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The Federal Debt Ceiling Crisis and Your Portfolio

First and foremost, I think the words found on the cover of The Hitchhiker's Guide to the Galaxy are appropriate here: "DON'T PANIC."

This game of fiscal "chicken" in Washington is childish and dangerous, but it is critical to remember that the United States economy is a heck of a lot more than the federal government. We really do not know what will happen if the debt ceiling is not raised other than that a lot of federal payments to people and organizations will not be made. Companies dependent on the feds for their business will certainly take a hit. I would reasonably expect that interest rates would rise across the board on U.S. Treasury securities, with a corresponding decline in their market value. At the same time a lot of money that otherwise would be loaned to the federal government will need to find a place to earn interest, so we could see the high grade corporate bond market actually rise. One thing for sure is that a lot of economic assumptions will go out the window.

Members of Congress are commonly elected after promising pie in the sky and everything from jobs to great wealth for everyone. It has always been sort of a game in which they would make unrealistic promises and then come home later to explain that they fought the good fight but were overcome by the system. This time, a majority of Republicans in the House of Representatives made some promises, and even signed a pledge that they would not raise the debt ceiling of the United States Government until some things happened over which they have no control. As a result, they are now honor-bound to do their best to crash the system.

In the midst of this crisis, I think it is good to review what the real issue is here. As recently as 2000, we had a substantial surplus revenue flow into the federal government when compared with the expenses. Our elected representatives made the decision to reduce the revenue rather than using it to pay down the debt. After 9/11 we increased spending to fund the new Department of Homeland Security and got very thoroughly involved in two (and now maybe three) wars. The mortgage security meltdown and the ensuing financial crisis were halted with another batch of spending, although not anywhere near as much as we have spent on the wars. We then had a relatively severe recession and now some relatively high unemployment. Recessions and unemployment decrease the revenue coming in to the government while mandating a greater outflow. Somewhere in the midst of all of that our elected representatives also passed into law the largest entitlement program, at least in terms of dollars, in our history, the Prescription Drug Benefit.

We are facing several problems at the same time. First, we failed to use the surplus in the early 2000s to pay down debt, instead opting for a tax-cut. Not too surprisingly, the deficit came back the next year. Second, we piled on quite literally trillions of dollars in legally mandated spending (the wars, Drug Benefit, Homeland Security, and three stimulus bills) without spending cuts and then we lowered taxes again. The only thing surprising about the current situation we have now, is that the members of Congress who voted for those spending laws without any visible source of revenue appear to be both surprised and angry that spending more

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than we take in has resulted in a lot of debt.

Don't get me wrong, I am one of those people paying lower taxes today than I would have under the old law, and I don't like writing checks to the IRS any more than anyone else. I recognize though that wars are expensive and we have to pay for them somehow. I also recognize that getting expensive medication into the hands of people over 65 was a critical issue in some cases. What I don't understand is the rationale behind supporting those high dollar spending bills while at the same time demanding that taxes be cut and the government not spend more than it makes.

Now we have some of the same members of Congress who championed all of those spending laws threatening to not pay the bills they ran up unless someone else agrees to somehow make it all go away. Frankly, the issue at hand is the wrong issue. Congress passed the laws mandating the money be spent. Most of the big tickets that are breaking the bank were passed when the same party had control of the House that has it today.

That is where we stand today. The conservative Republicans in the house will not tolerate any removal of the tax cuts and frankly, there is simply not enough discretionary spending in the whole budget to bring it into balance. As Jake has pointed out, the current revenue stream the federal government takes in could support Social Security, Medicare, Medicaid, and the Defense Department, and then we would be out of money; nothing for air traffic control, nothing for the Border Patrol, the Coast Guard, education, or anything else. That is where we stand.

Regarding your portfolios, we started exiting Treasury obligations months ago and our exposure to direct treasury risk is quite small. That does not mean that the stock market and the bond market might not take a plunge, but the reality is that American companies are doing quite well. As second quarter earnings have come in, the vast, vast majority of publicly traded companies are reporting they are earning much more profit than was estimated. Once a fix of some kind on the debt issue is in place the markets will rebound and I am convinced at some point investors will recognize that the world is not coming to an end and that stocks are cheap.

Meanwhile, my strong recommendation is to "hang in there." If the worst-case scenario plays out, then there will be no place to hide. If, as I suspect, our elected representatives come to their senses, then we will emerge stronger and better off than we are today. Either way, the best thing to do is to continue to invest for the long term and ignore the short-term craziness.

If you have comments or questions, don't hesitate to write.

Jeff McClure