Market Update

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A Double Matinee: Budget and Debt Ceiling

No one likes uncertainty; uncertainty can lead to lack of confidence, which typically does not bode well for the financial markets. However, we believe there are some macro level uncertainties hat are overly influencing investor confidence (sentiment), resulting in price declines in the equity markets. Unfortunately, the irrationality of our elected legislative officials has let two large bulls loose in the china store.

Macro issue number one is the ongoing partial government shutdown which began October 1st because Congress was unable to pass a budget. The other macro issue is whether Congress will vote to raise the debt ceiling before the Treasury runs out of money on or around October 17th. With the budget impasse and the upcoming debt ceiling vote, the '*Washington theatre'* is providing the capital markets a double matinee. Fortunately, we predict the outcomes will not be as bad as the previews indicate.

Each of these government issues is a big deal. However, many economists believe there is a very low probability of significant economic impact from the government shutdown and there is even less of a probability that Congress would allow the U.S. Treasury to effectively default on its obligations. Notwithstanding the views from several prominent economists, it appears, based on recent performance in the equity markets, that market participants have taken the worst case scenarios for the potential outcomes. While it is difficult to completely separate the two macro issues, it appears, based on the performance of the S&P 500, that market participants initially put more emphasis on the potential for a budget impasse following the Federal Reserve Chairman Ben Bernanke's announcement, on September 18th, that surprised the market. Contrary to the market's expectation based on Bernanke's comments following the previous Federal Open Market Committee (FOMC) meeting in May, the FOMC decided during its two day meeting not to adjust its Quantitative Easing (QE) policy. The QE policy since September 2012 has been to purchase $85 billion in mortgage-backed and Treasury securities each month to keep interest rates low to support economic growth. After returning approximately +5.8% from the end of August to an all-time high close of 1,725 on September 18th, the index declined 2.5% from the 19th to the 30th. The apparent concern is the potential economic impact from the lost spending as a result of the government shutdown. Now that the House of Representatives passed legislation on October 5th to provide back pay for the 800,000 furloughed Federal employees, the concern is how long the shutdown will last and what will be the ancillary effects on businesses and economic growth. According to Paul Ashworth, Chief US Economist at Capital Economics, the estimated reduction in spending due to the loss of income for the federal employees is approximately $155 million per day. On an annualized basis, the reduced spending from a week long shutdown could potentially reduce fourth quarter GDP growth by approximately 0.3%. This impact will be reduced once the employees receive back pay, assuming they will resume with their normal spending habits. A positive, from an economic perspective, is the fact that shutdown is occurring at the beginning of the quarter and that should provide enough time for economic activity to resume to offset any drop in spending.

The debt ceiling, on the other hand, could be a much larger problem if Congress does not vote to raise the level of debt the Treasury can issue to fund upcoming payments. At the end of last week, there was additional rhetoric in the press about the possibility of the US defaulting on its obligations if the debt ceiling is not raised.

In fact, on October 3rd, the U.S. Department of the Treasury issued a six-page report titled, ***"The Potential Macroeconomic Effect of Debt Ceiling***

Brinkmanship". In the report, the Treasury describes potential outcomes that could occur globally from an unprecedented default by the United States: "[a] default…has the potential to be catastrophic [where] credit markets could freeze, the value of the dollar could plummet, U.S. interest rates could skyrocket, there might be a financial crisis and recession that could echo the events of 2008 or worse." While this is a possibility, it does not appear probable. Even though members in both parties in Congress are not acting very intelligently to pass a resolution for the budget, continuing to play a game of chicken with each other on debt ceiling does not seem likely, even among irrational grown men and women. However, recent market activity would indicate that either there are market participants who believe a default is more than a mere possibility or who are trading the instruments for a quick profit based on the fear in the market. Credit default swaps (CDS) provide a hedge against credit risk or the risk that a bond holder will not get paid due to a default with the issuer. Over the last several days of last week, the price on the one-year and five-year US credit default swap (CDS) moved higher. As Friday morning, the price for one-year CDS is above the price for the five-year, which is not common. In fact, the price inversion between the one- and five-year contracts is considered a *"classic sign of credit stress"* and reflects concerns for a near term default. The recent price increases in the CDS indicates higher demand for the insurance to get paid should the Treasury not able to make the approximate $30 billion interest payment on November 15th. According to recent estimates from the Treasury Department, the cash available on October 17th will be $30 billion.

In the Treasury Department's report, they spend a lot time focusing on the effects from the 2011 debt ceiling brinkmanship even though they acknowledge near the end of the report that *"[a] precise estimate of the effects is impossible, and the current situation is different than that of late 2011…"* While this debt ceiling debate is similar to one that took place in July 2011, there is one factor that is significantly different: a credit downgrade. Prior to all of the bickering back and forth in Congress and the delayed approval of the resolution two days before the Treasury's estimated run-out-of-cash date in 2011, Standard & Poor's (S&P), one of the three primary credit-rating agencies, had indicated their intention to downgrade the U.S. credit rating from AAA as a result of the stalemate over the debt ceiling. The Republicans in the House used the potential downgrade as a leveraging tool to try to get more spending cuts before passing the resolution. As promised, S&P downgraded the U.S. to AA+ from AAA on August 4th, two days after President Obama signed the legislation. This time around neither of the two other credit-rating agencies, Moody's and Fitch, has indicated the U.S. is at risk of losing its AAA rating.

In this heightened state of uncertainty surrounding the outcome of the government shut down and a potential impasse on the debt ceiling, the markets do not need public officials trying to raise the stakes. President Obama stated in a CNBC interview on October 2nd that Wall Street *"is taking the crisis too lightly"* and, as previously mentioned, the U.S. Treasury Department issued a report on the potential effects of not taking the debt ceiling seriously. We believe everyone understands the severity of the situation; politics has a tendency to *'fog up'* the windshield to make things move more slowly. The timing of these warnings is suspect given the S&P 500 was up nearly 1% on October 1st, the day before the interview. The day after Obama's interview, the S&P 500 returned approximately -1.0%. With investor sentiment so skittish, the rhetoric of government officials can unfortunately have more influence on the pricing of securities than the fundamental data. Once these macro issues have been resolved, we believe the equity markets should trend higher as investor confidence improves along with continued improvement in the economic data. ▪

Written by: ROB LITTLE, CFA, CPA
Vice President, Investment Strategy & Research
For more information, please contact 407.585.1160
1525 International Parkway, Suite 2071 Lake Mary, FL 32746
www.lamcogroup.com