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PLANNING

Dear Clients,

In our inter-connected financial world, confidence acts as the key ingredient to keeping the system going. The issue with the potential US default is that our entire financial system is based upon the confidence that our government will not default on its debt obligations (US Treasury bills and bonds), which is a backdrop to the confidence in the US dollar. US government debt sets the standard for the creditworthiness ranking systems (Moody's, Fitch's, S&P) and has always provided a guide to the financial market players as how they should price other, riskier investments. The theory goes as follows: If an investor can loan money to the US government at a rate of 3%, then for that same investor to loan money to, let's say, a homebuilder, the homebuilder would have to offer a much higher rate of interest, let's say 8%. That is because there is more risk of default in lending to a homebuilder. More risk, more reward (higher interest rate). Easy enough.

However, the system is based upon having some benchmark and standard by which all other debt and interest rates are measured; a starting point if you will. That benchmark has been the US Treasury debt. Every municipal government and every company in America is affected by the rate that the US Treasury pays on its debt. If the rate on US Treasuries goes up, the interest rates on every US dollar-denominated debt will go up. Real estate loans? Yes. Car loans? Yes. Any type of loan? Yes. High interest rates make for slower business activity because higher rates make payments higher and tie up more cash for any given project/loan.

A Little Background

Since its inception, the Federal Reserve has had the privilege of unilaterally determining what rate the United States will pay as far as interest rates go. Think about that for a moment. Imagine if you could just make a general announcement that you are willing to borrow at X% today and have people line up at your door. No negotiation, no points, no credit check, no appraisal of collateral. That's power, and that is exactly what the US Treasury has (as of this writing.)

How do you lose that power? Ask Greece, Ireland, and this week, Italy and Spain. They will tell you that if you borrow and spend too much (abuse the power), then the power will be stripped from you very quickly and without much warning. The United States will wake up one morning, announce the rate at which the US will borrow, and nobody will show up at the door to lend. Imagine crickets chirping....

It is quite a humbling experience and an experience that I believe the US will face if we do not turn our government budget from deficit to surplus. A balanced budget is for status quo and we can't afford that. What we need is an annual budget surplus which would be directed towards systematically paying down our debt to get our national debt level back to a manageable size. It is just like household finances with more zeroes on the end. If you borrowed abundantly to get the kids through college or buy that big house, you have to tighten down later to pay it off. You would not need more loans. More loans would just get you in deeper. Likewise, our government does not need more loans.

What's Next?

Come August 2nd, we can pay the interest on the loans and I do not expect Geithner to choose a default on our bonds. I say "choose" because it would be a choice. Tax revenues would cover the bond payments, but just won't cover everything else and the bond payments. It would be like if you were constantly spending on a credit line (to live above your means) and when you hit the max on the credit line, you decided that the first bill you weren't going to pay was the mortgage so you could continue to eat steaks. To choose to default on the bonds would be a boneheaded move by Geithner (I won't even go there....).

Ramifications

However, regardless of how the budget deal works out, the damage has already been done. If you were China or Japan, our two largest creditors, how would you stomach a public discussion about how we might not pay you back? How likely would you be to loan someone more money when they are talking about not paying you back? Now, to be fair, there are some other complexities in play here, but when you boil it all down, you still end up in the same place. Lenders like to get their money back at the end of the loan. Additionally, lenders also like to lend in an appreciating currency (the US dollar is depreciating and it appears to be on a path for additional decline.)

In the end, if we do some serious budget cutting and get a balanced budget out of this, it could be a significant inflection point in our national financial trajectory. It could change things for the better. While I can hope for the best, I have to plan for the worst.

If we miss our interest payment and default on US government bonds, there will be no hiding from the ramifications. It will touch every corner of the financial globe in some way. However, like an earthquake, it will have an epicenter and the further away you get, the less the damage. The oddest part of this whole mess is that usually, when we have some impending financial storm or mishap, we go to the US Treasury Bonds for our version of a "safe house". Now, our safe house may be the most dangerous place to be. Even putting money "under the mattress" is out of the question because of the potential for runaway inflation.

Coping Mechanism

In anticipation of the safe house becoming more dangerous, I have been making efforts to lighten-up on equities in your accounts while keeping currency diversified by investing the proceeds into short-term global bonds (places like Germany, Sweden, Canada, Switzerland, Brazil, S. Korea, Singapore, Australia, UK, and others). Until we get some clarity, I have to continue to be defensive and continue to look for other ways to diversify.

Remember, if you watch anything about this on TV, the network's goal is to make you watch some more. Sensationalism is first and foremost. Take it with a grain of salt. The most likely scenario is that our government kicks the can down the road a bit and this ends up being political fodder for the 2012 election.

Best Regards,

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