Quadrant
ASSET MANAGEMENT

QAM Update
October 2013

The QAM letter that highlights topics that we think either affect the markets or are important to understanding them.

"Suppose you were an idiot and suppose you were a member of Congress. But I repeat myself."
Mark Twain

Of Shutdowns, Debt Ceilings, Defaults and American Politics

Setting the stage

The United States Constitution requires government spending be approved in bills passed by the United States Congress. Some programs are fully or partially funded for multiple years, and some are funded every year. All funding comes from the Congress expressing its will through law. This is the power of the purse given exclusively to Congress.

The United States Congress is made up of two houses: the House of Representatives (frequently referred to as "The House") and the Senate.

Once a bill is approved by one house, it is sent to the other which may then pass, reject, or amend it. For the bill to become law, both houses must agree to identical versions of the bill.

Currently, the House of Representatives is dominated by the Republican Party while the Senate is dominated by the Democratic Party.

The Senate is both a more deliberative and more prestigious body than the House of Representatives, due to its longer terms, smaller size, and statewide constituencies, which historically led to a more collegial and less partisan atmosphere.

Two Senators represent each state (100 Senators in total) and typically each Senator represents 4.3 million people; there are 435 members of the US House of Representatives and the average House Representative represents just over 707,000 people. Accordingly, the average Senator has a much larger voice and more influence than the average House Representative.

Act 1: Shutdown

Having failed to agree by late September on the budget for the fiscal year beginning October 1, members of the Senate proposed a resolution to continue funding the government at reduced budget levels through December 2013 as a stop-gap measure, to allow more time to negotiate over final funding levels for the full fiscal year.

Republican Senators demanded a delay of, or change to, the Affordable Care Act (also known as Obamacare) in exchange for passing the resolution.

Because Congress did not enact regular appropriations, or a continuing resolution for the 2014 fiscal year, appropriations have lapsed and about 800,000 federal employees were indefinitely furloughed without pay, while another 1.3 million were required to report to work without pay until an appropriations bill is passed.

The most recent previous U.S. federal government shutdown was in 1995–96. Since 1976, the United States Federal Government has had shutdowns on 17 occasions before 2013. Shutdowns prior to 1981 did not actually result in major offices being closed, due to more lax adherence to policy.

Average market performance during these shutdowns: decline of 0.5% in the S&P 500.

First Intermission.

Act 2: Debt Ceiling

The United States debt ceiling, or debt limit, is a legislative restriction on the amount of national debt that can be issued by the Treasury. Because expenditures are authorized by separate legislation, the debt ceiling does not actually restrict deficits. In effect, it can only restrain the Treasury from paying for expenditures that have already been incurred. The United States has had some sort of legislative restriction on debt since 1917. Periodically, a political dispute arises over legislation to raise the debt ceiling. When the debt ceiling is reached, the Treasury undertakes "extraordinary measures" which extends the time for the ceiling to be raised. On February 4, 2013, President Barack Obama signed a suspension of the debt ceiling that ran until May 19, 2013. After May 19, the debt ceiling was raised to $16.7 trillion, the level of debt incurred during the suspension, and the Treasury resumed extraordinary measures. Treasury Secretary Jack Lew notified Congress that these measures would be exhausted by October 17, 2013.

Again, in exchange for passing the debt ceiling resolution, Republican Senators demanded a delay of, or change to, the Affordable Care Act.

Warren Buffet states in an interview that “it makes absolutely no sense” for politicians to use the debt ceiling as a threat to get their way on other legislation.

“It ought to be banned as a weapon. It should be like nuclear bombs, basically too horrible to use,” Buffett said in an interview with Fortune magazine. On a more positive note, and based on previous experiences, Buffett said that “We will go right up to the point of extreme idiocy, but we won’t cross it”.

Perhaps the biggest irony of all this drama is the fact that the budget deficit (the root cause of debt) is silently in the process of improving. It is estimated that the 2013 figures will show the largest annual improvement in the deficit on record in dollar terms (down by more than $400 billion in only one year) and one of the largest reductions as a share of GDP in the history (from almost 7% last year to less than 4% of GDP this year).

Act 2 in progress.

Act 3: Default – An unlikely epilogue

In 1790, the newly formed nation deferred until 1801 interest obligations on debt it assumed from the states, but a full United States default has never happened in modern history.

In 1933, the U.S. refused to make payments in gold to redeem bonds that gave holders the option of requesting a prescribed amount of the precious metal instead of cash. While investors were paid on time and in full (in US dollars), some argued it was a default because the prescribed amount of gold was worth more than the U.S. dollars received due to a devaluation of the currency versus gold. The difference being 41%.

In April 1979, however, the United States may have technically defaulted on $122 million in Treasury bills, which was less than 1% of U.S. debt. The Treasury Department characterized it as a delay rather than as a default, but it did have consequences for short-term interest rates, which jumped 0.6%. Others view it as a temporary, partial default.

As we suggested in our August 2011 update - when S&P downgraded U.S. government bonds - , the US has serious fiscal problems; still, we think the probability of seeing the US government defaulting on its debt in our lifetime is as remote as convincing our teenage kids to stop texting and using Facebook.

But we do think that money (in all its forms) is not going to provide value for investors in the long term, given the spending habits of governments and the Fed's propensity to print money. Buffett recognizes that as well. "Our currency is not AAA, and in recent months the performance of our government has not been AAA, but our debt is AAA."

Act 3 has been described by many economists as a Greek tragedy. It has been warned that there could be a major slowdown to the economy, with job losses alongside a rise in interest rates affecting a range of products from credit cards to home mortgages. "The uncertainty associated with a technical debt default for the world's reserve currency carries costs that are potentially extreme and inherently unknowable and as such can be effectively classified as a 'Black Swan' event," well known economist David Rosenberg said recently in a report, referring to Nassim Nicholas Taleb's theory.

We at QAM consider the events as they unfold remembering that good companies and good governments will find a way. The political tangle is very complex and we would look with very skeptical eyes to anybody that would dare to predict how it will unfold. We know that life goes on. We know that if volatility continues to rise, this would be a buying opportunity for our Managers.

Companies with strong balance sheets, competitive advantages, sound economics and reasonable valuations are inherently of higher quality and outperform the general market in more challenging times. We expect companies selected by our Managers to hold value and outperform the Index in the long run.

For this reason we recommend investors remain committed to their long-term asset mix and be cognizant of liquidity issues that may affect their ability to ride volatile markets without jeopardizing their long-term results.

Q3/2013 in Perspective

Performance as of September 30, 2013 (CAD)

	3 months	1 year	3 years	5 years	10 years
S&P/TSX Composite Index	6.20%	7.10%	4.10%	4.80%	8.40%
S&P 500 Index	3.10%	25.00%	16.30%	9.30%	4.70%
MSCI EAFE Index	9.30%	30.20%	9.00%	6.20%	5.60%

Government of Canada Benchmark Bond Yields

	30-Sep-13	28-Jun-13	28-Sep-12
2 year	1.19%	1.22%	1.06%
10 year	2.54%	2.44%	1.73%
30 year	3.07%	2.90%	2.32%

Source: Bloomberg / UF

The third quarter of 2013 showed strong results with Europeans Stocks benefiting the most from the Fed message that it would be holding off tapering of its asset purchase program. The EAFE Index (Europe, Australia and Far East) returned 9.3% in CAD. Canadian Stocks represented by the S&P/TSX returned a solid 6.2% with positive results for every sector but utilities. The Materials and Financial sector showed particularly good returns, as commodity prices turned around and Canadian bank stocks rose as a consequence of strong earnings reports during the quarter. US Stocks, represented by the S&P500, posted a 3.1% return in CAD. The MSCI Emerging Markets returned 3.5% (CAD).

Medium to long term rates continued it ascent, albeit milder compared to the previous quarter, in Q3 with the 10-years Government of Canada Benchmark bond yield increasing 10 bps from 2.44% to 2.54%.

The Canadian Dollar appreciated around 1.75% in Q3 increasing from $0.95 USD to $0.97 USD at quarter end.

While the Equity Markets in general and the US market in particular have been holding up with all the noise coming from the Government shutdown and pending debt ceiling, volatility has been increasing since quarter end. The S&P has been down as much as 2% since its closing of Q3. In addition, the VIX, which measures the implied volatility in the equity index options market, has shown increases beyond 21 compared to 16 at quarter end. The VIX is considered by many as the "fear index" with a mark over 20 as an indication of fear in the marketplace. There is clearly uncertainty in the marketplace but in no way is this the final curtain call for equities.

WE MOVED!

As our business and QAM team continue to expand, so too must our workspace.

As of Monday, September 30th, we are operating out of new offices in 720-One Lombard Place (known as The Richardson Building) in Winnipeg, Manitoba (R3B 0X3). We enjoy the bigger and more attractive location and hope it will enable even better service for you, our clients.

Phone numbers and email addresses remain unchanged.

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