Market Turbulence Ahead

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This is your captain speaking…

When you're on a commercial flight, and the plane is approaching turbulence, the captain comes on the intercom to let you know to buckle up and expect 'rough air.' There should be similar warnings about 'rough air' in the markets, and this is a good time to offer one.

The market turbulence that we see approaching is a consequence of the debt ceiling debate—or, rather, the refusal of Congressional leaders to agree to raise the limit on the number of bonds the government is allowed to sell to finance its operations. The legal limit on the amount of Treasury debt that the government can issue is periodically raised—and it is always because Congress has already authorized a budget that will exceed the debt limit.

Yes, you read that right. Congress created a gap between revenues collected and expenditures and now is threatening not to authorize the payments that were approved. Don't try this at home.

Of course, this is a political issue, as are all things in Washington. Republican leaders, who control the U.S. House of Representatives, believe that their colleagues on the other side of the aisle will be so appalled at the idea of the wealthiest nation on earth defaulting on its fiscal obligations to bondholders, Social Security recipients, and government employees that they will be willing to negotiate Republican-proposed spending cuts, including reductions in federal health care, science, and education. Among the few specific proposals is a rule requiring low-income Medicaid recipients to work for 80 hours a month, blockage of the proposed student debt cancellation, and a repeal of a variety of green energy initiatives. The most contentious proposal would scale back medical benefits for military veterans.

Ironically, the Democratic budget proposal would reduce the federal deficit, over the long term, by $3 trillion. But instead of budget cuts, it would raise the highest corporate tax rate from 21% to 28% and impose a 25% minimum income tax on billionaires. The proposal would also raise the highest tax rate for couples earning more than $450,000 to 39.6%.

How likely is a default? The U.S. government actually hit its maximum debt ($31.38 trillion) on January 19 and has since been relying on accounting tricks like deferring pension investments in order to keep the doors open and the bond payment checks from bouncing.

We are now on a near approach to what insiders call the 'x-date,' the unspecified time when those measures will be insufficient, and the government will have to start deciding who to pay and (more to the point) who not to pay out of its diminishing resources. It's worth pointing out that previous debt-ceiling brinkmanship caused credit agencies to lower America's credit rating—once the highest in the world.

You can bet that quick-twitch traders, whose activities drive short-term market movements, are carefully watching this dance on the edge of default. If the government does run out of its ability to pay bondholders and workers, those traders would most likely retreat to the sidelines, and there would be at least short-term panic among lay investors who would see sharp lurches in the value of their stock holdings. None of this would affect the actual value of shares of stock (or the value of public companies) in any way, but in the short-term, especially when there are screaming headlines of potential default and dire economic consequences, confidence (or lack thereof) trumps rationality every time.

You know that, sooner rather than later, both sides will come to an agreement that the U.S. should pay its obligations, and some semblance of normalcy will be restored. In the meantime, the captain is advising you to fasten your seat belt.

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Jeffrey Broadhurst
MBA, CFA, CFP
Broadhurst Financial Advisors, Inc.

*****PRIVACY NOTICE*****

Our physical and mail address:
1911 West Point Pike
P.O. Box 301
West Point, PA 19486-0301

Contact us:
Phone: (215) 325-1595
Email: jeff@broadhurstfinancial.com