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SHUTDOWN? DEFAULT? CONSEQUENCES?

Article Courtesy of Bob Veres

It's possible that you've heard a news report or two about the government shutdown that started October 1, and now a dispute over raising the U.S. debt ceiling and possibly defaulting on the government's debt obligations as soon as October 17. The question for an increasingly nervous investing public is: how will this affect the U.S. economy and (not to be too selfish here) my retirement portfolio?

Interestingly, it is starting to look like the government shutdown, if it runs for weeks instead of months, might have almost no effect on the economy at all. Why? The economic impact that had economists worried was the loss of income suffered by tens of thousands of federal employees. But the Defense Department has continued paying all of its civilian personnel, simply by declaring all of them "essential employees." Not only were the leaders of the House of Representatives not inclined to argue; they have quietly passed legislation that would give back-pay to all federal workers who have been furloughed, just as soon as the stalemate ends. The Senate and the President are likely to go along, giving the country the worst of all worlds: paying most government employees for staying home and not providing a wide variety of services to the public.

"WE'VE BEEN KEEPING HIM ALIVE BY TELLING HIM THE MARKET IS UP."

Ironically, the way the politics are working, one can almost guarantee that there will be some kind of a stock market selloff before the shutdown ends. For the Republican leaders in the House, there is little cost to holding their ground so long as there is not a public outcry and loss of voter confidence. One of the sources of that pain would be a big drop on Wall Street. Indeed, if you listen closely to the speeches by President Obama and the Democratic leadership, you hear dire warnings that the of a market drop as a result of the shutdown--which is their way of focusing the public's attention on who to blame when it happens.

What is interesting about that is that the markets often deliver corrections after long, accelerating uptrends like what we have experienced in the U.S. since March of 2009, and with the 20+% returns that Wall Street has delivered so far this year. It wouldn't have surprised anyone to see some kind of a quick downturn this Fall regardless of whether the government was operating at full capacity or at a standstill. A week of small leaks in stock prices could lead to something larger as people realize they are sitting on nice gains and have no idea what Congress will or won't do next. The last time the government was shut down, stocks dropped 20%, the Republican leadership realized it wasn't winning any popularity contests and the stalemate ended. We've seen this script before.

A more consequential issue is the debt ceiling. Congress must raise the total amount that the U.S. government can borrow (by selling Treasury bonds) to pay its various obligations, including, of course, interest on its current Treasury bonds. Contrary to popular belief, raising the debt ceiling does not increase the federal debt; that debt exists whether or not Congress authorizes additional borrowing.

Failure to authorize the government to pay its legal obligations would create a self-induced fiscal crisis--ironic for a country whose representatives claim that they never want to become another Greece, and then talk about voluntarily defaulting on the nation's debt obligations, which even Greece has avoided.

One recent article suggested that a default on Treasuries would ripple through the global economy, among other things, causing anxious investors to demand higher interest rates and dramatically raising U.S. borrowing costs. That, in turn, would raise rates on mortgages, credit cards and student loans, pushing the U.S. toward or into recession and putting pressure on the stock market. One report suggests that if the U.S. misses just one interest payment, the downward impact on stock prices would be greater than the Lehman Brothers bankruptcy. In THAT aftermath, the stock market lost half its value.

Bigger picture, a default would undermine the role of the U.S. in the world economy.

The irony of the debt ceiling debate is that the gap between government spending and tax revenues has been closing rapidly on its own. In July, the Congressional Budget Office reported that the deficit had fallen by 37.6%, the result of tax increases and sequester-related cuts in spending. As a percentage of America's GDP, the deficit has fallen from more than 10% at the end of 2009 to somewhere around of 4% currently. Last June, the government actually posted a surplus of $117 billion, paying down the overall deficit, and the Congressional Budget Office has projected that September will also bring government surpluses.

Most observers seem to think that all of this will get worked out. After all, what rational person--in Congress or elsewhere--wants to self-impose these problems when we have plenty of economic challenges already? The stock market's calm trading days tell us that investors expect a compromise on the government shutdown in the near future. It may take a sharp day of selling to prod Congress off the dime. Foreign investors are still lending to the U.S. government at astonishingly low interest rates (despite modest increases over the past week), which tells us they aren't worried about a default.

The last time we went through this, the stock market plunges proved to be buying opportunities for investors. One of the great things about uncertainty and volatility is that it causes investments to periodically go on sale, and creates such anxiety that only disciplined investors are able to take advantage. There's no reason to think this isn't more of the same.

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INTEREST RATES ARE TRENDING UP. SO WHAT?

Article Courtesy of Bob Veres

If you haven't already, you will soon be hearing alarming reports of the "dramatic rise of Treasury bond rates," and the breathless implication in the articles and on the financial cable programs will be that this will have a disastrous effect on bond owners and the economy in general. Higher interest rates! More inflation! Lower economic growth! More interest on the ballooning federal debt! More competition for the stock market, and therefore lower stock prices!

If you look at the recent rise in 10-year Treasury rates in isolation, as several commentators have done (see Chart 1), it does indeed look remarkable: a rise of more than 70% from a May 2 low of 1.63% to somewhere in the neighborhood of 2.90% as you read this. If the Dow were to jump that far, that fast, it would have risen from 14,500 to more than 25,500. Yikes! Maybe the headlines are justified after all!

But if you put the recent rate rise into a longer-term perspective (see Chart 2), the recent "dramatic rise" looks awfully puny compared with some of the long-term swings in market history, and the current rate still looks quite reasonable. The high percentage shift is more a reflection of how low rates had gotten than a rise to dramatic heights.

So what's really going on here? You probably know why bond investors are asking for an extra 1.3% a year out of their longer-term fixed income investments these days: nobody knows when the Federal Reserve Board is going to stop buying Treasuries, or what, exactly, will happen when the elephant jumps off of the see-saw. The Fed's most recent meeting minutes suggest that it will be cautious about winding down its QE bond buying program. And you can bet that Fed economists will be watching the market for signs of impending damage, and curtail their curtailment if they seem to be causing a ruckus. But that still leaves a bit of uncertainty about where rates will go.

All professional investors know for sure is that when a big buyer walks away from the marketplace, gradually or not, there will be less demand for whatever they were buying than there was before. Therefore bond issuers--including the U.S.--will have to pay more (i.e., higher yields) to lure in the fewer remaining buyers.

How much more? In other words, how much higher will bond rates go? How much will the bonds you own today lose value during the messy pullback from QE stimuli? We can make this second question easier to answer by simply pulling money back away from longer-term bonds until the dust settles, leaving it to the experts and institutional buyers to make educated guesses and read the tea leaves.

But you have to answer the first question in order to know the answer to the obvious third one: what other consequences will rising bond rates have on your other investments?

When market forces get back in control of the bond markets, they will be responding to three things: how scary are the alternative investments (and therefore how much do I want to put in bonds)? What is the current and expected inflation rate? And finally: where do I want to be on the yield curve? (Are the longer-term rates attractive enough to lure you away from the relative safety of shorter-duration bonds?)

Right now, inflation is pretty low, in part because the high joblessness rate is making it harder for workers to ask for huge raises, in part because the banks have a lot of money to lend and not a lot of people asking to borrow it. A recent report notes that an astonishing 82% of the U.S. money supply is currently on deposit at the Fed, mostly in accounts held by large banks. (To put that in perspective, the average percentage from January 1959 through the end of 2007 was 6.18%.) By the laws of supply and demand, banks don't have a lot of leverage to demand high rates of interest.

If you believe that the unemployment markets are going to tighten up dramatically in the fairly near future, and that somehow millions of people will want to borrow most of the global supply of dollars, then you can project a high inflation rate. If not, then you should probably not worry about an explosion in the inflation rate for the foreseeable future.

When you're talking about alternatives to bond investments, you're mostly talking about stocks. If we see another Fall of 2008 scenario, people are going to flock to government bonds and drive rates higher. But the only thing we know about the Fed's decision-making process, from its notes and internal policy debates, is that it is only going to start exiting its QE program when it thinks the economy is healthy. If the stock market starts to look edgy, or the U.S. starts sliding back into recession, you can bet that the Fed will want to keep interest rates low and be a tad more gradual about ending its QE activity.

As to the yield curve, at the moment, short-term rates on Treasuries and most other fixed-income vehicles are about as close to zero as you will ever see them again. The Fed has announced that its policy rate is 0%, and until the economy gets fully back on its feet and unemployment comes down dramatically, this is likely to continue to be its policy rate. The spread between 3-month T-bills and 10-year Treasuries is currently about 2.8%, which is nearly twice as high as the 1.5% historical average. Can it go higher? Yes. On two occasions since January of 1970, the spread has reached as high as 4%.

If you add up all these clues, you come out with something very different from the disaster scenarios you'll be hearing in the news. The Fed is planning to stop buying Treasuries at some point in the future, and let market forces take over--but only when it feels like the economy is healthy, and only so long as it can do this without harming economic growth or hammering the stock market. The market forces themselves are unknown, but it's hard to see how the ten-year Treasury bond will rise above 4%--or, to put THAT number in perspective, to the point where it is yielding about twice the dividend yield in the overall S&P 500 index. That still looks like pretty weak competition for stocks.

So what we're seeing in the bond market appears, if you can get away from the breathless headlines, to be nothing catastrophic. Bond investors are demanding an extra 1.3% a year to compensate for all the uncertainty they face as they commit their money for the next ten years. They may well ask for a bit more in the future. Can you blame them?

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SCARY HEADLINES, REMARKABLE RETURNS

Dear Clients,

The threat of a government shutdown virtually guaranteed that the investment markets would close out the third quarter with a whimper rather than a bang. The S&P 500 index lost 1.1% of its value in the final week of the quarter as the U.S. Congress seemed to be lurching toward a political standstill that would shut down the U.S. government. All the uncertainty has tended to obscure the fact that most U.S. stock market investors have experienced significant gains so far this year.

And the recent quarter was no exception. Despite the rocky final week, the Wilshire 5000--the broadest measure of U.S. stocks and bonds--rose 6.60% for the third quarter--and now stands at a 22.31% gain for the first nine months of the year.

Other U.S. market sectors experienced comparable gains. Large cap stocks, represented by the Wilshire U.S. Large Cap index, gained 6.24% in the second quarter, and are up 20.77% so far for the year. The widely-quoted S&P 500 index of large company stocks gained 5.32% for the quarter and is up 18.62% since January 1.

The Wilshire U.S. Mid-Cap index index rose 9.02% in the latest three months of the year, and is up 26.19% as we enter the final quarter.

Small company stocks, as measured by the Wilshire U.S. Small-Cap, gained 9.68% in the third quarter; the index is up 27.53% so far this year. The technology-heavy Nasdaq Composite Index was up 11.16% for the quarter, and has gained 25.24% for its investors so far this year.

In the first half of the year, any diversification into investments other than U.S. stocks were dragging down returns. No longer. The broad-based EAFE index of larger foreign companies in developed economies rose 10.94% in dollar terms during the third quarter of the year, and is up 13.36% so far this year. The biggest surprise is Europe: a basket of European stocks rose 13.16% over the past three months, which accounts for virtually all of their returns this year; the index is now up 13.17% for the year.

Emerging markets stocks are climbing out of a deep hole that they fell into earlier in the year, returning 5.01% in the past three months, even though the EAFE Emerging Markets index is still down 6.42% for the year.

Other investment categories are not faring so well. Real estate, as measured by the Wilshire REIT index, fell 1,98% for the quarter, though it is still standing at a 3.84% gain for the year. Commodities, as measured by the S&P GSCI index, reversed their recent slide and rose 5.44% this past quarter, taking them nearly even, just down 0.27% so far in 2013. Gold prices perked up on the uncertainty over the government shutdown, gaining 9.26% in the recent quarter, though gold investors have lost 20.48% on their holdings so far this year.

Bonds have continued to provide disappointing returns both in terms of yield and total return. The Barclay's Global Aggregate bond index is down 2.24% so far this year, and the U.S. Aggregate index has lost 1.87% of its value in the same time period.

In the Treasury markets, the year has seen a bifurcated market; declining yields in bonds with 12 month or lower maturities, while longer-term bonds have experienced rising yields and a corresponding decline in the value of the bonds held by investors. In the past year, the yield on 10-year Treasuries have risen almost a percentage point, to 2.65%, and 30-year bonds are now yielding 3.73%, up 86 basis points over the past 12 months.

Municipal bonds have seen comparable rate rises; a basket of state and local bonds with 30-year maturities are now yielding 4.32% a year; 10-year munis are returning an average of 2.56% a year. The rises, of course, have caused losses in muni portfolios.

Perhaps the most interesting thing to notice about America's 20+% stock market returns so far this year--extraordinary by any measure--is that they were accomplished at a time when investors seemed to be constantly skittish. Just a few weeks ago, everybody seemed to be worried that the Federal Reserve would end its QE3 program and let interest rates find their natural balance in the economy. One might wonder why this would be such a scary event, since it is the Fed's economists way of telling us that the U.S. economy is finally getting back on its feet.

All eyes are still on Washington, but now they've moved from the Fed to the Capitol Building. The question everybody has been asking in the final days of the quarter is: what would be the investment and economic impact of a government shutdown? This question might be one to consider going forward, since the two parties seem to have a lot of fundamental disagreements over spending priorities, and budget battles could become quarterly events.

An article in the Los Angeles Times says that most economists and analysts seem to anticipate a partial two-week government shutdown. The lost pay for hundreds of thousands of furloughed federal workers would cut 0.3 to 0.4 percentage points off of fourth quarter growth--the difference between weak 2% growth annual growth that the economy is currently experiencing and an anemic 1.6% growth rate that would be flirting with recession. An estimate by Goldman Sachs puts the potential lost GDP at 0.9%.

Interestingly, Congress has quietly moved away from the issue that has triggered the last few budget stalemates, focusing this time on whether or not to fully fund the health care legislation. In the past, the issue was budget deficits, but it turns out that the budget deficit has come down dramatically over the past 12 months. The U.S. government posted a $117 billion surplus in June, and the Congressional Budget Office expects to run a surplus again in September--the result of revenue gains as a result of tax hikes plus the growing economy, coupled with a 10% reduction in spending.

What does all this mean for your investments in the final quarter? Who knows? Nobody could have predicted, at the start of the year, with all the hand-wringing over the fiscal cliff and new tax legislation, that we would be standing nine months into 2013 with significant investment gains in the U.S. markets and a resurgence in global investments led by, of all places, Europe.

This much we can predict: the recent uncertainties--the paralysis in Congress, worries about the direction of interest rates and whether the Fed is going to stop intervening in the markets--will give way to new worries, new uncertainties, which will make all of us feel in our guts like the world is going to hell in a handbasket.

But the headlines obscure the fact that investment returns are created the hard way, by millions of people getting up in the morning and going to work and spending their day finding ways to improve American businesses, generate profits, create new products and new markets, day after day after day.

Whatever ups and downs you will experience--and you WILL experience them, perhaps in the next quarter or the next year--that underlying driver of business enterprises and stock value is constantly working on your behalf. That will be true no matter what the headlines say, no matter how spooked you feel about whatever scary thing is going on in the world. Nobody enjoys the investment ride the way children enjoy the thrills of a roller coaster, but both seem to ultimately deliver their riders to a semblance of safety in the end.

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EXCITING CHANGES AT DFSC

Well, we finally did it. We initiated the move which had been discussed for well over the past year. We are appreciative of all the help and work you, as clients, have provided DFSC during this transition.

We're progressing ahead of schedule but recognize that this will be an ongoing process. Your Annual Review may be off your regular scheduled month in the short-term. We tremendously appreciate your flexibility and understanding when scheduling.

The TD Ameritrade website is quite user friendly and we encourage you to set up online access. This can be done by calling 1-800-431-3500 option 3 or by contacting our office.

Just a note, but typical 3rd Quarter billing has been delayed until the 4th Quarter. Your standard billing statement will be provided.