Treading Where No Market Analyst [Perhaps] Should Go!

This is a very tenuous juncture for the market, and yet another stressful time for investors. Yet one can't help but argue that a great deal of both the financial and emotional distress is self-induced – by Washington.

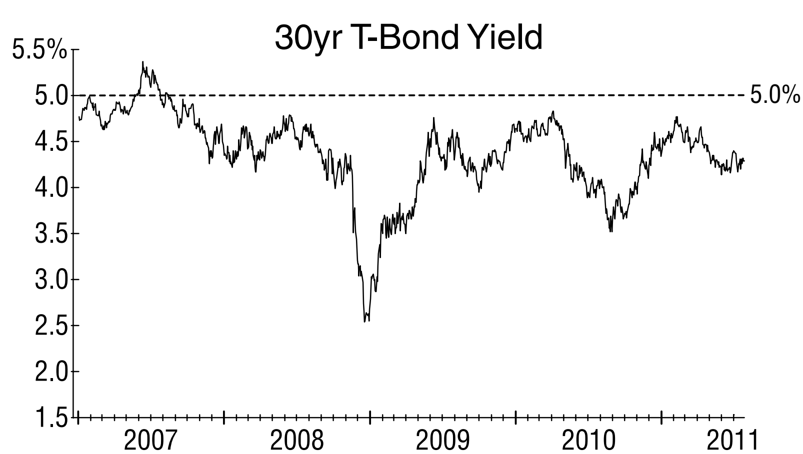
I generally try to stay out of the political discussions and debate in my Personal Perspective. One reason is that no matter what you say, you're going to step on someone's toes. And we deeply value every one of our subscribers – regardless of their political affiliation or affliction (just kidding!).

However, there are several observations about the current business climate, economic outlook, and political debt/default debate in Washington that I need to share. For if most (or even some) of what I perceive is correct, then it will help in understanding the likely investment scenarios ahead.

About the debt limit debate and possible U.S. default

I'm going to share a few thoughts or insights from a special letter that we sent out earlier this week to all Stack Financial Management clients:

- First, if the Federal Government actually defaulted on Treasuries, it could indeed have serious long-term economic and monetary consequences. But the likelihood of such a default is virtually 0%.
- The reason for this is the U.S. Government still takes in far more tax revenue each month than is necessary to pay interest on its debt [same for Social Security payments]. A great deal of what is happening in the media headlines is political posturing and emotional rhetoric.
- So failure to raise the debt limit by August 2 does not mean automatic default. If you perform an Internet search on "Clinton + debt limit + 1995" you will discover this same congressional showdown occurred 16 years ago. It was accompanied by identical fearful headlines and warnings of dire consequences, including this one from Federal Reserve Chairman Alan Greenspan: *"To default for the first time in the history of this nation is not something anyone should take in any tranquil manner."*
- In the final months of 1995, the Federal Government did fail to raise the debt limit and had to shut down, not once but twice (for a total of almost four weeks), before a political resolution to raise the debt limit was reached. But there was no default. And in spite of Washington's current fear mongering, the U.S. is not facing imminent default if the August 2 date is missed in raising the debt limit.
- At this stage of the showdown, the above message is strongly reinforced by both the U.S. dollar and 30-year T-bond yield. If default was indeed imminent, then the dollar would be plummeting and long-bond yields would be soaring. They're not.



(Continued on page 8…)

(Continued from page 7...)

About confidence – both consumer and business

Yet it's not that the political game playing and philosophical debate in Washington don't matter. That creates uncertainty. And uncertainty creates nervousness among consumers. And nervous businesses do not expand or hire.

While trying to stay out of most of the political debate, I must strongly agree with the notion that government spending does not create jobs. It can only create projects that help soften or shorten the impact of an economic recession. But those jobs are gone as soon as the projects end. Only business can create long-term employment. And government has the opportunity to provide incentives for creating those jobs… or not creating them.

There are at least three major political headwinds that the current economic recovery is struggling to overcome:

1. **Unknown health care costs.** Regardless of one's political position on the health care legislation that was passed in March 2010, the fact is that businesses –both large and small– have no idea what their final expense will be when the law is fully implemented in 2013-14.
2. **Concern about both personal and corporate tax increases.** Again, it doesn't matter which side of the political aisle you're on, the fact is that half the pundits in Washington want to raise taxes. And the more successful you are as a businessman, small business, or corporation, the larger the target that is painted on your back.
3. **Long-term fears about deficits and debt.** The media has done an excellent job of highlighting the dire consequences of the U.S. continuing down the current deficit path or defaulting on its debt. In fact, too excellent! How can any business –large or small– feel optimistic about their five year outlook when the media has portrayed that the U.S. is on the edge of a financial Armageddon?

How will all this uncertainty play out? That is anybody's guess. But in the meantime, these concerns are definitely keeping business on the defensive. And that's a major reason there has been so little job creation in this economic recovery – even in businesses that are doing extraordinarily well. Most business people I talk to are preparing for higher taxes, higher health care expenses, and the next economic downturn. There's not a lot of time to plan for the future if all you're doing is worrying about it. ***And that, in my personal perspective, is where Washington has shot this economic recovery in the foot.***

This economic recovery has been forced to climb out of the deepest recession since the 1930s. It's difficult to imagine where it would be today if not for the above headwinds, but we believe it would undoubtedly rest on stronger footing. And as shown by the graphs of CEO Confidence and Consumer Sentiment (expectations) inside this issue, there is a risk that footing might turn unstable.

Yet at the same time, we could be approaching an important turning point in reducing this uncertainty: What if a significant deficit reduction package is passed as part of the ultimate debt limit compromise? What if this political showdown needn't be revised for the next two years? In addition, what if the debate on tax increases is now postponed until the economy is stronger?

Yeah, those are a lot of *"What if's?"* But if given the opportunity, U.S. business is the most entrepreneurial and adaptable in the world. And you don't have to be a hopeful optimist to understand how –*if fear and uncertainty start to dissipate*– the next year just might turn out to be a lot brighter.

James B Stack

SUBSCRIPTION RATES (U.S. dollars): InvesTech Market Analyst and Portfolio Strategy . . . . $295/yr (Foreign add $2.00/mo)