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What's a Rational Person to do in an Irrational Environment?

Chip and I have chosen to earn our living in the wealth management arena, and specifically in the investment advisory branch. A primary motivation for us is our desire to use our abilities to safeguard and protect our clients' assets from the unknowns which threaten their financial well being.

In the course of our work we must weigh various risks before choosing to make investments which fit the risk/reward profile they have selected. Typical examples of the risks we daily consider are interest rate risk, credit quality questions, volatility, risk inherent in the economy and so on.

Until now.

What's the one heretofore non-consequential risk which never before was ratcheted into a money manager's thinking? Political risk.

Before summer 2011 it was unthinkable that the credit quality of the US Treasury market could be put on "watch" by Standard & Poor's and Moody's.

Before summer 2011 it was unthinkable that our elected political leaders would take us to the brink of financial disaster. Although unlikely, it is now conceivable they may ultimately paddle our canoe right over Niagara Falls, screaming "No compromise, never" all the way to the rocky shoals below.

If that is indeed the end result then I expect there will be serious albeit temporary consequences visited upon the investor class. The U.S. equity markets should swoon, but just for a short period. The U.S. bond market is anybody's guess.

Although most assume yields will jump given the potential credit downgrade, they might hold steady or even decline given the unattractive investment alternatives.

Some cynics are fond of saying, "Do you know when a politician is lying? Only when his lips move." Here are two current misstatements.

The math in the legislation of Speaker Boehner and Majority Leader Reid's plans has proven fanciful. On July 27th the Congressional Budget Office said that the Senate Democrat's alleged debt cap increase of \$2.7 trillion is actually \$2.2 trillion which means that it doesn't meet the GOP's demand that spending cuts exceed any increase in the country's debt ceiling.

Not to be outdone with that bit of political hyperbole, the day earlier the CBO also called a time out on the Republican House compromise legislation. It found that Speaker Boehner's plan, which claimed to cut \$1.2 trillion in spending over ten years, would actually only cut \$850 billion. So, as I write, it's back to the drawing boards for both.

The President has not helped his claim to being the "only adult in the room" either with his insistence that the Republicans drop their opposition to tax increases. That's akin to asking Catholics to renounce the Pope. Mr. President, when you're involved in a serious negotiation, you don't insist on that which you know is impossible. Sorry, you don't.

This political theater reminds me of the movie *War of the Roses*, with Michael Douglas and Kathleen Turner both destroying their household furnishings, property which belonged to both, just to spite the other.

Could this be a short term problem? Yes, for sure. Will this be a long term disaster? No way.

No one has focused on what a miss-the-date would actually mean. So here are the facts, should there be no debt ceiling adjustment before the August 2 doomsday date, the Tim Geithner-identified U.S. drop dead date.

For the rest of August the government will receive around \$172 billion. We will owe about \$306 billion. Of that, \$29 billion is debt obligations arising from our bonds. Without question, those bond obligations will be paid.

That leaves \$143 billion in revenues to cover \$277 billion in

government bills -- social security payments of \$49 billion, federal worker wages, VA hospital services, Grand Canyon Park Ranger services, Afghan war obligations, etc.

All those obligations will be prioritized somehow, someday. And the obligations not paid immediately will nevertheless be paid in due course, as soon as the politicians work out their spat.

Well respected Wells Fargo chief economist John Silvia even believes the government can delay the witching hour of August 2 by a month or more. So the August 2 date might even get magically moved at the last minute. Harry Houdini, where are you?

There are also rumors that the administration has told the Too Big to Fail banks that it won't allow a default to happen under any circumstances even if the debt ceiling isn't raised.

Call me an optimist, but I still think our elected politicians will get something done by August 2. British rocker George Michael put it best: "[You Gotta' Have Faith](#)."

Have you ever gone to a movie which has one of several endings, and five minutes before the dénouement, you still don't know who the murderer is? That's what's happening here, except it's not the murderer, but the outline of an agreement which remains unknown.

As I see it, these are the four most likely last scene scenarios for our movie. (A) We approve the \$3-4 trillion deficit reduction, Gang of Six Grand Bargain proposal. Surprising? Yes, but remember the December 2010 last minute, unexpected tax package agreement was equally surprising in its scope. (B) A small deal along the lines of \$1-1.5 trillion in both deficit reduction and spending limit increases, based on either Boehner or Reid's ideas, gets adopted. (C) The Mitch McConnell \$2 trillion deficit reduction bill, which gives the President the power to raise money in exchange for spending cuts, is selected as the "backup" when no other plan can garner the votes needed in both houses. (D) There is no deal by August 2.

But if not, there will be one by Sept 2. Mark my words.

In order to protect you against option D we have taken two actions. (1) We have sold multiple equities this week and will hold the proceeds in your accounts as cash while we let the political dust settle. (2) We have increased the shares of GLD, your exchange traded gold fund. Cash will cushion a

falling stock market. Gold is traditionally a hedge against weakness in the dollar and loss of confidence in the promise of Uncle Sam to pay his bond obligations when they come due.

But remember, even in instance D, it will be but a short term dislocation. And when the dust does settle we will use those recent cash proceeds to take advantage of the buying opportunities that the market presents us at that time.

You heard it here first.

Ciao.

I pen this missive on Wednesday morning, July 27th. Per SEC requirements which require clients be treated the same with respect to our trading policies, it must be embargoed until after we have completed buys and sells for all Westover clients in order that none of you "front run" our analysis. Accordingly, when you read this, it is my hope that what went on in Washington recently will have been much ado about nothing, that what went on down there proved but a tempest in a teapot with no long term damage being done to the innocents.