Market Update: 10/9/2013
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Good morning!

It has been impossible to escape the news and commentary on the prospects of an impending government debt default, which has greatly elevated over the last 9 days given the actual government shut-down. October 17th (next Thursday) has been identified as the day that the federal government will run out of money to pay its debts unless Congress agrees to raise the "debt ceiling", (a.k.a sanction additional borrowing capacity that will be utilized to satisfy its outstanding obligations). These debts are in the form of bills, notes and bonds issued by the government to take in cash to run the operations of our country.

Tensions in Washington are high as the inability of the 2 parties to engage in civil conversations has been a clear impediment to resolving their differences though productive negotiations.

Those tensions have spilled into the financial markets. In just 3 weeks, the Dow Jones Industrial Average has fallen almost exactly 900 points (or just shy of 6%*) and the short-term interest rates have exhibited spastic fluctuations (as an example, the yield on the 4-week Treasury bill has jumped from .0025% to .2625% over the same time period*).

In an effort to dissect the headlines and their prospective impact on our clients' portfolios, I wanted to initiate the first of several communication installments as we approach the deadline date. In each installment, the intent is to dissect one element of the debt ceiling/debt default debate and ultimately identify consequences of various outcomes. None of the installments are intended to supplant conversations with clients and we look forward to working through this situation together.

**Source: Bloomberg Market Data*

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Why the prospective government debt default is different than Lehman Brothers bankruptcy/credit default.

There has been a great deal written comparing the prospective failure of the US to meet its existing loan obligations (pay its interest and principal) to that of Lehman Brothers' bankruptcy in 2008. I think that there are far more differences than similarities and the differences are stark. Here are a few:

Lehman Brothers had very ambiguous counterparties due to the complex web of levered and securitized products within which they trafficked. Huh? Exactly! Lehman didn't just borrow money like the US government does; it was far more complicated than that.

Lehman bought loans of a similar type; sub-prime mortgages were a particular favorite, packaged them into a single security (a.k.a. securitization) and then sold them to investors. The investors were enticed by the high interest rates and the presumed high credit quality. (Many such loans were highly rated by the credit ratings agencies and therefore qualified for ownership by stringent entities.)

The demand for these types of debt products became so high that Lehman borrowed money themselves (a.k.a. leveraged their balanced sheet) to increase their capacity to act as a counterparty to the sellers and buyers of these loans. Such a process often required Lehman to hold these leveraged loans on their own books or at least create a deferred liability to deliver the stated rates of interest to the borrower. (Amazingly, sometimes these loans didn't even have specifically identifiable collateral – those that went by the *what-could-be-wrong-with-that!* title of: synthetic loans.)

Ultimately, for reasons too long to rehash, the payment streams - the cash flows upon which a bond's value is predicated - dried up, setting off a domino effect of defaults. This sent the promisors scrambling to minimize their identifiable liabilities and left Lehman holding a bag of devalued debts that was larger than their asset base, especially when magnified by the leverage they employed. More debts than assets equals insolvency.

Lehman had lost the confidence of the market/investor community, rendering it unable to borrow additional dollars to buy them time to rehabilitate their wretched balance sheet.

In my opinion, the US government would not be deemed insolvent were it to default on its debt for 2 important reasons:

1. A default today could be deemed "technical" because it would be the result of the government's unwillingness to pay, not its ability – completely different than that of Lehman Brothers;
2. The US government maintains its taxing authority as a future funding source to service its debts as well as its printing press – also completely different than Lehman whose operations, and subsequently its earning ability ceased in its debtor reconciliation process.

The US can and will avoid, again in my opinion, an actual default, but the longer it takes to commit to a sustainable funding strategy, the deeper the perceived consequences.

For instance, immediately before Lehman declared bankruptcy, its debt carried an investment grade credit rating. Such a rating is required for a company's bonds to be held in many money market funds – often considered interchangeable with cash. Upon default, and the immediate downgrade of their debt, not only did the money market funds have interest payment disruption, but they were required to sell the bonds, adding insult to injury. Such would not be the case were the US to technically default, as the payment disruption of sovereign governments is due to a lack of willingness, not lack of ability, to make interest and principal payments. The differentiation is critical as it relates to an overall assessment of creditworthiness.

IMPORTANT DISCLOSURES

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