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VIEWS FROM CAMELBACK MOUNTAIN

Some Thoughts on our Dysfunctional Government

On Tuesday, October 1, 2013, political bickering between Republicans and Democrats caused the U.S. to begin a limited government shutdown as the country starts a new fiscal year without spending authority. Republicans want to defund Healthcare Reform, most of which starts on January 1, 2014, due to strong philosophical opposition and numerous operational problems and delays. The Republicans also want federal government expenditures reduced to make our federal deficit smaller. Democrats are supporting Healthcare Reform and want to maintain expenditures. Both sides are "dug in" and appear to be determined not to "give in" even if the shutdown persists for quite a while. The President has a lot riding on this as Healthcare Reform is the key program that most defines his presidency. The Republicans, particularly about 45 Tea Party members, think the country is dangerously out of control with Healthcare Reform and consistent large budget deficits. Both sides are determined and a quick resolution is unlikely with no negotiations scheduled as of yet.

Financial markets started becoming concerned about this situation about 3 weeks ago and stocks are down 4.3% from their highs hit recently. While the market dislikes the uncertainty brought on by the budget impasse, it is even more worried about the federal debt ceiling which we are scheduled to exceed by about October 17, 2013. If the two parties can't agree to raise the ceiling by then, the U.S. could theoretically default on interest payments on Treasuries and/or other government obligations. This has driven concerns of catastrophic consequences.

Most recent government shutdowns have been resolved quickly or at least in 2 to 3 weeks. Three weeks would take us past the October 17th "deadline" on the debt ceiling. At this point, it looks to us like the budget impasse may last for a few months or more. If it does drag on we expect the congress will pass a short term debt ceiling increase. Raising the limit by $200 billion would probably be sufficient to delay a default for 3 months or so. Eventually both sides will have to negotiate and make sacrifices to gain an agreement. This won't happen until the political risks to the politicians begin to outweigh their perceived benefits in political positioning.

In the real world, this will further challenge the already slow growth of the U.S. economy and diminish any job growth. It will be a drag on corporate revenues and earnings. It virtually assures that the Federal Reserve will maintain its massive stimulus longer than it might otherwise have.

Past government shutdowns longer than a day or two have caused market declines mostly in the 2-5% range. Our summer 2011 impasse led to a fear of default and credit rating downgrade for U.S. Treasuries which along with some European credit market volatility helped trigger a stock market decline of 11% from which it quickly recovered after the resolution.

Since this impasse may take longer than previous negotiations, we anticipate that we may see a decline of 5 to 10% (4.3% of which has already occurred).

The sectors likely to be most vulnerable are cyclical companies like industrials, financial companies and businesses that sell a lot to the federal government like defense contractors.

With all the political fighting, this improves the chances that Janet Yellen will be appointed as the next chairman of the Federal Reserve. She would likely be approved easily by the Senate and we doubt the president needs to find something else to fight about with the Senate. The financial markets would likely be encouraged if she is appointed.

Despite the problems in Washington, the U.S. economy is growing slowly. While Europe is still not healthy, many economies in Europe appear to be stabilizing. China is also showing some signs of gradual improvement. With continued massive stimulus from our Fed and other central banks around the world, we expect that the market will recover fairly quickly.

In the unlikely event we do not get a debt ceiling increase in time, we expect that any “default” would be cured very quickly (in a few days). Everyone in Washington can remember the consequences that the foolish action to allow Lehman Brothers to go bankrupt unleashed.

On a brighter note, it is widely anticipated that the U.S. will surpass Russia as the world’s largest energy producer this year. This helps point out the rich resources available here in the U.S., which is one of many strong advantages our companies have. This is another reason for our long-term bullishness on America and its people and businesses despite our disappointment with our politicians on both sides.

Best regards,

Harry Papp

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