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The Debt Limit and Your Investments

The current high level discussions regarding the US debt limit are setting off a fury of opinion and media buzz which is rightly upsetting many Americans. There are numerous proposals with sharply divided and passionate opinions over the best course of action to take for the good of the country's finances. There is an equal amount of partisanship and political posturing clouding the issue. Many have advocated that inaction could be a catastrophe for the markets. Consequently the debate intensifies daily. We thought it best to share ideas among our 10 portfolio managers and then communicate our conclusions and advice to you.

Over the next few weeks, our elected officials must face two separate but related issues which have enormous significance for our financial markets and our children's futures. Around August 2nd, experts estimate the US Government will not have the cash necessary to fund government operations without borrowing money in excess of the existing statutory limit. This event would not trigger a technical default but would trigger automatic overnight cuts in federal spending equal to 44% of spending. Decisions about who and what functions get paid and when would be chaotic at best. The "limit" was designed to be a forcing mechanism to make significant cuts when spending gets out of control. Having a "limit" that can easily be extended defeats its purpose and avoids its consequences. The major bond rating agencies are considering downgrading the rating of U.S. debt which would have serious implications around the world. Treasury Secretary Timothy Geithner warns of a catastrophic impact of a default and a severe financial crisis. Some argue that he and others in government are loath to end a government gravy train that benefits too many.

The arguments about the debt limit, however, are a symptom of a much more serious problem, that is, that government spending, specifically entitlement spending, is out of control and is no longer supportable. Although some will argue that we have a revenue problem and that the answer is more taxation, the conversation must eventually turn to spending. The politics here are vicious and will likely become more so. It remains to be seen whether Congress and the White House will simply kick the can down the road or actually address the root problems. It is our view that a compromise will be reached that involves a combination of spending cuts and revenue increases in the near term, but that structural changes will be deferred to a later date. This would likely have negative consequences for the economy in the short run but may be perceived by the markets as a positive. Nevertheless, we see ample reason to be cautious.

Since the crisis of 2008, the economy is still fragile. The velocity of money is anemic as people use cash to dig out of excessive debt. Consumer debt is still at record levels, banks are still weak, and corporations are fearful to invest their cash. There is no good or easy solution to these problems. The Federal Reserve has few arrows left in its quiver. More austerity will lead to still lower velocity of money and a slower economy. Further, some argue that the market is currently sustained by, you guessed it, excess liquidity.

How should we proceed then as advisors? First, we cannot predict what will occur and our experience tells us that taking drastic actions would be unwise. Nevertheless, we have a history of being cautious and having a sense of heightened awareness in times like these. Many of our accounts are balanced with conservative fixed income investments to reduce risk. In the coming months, we will likely defer significant equity purchases and reduce some of our most volatile holdings. Our small, mid-cap and international holdings are already at reasonable levels but may be reduced further. Our emphasis will be on risk aversion and balance. We will emphasize consistent, more predictable growth and dividends as opposed to higher risk assets. Although we expect interest rates to remain low due to slower growth, we may focus more attention on hard assets, basic materials and bonds that offer inflation protection. As is our tradition, the changes we make will be marginal and not drastic.

Although the political process thus far appears dysfunctional at best and paralyzed at worst, our hope is that our law makers will take the painful steps to address both our debt level and spending in order to avoid a crisis like the one unfolding in Europe.

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