Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist

POLITICAL PULSE

Once More unto the Debt Crisis, Dear Friends

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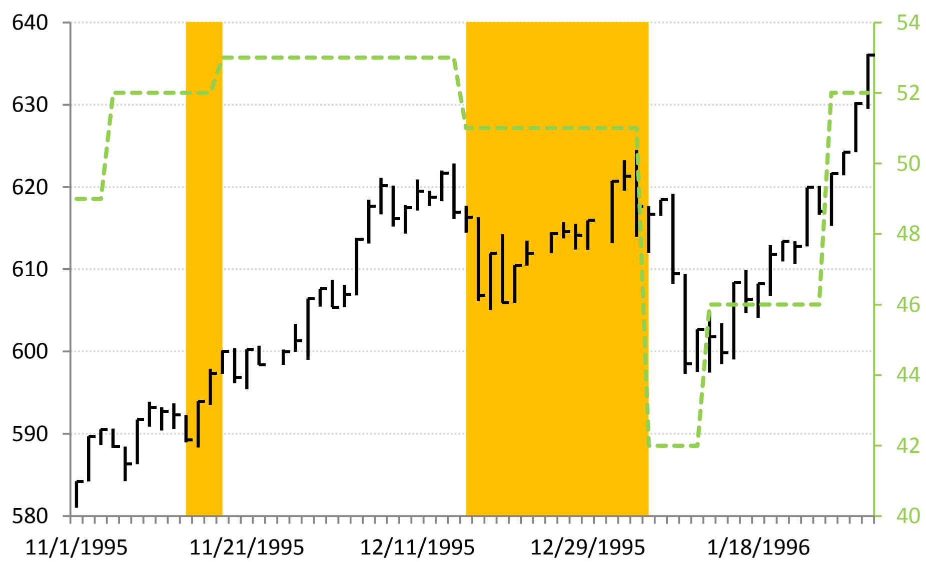
Donald Luskin

The next systemic threat? Likely less market risk and political risk here than meets the eye.

The month-end expiration of the continuing resolution that funds the US federal government, and the mid-October breaching of the statutory debt limit, are arguably systemic threats (see "A Little Distant Gunfire" August 29, 2013). Fed Chair Ben Bernanke thought so when he explained the FOMC's decision not to taper QE3 last week, saying, "upcoming fiscal debates may involve additional risks to financial markets and to the broader economy" (see "On the September FOMC" September 18, 2013).

- On the face of it this threatens to overturn our new strategic outlook for accelerating growth. Our shift in view is based on the idea that entrepreneurial risk-taking can finally revive, now that six years of constant imminent threats of systemic failure are over (see "A Major Upgrade to our Strategic Outlook" September 12, 2013).
- *To be sure, we can't rule out a systemic event here, a worst case leading to a government shutdown and a Treasury debt default.*

US federal government shutdowns
S&P 500 --- Clinton approval rating



Source: Bloomberg, Gallup, TrendMacro calculations

Update to strategic view

US MACRO, US BONDS, US STOCKS: The month-end expiration of the continuing resolution, and the mid-October breaching of the debt limit, are potential systemic threats -- and political risks to growth. Or are they? US stocks rallied during the 1995-96 shutdowns, Clinton's approval fell, and the GOP did well in the next election. Stocks fell sharply in the July/August 2011 debt limit crisis, but that unfolded in tandem with a far riskier crisis in euro area debt. US stocks didn't bottom until October when Europe's crisis was addressed. Obama's approval fell, and the GOP did better than average in the next election. The present debate is indeed risky, but risk-taking is essential to growth. In this case, the GOP is angling for relief from the costs of Obamacare, and for approval of the Keystone XL pipeline. The GOP won't get all it seeks here, but it may get something, and the risk of actual default is remote. There will probably be volatility while it plays out, but we don't expect any serious damage.

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- _*The very worst cases would likely result in global financial contagion. But most cases are not the very worst. We caution against the automatic expectation that the not-worst versions necessarily involve major systemic threats. That mind-set is a residual of six terribly risky years in which everything was contagious. Those years are now behind us.*_

In a deep sense whatever systemic risk we face now is itself the result of how *little* of it we have faced so far this year. Freedom from systemic risk is enabling political risk-taking that would have been impossible earlier in the year when the environment was so much more threatening. Remember, in the first quarter the GOP rolled over without a fight on both the continuing resolution and the debt limit (see "The Crisis Score is Four for Four" March 4, 2013).

- This is the political analogy of the revival of private entrepreneurial risk-taking we now expect.
- *But whether in the private sphere or the public sphere, risk-taking is, well, risky.*
- _*Yet only risk-taking can accelerate growth.*_
- In this case, the political risk-taking is indeed for the sake of growth. It is an explicit attempt by the GOP to reduce the anti-growth impact of Obamacare, and to help growth through the approval of the Keystone XL pipeline.
- Those are legitimate goals, worth taking some risk for. As we talk to clients, the implementation of the Affordable Care Act and the restriction of energy development are often cited as strong headwinds that stand in the way accelerating growth.
- This political exercise is risky, to be sure, and the GOP definitely won't get everything it wants. But it might get part of it. So as we go through the coming weeks of turmoil in Washington, we should bear in mind that while there is risk here, there is also reward.

Possible reward aside, _*what do we really know about the risks we face?*_ While a US Treasury default is unprecedented, and so presents potentially unique risks, we do have historical experience with government shutdowns.

- In November 1995, and then again stretching from December 1995 to January 1996, there were two back-to-back government shutdowns (please see the chart on the previous page).
- *These shutdowns were, in fact, both debt crises in which the statutory debt limit had been exceeded, and the Treasury faced imminent default. Unable to agree on a budget with the Republican-controlled congress, President Clinton had to shut down the government to divert funds for debt service to stave off default.*
- _*Yet the US equity market rallied during both these shutdowns.*_
- In a government shutdown essential services such as the mail and air traffic control, and emergency services, continue. There is no mechanism through which a shutdown of limited duration can cause meaningful economic damage.

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

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Interview with labor micro-economist John Haltiwanger
Federal Reserve Bank of Richmond *Econ Focus*
Second Quarter, 2013

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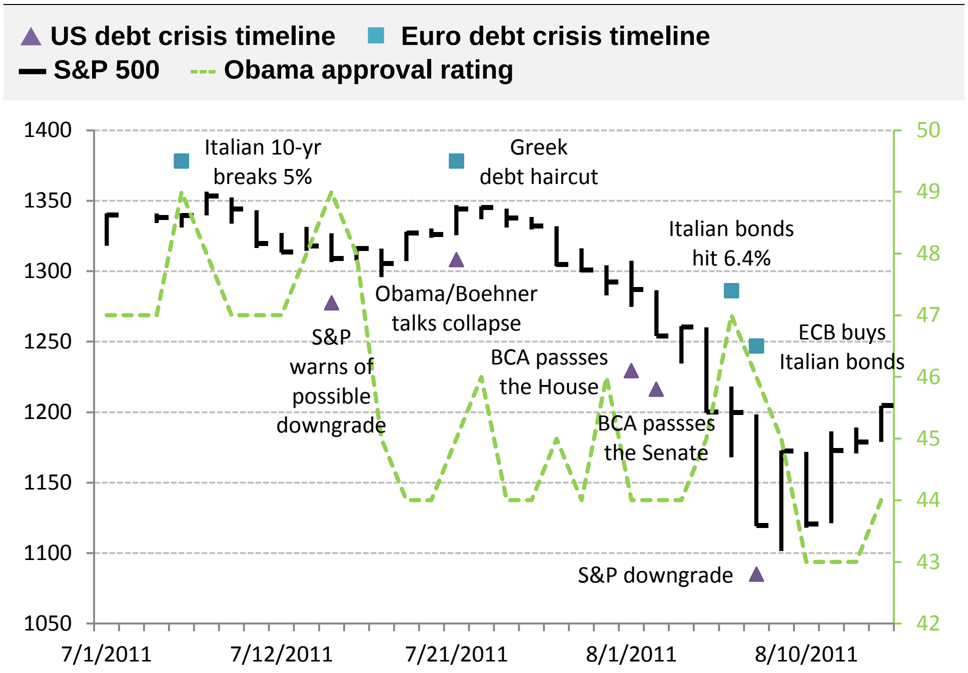
- The worst economic risk is political. If the GOP takes the public blame for a shutdown, that damages the outlook for a growth acceleration. Growth prospects would be stronger if the economy could look to GOP congressional gains in next year's mid-term elections, and to further gains and a GOP presidency in 2016 (again, see "A Major Upgrade to our Strategic Outlook").
- The conventional wisdom is that the 1995-96 shutdowns damaged the GOP. House Speaker Newt Gingrich (R-GA) *personally* behaved badly during the episode, and his reputation never recovered. But we don't see evidence that the GOP itself suffered.
- From the beginning of the first shutdown to the end of the second one Clinton's approval fell 10 percentage points (again, please see the chart on the first page).
- It quickly recovered, and Clinton was re-elected in 1996. But that was to be expected. With only a single exception -- when a very weak economy intervened against Jimmy Carter -- for more than a century incumbent presidents have *always* been re-elected (unless their party had occupied the White House for two or more terms; see "TrendMacro's Election Model" September 28, 2012).
- And in 1996 the GOP lost four seats in the House of Representatives. But this was a less-than-typical loss in a presidential election year in which the other party wins the White House. The GOP *gained* three seats in the Senate -- a post-war record for a presidential election year in which the other party wins the White House.
- And the GOP *did* get some of what it wanted. Clinton and Gingrich agreed to a seven-year balanced budget deal which turned out to be *very* good for growth.

Perhaps a more salient precedent for today's investors is the debt limit crisis in the summer of 2011. A government shutdown didn't occur -- with so much more debt to be serviced, it wouldn't have been much help -- but the affair resulted in the first-ever ratings downgrade of US Treasury debt.

- We certainly remember the 2011 debt limit crisis as a frightening event. Equity markets fell sharply while it was unfolding.
- *But two years on we should try to remember the full context. It is not certain at all that the US debt crisis was entirely to blame.*
- At the exact same time as the US debt crisis was happening, there was also a debt crisis in the euro area. Indeed, some of the milestone events of these two crises occurred on the very same days (please see the chart on the following page).
- The month-long period of twin crises started in Europe on July 6, when the Italian 10-year government bond yield aggressively breached 5%. This was a very real threat: it signaled a speculative attack on one of the world's fourth largest stock of sovereign debt, with potentially lethal impact on the viability of the euro currency union (see "The Sack of Rome" July 13, 2011) -- and the stability of the global banking system.
- The US crisis began eight days later, when Standard & Poor's placed the US Treasury on CreditWatch negative due to anticipated



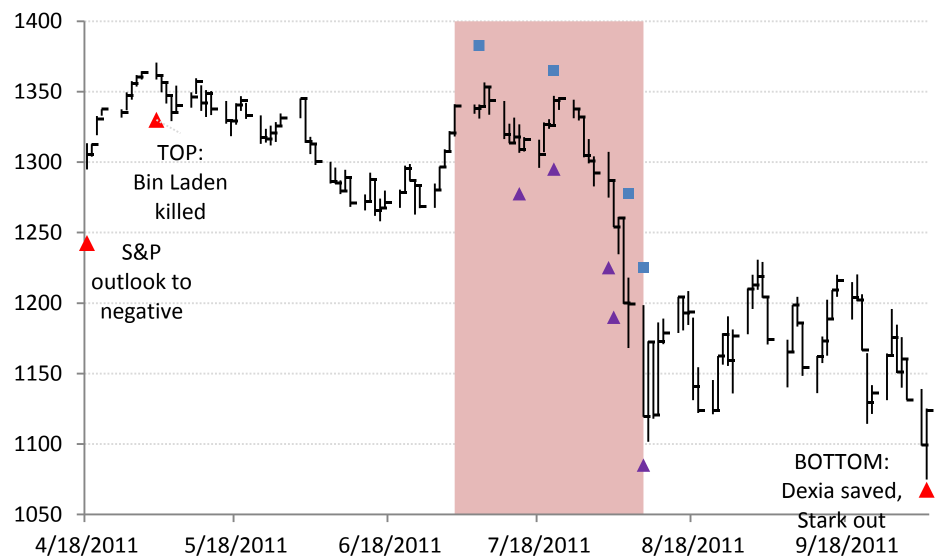
Source: Bloomberg, Rasmussen, TrendMacro calculations

political turmoil.

- The worst of the crisis began on July 21 on both continents at once. In the US, talks between President Obama and House Speaker John Boehner (R-OH) broke down when, after previously agreeing on a "grand bargain" of spending reductions and tax reform, Obama demanded additional revenues (please see *The Price of Politics* by Bob Woodward; Simon and Schuster 2012). In Europe, the managed default of Greek sovereign debt -- so called "private sector involvement" -- was announced, marking the first default since the formation of the common currency (see "Whatever It Takes" July 22, 2011).
- The US crisis ended on August 1 and 2, when the House and the Senate passed the Budget Control Act of 2011 which had been announced three days before (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011).
- But world equity markets continued to fall, as the speculative attack on Italy intensified, pushing the 10-year yield as high as 6.4% on Friday, August 5.
- After the close of US markets the same Friday, Standard & Poor's downgraded US Treasury debt from AAA to AA+. World markets reacted to the downgrade when they opened on Monday, August 8 (see "Downgrade: At Least the News is Out" August 8, 2011).
- On that same Monday the European Central Bank unexpectedly reactivated its dormant Securities Market Programme, and started buying Italian bonds, dramatically lowering their yields (again, see "Downgrade: At Least the News is Out").

- For the US, the debt crisis was over. It unfolded as the centerpiece of a 22.6% bear market in equities -- but it didn't begin that bear market, nor end it (please see the chart below).

— S&P 500 2011 bear market
▲ Key events ■ Period and timeline shown in prior chart



Source: Bloomberg, TrendMacro calculations

- That bear market began months before the crisis, on May 2. By that day equities had rallied considerably following Standard & Poor's downgrading its outlook on the US Treasury to negative. May 2, the day of the top, was the first market day after Osama bin Laden was assassinated. It also marked the all-time high in commodities prices, and the recovery high in oil prices (see "The bin Laden Commodities Crash" May 6, 2011) -- and the recovery high for emerging markets equities (again, see "A Little Distant Gunfire").
- *After* the worst was over in the US credit crisis, the euro area crisis continued.
- US stocks ultimately bottomed two months later. The low tick was on October 4. Italy would remain under speculative attack for another month, but on that day European authorities rescued the troubled French/Belgian global bank Dexia, and the day that ultra-hawk Jürgen Stark was replaced on the ECB's Governing Council with German Chancellor Angela Merkel's hand-picked dove, Jörg Asmussen (see "Europe Fails, US Stocks Flail" October 4, 2011).
- *We think that of the two crises unfolding at the same time, the euro crisis was the worse in terms of the intensity of systemic threat involved. In our view the chaotic break-up of the euro posed vastly more risk of financial contagion than a short-term technical default on US Treasuries.*
- Evidence for this view is the fact that US Treasury yields fell more than 100 bp while the US debt crisis played out, and fell even further after the downgrade. The inference is that global investors

never lost confidence in Treasury debt -- indeed, they valued it all the more highly as a safe haven from the threat in Europe.

- But it's probably a case of what behavioral economists call "availability bias" -- from the US perspective, it's only the US debt crisis that investors remember at this point. Nevertheless, we don't believe it was truly the main event.
- And as with the 1995-96 crisis, the conventional wisdom about the 2011 crisis is that it hurt the GOP politically. But here, too, we think there is little evidence to support the conventional wisdom.
- Obama's approval ratings fell steadily throughout the crisis, by about the same amount as Clinton's had (again, please see the chart on the previous page).
- Obama was re-elected the following year, as Clinton was. But again, incumbents are always elected -- and Obama was elected by an unusually narrow margin (see "On the 2012 Election" November 7, 2012). GOP losses in the Senate were average for a presidential year in which the other party wins the White House, and GOP losses in the House were below average. So where's the damage for the GOP?

At this point no one -- not even the drama's principals in congress and the White House -- knows exactly how the continuing resolution and the debt limit will be resolved. Both sides say they don't want a shutdown or a default, and there are simple ways to avoid both with short-term stop-gap resolutions while negotiations go on. We will be watching events closely, and analyzing them for clients as they unfold.

- For us, it will not just be about risk. That's very important, but the potential pro-growth rewards are important, too.
- At this moment we are hopeful on both fronts.
- Obama's negotiating strength is lower today than it was in 2011.
- Just by the numbers, his approval ratings then were exactly the same as today's -- 49%. But in 2011 the glory of having bagged Osama bin Laden was still fresh in his consciousness. Today, he is a lame duck laboring under the shame of his own party's rejection of his Syria initiative -- from which he was humiliatingly bailed out by Russian diplomacy.
- However it turns out, it will be a useful test of our proposition that the era of systemic risk and global contagion is over. Stay tuned.

Bottom line

The month-end expiration of the continuing resolution, and the mid-October breaching of the debt limit, are potential systemic threats -- and political risks to growth. Or are they? US stocks rallied during the 1995-96 shutdowns, Clinton's approval fell, and the GOP did well in the next election. Stocks fell sharply in the July/August 2011 debt limit crisis, but that unfolded in tandem with a far riskier crisis in euro area debt. US stocks didn't bottom until October when Europe's crisis was addressed. Obama's approval fell, and the GOP did better than average in the next election. The present debate is indeed risky, but risk-taking is essential to growth. In this case, the GOP is angling for relief from the costs of Obamacare, and for approval of the Keystone XL pipeline. The GOP won't get all it seeks here, but it may get something, and the risk of actual default is remote. There will probably be volatility while it plays out, but we don't expect any serious damage.