Profitis Capital Services LLC

Market Commentary

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A Line in the Sand?

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The Federal Government is insolvent.

This is not an opinion. This is not conjecture.

This is a statement of fact.

insolvent:

having liabilities in excess of a reasonable market value of assets held

Merriam-Webster Dictionary

As of 9/30/10 (fiscal year end), the total assets of the Federal Government were valued at $2.884 trillion. Total liabilities equaled $16.357 trillion. That leaves a net position of ($13.473 trillion).[1]

Since the net position of the U.S. Government is negative, a leverage ratio is incalculable. This is not an enviable balance sheet situation. One might argue that a nation could maintain a capital shortfall if its prospects for revenue growth were sufficiently rosy. Could this be the case?

The principle source of revenue for the U.S. Government is the income tax. For the 2010 fiscal year, individual income taxes accounted for 43.2% of the Government's $2.17 trillion in total revenue. Corporate income taxes added $157 billion to the top line as well.[2]

Therefore, the ability of the U.S. economy to generate employment and production is of great

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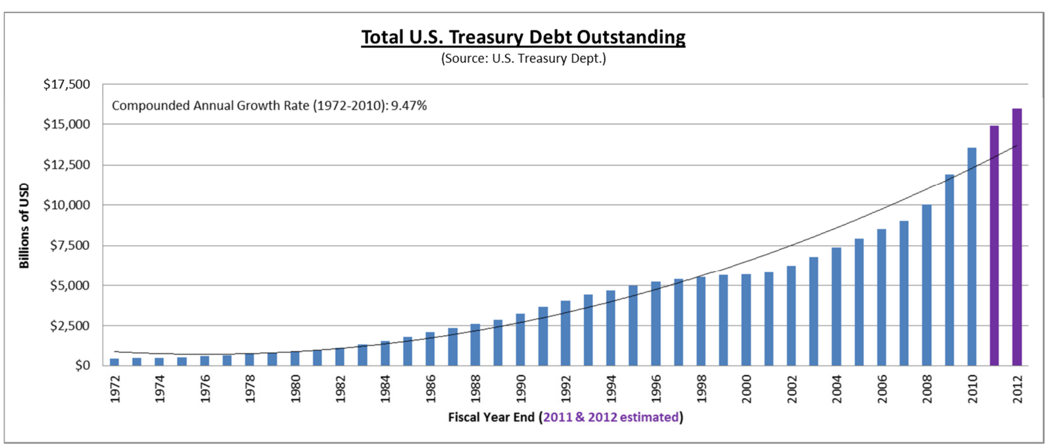

Chart 1: Total Treasury Debt
Total U.S. Treasury debt outstanding will reach $14.9 trillion by fiscal year end (FYE) 2011 and $16 trillion by FYE 2012. These estimates are based on projections produced by the Congressional Budget Office and the Office of Management and budget.[3]

importance to holders of U.S. Treasury debt. Although this is an obvious connection, the relationship between nominal GDP and U.S. Government revenue is quantified below (measured in billions of US$):

U.S. Government revenue = 45.182 + [0.168 * Nominal GDP]

Alternatively, the ratio of U.S. Government revenue to Nominal GDP has averaged 0.175 (standard deviation of 0.013) since 1972.

The vital conclusion: measuring debt outstanding relative to nominal GDP provides some insight into potential debt coverage. The U.S. debt to nominal GDP ratio measured 92.1% at fiscal year-end (9/2010). This marked a post-World War II era high and a significant increase from the 31.4% level during the first year of the Reagan White House. It marked the 17th time in the last 20 fiscal years that the ratio surpassed 60%.

In order for revenue to catch up with expenditures, GDP growth would have to dramatically outstrip the growth rate of spending. This is becoming more and more unlikely as the U.S. economy continues to mature and demographic trends point to increased entitlement expenditures. Therefore, the Treasury will continue to service and repay debt by *issuing more debt*. This raises two key points:

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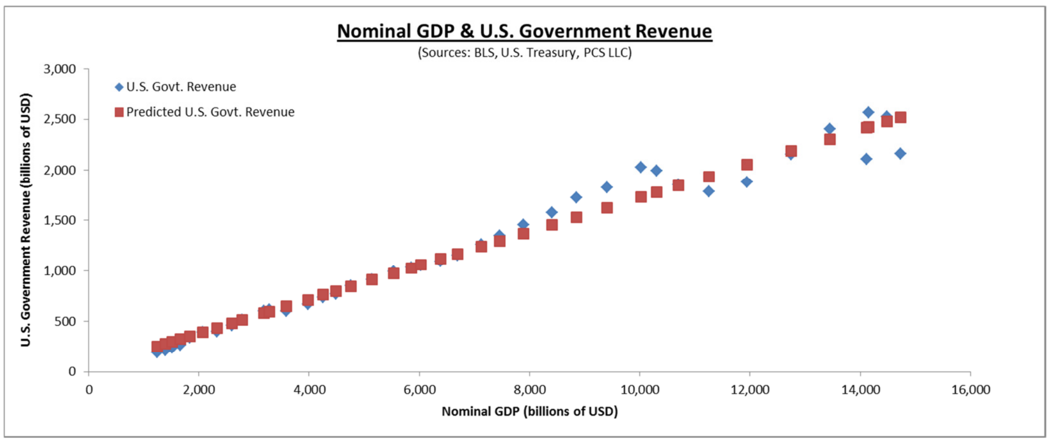
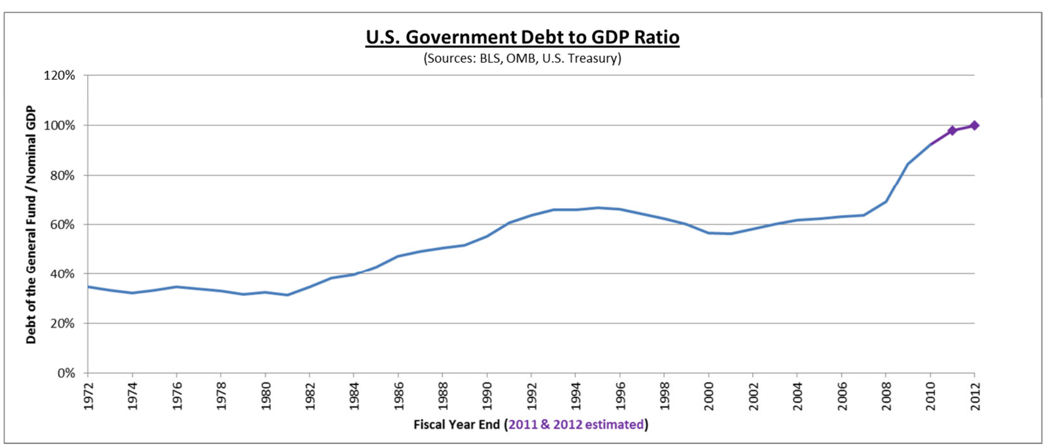


Chart 2: GDP & Revenue
The sheer size of the U.S. economy provides the Federal Government with an enormous tax base. However, the repayment of debt takes place in future time periods. Projecting the size of the future tax base is of considerable importance to today's creditors.

Chart 3: Debt Outstanding vs. Nominal GDP
The U.S. Government has significantly increased its presence in the debt markets since 2007. This is in the wake of deleveraging by households and private industry (financial companies in particular).[3]



- The Treasury will be extremely sensitive to market disruptions and imbalances in the market for its debt securities.
- "Crowding out" of private industry can negate fiscal policies that promote economic growth

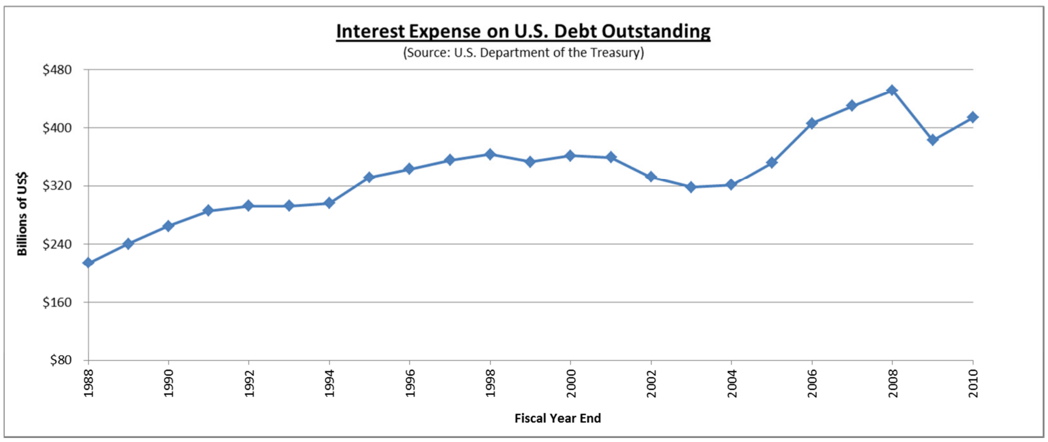
At this point, the U.S. Government is the only significant issuer of debt. In fact, deleveraging seems to be the major theme in balance sheet acrobatics:

	Compounded Annual Growth Rates: Debt Outstanding		
	5 Years	10 Years	20 Years
Total	4.85%	6.71%	6.83%
Households	2.63%	6.71%	6.81%
Municipalities	5.60%	7.35%	4.62%
Federal Government	15.14%	10.89%	6.92%
Non-Financial Business	5.34%	5.23%	5.49%
Financial Business	1.62%	5.61%	8.79%

Source: Federal Reserve Flow of Funds Report (Z1)

Chart 4: Debt Service

Despite a material increase in the debt outstanding, debt service has increased by an average of 3.28% per year since 2005. The decrease in *nominal* interest rates has provided the Government with a unique opportunity to refinance and increase leverage.



Is this leveraging of the federal government's balance sheet the appropriate solution for the current economic malaise? How do we judge its success? Do deficits really matter?
To be continued………

$14.294 trillion

Limit on U.S. debt outstanding, as of 2/12/2010. At its current growth rate, the debt outstanding will each this limit by the middle of March, 2011.[4]

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[1]2010 Financial Report of the U.S. Government: http://www.fms.treas.gov/fr/10frusg/10frusg.pdf

[2]Office of Management and Budget The Budget Table 2.1-Receipts by Source:
http://www.whitehouse.gov/omb/budget/Historicals

[3]Congressional Budget Office The Budget and Economic Outlook
http://www.cbo.gov/doc.cfm?index=11705

Office of Management and Budget The Budget:Supplemental Materials
http://www.whitehouse.gov/omb/budget/Supplemental

[4]PCS LLC estimate

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