

# **KWAG August E-mail Update**

## **The Good, the Bad and the Ugly**

Good Morning. Unless you have been traveling in the remotest area of the globe, you have no doubt heard the news that the U.S. Government is about to default. The problem is, a default isn't really an option and never has been. In order to default, the U.S. Government would have to suspend scheduled interest payments on our outstanding Treasury securities, which has essentially zero chance of occurring. Even if the current debt deal wasn't passed by the Senate, there are a number of other scenarios that could play out. Almost no one believes any of these would include an actual default by the federal government. We realize this may come as a surprise if you follow the news, because practically all you hear is that the government will default if the debt deal isn't passed. This is either ignorance on the part of the media, a blatant attempt to incite fear and panic in order to boost ratings, or some combination of the two. In any case, it's another example of the kind of irresponsible journalism we've sadly become so accustomed to.

## **The Markets**

Given the inflammatory tone of the coverage of the "potential" debt default, the financial markets have behaved quite calmly. Over the month of July, the S&P 500 declined 2.15% and the Russell 2000 fell 3.67%. Dips of this magnitude are common and nothing out of the ordinary and certainly don't portend panic or concern on Wall Street. In fact, most of the selling pressure in stocks over the past week seems to be coming from individual rather than institutional investors. Individual investors, perhaps spurred by inflammatory news stories, are notorious for panic-selling near market bottoms.

## **Our View**

As is to be expected, we've fielded some concerned calls and emails over the past few weeks, and these have increased as we've moved closer to the much publicized August 2<sup>nd</sup> deadline. The message we deliver each time is that we're not concerned about the effects of Washington's dysfunctional nonsense on the long-term health of our client portfolios, and should the volatility present significant opportunities, we will take advantage of them. Our view has remained unchanged throughout this uncomfortable period because, the political gamesmanship aside, this problem can (and will) be fixed with the stroke of a pen. That said, we expected volatility to flare up and felt it would likely intensify as we got closer to the August 2<sup>nd</sup> deadline, which is essentially what occurred.

### **Investing in the Global Economy**

In our recent newsletter we outlined why we feel confident about our global portfolios going forward. Remember, our fund managers are buying well-run, global companies who, in most cases, are reporting record cash flows and healthy profitability. Thanks to our dysfunctional Washington politicians, those companies are now on sale! In fact, the current political posturing provides yet another opportunity to reaffirm that we invest in the global economy, which is far removed from the turmoil that might be occurring in Washington on any given day. As a refresher, here's why the global economy, not Washington, will drive the financial markets over the long-run and how we feel we can best position our client portfolios as a result.

1. There are significant global macro-economic and demographic factors that will drive corporate investment and profitability for years to come.
2. The best way to participate in this profitability is by owning publicly traded companies.
3. Companies today are largely global and therefore more insulated from both the domestic economy and the whims of our politicians.

4. Companies today are enjoying access cheap and abundant labor, and very low-cost capital, making it easy for them to expand and boosts their profit margins.
5. The best way to find and invest in the best positioned global firms is through money managers who are highly skilled and have years of experience.
6. Even skilled and experienced managers need to be monitored, however, and we do this continuously.
7. Research shows that the most successful investors tend to be those who maintain a long-term perspective, hold well-diversified portfolios, and rebalance their portfolios as needed. We adhere to these tenets religiously.
8. We think it's critical for investors to recognize and embrace inevitable short term volatility in the financial markets, and use it to their advantage.
9. It's critical for investors to reduce "market frictions" over the long run, which is why we focus on minimizing fees, taxes, and transaction costs.
10. We are "evidence-based" investors, driven by a logical, research-driven investment process that has been shown to maximize the likelihood of success over the long-term.
11. We are a client centric firm and remain dedicated to each client's unique individual needs.
12. We love what we do and we're passionate about it. We are incredibly blessed to have so many clients who place their trust in us and we take this responsibility very, very seriously.
13. We believe it's important to practice what we preach, which is why we invest in the exact same managers that we recommend to our clients.

So while we recognize the current political shenanigans in Washington make some people uncomfortable, it's important to recognize this is a short-term

situation and that it will be solved. As such, it will have no impact on the long-term success of your portfolio. In fact, the associated volatility may even provide opportunities for long term investors to take advantage of via rebalancing or investing additional funds.

### **America's Deficit 101**

Okay, now that we've put fears of an imminent default to rest, we still believe it's instructive to examine five issues that are necessary to understand before you can begin an honest debate about how to deal with our debt situation. Specifically, we have included a link to five charts that was forwarded to us from a friend who has no "dogs" in the political fight. He felt this group of tables would provide some much needed perspective on the current debt picture and we agree.

### **Charting Our Crisis: A Primer**

The following link:

<http://www.nytimes.com/interactive/2011/07/28/us/charting-the-american-debt-crisis.html?hp> examines five key areas we all Americans should probably be aware of. While we don't think the current debt-ceiling issue will play a major role in our portfolios over time, the debt and deficit debate will be with us for some time and we believe everyone needs to be aware of some of the more basic facts surrounding the discussion. The five charts, in order, display the following:

1. An estimate of when the US will run out of money.
2. Payments the government will need to make after August 2.
3. When and how the national debt was accumulated and who holds our bonds.
4. How often the debt limit has been raised in the past and debt as a percentage of GDP.
5. How bond rates could rise if our debt is downgraded.

These charts provide a nice, easy to understand overview of the debt picture. Specifically, they provide a sense of proportion and provide a clear picture of what the issues are. The first table provides a “window” of when the debt ceiling will be reached. The actual date of when this will occur is still not certain, even though most believe it is several days beyond the August 2nd date being used by the press and the federal government.

The second table is interesting because it shows which bills are due on various dates going forward. By raising the debt limit, the government can issue NEW debt to cover a number of essential bills which include social security and a number of federal paychecks. In other cases - like those when short term debt matures - some argue that we could just rollover (or refinance) that debt without any real effect on our current debt picture. The truth is, we probably have until August 10th to raise our debt limit, which is why you have seen our markets trend downwards in a slow organized fashion. As we mentioned earlier, trading volume has been light of late and appears driven mostly by panicked individual investors rather than “smart” institutional money.

### **Debt Accumulation & Debt Holders**

The third table is interesting for a number of reasons. To us, how we got here is largely irrelevant. What matters most is where we go from here. That said, it’s probably important to note that everyone who has held office over the past 30+ years bears some responsibility for getting us to this point. Since we’re the ones who elected them, we bear some of the responsibility as well. However, what is perhaps more interesting is who actually holds our debt. Many American’s have been led to believe the Chinese hold most of our debt and thus play a vital role in how our country operates. This table clears up this misconception, showing that of the \$14.3 trillion in debt, China holds \$1.2 trillion, which represents 8% of our outstanding debt. Private U.S. entities (individuals, banks, corporations, pension funds, etc.) the Social Security Administration, the Federal Reserve, and other

governmental agencies hold \$9.8 trillion or 69% of our outstanding debt. How many American's knew that?

### **Raising the Debt Limit**

Table four shows how often we have raised the debt limit since 1960. Over the last fifty years, the debt limit has been raised 78 times, usually without fanfare or even a mention in the popular press. The debt ceiling will be raised this time too. To those of us who follow such things... that's a given. However, what's more important is the level of debt as a percentage of GDP. Increasing the debt ceiling has never been a problem in the past because the economy has typically grown more rapidly than the debt. In recent years, however, the pace of spending has increased and revenues, impacted by two recessions, have decreased. So today, because the economy is growing at such a tepid pace, any increase in the debt ceiling will be contentious since it will result in a higher "Debt to GDP" ratio. In other words, the key issue is not the debt level itself, but the debt level compared to GDP. If we want to solve our debt problem, we either need GDP to grow faster – which is likely not going to happen anytime soon – or we will need to reduce our annual deficits. As we have said many times before, lower interest rates (thanks to the Federal Reserve) have kept interest payments low and given us time to deal with the deficit problem, but it's still something we have to address, and soon.

### **Worst Case Scenario**

The final chart shows interest rates on government debt across the globe. Interest rates are a function of a number of things, including but not limited to; liquidity, term structure, inflation, solvency, the percentage of domestic versus foreign debt holders, and credit worthiness. So even though credit rating agencies could reduce our AAA credit rating, we're not convinced it will have huge effect on interest rates or the desirability of our debt.

In addition, Australia and Canada both had their debt ratings decreased in decades past and both used those events as opportunities to fix their domestic balance sheets. Today, both carry a triple AAA rating. So if our credit rating was decreased, we believe it will act as a wake-up call for Washington to quit playing politics with the nation's finances and fix what's broken.

## **In Closing**

As usual, if you have any questions or concerns regarding our updates, your portfolio or any of our investment strategies, please feel free to contact us immediately. We always look forward to hearing from you and appreciate all of your referrals.

## **Joe and The Gang at KWAG**

### **KIELY GROUP ADVISORS & OFFICES**

#### **Asheville, NC**

Joe Kiely, PhD

[jkiely@thekielygroup.com](mailto:jkiely@thekielygroup.com)

828-350-8681

#### **Sunset Beach, NC**

Brownie Cordell, RIS

[bcordell@thekielygroup.com](mailto:bcordell@thekielygroup.com)

910-579-8075

#### **Greenville, NC**

Scott Below, PhD

[sbelow@thekielygroup.com](mailto:sbelow@thekielygroup.com)

877-366-5623

#### **Katie Burr**

Kiely Wealth Advisory Group, Inc.  
Operations & Client Services Director  
Chief Compliance Officer  
4405 Stafford Glen Court  
Oak Ridge, NC 27310  
336.298.4316

*This e-mail is confidential and may well be legally privileged. If you have received it in error, you are on notice of its status. Please notify us immediately by reply e-mail and then delete this message from your system. Please do not copy it or use it for any purposes, or disclose its contents to any other person. To do so could violate state and Federal privacy laws. Thank you for your cooperation. Please contact Kathryn Burr at 336-298-4316 or e-mail [katie@thekielygroup.com](mailto:katie@thekielygroup.com) if you need assistance.*

*Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable. Past performance may not be indicative of future results. Please remember to contact Kieley Wealth Advisory Group, Inc. if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. Please also advise us if you would like to impose add. or modify any reasonable restrictions to our investment advisory services. A copy of our current written disclosure statement discussing our advisory services and fees continues to remain available for your review upon request.*