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Asset Management LLC

Six Beacon Street
Suite 925
Boston, MA 02108
Ph: 617.722.8322
Fx: 617.249.2020

Investment Commentary—October 2013

In preparing investment commentary each quarter there is always a slight fear that one's words, no matter how insightful or elegantly composed, will be overtaken by events. This quarter that slight fear has been replaced by near certainty; by the time you see these pages, dear reader, the investment world may have been altered dramatically as the confrontation in Washington, DC over the debt ceiling (as well as the less ominous government shutdown) continues to unfold. We'll take the unusual step of adding a brief update at the end of the commentary for any late breaking developments; in the meantime, let us describe the landscape as we see it now.

To begin, our expectation and hope is that the standoff in Washington is resolved before the U.S. Treasury runs out of cash to pay its bills. If, sometime in late October or very early November, the U.S. defaults on some of its obligations, the financial world will be a very different and considerably more dangerous place.

The phrase "some of its obligations" was chosen carefully. The extreme members of the House GOP who precipitated the crisis are certain that even if the debt ceiling is not lifted, the U.S. Treasury will be able to prioritize payments of principal and interest on the debt. In other words, they assure us, there is no risk of a debt default. One surely hopes and assumes that the Treasury would attempt such a prioritization if necessary, but it's far from clear whether the relevant payment systems could be successfully jiggered to accomplish it. We must then contemplate two scenarios in the event that Congress fails to increase the debt ceiling in time. The more gruesome of the two is a true debt default, i.e. missed payments of interest or principal on Treasury securities. As these securities form the bedrock of the global financial system a debt default could precipitate a financial crisis with unpredictable but potentially devastating consequences.

If the Treasury is able to honor debt payments by prioritizing them over other obligations, the situation is a bit less dire, but grim nonetheless. There would be no easy or painless way to choose between Social Security recipients, Medicare providers, members of the Armed Forces, and others. There would be tremendous discord if such a situation persisted for more than a few days. Confidence would plummet and the economy would take a huge hit. Further, while bondholders would be happy about being paid, they would not take lightly that the U.S. had defaulted on other obligations, perhaps demanding a permanent penalty in the form of materially higher interest rates on U.S. debt.

It's hard to know exactly when, absent an increase in the debt ceiling, the coffers will run dry. The Treasury has identified October 17th as the critical date, but the cash may hold out as late as November 1st when a large Social Security disbursement is almost certain to exhaust any remaining funds. Our baseline expectation is that around the 17th or shortly thereafter, perhaps nudged along by a tumble in the stock market, Congress extends the debt limit for a long enough period of time to enable negotiations over the fiscal 2014 budget to be completed.[1] Let's hope so.

Assuming this benign baseline scenario plays out we remain cautiously optimistic on the global economy. Beginning at home, economic activity in the U.S. has been remarkably resilient over the last couple of quarters. Reading the financial press over the last few months, one might have gotten the impression of a weak economy that is further threatened by the late spring surge in interest rates. True, if one focuses only on GDP (tepid), monthly employment numbers (not so great of late) and the direction of mortgage rates (up, at least until a few weeks ago), the picture looks bleak, but a closer examination reveals substantial underlying strength.

To begin it's critical to view recent economic performance in context. The last-minute (is that redundant with respect to major Congressional legislation?) fiscal cliff deal imposed a burden on the economy by ending a temporary payroll tax cut. This has been compounded by the sizeable budget cuts known as sequestration that went into effect earlier this year (and which had its genesis in the *last* debt-ceiling deal in 2011). Most economists estimate that the resultant "fiscal drag" has been running around two percentage points. Given that GDP has been in the neighborhood of two percent, we could be seeing growth close to four percent (!) were it not for the effects of the fiscal cliff deal and the sequester. And these effects are expected to begin waning right about now and throughout 2014.

What of this summer's weak employment numbers? Job growth that had been running close to 200,000 a month, enough to slowly but steadily chip away at the unemployment rate, dropped to around 150,000 a month over the last three months, barely enough to keep the unemployment rate from going up. We'd be more concerned but for the fact that data on payroll growth is very noisy. This is true even for the final, revised numbers, but is especially true for preliminary estimates, which is all we have for July and August. (We can't comment on the September data which is a casualty of the government shutdown!) Jobless claims, which we often discuss in these pages, are much less noisy and that data series has been on a tear, with the four-week average of initial jobless claims recently achieving the lowest level since May 2007[2].

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[1] In reality, there are countless variations on this baseline scenario depending on the length of the debt limit extension and the clarity of a path to full resolution of the budgetary (and other) issues dividing the two parties. In essence our baseline scenario is for a temporary extension accompanied by an agreement on a process to resolve these differences <u>and</u> a perception that the process creates reasonable assurance of a full resolution. The "reasonable assurance" is where the rub is likely to come and we may be proven too optimistic. If the temporary resolution appears simply to set up the prospect of yet another stalemate, say around Christmas time, it's hard to imagine markets, consumers or businesses responding well.

[2] This data has been muddied a bit in the last month or so by problems with the claims processing system in California. But, even accounting for this, the trend in these figures have been very encouraging.

If things are so rosy, why did the Fed get queasy last month about "tapering" its bond purchases? Our guess, and it's only a guess, is that they were a bit surprised by the extent of the rate spike caused by their initial discussion of tapering. Further, it wasn't hard to see that bad things were brewing in Congress. On that score, perhaps the only question is this: With political observers having months ago identified early fall as the time when disagreements over the budget and the debt limit would come to a head, why did the Fed ever contemplate that it might begin to taper at its September meeting?

Putting the grim picture in Washington to the side (other than that Mrs. Lincoln ...), prospects in almost all of the *developed* economies look better than they did six months ago. Back then Europe was still in the throes of a seemingly endless recession, which can now be seen to have ended sometime in the second quarter. Of course Greece, Portugal and Spain, and, depending on one's definition, Italy, remain mired in a depression. But those economies are shrinking a bit more slowly and countries in the north are growing a bit more quickly and it all adds up to growth for the Eurozone as a whole, even if one needs a magnifying glass to see it. The U.K. which tends to be influenced by its neighbors across the channel is growing now as well. Meanwhile, the Japanese economy continues to respond nicely to Prime Minister Shinzo Abe's program of monetary and fiscal stimulus and structural reform.

If trends in emerging markets were as positive as those in developed markets, the global economy would be a picture of health. Unfortunately, emerging market countries have been beset by a panoply of challenges, ranging from infrastructure overinvestment in China, to rampant inflation and excess consumer debt in Brazil, to a sclerotic regulatory apparatus in India. Still, these problems have been going on for some time and on balance don't appear to be getting any worse. If, as seems most likely, emerging market economies can simply continue to grow at what feels like a subdued pace (about 4.5%) compared to the breakneck speed of years past, momentum elsewhere will lead to a modest though admittedly tenuous acceleration of global GDP.

Of course all of that assumes a smooth (or smooth enough) resolution of the latest debt ceiling crisis. Such a resolution seems likely but by no means assured.

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Boston, MA

Late Update: Senate Majority Leader Reid and Minority Leader Mitch McConnell appear to have struck a deal that will keep the government funded until mid-January, extend the debt limit through early February, and set up a committee to resolve budget differences. Speaker John Boehner will likely put the deal to a vote in the House where, mostly on Democratic votes, it should pass. Time will tell whether this is the beginning of a longer-term resolution or only a temporary respite.