Quarterly Newsletter / Autumn 2013

Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.

It is rare for our Newsletters to be written when the economic and political scenes do not offer compelling issues on which to hang the narrative. The Eurozone crisis, the fortunes of the Chinese economy or the seemingly endless political turmoil in the Middle East have all provided material aplenty in recent issues. On this occasion, the elephant in the room or, more correctly, the elephant and donkey, is the political situation in the United States where large swathes of the government machine have been shut down since the 1st of October by the ongoing wrangle concerning the budget and the level of government spending.

You may be forgiven for thinking that this had all been dealt with and resolved at the beginning of the year (see our Winter 2012/2013 Newsletter) but, to coin a hackneyed phrase, the 'can' had merely been 'kicked down the road' and the issue is likely to dominate proceedings for some time yet, particularly as all eyes are turned to the US to provide the spur for a resurgence in global economic growth.

This is not the first time that a crisis of this type has arisen – it won't be the last one, either! – and the plight is not necessarily disastrous. In fact, since 1976, we have seen no fewer than 18 such partial government shutdowns. In November 1995 and January 1996, for example, there were two similar shutdowns, lasting a combined 26 days. The political balance was the same as today: a Democratic President and a Republican-controlled Congress. On that occasion, it was President Clinton versus Newt Gingrich, the then Speaker of the House of Representatives, and the issues were not that dissimilar to today's problems. It also concerned the level of proposed government spending, and Medicare played an important part in that face-off. This time round, it is the deep-seated opposition to the Affordable Care Act, popularly (or not so popularly!) referred to as 'Obamacare'.

This series of reforms was brought into law in an attempt to address the inequalities inherent in the system of healthcare provision and to provide a measure of security for the estimated 40 to 50 million Americans who cannot afford health insurance. This has incensed the ultra-libertarian wing of the Republican Party which has coalesced around a grouping of Tea Party politicians who see the budget approval as a means of preventing implementation of the reforms. Not even Bill Clinton, himself a keen advocate of such a policy, tried to pursue far-reaching healthcare reform in the face of a divided House. Gingrich estimated that the presidency required something like 70% support in Congress in order to pass such contentious legislation, and Obama currently falls well short of this.

In the nineties, Clinton prevailed by achieving most of his ambitions, and the events seriously damaged Gingrich politically, with his career waning thereafter, although he re-emerged to stand as a candidate for the 2012 Republican Party presidential nomination. However, some observers still believe that the Clinton/Gingrich confrontation led to Clinton's runaway victory over Bob Dole in 1996.

That historical lesson will not have been lost on the traditionalists within the Republican Party, worrying whether the shenanigans of the Tea Party exponents might harm their chances in forthcoming elections. Recent opinion polls show that the American citizens are fed up with their politicians' inability to govern responsibly, and the polls favoured Obama's stance rather than the Republicans. That may well have been an important factor in the Republicans' decision to find a compromise for the time being, but the deep-seated problems will not go away. We unfortunately have to expect the same arguments being debated again in December and January. God help us!

The consensus had broken down in part because the Republican moderates who are seeking the traditional quid pro quo compromise are facing opposition from the increasingly belligerent and vocal Tea Party within its own ranks, thus raising the spectre of a faction that has abandoned the old ‘rules’ and is actually viewing government paralysis as a price worth paying in order to defeat the health measures of what it perceives as a socialist presidency.

We said in our Winter Newsletter that American politicians appear to make a habit of ugly infighting, only for an agreement to be reached at the very last moment, and so it has proved again this time round. However, this political game of brinkmanship is costly for the US economy as a whole. It is estimated that the US loses 0.1% to 0.2% of GDP growth for every week that the government remains closed.

Some 800,000 ‘non-essential’ public servants have already been furloughed – a polite way of saying ‘sent home without pay’ – and visitors from overseas have found parks and museums closed. The US space agency has been hardest hit with 97% of its staff sent home, and only the essential emergency services and the armed forces remained unaffected. All this has a negative effect on the American psyche and is not conducive to their ‘feel-good’ factor, quite possibly affecting consumer spending which is so important for the economy. This negativity would have been exacerbated and become a much bigger problem with the looming postponement of pensions and social security payments by the end of this month.

Furthermore, failure to resolve the debt ceiling problem by today, 17th October, would have had even more serious repercussions. If no agreement had been reached, the Treasury would eventually be forced to break the law in some manner, either by defaulting on interest payments or by issuing more debt without budgetary approval. The only other alternative would have been a drastic reduction in expenditure since current government receipts only cover approximately 80% of budgeted expenditure. Without the facility to bridge this gap by rolling over government debt through the issue of new Treasuries, the US would have been be faced with austerity by default which could have led to a reduction of 4% in GDP over the coming year. That would be tantamount to a serious, deep recession.

The debt ceiling was first introduced in 1917 and was designed to overcome the need for the Treasury to request permission of Congress every time it needed to print banknotes or borrow through the issuance of Treasury bills. Accordingly, an enabling law was passed in order to allow this to happen within prescribed limits which were periodically re-assessed. In fact, the ceiling has been raised 78 times since 1960 as was intended by the proviso linking its automatic extension to the budget requirement. It would be wrong to regard this repeated extension as a failure of the ceiling. Rather than being a restraint on expenditure, the ceiling was intended to work as a mechanism to *allow* government borrowing. This provision for automatic extension was scrapped in 1995 by the Republican-controlled Senate, thus enabling the debt ceiling to take on its current status as a potential political weapon with which to threaten or beat the executive.

Similarly, the requirement for Congressional approval of the budget is not intended to provoke continual stalemate but is rather one of a raft of ‘checks and balances’ on unfettered presidential power, which should ensure that consensus politics prevail. This sounds all very well in theory but can break down should the system be faced with either an ambitious President keen to leave a second-term legacy or an intransigent Congress. Arguably, both have been in evidence this month.

As stated earlier, there have been many occasions when government income has been insufficient without new funding to replace it, thus forcing government shutdowns. On most of these occasions, however, the shutdown occurred over a weekend and lasted only a few days, so that the perceived impact was minimal, the exception being the mentioned 26 day closure under Bill Clinton in 1995/1996.

We have written rather a lot about the political stand-off in America in this Newsletter, and whilst the media have covered the personalities and financials involved, we thought you might be interested in reading about the background of the so-called debt ceiling and the consequences of legislation brought in a long time ago.

In any case, when the world's largest economy cannot agree on budgetary issues and appears hell-bent on either defaulting on its debt obligations or making drastic cuts to spending, then the prospects for the global recovery suddenly look a lot less rosy, and that has an impact on your investments and savings.

Clearly, financial markets have been rattled by all this uncertainty. Witness the relief rally last week which followed Speaker Boehner's conciliatory offer to postpone expiration of the ceiling whilst talks were held. His comments triggered the biggest rise in US stocks for nine months, and much the same happened yesterday after this latest so-called agreement: the Dow Jones added over 200 points.

Looking at the third quarter of 2013 (beginning of July until end of September), stock market valuations have been up, with the Dow Jones leading with an increase of 14.7% (S&P 500 4.7% and NASDAQ 10.8%). The FTSE managed 4%, the Eurostoxx 50 11.2%, the Nikkei 225 5.7% and China 9.5% (CSI 300). Over the first three quarters of this year, only China has recorded a negative performance by retreating some 4.5%.

Hopefully, things will now calm down sufficiently for investor sentiment to turn more positive again, and in that respect we are pleased to note a gradual improvement in the economic fortunes of the UK, China and, dare we say it, Europe.

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