TUG OF WAR

A government shutdown is not normal and that is why it has been the key focus of most news organizations. The shutdown, however, is not the only news story. Congress is also wrangling with the problem of the government debt ceiling limit being reached. These two totally separate issues have morphed into one BIG ISSUE and are confusing many people. Therefore, an explanation is in order. To keep this simple, think of how a credit card works with credit balances and spending limits:

1. The Shutdown relates to how much the government spends.

2. The Debt Ceiling relates to how much the government borrows.

The Shutdown

Our government has not had a budget passed in over 4 years. Our elected officials are only able to pass "continuing resolutions" which ultimately expire. By "resolution" they mean, let's not fix this problem now, we will "kick the can down the road" and fix it later.

Every resolution is typically written with a time limit and a set of "stop spending" gaps. If the budget or spending is not fixed, then non-essential services, like parks, national monuments and passport services are shutdown. Therefore, if you are planning on going to Yellowstone Park or visiting the World War II Memorial in Washington, you would not be happy to arrive at your destination and find the parks to be closed, but it is not a "life or death" predicament.

Government shutdowns have occurred 17 times in the past. The affect it has had on the financial markets in the past has been quite minimal and in many cases a year later markets have had positive performance. However, what makes this particular shutdown unique is that it's coupled with a debt ceiling expiration, or in other words the government has reached its credit limit. Shutdowns and debt ceilings are on one side of this "Tug Of War." On the other end of the rope, is an economy, which is showing some signs of improvement.

The Debt Ceiling

Having a high credit balance on a charge card tends to invite financial trouble. Paying off the debt becomes more difficult as interest accrues. Once the credit limit (debt ceiling) has been reached, the next purchase would likely be denied, unless of course you apply for additional credit thus increasing your credit limit (or in this case, the debt ceiling limit).

After October 17th the government will no longer be able to service its debt unless Congress approves an "increase" in the national debt ceiling from the current level of $16.7 trillion.

Our government has been here before, some 75 times in fact since March 1962; 11 of which occurred in the last decade. If the debt ceiling is not raised our government cannot pay its bills – resulting in a default.

Every debt crisis has its own unique set of issues. Is this time different? The short answer is yes. The "Tug Of War" which exists today between the shutdown/debt ceiling crisis verses an improving economic landscape, albeit modestly coupled with The Federal Reserve easing program (QE stimulus) puts us in uncharted waters. Our economy has simply not been in this position before. Looking at past market performance after debt ceilings have been raised is of little value in offering guidance this time. The raging battle going on within the branches of our government is a deeper problem.

The Bigger Problem

The Federal Government is spending over $3.5 Trillion per year. There is no budget which has been passed and little hope of anything substantive getting done. The government has nearly $17 Trillion in debt and $60 Trillion in unfunded spending promises (Medicaid, Medicare and Social Security). The Federal Reserve has also expanded its balance sheet by four times to almost $4 Trillion. Part of this expansion has been due to the $85 Billion per month the Fed has been injecting into the economy to stimulate growth and keep interest rates extraordinarily low for many consumers and businesses.

As David Malpass, economist and former Reagan Deputy Treasury Secretary said, "These are crisis level problems. Whether the government is open or closed, they are surely grounds for immediate talks between the President and Congress on ways to pare ineffective federal programs, restrain spending and reduce borrowing." $250 Billion or some 80% of spending runs on autopilot without any congressional involvement or control.

Consequences of Higher Interest Rates

1. Choking on Debt: As a debtor nation our liabilities are financed within our own Treasury bonds, our government's internal "credit card." These same Treasury bonds act like a revolving line of credit. We purchase long-term dated maturities by borrowing short-term money. The debt explosion from the Great Recession and all the "programmed" spending occurring has become one big adjustable rate mortgage. Therefore, if interest rates rise, the cost to service our debt could become incredibly burdensome.

2. Who Will ~~Buy~~ Finance the US ~~Bonds~~ Debt? Ultimately, institutions both foreign and domestic finance the credit line of this scheme. Will there be a day when these institutions demand more interest for the credit risk they are taking given the shenanigans being played without fiscal restraint? What does our economic footprint look like internationally and what unintended consequences will arise from our nation not being fiscally responsible? Furthermore, how does that translate down to a portfolio management level?

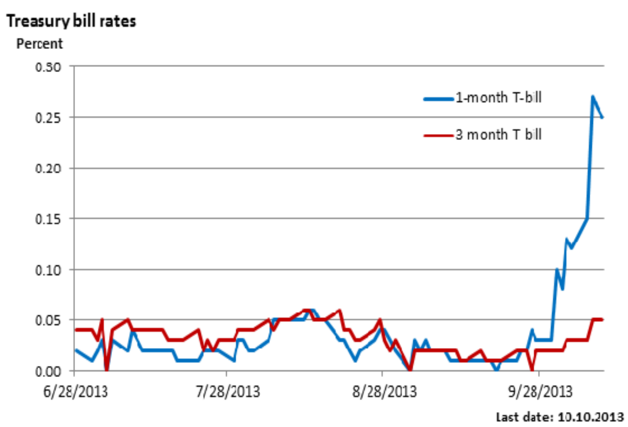
Default

The US Government defaulted after the Revolutionary War, as "Grants Interest Rate Observer," recently wrote. "Default" is defined as "a debtor that has not met his or her specific legal obligations according to the debt contract."

The new America owed some $12 million in debt in arrears to foreign governments around 1790. Our then secretary of the Treasury, Alexander Hamilton paid these debts in appropriate amounts of gold and silver. Eventually it was paid off, but it was nonetheless a default.

Up until the Roosevelt (FDR) administration, the dollar represented 1/20 of an ounce of gold. The New Deal brought a redefinition of our paper dollar currency to 1/35 of an ounce of gold. Years later, the Nixon administration wiped away the gold backing of the dollar and made the dollar a truly “paper” currency. (Thanks to Jim Grant, “Grants Interest Rate Observer” for the above information.)

This crisis is also impacting short term Treasury bills. As the graph below illustrates the possibility of default is significant enough, that it has caused some investors to sell Treasury bills.



This change is quite dramatic and likely missed by most investors. If there was a delay in payment of principal or interest, constituting a default, the financial ramifications would dwarf the crisis of liquidity experienced during the Great Recession. Investors will read this as an indication of US political unwillingness to meet debt obligations.

In a worst-case scenario we could see the following:

1. Higher short term interest rates.

2. Liquidity Issues: Money market funds invest in short term Treasury bills, therefore a default could cause cash reserve funds short-term challenges in meeting withdrawals. Other fixed income related bonds will be affected as well.

3. Market Volatility: Liquidity concerns may cause managers to withdraw funds from other asset classes. The impact would be felt worldwide.

Expectations & Results

As the DC dysfunction continues, we believe that a debt deal will ultimately get done. The likelihood is the deal will be a modified “kick the can down the road” plan. We envision lawmakers will raise the debt ceiling and revisit this sometime after the New Year.

The chief political strategist at Potomac Research Group, Greg Valliere, summed it up best in a recent research note: “The bottom line for investors [will be] that the House GOP blinked on the debt ceiling. Default never was likely and now chances are close to zero. Market psychology has soared because default is off the table but business and consumer psychology has taken a more lasting hit. Fresh crises loom --so the fragile recovery may stay fragile because Washington is still dysfunctional.”

What does this all mean for investors? We see the following opportunities developing:

- Movement in interest rates and some liquidity issues make tax free bonds more attractive. Five percent tax free yields relate to a 9% taxable equivalent in high tax brackets.

- Inflation expectations are on the rise. We are continuing to reduce interest rate sensitive bonds in portfolios.

- No real deflation concerns. We are modestly reducing our exposure to alternatives.

- We see international opportunities, as Europe is showing continued signs of improvement.

- US Stocks have easy comparisons to last year's earnings. Managers are focused on revenue first, earnings second. It's harder to grow revenue than improve earnings. Key companies are under promising and over delivering.

- US markets may get positive tail winds from Europe.

We expect many of these issues to come to a head in the next few days. If the resolution Congress agrees upon provides only for a "short-term resolution", we will be revisiting this same "governmental anxiety" in less than six months. No matter what the outcome, we intend to remain diversified, trying to both protect and grow wealth while taking on reasonable risk.

Warmest regards,

JJ