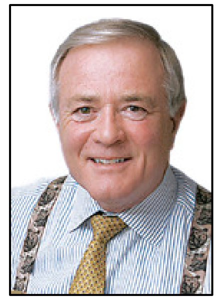
DJC
THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON



William Rutherford

U.S. Congress reveals itself a circus

Published August 5, 2011

"You can always count on Americans to do the right thing – after they've tried everything else." – Winston Churchill

All eyes have been on the U.S. Congress … unfortunately. The world has lost confidence in our ability to manage and pass laws. As we crawfished toward a resolution of the debt ceiling crisis, we no longer looked like a country with strong leadership, but rather like a banana republic.

As David E. Sanger wrote in the New York Times on Aug. 1, "… the brush with default has added a new dimension. It has left America's creditors and allies alike wondering what had changed in American politics that a significant part of the country's political elite was suddenly willing to risk the nation's reputation as the safest place for the rest of the world to invest.

"It raised questions about whether the United States now faces brinkmanship over a variety of issues between an emboldened conservative movement and a president whose authority is under challenge," Sanger continued. "And for all the talk on the right about 'American exceptionalism,' especially among members of the Tea Party, it put doubts in the minds of many about whether America's military and economic dominance is something the country is still willing to pay for – and will always survive.

"The new head of the International Monetary Fund, Christine Lagarde, seemed to give voice to that concern when she noted on CNN that in the past there was always 'a positive bias towards the United States of America, towards Treasury bills.' The events of the past few weeks, she said delicately, are 'probably chipping into that very positive bias.' "

Democrats said it was a manufactured crisis, that we had always passed the debt ceiling increase in the past, and there was no reason to change now. Republicans said the past doesn't work anymore and that a new approach is needed. So, manufactured or not, we reached an impasse.

For weeks, the two parties talked past each other, and over the heads of the opposition to the American public. In many ways these negotiations could be seen as a prelude to the next presidential election. Positioning President Obama for defeat was a goal for Republicans.

It remains to be seen who will be judged the winner in this slugfest, but the president's poll numbers dropped considerably during the process. Indeed, even Obama's own supporters were critical of his leadership. The president was forced to capitulate on many issues, and Democrats got almost none of what they wanted. None of that means the president won't win the next election, but the task just became more difficult. Of course, the election is still a long way off.

The House passed the budget deal, 269 to 161, with Republicans providing 174 of the votes, and Democrats voting 95 for and 95 against. Democrats held back to force Republicans to vote first and show that the deal would pass; then they committed their own votes. The Senate passed the measure Tuesday, 74-26, and it was signed by the president shortly thereafter.

As we entered Monday, Aug. 1 without a deal, Asian markets were off sharply. As the day wore on, the parties engaged in tough bargaining, and optimistic sounds were heard. Asian markets, which open hours before those in the U.S., rebounded sharply to close up on the day as the parties grew more optimistic.

Similarly, U.S. markets opened up 139 points as optimism over a deal buoyed investors, but then dropped sharply lower, after U.S. manufacturing numbers for July showed barely any growth and renewed worries about the economy. The Dow was down as much as 110 points, but as optimism over the budget resolution improved, it recovered slowly to close down only 10.75. This was surely a show of strength in a difficult environment.

Eyes now turn the economy, so on Aug. 2, global markets opened weaker. Investors renewed their focus on European debt crisis, and global economic growth. U.S. growth in the first half of the year has been anemic. Usually when growth is below 2 percent, like now, a recession is likely imminent. This is surely bad news for millions of Americans, and for President Obama's re-election prospects.

A question remains: Will the U.S. credit rating be downgraded in spite of the deal? Many observers think that could happen based on the sloppy way the problem was resolved. As the reasoning goes, even though we have the capacity to pay our bills, our will to do so looks shaky and therefore does not deserve AAA rating. Such ratings, after all, require extremely strong capacity for debtors to meet their obligations. AA+ ratings require that very strong capacity. It is not just a difference in semantics because the rate of interest paid on the debt can be affected.

The risk the rating agencies run is if no one pays any attention if they downgrade U.S. debt. The agencies would suffer a big loss of credibility. This could happen – after all, where else can institutions and individuals invest their money with more security and liquidity? Perhaps small investors can find a better home, but investors who need large capacity will find few places to park their money. The U.S. wins the 'least ugly' contest.

Given the choices before investors, U.S. Treasurys are still a good place for bond money, and equities generally are a better place than bonds.

William Rutherford is the founder and president of Portland-based Rutherford Investment Management, listed in Barron's as one of the nation's leading separate account managers. Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com. *Information herein is from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Investment involves risk and may result in losses.*