Grey Value Management

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THE RIGHT KIND OF CHAOS

As it cascades from Capitol Hill across the globe's capital markets, the current financial mayhem has fostered an interesting misperception: That the pitched political battle over America's fiscal future is a purely negative phenomenon. It is not.

To be clear, Friday's downgrade of US sovereign debt by Standard and Poor's wasn't immaterial. Because the credit rating of US Treasury debt is the basis for many other obligations, including that of the mortgage giants Fannie Mae and Freddie Mac, investors have reason to fear a contagion effect. But a credit rating compression is more likely than a lock-step downgrade across all forms of American debt. It is only those obligations backed by the credibility of the US government that have any reason to decline in direct sympathy. Hence, demand for mortgages issued by Fannie Mae but backed by real assets may actually increase, while paper issued by Fannie but back-stopped by the US government may have to offer higher rates to attract bidders.

Viewing the downgrade in isolation, one can only admire S&P's audacity. Having been asleep at the mortgage ratings switch throughout the swelling of that toxic bubble, they now want to characterize proactively stating the obvious as an act of intellectual courage. If you buy that, I have some AAA-rated sub-prime mortgages you may be interested in.

Ratings agencies aside, the atmospheric aversion to political compromise in DC is admittedly disturbing. A large number of debt ceiling hardliners seemed to have hijacked Barry Goldwater's call to arms: Extremism in defense of our economy is no vice. This is counterproductive – especially when it contemplates strategically defaulting on our debts. There's nothing patriotic about being a deadbeat. If we willfully renege on debts the rest of the world knows we can pay, forget AAA; we don't deserve to be rated BBB.

That said, we should prefer a modicum of extremism to fiscal fatalism. Japan may chide our political dysfunction, but there are logical reasons to favor the ulcer-inducing brinksmanship of the past month over the controlled failure of Japan's lost decades. Europe's PIGS – Portugal, Ireland, Greece and Spain – are in slow-motion collapse. Would this be the case had the fight for fiscal rectitude been taken to the appropriate extreme ten years ago? What of Italy? China, America's biggest creditor, admonishes us to "cure our addiction to debt." They can provide this advice only because our economic data, unlike theirs, is transparent and trustworthy to begin with. We'll see how well their accounts balance when the factory smoke clears; trees don't grow to the sky.

It's easy to envy China's ability to mobilize huge amounts of capital quickly, but spending quickly and spending efficiently are two very different things. If a single party political system were the optimal economic model, we'd all be driving Soviet sports cars.

Regardless of the problems that brought us here (two wars, stimulus spending, tax cuts for the rich, spiraling entitlements, among others – take your pick), the recent downgrade was yet another sign that we stand at an economic inflection point. Given the scope of the fiscal problem, the pain required to pre-empt it *should* be substantial. That we must contemplate these decisions against the backdrop of the worst economic contraction since the Depression only makes them more agonizing. But it is what it is.

When they engineered the system of checks and balances into our national DNA, the Founding Fathers knew all too well that it's a very thin line that separates dispute from dysfunction. It is an unfortunate truth that the heat of the present debate is proportionate to the scope of the problem. If the current morass enables America to pre-empt disaster, the country's dysfunction will have proven to be its saving grace. It won't be the first time. Provided we're not paralyzed by our differences, it's the right kind of chaos.

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