Bragg Financial Advisors: Our Thoughts about the Debt Ceiling Standoff in Washington

July 27, 2011

We Are Not Recommending Changes to Client Portfolio Allocations
You have likely been following the debate in Washington regarding an increase in the federal government debt limit. The government estimates that it will be unable to meet its financial obligations if an increase in the debt ceiling is not approved by Congress and signed by the President by August 2. While we expect market volatility to persist throughout this time of uncertainty, we think it makes sense to stick with a long-term investment plan. If we knew we could go to cash temporarily as the market fell and then step back into the market at lower prices "once the danger had passed," we would certainly do that. We simply do not know if or when the market will fall and if it does, we do not know how much it will fall. We certainly won't know when "the danger has passed," as there will always be something to worry about.

In the next few days, the market may drop as a result of a failure of our elected leaders to reach an agreement, but on the other hand the market may rise on news that an agreement has been reached. Trying to time the market is just a tough game to play and one that we fear we will lose. Losing at the "game" of market timing can be extremely expensive. Having said that, if you would like to discuss your allocation or if you would like to make a change, please let us know.

We Think an Agreement Will Be Reached
We believe that the potential economic fallout resulting from a failure by our elected leaders to increase the debt limit would be sufficiently catastrophic to move them toward a solution before the supposed August 2 deadline. Failure to reach an agreement would likely result in an immediate contraction of the economy as the result of a government shutdown and could potentially result in a default on US Government debt. An agreement to raise the debt could either take the form of a band-aid or a more constructive long-term fix to our nation's fiscal problems.

The Real Problem
The current battle over the debt ceiling is but a symptom of a larger problem that we think is of great concern to us as investors. That problem of course is the absence of a long-term plan to deal with our country's burgeoning debt and unsustainable deficit spending. It is crucial that our country develop a credible plan to tackle this issue in order to maintain the nation's AAA credit rating that we have enjoyed since ratings were first issued by Standard & Poor's in 1941.

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A true long-term fix will likely require higher tax revenues or lower government spending, but more likely a combination of both. While these solutions could certainly have a dampening effect on the economy, we believe taking the medicine today is the wise course. The other option is to raise the debt ceiling without substantive budget adjustments, effectively kicking the can down the road. While this would avert the disaster and possible default, it would not rule out a downgrade by the rating agencies, which could cause significant turmoil in financial markets.

The deteriorating finances of the Federal government have caused the rating agencies (Moody's and S&P) to question the ability of the US to service its debt. On July 13, Moody's placed the US government rating on review for a possible downgrade, stating that it "considers the probability of a default on interest payments to be low but no longer de minimis." On July 14, S&P made it clear that they would be looking carefully at the details of any agreement to discern if it is credible, saying, "We may lower the long-term rating... into the 'AA' category... if we conclude that Congress and the Administration have not achieved a credible solution to the rising US government debt burden and are not likely to achieve one in the foreseeable future...If Congress and the Administration reach an agreement of about $4 trillion, and if we conclude that such an agreement would be enacted and maintained throughout the decade, we could, other things unchanged, affirm the 'AAA' long-term rating..."

The US has never experienced a downgrade so it is impossible to forecast what would result. At a minimum we would expect higher borrowing costs across the board which could impede economic growth. In this event, corporate earnings and employment could be under pressure. Worst of all, a downgrade would mean that we haven't solved our nation's fiscal issues, and the climate of uncertainly would continue.

You may recall reading the article entitled "The Three Little Pigs" in our 1st Quarter Investment Commentary. It describes the connectedness between our government, our consumers, and our corporations wherein the poor health of one will eventually affect the others. Click here to read that article.

The debt ceiling debate has focused tremendous attention on this issue. We are hopeful that this intense focus will move us toward a more sustainable path going forward.

Thank you for choosing Bragg to help you with your financial planning and investing. Please let us know if you would like to discuss this or any other issues on your mind.

Sincerely,

Benton S. Bragg

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