

AUGUST 2011: MARKET COMMENTARY

The Debt Ceiling and Budget Battle reign supreme on most investors' minds. Rightly so, it's a big deal. Yet, keep in mind that this battle is scene I, Act I of a very long drama that will unfold over decades, not just a few weeks. As of this writing, no agreement has been reached, but comments below should be relevant anyway. Regardless of the outcome of these negotiations, future Congresses and Presidents will undoubtedly modify plans and agreements, or even totally disregard them. Whether you're interested in this topic or not, if you pay any attention to politics, the economy, or even general news, it's likely to remain a key issue for a long time.

The stakes are extraordinarily high. The Bureau of Economic Analysis states that total government spending has risen to 37% of GDP up from 27% in 1960. It's projected to hit 50% by 2038. The Tax Foundation reports that the share of federal income taxes paid by the top 5% of earners has risen to 59% from 43% from 1986 to 2008 as tax rates have become more progressive. Over the 24 year period ending in 2009, the percentage of Americans paying no income taxes increased to 51% from 18.5%. Over the past 30 years, our debt has increased to about 100% of GDP from 42% in 1980. We're trending rapidly toward a European economic model – that Europeans are now trying to abandon – yet wonder why we're facing similarly low growth and high unemployment levels.

With this background, the immediate debt ceiling debate faces two primary focuses – positioning for future elections and trying to avoid a debt downgrade. While the first is likely much more important, the second is obviously immediate and could provide more excitement than anyone wants.

Both parties are using the debt ceiling debate to position themselves for next fall's elections. Both sides are trying to highlight their principles – which are exceedingly dissimilar – through appearing resolved, or many would say, stubborn. The current actions are part of a grand drama staged by politicians trying to position themselves as principled and responsible, and the other party as reckless and negligent. Hence, progress will be very difficult.

Standard & Poor's threat to downgrade U.S. debt has substantially elevated the importance of negotiations. The AAA credit rating enjoyed by the U.S. benefits all Americans and most of the world through providing stability and cheap capital. Currently, Standard & Poor's has projected the odds of a downgrade at better than 50/50.

The reasons are easy to see. Not only are the two parties far apart ideologically, when they finally did propose a bi-partisan plan to President Obama, he rejected it. Under these circumstances, meaningful success will remain elusive. To maintain the AAA rating, S&P has said that an agreement must 1) present a credible plan to rein in unsustainable government spending including a sizeable 10-year debt-reduction, and 2) have support from leaders of both political parties. This agreement seems very far off.

Yet, if history is any guide, the negative impact of a downgrade on US financial markets could be short-lived and possibly even negligible rather than catastrophic as routinely suggested.

When Standard & Poor's cut Japan's rating not once but three times between 2001 and 2002, the result was not market chaos or soaring government borrowing costs, but instead a steep decline in borrowing costs as yields fell. Noted investor Jim Rogers suggests the market has already accepted the U.S. as a less-than-AAA credit entity. This may be why financial markets have remained relatively calm while negotiations stall. S&P has tacitly acknowledged the same fact and has admitted that the U.S. already should have a AA rating.

The other major issue is default. While many are again predicting dire outcomes if the U.S. heads down this path, reality would likely be quite different. Obviously, default won't be welcomed by financial markets, but it's also not likely to cause widespread financial chaos. The bigger impact would probably be the loss of credibility by the U.S. government as we demonstrate to the world our inability to govern ourselves.

As mentioned, this story will evolve over many years. As a nation, we have prided ourselves on freedom and free-enterprise, yet we're steadily moving toward a majority of the population becoming vested in a social welfare state with high levels of taxation, government social spending, and state control. Politically, our two major political parties stand for very different things. This issue isn't going to be resolved quickly.

All the attention on the debt ceiling has mostly drowned out the continued strength of corporate America. In spite of the struggling economy, earnings of companies in the S&P500 stock index are the highest in four years a third of the way through second-quarter reporting season. Given recent high levels of earnings already enjoyed by corporate America, continued increases are impressive. Furthermore, about three quarters of companies reporting so far have exceeded analysts' expectations.

In many cases, the gains result from international operations. Even firms seen as typically American highlighted the strength of their operations outside the U.S. McDonalds and GE reported slow growth in the U.S., but excellent revenue increases beyond our borders. And, emerging markets continue to power forward along with many developed economies outside of the Eurozone.

We expect the next few days and weeks to see substantial volatility regardless of the direction discussions take. Even though Washington seems to be completely dysfunctional, private enterprise – and profits – are strong and are likely to remain so. While uncertainty and a government default may hinder some future growth, we don't believe it will derail markets even if it upsets them a bit. Investors need to keep their wits about them in spite of Washington's antics. And, we still think there's still a reasonable chance that this conflict will be resolved. Hopefully, Washington can follow the NFL's lead and reach an acceptable deal in spite of numerous fundamental differences between sides. Like football, politics is a contact sport, and this game is just starting. Hopefully spectators of all types can win somehow.

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