Integra Market Insights

Equity Associates Inc.

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Issue #21 - "Democracy at '*Work*'"

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'Democracy is the worst form of government except all those other forms that have been tried.' - Sir Winston Churchill

With the shutdown in Washington officially underway as of 12:01am this morning, we have decided to focus this month's IMI on the developments south of the border.

What's going on?

The most immediate concern is that thanks to a 'do nothing' congress, federal spending has been suspended to mandatory services only. This means that the US government does not have the authority to pay for the salaries of approximately 800,000 federal employees, meaning they have effectively been temporarily laid-off until a budget can be passed.

To compound the matters, the debt ceiling debate will resurface as the US government has once again reached its limits of borrowing capacity, as arbitrarily defined by congress. Should no deal be reached by October 18th, the US government could default on its debts, which would have important ramifications on the worldwide economy.

Why is this happening?

The republican controlled House is being held hostage by 'Tea Party' conservatives who are using their power to 'do nothing' in hopes of forcing concessions from the democrats. In the republican cross-hairs are Obamacare, entitlement reforms, a rollback of environmental regulations and the approval of the KeyStone XL pipeline. In response to these requests, President Obama asserted "I won't negotiate on anything when it comes to the full faith and credit of the United States of America."

What is the debt ceiling?

The debt ceiling is an arbitrary number decided by congress that sets the borrowing limits for the US Government. Think of it as the limit on a personal line of credit you might have with the bank. As the US debt approaches that ceiling (or limit), by law, it is unable to borrow further until that debt ceiling is lifted.

What would be the impact of raising the debt ceiling?

Short-term impacts would be nil as it would allow for continued support of the US recovery. Over the long-term, it would send the US further into debt, which will ultimately have to result in higher taxes or cuts in social spending programs.

What would be the impact of NOT raising the debt ceiling?

In theory, this would have severe long term impacts as it would result in the US not paying its debts on time. Think of what happens when you let a bill go unpaid as you don't have enough cash on hand to make the payment? Your bank starts to call, your credit rating takes a hit and suddenly when you want to go borrow, you need to pay a lot more interest. In short, it would affect the credit worthiness of the US at a fragile time and more than likely result in its losing reserve currency status. Now, in practice, we do not believe this to be likely as raising a purely notional number can be resolved with the flick of a pen and many alternatives are available to avoid this calamitous scenario.

Is this the first time the US reaches their debt ceiling?

Not by any means, since it was introduced in 1940, the debt ceiling has been raised over 100 times, 7 of them during the Bush Presidency and 18 times during the Reagan administration. Some of you may recall that during the summer of 2011, this same 'crisis' unfolded thanks to the leadership (or lack thereof) of the same Speaker of the House, John Boehner. The short term consequences of this politicking was an important drop in the value of the US stock market, which once resolved, lead to one of the great bull markets of the last decade.

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Issue #21 - "Democracy at '*Work*'" Page 2

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Is this the first time the US shuts down government?

Since 1970, there has been 17 government shut downs. The most recent was in 1995 and in 1996 during the Clinton administration, when republicans led by Newt Gingrich caused a government shutdown of services. The first lasted five days, while the second only affected certain parts of government yet went on for three weeks. This ultimately led to a period of growth and balanced budgets.

Why all the fuss then?

In our opinion, there are two major reasons why the two parties are at such an impasse at present.

1. Politics!!! As usual, some politicians are thinking of their own party rather than thinking of the greater good and so are throwing sticks in the wheels. It certainly does not help that in 2006 a young senator from Illinois (Obama) voted against raising the debt ceiling while the United States was involved in two costly wars, while at the same time the "Tea Party" Republicans have promised their constituents a tougher stance on government spending.

2. Divergent opinions on how to address the problem. Republicans are taking a simple approach at relieving their debt burden, to cut spending (without touching the military!!!). Democrats want a blend of reduced spending and tax reforms to improve revenues.

Is this a good thing or a bad thing?

In the short term, this will likely mean increased volatility on the stock markets, but for those who are taking a long-term approach this will likely mean some good buying opportunities.

The fact that the US is taking a proactive role in fixing their debt problem is a positive one when compared to the many European countries that are simply pushing the problem to a later generation by further increasing their debt levels without considering the eventuality of dealing with them.

In actual fact, Japan has a much more severe debt burden than the US, as do many European countries. The key difference here is that the US maintains a considerably lower income tax rate, thus giving them a lot of room to manoeuvre. For anyone who has ever travelled to the US to buy goods such as beer or cigarettes versus those purchased here in Canada or even Europe, it is easy to see that the US can stand to increase some taxes. That is not the case with some of the higher-taxed European countries who will have to go back on social promises such as pension plans starting at age 60, or fully paid health care systems for all citizens in order to meet their financial obligations.

What does this mean to you?

A rougher ride for international investors as the US economy is held hostage by narrow-minded men concerned with their self-interest rather than that of the greater good. No doubt, fear will creep its way back into the investor mindset and we will likely see a few days of market selloff. Over the long-term, I believe this presents a great opportunity for Canadian investors looking to increase global holdings as this man-made crisis will likely mean a short-term drop in stock prices as well as the USD vs the CAD. This means cheaper prices combined with a higher purchasing power for Canadians.