

## Debt Limit Showdown at the Not OK Corral

### Infrequently Asked Questions

“The fact that we are here today to debate raising America’s debt limit is a sign of leadership failure. It is a sign that the U.S. Government can’t pay its own bills. It is a sign that we now depend on ongoing financial assistance from foreign countries to finance our Government’s reckless fiscal policies. ... Increasing America’s debt weakens us domestically and internationally. Leadership means that ‘the buck stops here. Instead, Washington is shifting the burden of bad choices today onto the backs of our children and grandchildren. America has a debt problem and a failure of leadership. Americans deserve better.”

Senator Barack Obama, 2006

For the 75<sup>th</sup> time since 1962, the U.S. Congress is being asked to raise our nation’s debt ceiling. What purpose an ever-levitating ceiling serves remains a mystery to me. The fact that many of the politicians who are now claiming to be shining beacons of fiscal prudence repeatedly cast votes in prior years to increase government spending and borrowing also strikes me as odd. In addition, we have our President begging for an increase to the debt limit though he (rightly) opposed such an increase when he was a mere Senator in 2006. If I didn’t know better I’d think our politicians were playing politics.

Nevertheless, here we are. Politicians, the media, and Wall Street are trying to out-doom one another. Maybe it’s just me, but this feel like Y2K and TARP all over again. Fear is a wonderful motivator and a terrific political tool.

Sadly, it is politics that has taken center stage as Congress and the President jockey for credit and hone their finger-pointing skills. Desperate calls for action mean that, once again, there will be no meaningful reasoned discussion of the role government should play in our society and the cost of that involvement. We must simply do something before the Earth stops revolving on August 2nd!

Understandably, all of this fear mongering has resulted in some investor angst. In the past week, I’ve had a number of you contact me with practical questions about what the debt limit showdown means for the country and for your personal finances. I’ll attempt to address some of these issues in a Q&A format.

### **Do you think an agreement will be reached?**

- Yes. It may not be before the “deadline,” but an agreement will certainly be reached. The more adversely the financial markets react to this drama, the quicker a resolution will be reached.

### **What if the deadline is missed? What will happen?**

- The reality is that the government will still have income coming in, but it will be less than the expenses it has to pay. The government’s credit card will be maxed out, so it will have to live within its means.
- Since expenses will exceed income, the government will have to choose who gets paid and who will be given an IOU.
- Those who have to wait will be made whole once a resolution is agreed upon. This will create short-term cash flow problems for some of those who aren’t paid, but everyone will eventually be paid in full.
- The credit rating of the U.S. may be downgraded. This could (and should) happen regardless of the debt limit being raised given the nation’s debt, deficit, and dollar devaluation.
- We could see further weakness in the equity markets the longer this drags on, but it’s impossible to know how much of any weakness is due to the debt limit impasse versus other factors.
- We could see a relief rally in the equity markets once an agreement is reached. Treasury securities could actually sell-off somewhat as the flight-to-safety trade reverses. If folks have bought gold as a safe haven, we could see a short-term correction in the metal.

### **What will an agreement look like?**

- The debt [non]limit will be extended for the 75<sup>th</sup> time since 1962.
- Some token amount of spending cuts will be agreed upon. Although the total dollar amount may sound significant, keep in mind that the amount refers to the total over a decade. In other words, the claim of cutting \$2 trillion really means \$200 billion per year. This may still sound wonderful, but recall that our current annual deficit is \$1.5 trillion. Our debt will still grow significantly in the years ahead.
- The cuts may well be focused on later years. This would enable a future Congress and President to significantly change (reduce) the cuts.
- Some promise toward movement on a balanced budget amendment is likely.

### **Will any outcome be meaningful?**

- It’s healthy that this debate is happening at all. Despite the bashing they often take in the media, we owe any debate at all to the freshman Tea Party congressfolk. Love them or hate them, their demand for substantive deficit reduction will result in a modestly less insane budget deficit.
- Unfortunately, there is simply no way to address our funded and unfunded debt burden without reforming and/or shrinking Social Security, Medicare, and Defense. None of the proposals presented so far address the unsustainability of these programs. These are unlikely to be seriously addressed until interest rates rise significantly. The real problem is not being addressed in the current debate.
- The other key takeaway from all of this is that we’re very unlikely to see any significant fiscal expansion any time soon. I’ve warned throughout this “recovery” that the economy was still sick.

Recent employment, GDP, and sentiment indicators are bearing this out. It's no coincidence that the economy is weakening again as the effects of prior stimulus wear off. If fiscal stimulus is off the table (as it should be), it may not be long until we're back in recession, if we're not there already.

### **What if the U.S. loses its AAA rating?**

- There could be some short-term dislocation in the financial markets, but we've all had time to prepare.
- Does anyone seriously believe we're AAA?
  - We have a total federal debt burden of \$50-100 trillion and a Federal Reserve which has shown skill at little else besides reducing the value of the dollar.
  - China's credit rating agency, Dagong, rates the U.S. at AA and has warned that they will likely lower that rating another notch even if there is a debt limit agreement. Although this is merely symbolic, Dagong has it right.
- Will interest rates soar?
  - Treasury bonds have actually rallied (yields have fallen) during this "turmoil."
  - Bond market investors are generally a fairly conservative lot, and they don't seem too worried. I think they have it right.
  - I do believe that there is a greater risk of interest rates rising than falling over the next decade, but this debt limit issue is unlikely to be the catalyst. It's just one more piece of the puzzle.
- Can the dollar be replaced as the world's reserve currency?
  - Eventually it will be, but that won't occur overnight. Remember, most people and institutions have to keep their wealth in some currency. If they don't want to own U.S. dollars, where will that money go?
  - Would you rather own the Euro given the sovereign debt crisis in Europe?
  - Japanese yen? They have a relatively larger debt burden than we do, ridiculously low interest rates, and a demographic time bomb.
  - Swiss Francs? Sure, but there aren't enough of them to replace the dollar.
  - Chinese Yuan? Eventually it will play a bigger international role, but it's still far from an international currency.
  - Gold? Gold will benefit over time, and we may well end up with some form of a gold standard again, but this is still years in the future.

### **Will my Social Security check be paid?**

- Yes. Seniors vote, and there's a big election in 2012.

### **Should I sell my Savings Bonds?**

- No. These will be paid in full and most likely on time. The worst case is that your check from the government is delayed, but you will absolutely be paid in full every cent of interest and principal that you are owed.

**Are we doing anything in the portfolio because of the debt limit debate?**

- This debt issue didn't sneak up on us. I've been discussing this and warning about this for years. The debt overhang has been and remains a key factor in our portfolio construction.
- The good news for us is that volatility has increased alongside investor nervousness.
- Though many fear increased volatility, we welcome it as it creates opportunities.
- Given our conservative position, we have plenty of dry powder to take advantage of any opportunities if a panic develops.
- We boosted exposure to two holdings last week (in many accounts) as market jitters helped drive them back to attractive levels. Other names on our watch list are getting closer to buying levels.
- We should all be rooting for a big sell-off. Our portfolios would take a short-term hit, but we'd be able to put some of our dry powder to work and increase our risk exposure at attractive levels.

**What are you worried about?**

- As mentioned, I'm not worried about the debt limit. It will be raised and some token and largely irrelevant spending cut agreement will be struck.
- What concerns me are the very things we've been discussing for some time, including:
  - Sovereign debt crisis
  - Weakness of private sector growth
  - Dependency of global growth on stimulus
  - Currency debasement
  - China real estate bubble (also Australia and Canada)
  - Slowdown of U.S. growth
  - Ill-conceived and dangerous monetary policy
  - Unattractiveness of most asset markets

In sum, an agreement will soon be reached to raise the debt limit, and this story will fade from the news. The underlying debt and spending problem will be kicked a little further down the road. To the degree that increased volatility creates opportunities for us, the frustration of this latest farce may prove fruitful.

Best,

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