

# HEADWATER INVESTMENT CONSULTING, INC.

*Registered Investment Advisor*

## *Thoughts on Debt Ceiling July 26<sup>th</sup>, 2011*

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### **View of Current Situation**

Recently, I have been giving a lot of thought to the political battle in Washington over raising the U.S. debt ceiling and its possible effects on investment portfolios. Although I am sure you have been reading and hearing plenty about this problem, since you have entrusted us with your assets, I am sending you this note with our take on the issue.

First, it is important to note that the crisis is a synthetic creation resulting from political maneuvering. Most other nations do not have self-imposed debt limits and few question the U.S. Treasury's ability to borrow funds in the immediate future. In other words, the United States is not facing a debt crisis similar to the one affecting European countries such as Greece, Iceland, Ireland or Italy. Those countries are having difficulty finding actual buyers for their debt obligations, whereas the United States should have no problem attracting buyers for additional U.S. Treasuries provided Congress raises the debt ceiling by August 2nd. Therefore, the debt ceiling is really a political maneuver leading into the 2012 elections, and nobody seriously questions the U.S. Government's economic ability to issue more debt as long as Congress allows it to do so. While most citizens are rightly concerned about long-term U.S. Government debt and deficits and their impact on economic growth, the present crisis is politically, not economically, driven. It is as if we all know the big rapid is ahead, but Congress has yet to start paddling to shore.

Second, most financial panics are caused by things we do not anticipate, so-call "Black Swan" events. That is, a rare and unpredictable event falling beyond the realm of normal expectations. The financial turmoil in 2008 was a classic Black Swan. Conversely, the current debt-limit standstill has been looming for months and dominating headlines for weeks. This has resulted in increased market swings, including the biggest one-day percentage increase this year, yet the markets have avoided steady, precipitous declines. Thus, stock prices seem to be taking the possibility of failure into account and the absence of any large drops suggest the markets believe Congress will reach an agreement; however, the increasing volatility is indicative of a elevated degree of uncertainty.

### **Highest Probability Outcome**

I anticipate a last minute, down-to-the-wire congressional deal. However, given the difficulty in reaching political consensus thus far, I do not expect a robust outcome. By robust, I simply mean a credible plan to

substantially cut long-term spending in excess of any additional revenue. I expect a temporary, stopgap solution with few, if any, details regarding tax or spending proposals. The deal will likely avoid many of the hard decisions while allowing the Treasury to issue more debt.

### **Alternative Outcome**

Alternatively, just like playing a game of chicken, Congress might not agree to raise the debt limit and force the Treasury to make very difficult decisions. In this scenario, the government's current obligations will not all be met. That is, someone will not get paid; this could be employees, suppliers, retirees, bondholders, or some combination thereof. In my view, such a result would be deplorable and unconscionable, and I hope it does not happen.

However, if the government is forced to default on some of its current obligations, I expect a severe reaction from the financial markets. The bond market will be less serious, and I do not expect Treasury bonds to lose significant value. It is very hard to imagine any default in Treasury bonds where investors would receive much less than the amount they invested. The more likely impact on Treasuries will be a delayed interest payment that will get priced into the value of the bonds. The delay in payments would diminish the U.S. Treasury's ability to borrow funds in the future, resulting in higher borrowing costs and interest rates, but current treasury investors will likely avoid unsustainable losses. On the other hand, a congressional failure to avoid a self-imposed problem reflects poorly on our long-term ability to put our fiscal house in order. Such a failure would likely be priced into the stock markets since they are a forward-looking gauge of a

nation's prospects for long-term prosperity. Thus, stock markets would feel most of the impact of any failure to raise the debt ceiling and experience a severe reaction.

### **What to do**

The lesson we have learned from our experiences of financial turmoil over the last decade or so is best summed up by the phrase "hold steady." During this period, we have witnessed tremendous short-term stock market losses caused by the popping of the internet bubble, a terrorist attack on two of our major cities, the near collapse of the world banking system, and, most recently, a tsunami and nuclear scare in one of the world's largest economies. Yet, in each of these instances, significant stock market losses were followed by significant stock market rallies. Although the timing of the rallies varied and was impossible to predict, the market consistently rewarded the disciplined, focused investor. The current failure to raise an arbitrary debt limit because of a game of political brinkmanship by our elected officials will have market consequences, but I doubt it will be viewed as a historical event that changed the normal market cycles of decline and recovery.

As always, we are continually reviewing the portfolios we manage to ensure they stay within our targets of proper diversification. Times of heightened uncertainty are not good times to completely reconfigure portfolios. While a broadly diversified portfolio cannot protect against short-term losses, it does help limit extreme volatility and historically provides consistent returns.

Please contact us if you have questions or concerns.

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