October 7, 2013

Dear Clients and Friends,

The United States and Iran have been opening up new channels to communicate and negotiate, punctuated by a phone call this week between the U.S. and Iranian Presidents, after many years of a standoff. Ironically, this historic event occurred while a domestic standoff in Congress has shut down the U.S. government for the first time in 17 years.

The failure in Washington is disappointing, if not a surprise. However, history tells us it is not necessarily a bad thing for investors. The 16 government shutdowns over the past 37 years, which have ranged from one to 21 days, have not been particularly negative for stock market investors, averaging only a 2% decline for the S&P 500. More importantly, from a longer-term perspective, they preceded above-average returns. The S&P 500 Index has risen 11% on average in the 12 months following the shutdowns, compared with 9% for all periods. Notably, in the last government shutdown 17 years ago in late 1995, the S&P 500 rose 21% in the subsequent 12 months.

As the government shutdown began on the morning of October 1, stocks actually rose after falling modestly in the preceding days. That reaction makes sense, since selling stocks into short-term political uncertainty has been costly for investors in recent years.

Of course, the shutdown is not the only issue facing investors from Washington. We are also approaching a breach of the debt ceiling on October 17, leading to the remote-but-heightened threat of default on some U.S. obligations if lawmakers fail to increase the limit on total U.S. federal government debt. Fear over the threat posed by the debt ceiling seems well contained at this point. For example, the VIX, often called the "fear gauge," is currently around 16 and not at the 48 level seen in August 2011, when the debt ceiling was last the subject of a battle in Washington and stocks fell 17%. Also, default concerns currently seem minimal with the discount on the one-month T-bill at just six basis points versus 17 basis points at the peak of fear in early August 2011. Perhaps this is because the economic and fiscal backdrop in the United States, and especially Europe, is much improved relative to the 2011 episode.

While it is good news that the markets have been relatively steady, without a negative market reaction there is less pressure on politicians to compromise. Furthermore, the longer the shutdown goes on and the closer we get to the debt ceiling deadline, the more the market is forced to make politicians act. We continue to monitor events closely and believe this is not a time for indiscriminate selling but rather a time to look for opportunities to buy on weakness. As always, if you have questions, I encourage you to contact us.

Best regards,

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The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. When sentiment reaches one extreme or the other, the market typically reverses course. While this is not necessarily predictive it does measure the current degree of fear present in the stock market.

The economic forecasts set forth in this letter may not develop as predicted.

Tracking #1-206891 | (Exp. 10/14)