



July 11, 2011

Dear Clients and Friends,

“Some debts are fun when you are acquiring them, but none are fun when you set about retiring them.”
~ Ogden Nash

We’ve commented many times in past letters that the average corporate balance sheet (outside the financial sector) is as solid as it has been in decades. Cash is plentiful, the debt burden is low, and as a recent Bloomberg news report stated, the “earnings yield” is at a 26-year high. Businesses are being run more efficiently, eking out productivity gains from employees while keeping costs low. Sure, there is the occasional headline-grabbing example of corporate excess – often in the financial sector! – but generally speaking, corporate America is in UFC fighting condition. Looking at business-level factors like operating margins and cash flows, one sees tremendous opportunity for investment.

But the devil’s not in those *micro* economic details; he’s running wild in the *macro* and raising a ruckus. From the halls of Congress to the shores of the Hellenic Republic, an ill wind of economic reality is sweeping over debt-ridden nations and giving cause for concern. These macro headwinds are, in our opinion, the primary impediment to the global economic recovery. The basic problem: too much debt, and the uncertainty over how to deal with it.

As PIMCO’s Mohamed El-Erian recently wrote, the US’ debt ceiling “has been raised more than 70 times in the last 50 years, mostly without commotion. It must be raised again this summer if the United States government is to continue paying its bills on time. But now America’s debt ceiling has become the subject of intense political posturing and touch-and-go negotiations behind closed doors.”

What most don’t realize is that the debt ceiling has already been hit. Treasury Secretary Timothy Geithner has given Congress some financial flexibility by moving money around and tapping unused funds to pay the government’s bills. This flexibility is what is expected to run out in early August.

If the debt ceiling is not raised, the US can only spend what it actually takes in as current revenues. As the US currently borrows about 40 cents of every dollar spent, this would imply shutdowns and disruption of government services. It doesn’t necessarily imply that the government will not pay its debt. It would be up to the Treasury to prioritize the order of payments.

A debt ceiling agreement is highly likely. The question is, will it arrive with or without collateral damage? In comparing the debt limit debate to a game of “Russian roulette,” Berkshire Hathaway’s Warren Buffett said, “We don’t need to tell the rest of the world that anytime people in Congress start throwing a tantrum that we’re not going to pay our bills.”

“I don’t make jokes. I just watch the government and report the facts.”
~ Will Rogers

We want to underscore the point that the debt ceiling discussion is, at this point in time, one of politics, not economics. The US has the ability to pay its debts. The debt ceiling – a limit on borrowing – is set by Congress as part of the checks-and-balances system. Congress can raise the ceiling today if it wanted; it is only political intransigence that keeps it from doing so, or from avoiding the problem altogether by coming up with something that vaguely resembles a balanced budget.

Here at FBB we do not currently have significant direct US debt exposure other than in the money market funds. Those funds do hold Treasury bills due in August that could be affected, at least in the short run. Our baseline expectation, subject to change, is that even if the US “defaults” on these bills (i.e., can’t issue new debt and “roll” it to new maturities,) holders would still be paid, albeit with a delay. There is no way to predict the impact, if any, on other segments of the US bond market, or the US stock market, or the global financial markets, but we will be watching closely for further developments on this front.

European debt is a more complex issue. Those troubled countries, especially Greece but also Portugal, Ireland, Italy and Spain, have less flexibility than the US, having hitched themselves to the Euro currency wagon and the Maastricht Treaty limitations. (Granted, it was Greece’s flagrant violation of Maastricht terms that led to its current condition, but that’s neither here nor there now.)

The growing worry is not about the fiscal stability of those European nations, with several having already been downgraded to “junk” status by the bond rating agencies, but about the European banking system and its cross-holdings of Euro sovereign debt. Our own research uncovered excessive European bank exposure in US money market funds, with many US funds holding 40% or more of their investments in European banks. Within days of our taking steps to minimize this exposure by changing money market funds, Bloomberg ran a story with the headline, “U.S. Money Funds Risk Losses If Europe Crisis Sparks Wildfire.” Talk about timely!

“What a long, strange trip it’s been.”
~ The Grateful Dead

What a wild, strange year it’s been so far, and we’re only halfway through! A major Japanese earthquake / tsunami / nuclear meltdown and the resultant supply disruptions around the globe. Middle East uprisings. Commodities soar, sparking inflation worries. Commodities plummet, sparking deflation worries. QE2 fiscal stimulation ends. Greek default concerns continue. United States default concerns continue!

It’s remarkable, we think, given these tumultuous events and ongoing fiscal woes, that the financial markets have held up as well as they have so far this year. Perhaps the micro factors matter after all – a silver lining to those dark macro clouds.

Sincerely yours,

Mitch Schlesinger
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