October, 2013

COMMENTARY

Crisis Fatigue: The Sequel

ECONOMIC STATISTICS					
	3rd Qtr (9/30/13)	2nd Qtr (6/30/13)	% Change	1 Yr Ago (9/30/12)	% Change
S&P 500 Index	1,681.55	1,606.28	*4.7%*	1440.67	*16.7%*
10 Year Treasury Yield	2.61%	2.49%		1.63%	
Gold Spot ($ / oz)	$1,328.94	$1,234.57	*7.6%*	$1,772.10	*-25.0%*
WTI Crude Oil (next future)	$102.33	$96.56	*6.0%*	$92.19	*11.0%*
GDP Qtr / Qtr	N/A	2.5%		2.8%	
CPI Y / Y	1.5% (Aug)	1.8%		2.0%	
Unemployment Rate	7.3% (Aug)	7.6%		7.8%	

In September, as the latest Washington crises took on an air of inevitability, we collectively rolled our eyes. We've been writing about Washington and other political crises for some time now. We dealt with the "Fiscal Cliff" (Remember that? Neither do we.) in our January write up, and our April Commentary was titled "Crisis Fatigue". So we thought it would be appropriate – not to mention less work – to renew that title. These crises all seem to have the same basic plotline. We have an immediate crisis which inevitably passes as the particular problems of that day are resolved for the time being. Of course, what causes the particular crisis to abate is not an actual solution, but some compromise which accomplished little more than delaying a real solution for another day. The one thing politicians seem to forget is that "another day" eventually arrives.

As such, Washington is back in crisis mode again. And we, the American people, predictably are reacting however we react – in fear, disgust, amusement, boredom, etc. We'll attempt to make it easy on our readers by making bold predictions regarding the current partial Federal government shutdown and the upcoming vote with respect to the Federal debt ceiling. First, after much handwringing, the parties will reach a "grand bargain" which will avert the immediate disaster but solves nothing. Solutions to the underlying problems facing this nation will have to wait for another day. Second, there will be no meaningful progress to solve any of these problems until the next crisis arises. Third, when that next crisis inevitably arises, we will once again have to contemplate what this all means. Rinse, lather, repeat!

In order to proceed from this point, then, we must consider what we actually expect and what could go wrong. Our actual expectation is that the current Washington foibles are nothing more than distractions, though they do serve to undermine investor confidence. As such, they dampen potential upside returns in the market while increasing volatility in the short run. Still, investors should ignore the consternation caused by the immediate crisis and focus on opportunities it creates for reaching long-term goals. We do understand that, in general, most individuals are risk minimizers. They would rather pass on the upside than accept the risk of the downside – even if the probability of the upside vastly exceeds the probability of the downside. This perspective is very rationale. Where we think many get it wrong, however, is that they don't perceive the failure to obtain long term goals as a risk. Just as most individuals are risk minimizers, they are also more focused on the near term. This is, in our opinion, a mistake.

These are simple thoughts with a simple course of action to follow. If that is sufficient, there is no need to proceed further with this Commentary. If not, then read on.

As we said above, though we don't expect it, events can get out of control. So how can they? What we'll focus on is what has at least a reasonable probability of actually occurring. We'll avoid getting into a discussion of those events which, though not impossible, are so unlikely that a discussion would serve no purpose other than to feed into our worst fears.

Starting with the partial government shutdown, we do not believe it is a crisis yet, though it is a problem. Assuming that the shutdown is protracted, eventually businesses that supply the government will reduce operations impacting their employees, investors, and suppliers. Likewise, those employed directly by the government will be impacted. Besides the individual hardships, this impact can have a ripple effect on the economy, curtailing growth. Presumably, an agreement will eventually be reached, and most of the impact will be reversed. Still, this is incredibly inefficient and will increase the cost of doing business. Yes, this is a negative, but not one we'd lose sleep over. Ironically, this path may even reduce our deficits. Though unemployment payments might increase, the lack of Federal spending should more than offset this. As much as we are in favor of reduced deficit spending, we must state that this is a terrible way to go about it.

So a partial government shutdown is unlikely to be a disaster, but where things can get really out of control is with the debt ceiling. The Federal government by law has a limit on how much it can borrow. This is true even if spending exceeds revenues by more than the borrowing limit. Since it is only a law, the debt ceiling can be raised – as it has been raised numerous times in the past – or it can even be repealed. However, both political parties find the debt ceiling a useful tool. Let's say, however, for the sake of argument, the current political game of chicken reaches the point where the debt ceiling is not raised and the Federal government runs out of cash. Question number one: does this mean there must be a default of government debt? The simple answer is, no. **If we default on our debt, it is by choice.** The government would likely default on obligations, be it salaries to employees, payments to contractors, reimbursement of Medicare expenses, to name a few, or even social security payments. But nowhere is it written that we must default on debt obligations. In fact, there are strong Constitutional arguments (which we won't go into here) as to why debt service would need to be the last item cut. Of course, in the real world, decisions are made and implemented before they are litigated. An actual debt default would be an unmitigated disaster resulting in falling currency, soaring interest rates, and economic contraction. Even given our less than enthusiastic endorsement for the collective wisdom in Washington, we do believe our elected officials are wise enough to avoid this course of action.

More likely is that if the debt ceiling is not raised, we continue our debt service while other payments are suspended. The dollar would likely fall, interest rates would likely rise, and the politicians would then probably go into crisis mode. They would probably come to an agreement and kick the can down the road a little farther, thereby ending the immediate crisis. The aftermath would be a situation where foreigners are a little less likely to invest all their funds in the U.S., leaving us with an ongoing level of interest rates higher than we would otherwise have. The impact on the equity markets would probably be fairly negative in the short run, and have the residual effect of increasing the uncertainty level – thereby keeping prices lower than they otherwise would be. However, our best guess is that this scenario would not be Armageddon for the markets – though it might feel like that for a bit of time.

So what is our bottom line? Investors should view their funds as not a single pool, but a series of pools earmarked for different periods of time. For needs within the next few years, keep those funds fairly liquid. Do not take on unnecessary risk. For needs which will occur at least five years down the road, invest for the long-term. Do not ignore these needs. Turn off the TV, avoid paying attention to the drama. This too shall pass.