fannie Mae. The Lehman Brothers collapse was disorderly and destructive. Had the Fed and the government treated Lehman as they did Fannie Mae, the recession would have been far less severe. The Fannie Mae collapse was government controlled, orderly and spread out over enough time for markets to adjust.

China has a strong government that is in control of the credit consequences. The unwinding of bad real estate loans is orderly and supported by the government's strong balance sheet. There isn't going to be a Chinese Lehman Brothers. The pessimists who are looking for a Chinese

financial crisis and deep recession are going to be disappointed again. The rate of growth in China has slowed, but is running at a still very respectable 7.5% annual rate.

Europe

Forgotten by almost all of the euro crisis pundits is Cypress. Just a few weeks ago, the Cypress economic collapse was in all the headlines. Lately it has been hard to find Cypress mentioned in any financial news reports. The reason is that the Cypress bank mess has not spread to other regions. In other words, the euro has passed the Cypress stress test. The euro sovereign debt situation has not been resolved. Overall, Europe is in recession, likely to decline by 1% or so this year. But Cypress shows that the stress within the euro region banks is significantly less than many pundits claim. Europe may not contribute much to the global economy this year or next, but neither will it dag the world down into another recession.

The Global economy

Last year the global economy grew at a 3.1% rate. With China slowing, Europe still in recession, and uncertainty about the U.S. growth rate, the current estimate is that 2013 will be a repeat of last year. There is hope that next year the global growth rate will improve to 3.8%, possibly 4%.

The really good news is that there are no current indications of a significant slowing, never mind a new recession.

Stocks and Technology

Large multinational corporations have demonstrated their ability to grow operating earnings at a rate significantly faster than the rate of underlying economic growth. That is likely to continue, if not accelerate, thanks to technology. Here is what Argus Research says about technology and corporate profits: “Technology has become a massive productivity driver. The next iteration of technology-based around analytics, big data, enterprise mobility and the cloud-should drive even more productivity gains.” On July 15, a Bloomberg Article was titled: “Corporate Spending Set to Surge.” That prediction is based on May data showing orders for capital

goods up 1.5%, the third monthly increase, and a 4% surge in spending on IT (Information Technology).

Reading corporate earnings reports we can see that Argus and Bloomberg are correct. Google is expanding its Android base in Austin Texas. AT&T is upgrading its network and launching a huge new facility in Austin. Verizon is upgrading, expanding and improving its network. Intel is about to deliver smaller, faster, cheaper chips that use less power. Texas Instruments is enjoying success with its new analog chips. Microsoft is looking forward to new technology that will make all sorts of devices cheaper, faster and more comprehensive.

Technology has been a major factor in driving string growth in corporate profits. Profits will continue to benefit from technology for this year, next and into 2015. The message for investors is two-fold. First, own stocks in the big technology giants. Second, own stocks in financially strong companies that benefit from new technologies, and can leverage opportunities in a slow growth environment.

There are some hedge fund managers saying,"Sell into this rally." That is very short-term thinking. Of course stocks fluctuate, but the best returns come from holding on and benefiting from the long cycle.

NEWS AND VIEWS ON OUR COMPANIES

BP, NYSE, BP, $41.85, reported a disappointing second quarter. Adjusted second quarter earnings per ADS were $0.86, well below the $1.09 analysts expected. Higher taxes and lower oil prices accounted for the disappointment. Downstream profits were up from a year ago. BP is still struggling with the aftermath of the Gulf oil spill and it may take another year before all claims are fully resolved. Clearly BP is trying the patience of even long term investors. However, there are good reasons to hold on, enjoy the generous dividend and wait for significant future capital gains.

Here is what analysts at Standard & Poor's have to say about BP: "We think BP remains financially and operationally sound, and well placed to handle the cleanup. Reserve replacement in 2011 was above 100%, and guidance is for 1% production growth per year until 2015. BP had a December 2012 net debt-to-asset ratio of 18.7% and $20 billion in cash. It also has what we view as a strong track record of exploration success. We

believe BP will hone efficiency over the next three years, while its deal with Rosenfelt and India's Reliance have promising long-term potential."

The dividend is $2.16 per ADS per year, for a current yield of 5.2%. That alone makes holding the shares worthwhile. Successful implementation of BP's plans over the coming two to three years could produce a 50%+ capital gain. My advice is to buy BP below $40.

Cheesecake Factory, NASDAQ, CAKE, $43.05, reported second quarter earnings that were below expectations. Adjusted earnings per share were $0.54. Analysts were expecting $0.57 a share. Management also reduced full year earnings guidance to $2.10-$2.15. At first glance that might seem like a reason to sell the stock. Some did. The stock fell about 5% after the news. The sellers will likely regret that decision before long. The earnings miss was due to bad weather. When the weather turns nasty the plastic curtains come down and the patio seating is sharply reduced. Patio seating is very popular and an important aspect of Cheesecake Factories restaurants. The evidence is that the weather remained a problem in July and that is why management cut the full year guidance. Weather can turn favorable as quickly as it turned negative. When the weather improves, Cheesecake Factory's earnings will bounce back quickly. Here is what Argus Research has to say about Cheesecake Factory: "We continue to view Cheesecake Factory as a well-managed firm that remains one of the best high-end casual dining chains. Other positive factors include the company's solid operating margins, lack of debt, unit expansion plans, commitment to share buybacks, and relative affluent customer base." Argus rates the stock a buy with a twelve month stock price target of $52. I agree.

Citigroup, NYSE, C, $51.75, reported a 42% increase in second quarter profit to $1.34 a share, beating analysts' expectations. Revenue rose 8%. Expenses were up 1%. Capital ratios are well within regulatory requirements. Citigroup has made significant progress since the financial crisis of 2008, but still is a work in progress. Argus Research has a Sell rating on Citigroup's stock. That seems harsh given the improvement in leverage, and the global scope of Citigroup's business. Standard & Poor's rates the stock a buy with a $57 stock price target. That looks to be more reasonable. However, given the remaining risks, a potential capital gain of less than 10% does not make the stock a compelling investment at the current price. The second quarter definitely was good news. Standard & Poor's expected $1.20 a share, $0.14 less than the actual results. Standard &

Poor's probably will raise their full year 2013 earnings estimate to $5.10-$5.20 a share. Granted, the second quarter makes the stock look more attractive. However, I am continuing my hold rating until there is more evidence that sales and earnings growth are both sustainable.

Halliburton, NYSE, HAL, $45.70, provided shareholders with lots of good news. The company has settled the criminal charges arising out of the Gulf oil spill. Halliburton has agreed to pay a $200,000 fine, but settling a criminal case does not necessarily mean Halliburton did anything that violated the law. It could be that this is the least expensive alternative. In any case, the fine will not hamper Halliburton. That is clear from the news that Halliburton is launching a $3.3 billion share buyback program. The buyback will be done through a Dutch auction tender offer at a price range from $42.50-$48.50. The buyback will be completed by August 22. The buyback will shrink shares outstanding by 7.6% and will have a material impact on earnings per share in coming quarters. This latest buyback comes in addition to a buyback of 23 million shares (2.5% of shares outstanding) for $1 billion during the second quarter. As if retiring about 10% of the shares outstanding wasn't enough, management announced a 39% increase in the dividend to $0.50 per share per year. Plus management said the buyback program will continue buying back shares and has $5 billion authorized (12% of shares outstanding) to be used over the coming five years.

When it comes to earnings, Halliburton reported earnings per share of $0.73 a share, down 8% from last year but better than the $0.72 analysts were expecting. Prior to all the good news on share buybacks Standard & Poor's had a hold rating on the stock and a $3.22 per share earnings estimate for 2013. Before all the good news Argus Research rated the stock a buy with a $48 stock price target and a 2013 earnings estimate of $3.15 a share. With fewer shares outstanding I expect analysts will raise their 2013 estimates to $3.25-$3.30 a share. Halliburton is a strong company, a leader in generating international sales. Over the coming year the stock should gain respect and trade at a P/E close to 18. Halliburton is a buy. My twelve month stock price target is $55.

Halliburton's stock buyback Dutch auction runs until August 20. My advice is to do nothing. Keep all your Halliburton shares.

Intel, NASDAQ, INTC, $22.85, reported second quarter earnings of $0.39 a share, a penny below the consensus estimate. Sales at $12.8 billion

were in line with the analysts' estimates. Intel is a semiconductor giant and dominates the PC market. The second quarter suffered because PC sales were sluggish and most analysts expect that to be the case in coming quarters. Intel was slow to get involved in the mobile and hand held technology market, but has been making real progress in that regard. Intel has a new CEO. Analysts are waiting to see how the changes he is making work out in terms of sales and profits. He has already flattened the management structure to improve new product development and basic decision making. The analyst community is divided. For example, Argus Research rates Intel a hold with a 2013 estimate of $1.78. To give Argus credit they had the right number ($0.39) for second quarter per share earnings. Standard & Poor's is more optimistic, with a buy rating and a 2013 estimate of $1.92. The gap for 2014 estimates is also quite wide. Standard & Poor's sees $2.09 a share, while Argus thinks $1.95 is the right number. Intel is in transition, with a new CEO and an aggressive move into new markets. However, the company is financially very strong and has a history of successfully following co-founder Gordon Moore's 1965 rule. Often misapplied, Moore's rule is really an observation that the value of existing computers will always go down as new, more powerful and less expensive devices are produced. Intel dominates the PC market because it stayed ahead of the competition. Intel is ahead of the competition in servers, and moving fast in mobile and hand held devises. Intel's new CEO predicts a huge drop in PC prices (and a corresponding jump in sales) thanks to the company's new chips. He sees clamshell and touch screen PCs selling for $300 or less. I am keeping a buy rating on Intel with a $30 twelve month stock price target.

Microsoft, NASDAQ, MSFT, $31.50, reported fourth fiscal quarterly results that were below analysts' expectations and disappointed investors. The stock fell sharply after the news. In the quarter, Microsoft earned $0.59 a share, far better than the $0.06 loss reported last year. However, analysts were hoping for a much better quarter with earnings per share of $0.75. For the fiscal year that ended June 30, Microsoft earned $2.62 a share, down from last year's $2.78. The main reasons for the decline were a sales slump in the PC market, and a price cut for the new tablets. The good news was that sales in the fourth quarter were up 10% over the prior year quarter. When it comes to Microsoft, the media focus on consumer purchases of Windows and PCs. It has been well known for quite some time that Microsoft is lagging behind in consumer applications and products. However, Microsoft is strong in enterprise applications and products. In fact

growth in that part of the business is strong enough to offset the decline in the consumer business.

In response to the changes in the market for consumer technology and associated devices, Microsoft is reorganizing. The organizational structure is changing to allow faster response to market developments, and more efficient decision making.

For this fiscal year Argus Research has an estimate of $3.06 a share. Standard & Poor's estimates $3.00. After the fourth quarter, I expect Argus to reduce their estimate to $3.00, matching Standard & Poor's. The stock price target depends on the outlook for future growth. If the 10% sales growth seen in the fourth quarter is sustainable, the stock should warrant a 15 P/E or a $45 stock price. If earnings and sales are stagnating, as many analysts believe, then the P/E will likely be 10, for a $30 stock price. Morningstar's analyst took a good look at the fourth quarter details, evaluated the positives and negatives and concluded that their $35 fair value was still the right stock price.

In my view the demand for technology will remain strong. Prices for existing technology and existing devices will come down, stimulating demand. Intel's new chips are a key factor for future PC and related device prices. Microsoft's management referred to Intel's new chips in the conference call following the earnings news. While they did not make any specific predictions, they did say the new chips are "exciting." The market's negative reaction to fourth quarter results is a buying opportunity. Microsoft is a buy.

Nokia, NYSE, NOK, $4.09, reported a smaller second quarter loss, but a sharp fall in total sales even though sales of the new Lumia phones were up 32%. CEO Stephen Elop said there were "some signs of recovery (in the mobile phone business) in the latter part of the second quarter." The Lumia 520 he said "enjoyed a strong start in markets like China, France, India, Thailand, the UK, the USA and Vietnam." Richard Windsor, an independent telecommunications analyst, had this to say about Nokia: "I am optimistic that Nokia will have a good Q3 and this will set the company up nicely for a run into Q4 and 2014." Nokia is far from making a full recovery, but is definitely moving in the right direction. Nokia is a hold.

Novartis, NYSE, NVS, $73.35, reported a 5% decline in second quarter profits, but management increased its guidance for full year operating results. Previously management said that 2013 results would be down by a mid-single digit percentage. Now they say the decline will be in the low single digits. The reason for the decline is due to a slight delay in introducing a generic cardiovascular drug Diovan. On a positive note, several new drugs posted strong results. For this year, analysts at Standard & Poor's rate Novartis a hold and expect 2013 earnings of $5.39 a share, rising to $5.83 in 2014. Novartis is a financially strong and highly innovative and diversified pharmaceutical company. The stock at 13 times the Standard & Poor's 2013 estimate is undervalued. I rate Novartis a buy with a twelve month stock price target of $85.

SEI Investments, NASDAQ, SEIC, $32.25, reported a good second quarter. Sales were up 13.8% and better than analysts expected. Earnings were $0.47 a share, well ahead of last year's $0.28 a share. However, this year included $0.16 a share from a payment in a settlement in favor of SEI from litigation over an SIV (structured investment vehicle). Earnings from operations at $0.32 a share were still better than a year ago, but below the $0.34 analysts were expecting. During the quarter SEI bought 1.7 million shares at a cost of $50.5 million. Share buybacks are likely to continue this quarter and in coming quarters. For all of 2013 analysts are expecting earnings per share of $1.38 rising to $1.73 in 2014. The stock is trading at 23 times this year's estimate and 18 times the 2014 estimate. Following the second quarter earnings news, the stock traded up on heavier than usual volume. There has been no special news to account for the heavier volume of trading. Absent some news, such as a merger or acquisition, the stock could trade back below $30. My advice is to buy SEI below $30.

Wyndham Worldwide, NYSE, WYN, $61.85, reported a strong second quarter. Sales were up 10%. Earnings were up 11.4% to $0.98 a share. Management raised full year guidance to $3.66-$3.76 a share. Management also added $750 million to the stock buyback program, bringing the total to $874 million. The stock has done well and the P/E has come up, but Wyndham still trades at a P/E of 16.6 times the midpoint of management's guidance, well below its well known competitors. Wyndham is a buy. My twelve month stock price target is $70.

Zoetis, NYSE, ZTS, $31.45, is, in terms of revenue, the world market leader in animal health. It is also the only publicly traded pure-

play animal health and vaccines company. Animal health is a global growth business, making Zoetis an attractive long term investment.

Until this year, Zoetis was a wholly owned division of Pfizer. In January Pfizer sold 20% of Zoetis to the public through an IPO. In June Pfizer offered the remaining 80% to Pfizer shareholders through an exchange offer. The offer was substantially over-subscribed. Zoetis is now a fully independent company.

On April 13, 2013, Zoetis reported first quarter results. Adjusted earnings per share were $0.36, up 20% from the prior year and well ahead of analysts' expectations of $0.33 a share. The adjustments were for one-time items associated with the IPO and spin off from Pfizer. In the quarterly report, management offered guidance for future results. Full-year earnings per share are expected to range from $1.36 to $1.42 on revenues of $4.425-$4.525 billion. The current consensus among analysts is for full-year earnings of $1.40 on revenues of $5.522 billion.

Zoetis offers animal health products for livestock and domestic pets. Sales of livestock related products have grown at an 18.5% rate over the last three years. Pet related products have grown at a12.5% rate.

In the first quarter, sales of products for cattle, which account for 36% of total revenue, fell 2.5%. That was due to the drought in several U.S. cattle producing states. The stock pulled back on that news. However, sales for other livestock groups were strong enough to lift overall livestock revenue by 2.2%. The best take away from the first quarter is that Zoetis' highly diversified product base is a major plus, insulating profits and sales from temporary setbacks in any one product category.

Zoetis is financially strong, with $468 million in cash and cash equivalents, and average net profit margins of 10%. The debt/capital ratio is currently on the high side at 83% because Zoetis raised $3.65 billion through a bond issue just before the IPO.

Major research groups including Argus see Zoetis' earnings per share growing at an 11% compound rate over the next five years. Both Argus and Deutsche Bank research have a twelve month target price of $38 for Zoetis. They also agree on a 2014 earnings per share estimate of $1.62. There is a dividend of $0.26 per share per year for a current yield of less than 1%.

Following the conclusion of the Pfizer exchange offer the stock dipped to a low of $28.97. I will not be surprised to see the stock fall below $30 again. My rating is to buy Zoetis below $30.

CLOSING THOUGHTS

There is another Washington budget battle coming, but this time it may not get as much media attention or be as nasty. It is our national debt ceiling that precipitates the battles.

Before 1917, the Treasury had to get specific approval from Congress for every bond offering. Congress had the nation's borrowing under tight control. Congress could approve or disapprove of borrowing, bond issue by bond issue. Imagine if that were still the rule today! Our Treasury issues bonds, notes and bills in vast numbers and in vast amounts. Congress would be spending all its time saying yea or nay to each and every Treasury bond, bill or note. As a part of the Second Liberty Bond Act of 1917, the Congress changed the rules on Treasury borrowing. Instead of requiring approval bond by bond, Congress established a maximum amount the U.S. Treasury could borrow. That upper limit has become known as our nation's debt ceiling. The debt ceiling amount established in 1917 was $15 billion. At the time that was thought to be far more than our nation would ever need to borrow.

As we know the debt ceiling amount has been raised over and over again. It now stands at $16.394 trillion and was reached at the end of last year. The Treasury Department has some flexibility, called "extraordinary measures," that it uses to avoid running afoul of the debt ceiling limit. Eventually, however, the Treasury has to face the Congress and ask for an increase in the debt ceiling. Jay Carney, the President's White House Press Secretary, may not understand, but the Treasury is part of the executive branch of government. That is why the debt ceiling battle includes the President.

(Early on, as the IRS scandals were making headlines, Jay Carney said the IRS is an independent agency.) Not so - the IRS is part of the Treasury Department and therefore a part of the executive branch of

government. The IRS scandals, like the debt ceiling, land right on the President's desk.

The media expected the debt ceiling battle to erupt by February. It is now August; the Congress is in summer recess, and while there is some talk about the debt ceiling, there are no raging battles at the moment. The media should be wondering why the battles have not begun. How is it that the Treasury has been able to pay the nation's bills for more than seven months after hitting the debt ceiling? The answer may surprise you.

Federal spending has been going down and tax collections have been going up. In June the federal government ran a $117 billion surplus. That is why the Treasury has not been compelled to go, hat in hand, to ask Congress for more borrowing power. The President has made some political comments about not negotiating with Republicans, but that has fallen between the media cracks because no one knows exactly when the debt ceiling will once again become a hot political issue. The current assumption is that the battles will begin this fall. However, that is not cast in stone.

The federal deficit has been falling fast, down about 50% in the first six months. The sequester has forced spending cuts and new spending legislation is dead-on-arrival because of the political grid-lock in Washington. In the twelve months to June this year, federal spending was down 6% from a year ago. Over the same period, tax receipts were up 13.4%. Corporate tax receipts rose 23.6%. Individual tax collections rose 13.8%. If the spending and tax collection trends continue, the debt ceiling battles may be delayed longer than expected. However, the gap between receipts and outlays is still too wide. It is unlikely that it will be closed any time soon. That means there the debt ceiling will eventually become a hot political issue.

When you get into the details, the federal budget is a maze of sensitive issues. However, looking at the broad picture the issue is relatively clear. The federal government is spending more than can reasonably be expected to be collected from taxes. As a share of GDP, federal government outlays fell to 23.3% in the first quarter. Given the June surplus they were probably a bit lower in the second quarter. The problem is that the historical average for federal spending is 19.7% of GDP. Given that we also pay taxes locally and at the state level, that is most likely the real upper long-term limit for federal spending. Federal revenue increased to 18.4% of GDP in the opening

quarter and probably was higher in the second quarter. That, by the way, was up from 15.8% in the third quarter of 2009. The long-term historical average for revenue is 18% of GDP.

In my working life I have seen the federal government try all sorts of things to get the revenue to rise above 20% of GDP. I have seen marginal income tax rates at 70%, taxes on "unearned income," windfall profits taxes, and in the Clinton years, elimination of - or severe limits on - what used to be ordinary deductions. Looking back we can see that revenue stubbornly refused to cooperate. The 18%-20% level remained a ceiling.

The recent figures on tax receipts and federal spending are encouraging. The recovery from the 2008 financial crisis has been subpar. Government spending on welfare and unemployment insurance has risen. Never-the-less, new trends in federal spending and taxes have emerged. The clear message is that, even with slow growth, the federal government can be fiscally responsible. Private sector growth will mean more federal tax revenue in the quarters ahead. Keeping the lid on federal spending may be more of a political challenge, but experience these last few years says it can be done.

At the very least the plunging U.S. federal deficit in 2013 gives the pessimists something hard to chew on.

Next weekly Hotline: Wednesday August 14, 2013

All the best,

John Dessauer
August © 2013