KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

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## Thoughts on Recent Events: Debt, the Economy and the Markets

This past Friday, Standard & Poor's reduced the United States debt rating one notch from AAA to AA+. Meanwhile, the European Union is struggling to support troubled nations, such as Greece, from defaulting on their debts. In both cases, politicians are failing to make the tough but necessary decisions for the long-term financial health of the countries they represent. However, these near term fears and political shortcomings do not fully reflect the very long-term dynamics of a country's financial health.

Beginning with the U.S. debt situation, Standard & Poor's downgraded the U.S. credit rating because of concerns about the "effectiveness, stability, and predictability of American policymaking and political institutions." S&P believes that the extremely polarized debate between the two political parties will not allow a balanced and reasonable debt plan to be agreed upon "any time soon." We agree with S&P that the recent inability for politicians to compromise was both disturbing and embarrassing. However, we do not agree that it is a basis to change the outlook for how the debt situation will likely play out over the next few decades. Every bi-partisan and non-partisan study has effectively come to the same conclusions regarding the U.S. debt situation:  the growth in entitlements and discretionary spending must be restrained and revenue from taxes must be increased. When it comes to spending, future healthcare costs and current defense expenses are the major issues. Both must be reduced from their current growth rates in some manner. It is also agreed that tax receipts must increase. Economic growth is the most important factor for increasing tax revenue, but it is also broadly agreed that tax reform is needed.

By itself, Standard & Poor's decision to cut the U.S. debt rating is likely to have little if any effect on the financial marketplace. Ironically, in the near term, U.S. borrowing costs will probably decrease rather than increase from this decision because investors naturally flow to U.S. Government securities in times of uncertainty. From an investor's standpoint, the major rating agencies have little credibility left after not only failing to warn of an impending housing collapse in 2007, but also in helping fuel the bubble by assigning AAA ratings to toxic mortgage securities created by deceitful investment banks. This credibility was further put into question Friday as the Treasury quickly pointed out that S&P made a $2 trillion "basic math" error in their U.S. debt analysis, an error which S&P later admitted. When asked if S&P's downgrade would affect his opinion on Treasuries, Warren Buffett responded "no", and that "if anything, it may change my opinion on S&P." Over time, the only thing S&P's report may accomplish is to spur serious progress on the debt issue within the halls of Congress. The public is likely to demand the political parties "act like adults" and compromise. Practical compromise has been the major underpinning of successful American democracy.

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The bigger concern for investors is the European debt situation. In the late 1990s, a number of European countries agreed to convert to a single currency to promote trade and reduce complexity. Over the past decade, several more countries joined the Union to enjoy the economic boost it provided. However, there was no mechanism put in place to enforce fiscal discipline on budget deficits and debt levels. There was only a "gentleman's agreement" to adhere to guidelines. Member nations are supposed to keep their overall deficits at 3% or less and debt at acceptable levels of GDP. Unfortunately, these limits were carried out on the honor system by seventeen separate nations and their politicians have not always been "honorable." As an example, it has come to light that Greece manipulated their reported deficit levels with the help of deceitful investment banks (Goldman Sachs) to initially gain acceptance into the European Union. Now that the recession has ravaged the finances of countries across the developed world, the weakest Euro members are struggling to sell their debt to investors while their participation in a common currency removes their ability to devalue their currency to spur trade and economic growth.

What is needed is for the European Union to agree to some form of fiscal union. This would mean guaranteeing the debt issued by the weaker nations or issuing Euro area bonds guaranteed by the union itself. This is the same way that debt issued by California or Michigan is ultimately guaranteed by the U.S. government. The majority of policy makers in Europe recognize this inherent fault in their system and have suggested such a change in their union. However, Germany is the richest and largest member of the European Union so this decision is dependent on them. Unfortunately, agreeing to such an arrangement would be political suicide for German law makers. The German people do not feel it is their duty to pay for Greece's lack of financial discipline. Of course, the majority of Germans do not understand that their country has benefited more than any other from the European Union. The Union has enlarged their markets and allowed their currency to be held artificially low, leading to higher exports and economic activity. As a result, Germany's unemployment rate is actually lower today than it was before the recession began in 2007.

In conclusion, the debt problems that are causing widespread fear in the marketplace are controllable and have fairly straightforward solutions. Regrettably, up to this point there has been a lack of leadership and political will to make tough decisions to improve the fiscal situations in both the U.S. and Europe. However, we believe that policy makers will eventually reach these difficult conclusions, because the alternative is a much worse outcome that will be even more damaging to their political careers.

In the meantime, we believe the unjustified but extreme recent market volatility has created many buying opportunities. The past several days have many echoes of August 1998 (Russian debt default and Long Term Capital Management Crisis) when the markets dropped a sharp 20% before recovering two months later and then going on to new bull market highs over the next two years. Recent market activity has been totally dominated by hedge funds and short-term professional traders while many traditional institutions in Europe and the U.S. are on summer vacation. Leveraged traders who have been caught on the wrong side of the market have been indiscriminately selling to reduce their borrowings. This has cascaded into a panic which should "blow itself out" within weeks if not days.

From an economic standpoint, both interest rates and commodity prices have declined dramatically, benefiting consumers. In addition, despite recent disappointing job growth, corporations are extremely healthy with over $1.9 trillion in cash and are experiencing record high profitability. In fact, corporate profits were 22% greater in the first quarter of this year than they were in the last quarter of 2007 (the last quarter before the recession). Over the past few weeks, 72% of companies exceeded second quarter profit expectations and, in total, have reported earnings 17% higher than a year ago based on a 13% rise in revenue. Although corporate management teams are frustrated by the political impasse, they still expect strong profit growth for the rest of 2011 and in 2012.

As investors, we must remember that the hardest part of successful investing is being able to do the opposite of what the crowd and our emotions urge us to do. It is dramatic periods such as this that can cause irreparable harm to a portfolio if short-term, emotionally-satisfying decisions are made at the expense of long-term goals. In the past, the best market days have almost always come within 30 days of the worst. Locking in losses and missing the recovery may provide short-term psychological relief, but it will not help investors reach their primary goal of growing their assets ahead of inflation while also providing consistent income for living expenses.

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