Lassus Wherley ...a view from the top

Building Better Futures

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Another Fine Mess…………..

So far it has been a very interesting 2013. The financial markets have been relatively happy in spite of continuing challenges in Washington and around the world. The election results in Italy triggered some negative results in the markets earlier this week and we had Fed Chair Ben Bernanke adding some to that negative thinking. His remarks yesterday seem to have made everyone a lot happier. And all of that is before we get to what we believed would be the real challenge - $85 billion in automatic spending cuts that will occur if Congress doesn't take action by March 1st. Given that the end of the month is here, it certainly doesn't look like anyone is working very hard on finding a better solution.

Isn't it interesting how quickly we moved from major crisis in the financial markets to maybe it isn't as bad as we thought. The bottom line is every day is a great adventure in the world of politics and the financial markets. Here's hoping our elected leaders actually earn some of their pay over the next week. They definitely rival some of the Oscar winners when it comes to drama.

The Sequester

The sequester is the name for the budget process which calls for $1.2 trillion in cuts to government spending over the next 9 years (2013-2021). The sequester is in essence an automatic reduction of expenditures. The size of the cuts were reduced from $109 billion, and the date at which the cuts were to take place was moved from January 2nd to March 1st by the New Year's Day compromise reached by our policymakers in DC. The cuts are split evenly between defense programs and non-defense programs for each of the nine years. The defense cuts fall mostly on discretionary defense accounts ($42.5 billion) with $0.10 billion in cuts for non-discretionary defense. The non-defense cuts are distributed among discretionary programs ($26.4 billion), Medicare ($11.2 billion), and non-defense mandatory programs ($5.0 billion) including farm, health care and education programs.

If these $85.2 billion in cuts take place as they are now scheduled to on March 1st, no one knows just how they will be implemented - whether there will be layoffs, furloughs, shortened work weeks or other measures. If the cuts take place, however, they will serve to further drag down the economy when it is already being hit by the end of the 2% payroll tax holiday and the higher income taxes on high-wage earners that were part of the New Year's Day compromise.

Senate Democrats would freeze the sequester through year-end and offset the original $109 billion with an even mix of spending cuts and tax increases. The sequester cuts may well stay on the books into April and then Congress may attempt to find a compromise solution to change this piece of legislation. The crux of the matter is that the White House and the Democrats will expect any measure to include both tax increases and spending cuts, while Republicans will insist that the $1.2 trillion in

deficit reduction come entirely from spending cuts.

We expect negotiations over this matter to be difficult. At the end of the day, however, Democrats and Republicans will eventually come up with other budget measures to avoid making these cuts or maybe even roll some of them back after the fact. The best alternative at this late date is probably another kick-the-can-down-the-road delay. This process will certainly continue to increase volatility in financial markets.

Excitement in Italy

On Monday, February 25th, Italians went to the polls to vote in a general, parliamentary election. We certainly knew the election was happening but did not expect the lack of a clear-cut winner. This ambiguity left markets in a definite funk. Investors are concerned that this inconclusive election will make it harder for Italy to tackle its budget problems. The results of this election call into question much of the progress that has been made since the summer of 2012. This progress was focused on making the debt of the weaker European nations more attractive to investors and stabilizing financial markets in Europe.

The official results of the election were released on Tuesday, February 26th. There were several upsets. First, the Five Star Movement, the party of the upstart comedian and populist, Beppe Grillo, won 25.55% of the votes, the largest share for any party. Democratic Party leader Pier Luigi Bersani won a majority in the lower house by a whisker. Ex-premier Silvio Berlusconi won fewer votes than Bersani in the Senate, but enough to block Bersani from declaring victory. No formal steps can be taken until a new parliament convenes on March 15th. This lack of resolution will give European markets, and perhaps global markets as well, a good dose of uncertainty which we are never happy to see.

These inconclusive results also make new elections likely in a few months. Both Bersani and Berlusconi will seek to avoid this, however, as Grillo may well get the lead again the next time. Most interesting, perhaps, is that outgoing Prime Minister Mario Monti won only about 10% of the votes. This was seen as a sign that the Italians had had enough of the austerity programs which Monti had tried to get them to accept in order for Italy to be able to get funds from the European Union.

The sovereign debt crisis in Europe has never really gone away but has been on the back burner since Mario Draghi, the European Central Bank (ECB) head, made his famous comment last July that the ECB would do "whatever it takes" to support the euro. This comment, along with the creation of a new program (OMT or outright monetary transactions program) under which the ECB could buy the debt of eurozone member nations, had reassured investors that the euro was secure. Bond investors bought the high yielding debt of the countries on the periphery of the eurozone such as Italy, Spain and Portugal, and their interest rates came down precipitously.

For the moment, this progress and the good feelings about European sovereign debt have been called into question. Two points stand out at present.

First, the ECB never really implemented its OMT program because retail and institutional investors bid up the debt of Spain and Italy, thereby effectively doing its work for them. (Under the OMT program, Spain and Italy would have to ask for help from the ECB in order for the Central Bank to buy their debt, and this debt would be bought in exchange for promises to implement certain austerity measures.)

Also, given doubts about the ability of Italy to govern itself now with no clear leader having been elected, it is unlikely that investors will be willing to buy their debt or the debt of other countries on the eurozone periphery until they see higher rates.

The bottom line is that the European debt situation was never really resolved; it just went away for awhile and now, like a bad penny, it is back.

Stay Tuned for More

We have received some excellent questions from clients recently and will devote much of the next issue of a View from the Top to answering those questions. Here are some of them to think about:

- What is the issue with corporate pensions, and how does that impact the financial markets?
- What will cause interest rates to rise, and if they do, how will that impact my portfolio?
- Could you explain high-speed trading and dark pools and their effect on retail investors? Should we be worried?

We are also working on a new look and feel for a View from the Top with a broader base of content and will be rolling it out very soon.

As always, please keep us apprised of any upcoming cash needs which you may have. This enables us to raise cash well in advance of the need and at what may be a more opportune time. Also, please continue to send us your questions.

The world of finance and investment is never dull and boring. Sometimes boring would be a really good thing, but until that day comes, we will continue to focus on ways to balance risk and return.

Stay warm and have a happy Spring!

Diahann

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