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Portfolio Management and Your Peace of Mind - The Government Shutdown and Debt Ceiling

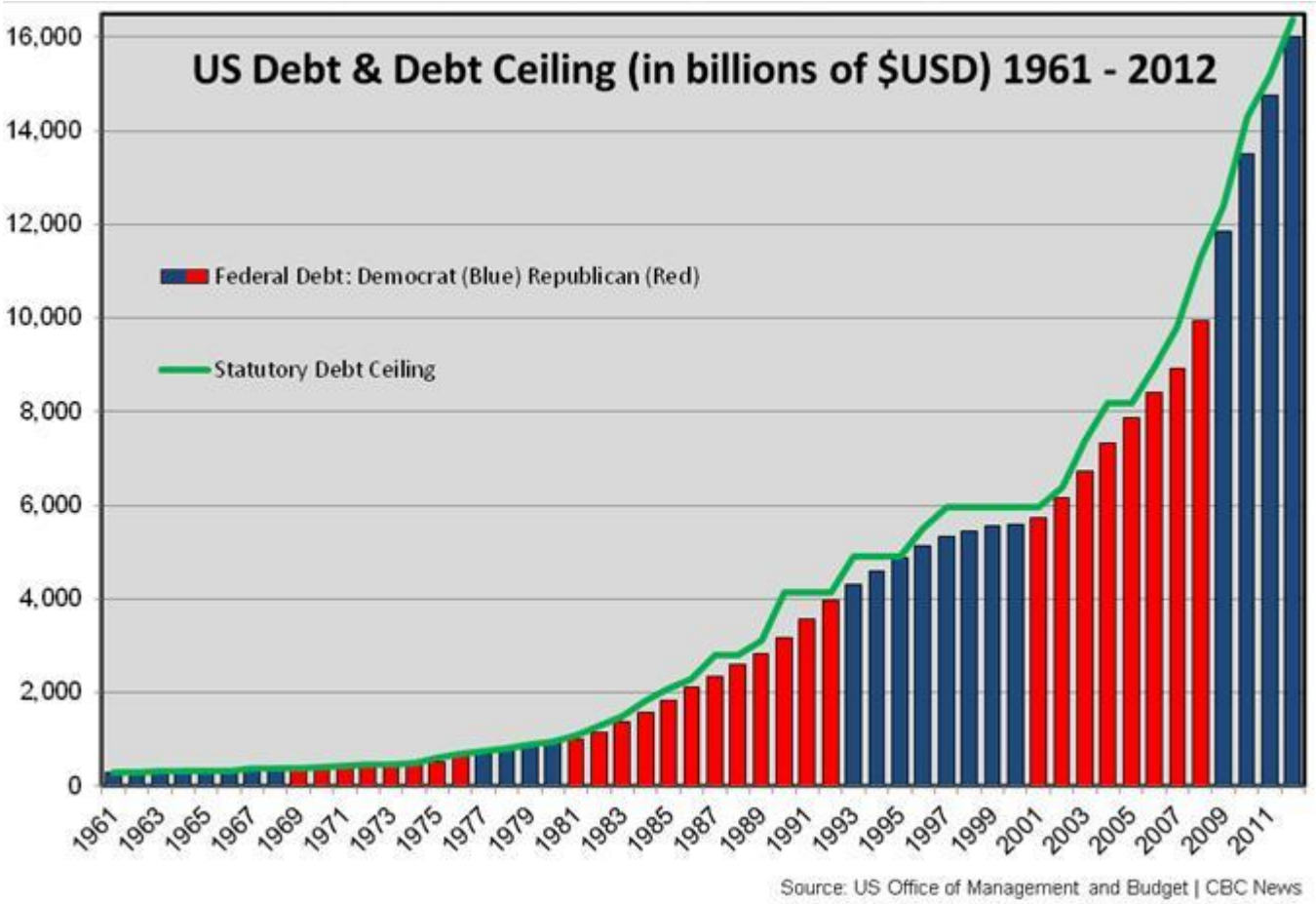
In the fine print of most mutual fund marketing material you will likely find the standard disclaimer that “past results are not indicative of future performance”. Though, like many aspects of investing, few things are universally true.

As we neared the middle of the year, global stock indices were surpassing their all-time highs on the back of extended rallies. Despite this, several months of optimism were discounted in a couple of “risk-off” weeks as the second quarter drew to a close. Markets promptly fell, amid fears of reduced monetary stimulus as well as the perceived risk of a “meltdown” in the Chinese banking system.

Last month marked the end of the third quarter, where a similar story unfolded. Equity markets continued to register strong gains, with the downturn at mid-year proving to be a buying opportunity. However, great returns of late have once again taken a backseat to the distractions of a 24-hour news cycle. This time around, worries stem from the current government shutdown and debt ceiling debate in the US. Given the amount of media coverage it has received, we would like to address this situation and the impact it may have on markets.

Although the past may not perfectly predict the future, historical experiences do put this period in perspective. Interestingly, US government shutdowns have been fairly common. In fact, the current one is the eighteenth such event since 1976. Most of these shutdowns lasted only a few days and were quickly forgotten. One of the longest shutdowns – and the one being used as a yardstick for today – occurred seventeen years ago when the US government was shuttered for a total of twenty-six days. Even that prolonged shutdown in 1995-1996 caused only minimal damage to the economy and the stock market actually rose during the period. Likewise, by all accounts the current impasse will have little long-term impact on markets or the broader economy.

However, it is true that this time of year has historically been challenging for stocks. While the effects of the US government shutdown are most likely to be muted, this does not mean we are out of the woods yet. A failure to raise the debt ceiling by the mid-October deadline (and the potential default on supposedly risk-free Treasury bonds) could significantly disrupt markets in the US and abroad.



Those who attended our Speaker series in January may remember that we touched on the potential for further US fiscal battles this year. We noted that historically an increase in the borrowing capacity of the US government has been a non-event. As depicted in the graph above, going back to 1961 the debt ceiling was raised nearly 80 times, under both Republican and Democratic presidencies. Only recently has this become an issue, stemming from the vitriol and partisanship that currently plagues Washington.

At the time of writing, the S&P 500 was about 4% off its recent high in late September. In the short-term, the market could fall further, especially in light of the great advances we have seen thus far in the year. While a replay of the 2011 debt ceiling debate would certainly be bad for markets – the S&P 500 plummeted more than 15% ($USD) in matter of weeks – it is worth noting that those who stayed the course benefitted from a 25% rally in the following months. Time and time again, it can be shown that short bouts of volatility usually distract from more important long-term trends in the markets.

With the current situation largely caused by politicians, as we have seen in the past, a last minute solution is likely to be reached. As Winston Churchill noted, “You can always count on the Americans to do the right thing – after they’ve tried everything else.” Sometimes history does repeat itself.

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