

## **“Carmageddon” in Los Angeles and the U.S. Debt Crisis**



The weekend of July 16, 2011 was predicted to be a traffic disaster of epic proportion for the City of Los Angeles – and was dubbed “Carmageddon.” A ten-mile stretch of Interstate 405 was going to be closed for a bridge demolition in preparation for road widening. If you have ever driven the “405”, you know that it is usually gridlocked at all times. For weeks, authorities warned people that driving as usual could paralyze much of Los Angeles. Local celebrities were asked to send out warnings to Twitter followers. The project’s contractor faced a fine of \$6,000 for every ten minutes of delay in getting the freeway reopened by the deadline on Monday morning. From every reasonable perspective, people were bracing for the worst.

Drumroll, please. The work was finished nearly a day early. The contracting firm that faced fines for delay in the reopening will actually collect a bonus of \$300,000 for finishing the job early. A local resident was quoted as saying “This Carmageddon thing was the best weekend ever in L.A. There was no traffic anywhere. I think we should have Carmageddon every weekend.”

The United States of America is likewise bracing for a crisis. On August 2, 2011 the federal debt limit will be reached and, unless Congressional leaders can come to an agreement about spending cuts and tax changes (talk about gridlock!), the U. S. government could default on its obligations. Unthinkable! Head for the hills! Batten down the hatches! Sell all your stocks! Buy gold!

There is no question that now is the time for action. However, to put things into proper perspective, the government’s original debt cap was \$11.5 billion in 1917 and it has been increased 100 times from its inception, and 15 times since 1995, now standing at \$14.3 trillion. While this seems like a huge increase, the more important measure should be the total outstanding debt-to-GDP ratio, as economic output has also risen. While the outstanding government debt-to- GDP ratio has risen over the last 30 years to a level of approximately 97%, it remains well below the level of 109% that it reached during World War II. Also the annual federal deficit-to-GDP ratio has also increased over the last decade to a level of roughly 9%. This ratio also remains well below its historical peaks of in excess of 15% during World War I and in excess of 25% during World War II.

The Heritage Foundation, Washington DC’s preeminent conservative think tank, has indicated that while the current debt situation is not yet in a perilous state, that entitlement spending will need to be curtailed in the future or by the year 2050, entitlement spending alone will consume all tax revenue.

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From a market perspective, the economic concept of market efficiency stipulates that current security prices accurately reflect all known information. As such, both debt and equity prices currently reflect the uncertainty associated with the domestic debt issue. As an example, the 10-Year Greek Government Bond currently yields approximately 16.0%, reflecting the risk in that country's debt loads. The 10-Year Irish Government Bond yields roughly 14.0%, reflecting the risk in that country's finances. However, the 10-Year German Government Bond currently yields 2.4%, reflecting the countries' status as the strongest member of the EU. The 10-Year US Government Bond currently yields 2.9%, clearly reflecting that the financial markets do not support the doom and gloom coming out of Washington.

Even if Congress does not get its act together and increase the debt limit by August 2nd, legislators will have to at some point. This should be viewed as, at worst, a temporarily exogenous shock to the financial system that cannot be accurately market timed like any other external shock. The markets will adjust to the issue and move on. In the event that there is no agreement by the deadline, there is a chance that interest rates could rise. However, bond portfolios with short-term, high-quality instruments should mitigate any price declines caused by a temporary, or permanent, yield increase. Equity prices will also likely fluctuate in an unpredictable fashion as they continue their long-term march higher.

As the Great Gods of the Potomac continue to bicker and squabble, at least now, as they have incentive, they are finally beginning to address an issue that has been festering for years. Like any other pivotal point in history, these discussions are both critically important and highly contentious. But at the end of the day, the planning should prove highly beneficial to the nation's long-term fiscal health.

As the good people of Southern California realized, if you want to protect yourself from "Carmeggedon," provide proper incentive to your construction crew and stay off the highway. As the good people of America and the world will realize, if you want to protect your portfolio from any long-term effects of the possible default of US government debt, tune out the hype.

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