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The best and safest thing is to keep a balance in your life, acknowledge the great powers around us and in us.
- Euripides

Imagine a family, let's call them the Johnsons, who find themselves in the habit of spending far more than they make. Last year the Johnsons earned a very nice income. To be precise, they made $217,000. The problem is they spent a lot more than that. In 2011 the Johnson family spent a total of $382,000. Fortunately, their lenders have confidence in them and were eager to loan the family the difference. As a matter of fact, for the time being lenders are happy to loan the Johnsons all the money they want at very low interest rates. So the Johnsons simply borrowed the $165,000 they spent over and above their income last year. However, 2011 was not the first year the Johnsons overspent. They have been spending more than they earn for many years now and as a result their total debt has ballooned to over $1,500,000, or nearly seven times their annual household income.

To make matters even more worrisome Mr. and Mrs. Johnson are both 60 years old and are not sure how many more years they can continue to work and earn the high income. As if that were not enough financial stress, they have promised their parents (both sets) that they will pay for their basic living expenses and healthcare costs. When they made the promises they did not expect their parents to live so long and their care to be so expensive but now that their parents are counting on them they have little choice but to pay the bills. And then there are the Johnson's kids. Well, they are not really kids as both are in their late twenties, but neither has been able to find a good job and both are now in graduate school. They are borrowing to fund grad school and still need some help to pay for living expenses.

Thankfully, and surprisingly, the Johnsons' creditors are confident that everything will be okay and they continue to provide all the funds the Johnsons need, and even charge them an extremely low interest rate. The Johnsons simply refinance old debt as it comes due and borrow more each year to fund the amount they spend over and above what they take in. On the surface, the lenders' confidence appears to be well placed: The Johnsons have a great reputation, they have always paid their bills on time, and they are viewed as prominent leaders in their community.

While the lenders are comfortable largely because of the Johnson's good credit history, the financial risks confronting the family are escalating. The amount they borrow each year is increasing and they have no plan to solve their financial problems. No real plan to increase their earnings and no real plan to cut their expenses, but very real and growing obligations. Well, they did have a lengthy and contentious emergency family meeting last summer where they reluctantly agreed on nearly $9,000 in spending cuts for 2012, but that hardly seems meaningful in the grand scheme of things. Their debt already exceeds $1.5 million and that does not include the promises to help the kids and the even more expensive promises to support the parents. The Johnsons find themselves in an increasingly dangerous financial position but it appears they will not have to make the tough decisions until borrowing becomes difficult, expensive, or even impossible. At that point, the Johnsons will be in big trouble. It is almost unimaginable that they could earn enough additional income or cut spending enough to start paying down the debt they have accumulated.

Now, when we think about the story of the Johnsons we understand that their situation is unsustainable. We respect and appreciate the Johnsons' desire to financially support their parents and their kids. The part that causes us to scratch our heads is the willingness of the lenders to fund it all. Not only are they willing to roll over the Johnsons' existing debt at ever lower interest rates as it comes due, they seem perfectly willing to fund the gap between income and spending each year. Anyone with a basic understanding of finance would say that is not the way borrowing works in the real world. In the real world, the Johnsons would have little to no ability to borrow additional money and they would likely be paying extraordinarily high interest rates. In the real world the Johnsons would be headed to bankruptcy court in fairly short order.

Well, as you might have guessed by now, the Johnsons are a fictional family that I made up to describe the financial position of United States government. I simply dropped seven zeros off all the actual numbers pertaining to our country's financial situation and used a family name in an eff ort to make the severity of the problem more clear and understandable. The promises to the parents represent future costs of Social Security and Medicare. The assistance to the kids represents unemployment insurance payments and other federal programs. The emergency family meeting was a reference to the debt ceiling standoff last summer. The age of Mr. and Mrs. Johnson, 60, was chosen to reflect America's aging demographic profile. While a family could never borrow so much so easily and so cheaply the United States government can, at least for now.

Cheap and easy financing is critical to this story and it is important to understand how it is happening. The source, what makes it all possible, is, in a word, confidence. That's right, the medium of exchange that we use to buy goods and services, the world's reserve currency, the good old American dollar that the United States government is borrowing and spending is backed simply and exclusively by confidence in the present and future value of a dollar. It is not backed by another asset and it is not redeemable for anything else. Furthermore, the U.S. government has the power to set short term interest rates (borrowing costs) and the power to create more dollars out of thin air. Since the economic crisis that started in 2008, the federal government has cut short term rates to essentially zero and has more than doubled the supply of dollars in the system.

In short, while the U.S. economic system is based on confidence, key measures such as debt, deficit and money supply figures suggest that this confidence may not be well placed. While it appears that increased borrowing and spending (sometimes called stimulus which sounds much better) have helped improve investors' spirits and boosted the economy of late, the financial system appears unstable and risky. The problems are large, are growing at an increasing rate, and are not unique to the United States. Developed countries around the world, including several European countries and Japan, are struggling under the weight of enormous and growing debt loads. Their economic systems, like ours, are also confidence based, and of course they are all interconnected. It is not difficult to imagine scenarios that could shake confidence and cause a severe, global economic contraction.

Now that we have a rough sketch of the situation, as unsettling as it may be, we can discuss a strategy to deal with it. Imagine another family, the Madisons, if you will. Mr. and Mrs. Madison are both 60, he owns the best bakery in town and she teaches economics at the local university. They have $1,000,000 to invest and make decisions as a team. Mrs. Madison, with her in-depth understanding of economics is deeply concerned about global financial imbalances and the unsustainable path the United States is on. Mr. Madison is concerned about generating enough growth of capital to provide the income they will need in 5 or so years when they both plan to retire. The couple has no debts other than a $250,000 mortgage loan at 4%. Currently the $1,000,000 is in bank deposits. Mr. Madison is quick to point out they are getting a 0% return while Mrs. Madison reminds him that the money is FDIC insured and liquid. Mr. Madison, an entrepreneur, has made money owning businesses all his adult life and wants to buy shares in public companies that he thinks are solid and likely to grow. Mrs. Madison is concerned about the precarious economic situation and volatility in the financial markets. They both respect each other's opinion; they have been an effective team in their long marriage.

Mrs. Madison suggests a plan that is balanced and built on the expertise and the concerns they each have. She will invest half the money defensively to give them financial flexibility in case of an economic crisis. With the defensive half, she will take $250,000 and pay off the house, in effect earning a 4% return, and put the rest in high-grade short-term bonds. The bonds pay very little, she acknowledges, but they are liquid and are likely to hold up well in a crisis. Mr. Madison will invest the other half for "offense". As an entrepreneur he knows from experience that owning a business can be an effective way to generate a growing stream of income. He also knows that owning a business involves risks and, since he values his wife's insights into the economy, he decides to focus on buying shares in businesses that tend to be less sensitive to the economy. He also knows from experience to buy into companies with trustworthy management, attractive economics and not to pay a high price for projected growth that might not happen. Mr. Madison decides to invest primarily in three sectors that he thinks can do well even if the economy struggles. Companies that make quality everyday products such as ketchup, toothpaste and soft drinks; companies that off er healthcare solutions from artificial hips to plans that reduce drug costs; and companies that are benefiting from the growth of the internet such as online software providers, electronic payment systems and makers of equipment that move data across the internet.

The Madisons' plan recognizes both the high level of economic and financial market risk as well as the opportunities present in quality, well run companies with attractive growth potential. As for the Johnsons, sadly, they have no plan and it will likely take a crisis to force them to deal with their financial problems. If and when that time comes, the Madisons will be debt free, liquid and likely in a good position to take advantage of any opportunities the crisis may present.

Phil McCauley III
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