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TRENDMACRO LIVE!

On the Shutdown and Debt Limit Deal

Thursday, October 17, 2013
Donald Luskin

A contrarian case: the GOP won! Either way, stalwart markets prove the era of risk-off is over.

The crisis of the government shutdown and the debt limit is over, very much along the lines we have been anticipating (see, first, "Once More unto the Debt Crisis, Dear Friends" September 25, 2013; and most recently "Down to the Wire, and Beyond" October 15, 2013).

- The bill (text, summary) funds the government through January 15, 2014, raises the debt limit through February 7, 2014, and gives back-pay to workers furloughed in the shutdown.
- The debt limit hike is a "negative consent" process, in which the president announces he intends to use more debt authority, and then congress passes a bill to say he can't -- so that GOP members can go on record as being against it. The president vetoes that bill.
- The key for markets is that like the last time the debt limit was raised -- February's No Budget, No Pay Act of 2013 -- the limit is in fact *suspended through a given date*, rather than *raised by a given dollar amount.*
- *So the federal Treasury can issue debt without limitation through February 7, and that amount, whatever it is, becomes the new limit.* That means the Treasury can use issuance without limit to replenish the exhausted sources of "extraordinary measures" it has used to defer default.
- Therefore after February 7, if the debt limit hasn't been raised again, the Treasury can employ those measures again, extending the effective deadline to default by at least a month. Indeed, the bill's language explicitly permits this.
- *So we will not face another shutdown cliff until January, nor another default cliff until March.*
- And, oh, we almost forgot -- the bill authorizes payment of $174,000 to the widow a recently deceased senator.

Explicit pro-growth GOP policy gains were minimal at best.

- The bill contains a commitment to income verification for Obamacare subsidies, but nothing else touching the flashpoint issue for conservatives that ignited the crisis in the first place.
- By the time the first deadline arrives -- the January 15, 2014 expiration of the continuing resolution -- Obamacare's individual

Update to strategic view

US MACRO, US STOCKS, US BONDS: The shutdown and default crisis is over, with the debt limit suspended till February, and the next default deadline pushed out to at least March. Pro-growth GOP policy gains were minimal. We stand against the dominant narrative that the crisis damaged the GOP. The sequesters are intact, and will be effective leverage for coming budget battles. And by playing to its base, the GOP has set itself up well for the political demography of the 2014 mid-term elections. Most important, the minimal reaction by markets through the crisis supports our new secular view that the global economy now presents a robust platform for risk-bearing. The mean equity risk premium should continue to fall as earnings growth picks up, with both higher stock prices and higher bond yields.

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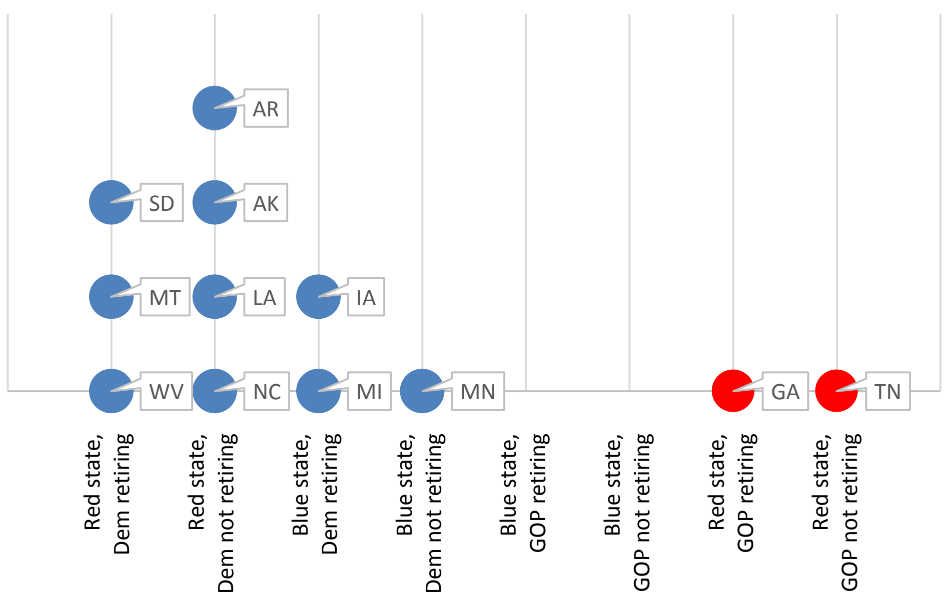
mandate will have already gone into effect, so it will be too late for its opponents in the GOP to fight to delay it.

- Separate resolutions will create a congressional conference committee to produce the first federal budget since 2009, reporting out by December 13. It will be chaired by Senate Budget Committee Chair Patty Murray (D-WA) and House Budget Committee Chair Paul Ryan (R-WI).
- We don't expect any "grand bargains" out of this conference, and probably not even a budget.

But we don't regard this affair as a political failure for the GOP, nor a setback for its economic policy agenda (which we believe to be more pro-growth than that of the Democrats).

- We regard as nonsense such analyses as the two lead stories on the influential Politico web site last night -- "Obama Wins" and "House GOP Gets Nothing."
- What did Obama "win," except the *status quo*? The GOP didn't give the Democrats an inch on the sequesters. They will be the GOP's negotiating trump card going into the budget conference, and -- if need be -- in the next continuing resolution debate in January.
- And the House GOP -- and the Republican party overall -- did not get "nothing." To be sure, not much in policy objectives, but that's not a failure except versus an unrealistic counterfactual -- neither party can accomplish a lot in a divided congress.
- *What the GOP gained, for remaining unified in a desperate battle, despite seemingly powerful internal divisions, is political energy among its own base -- setting up for next year's mid-terms.*

2014 competitive Senate races ● Democratic seats ● GOP seats



Source: Cook Political Report, TrendMacro calculations

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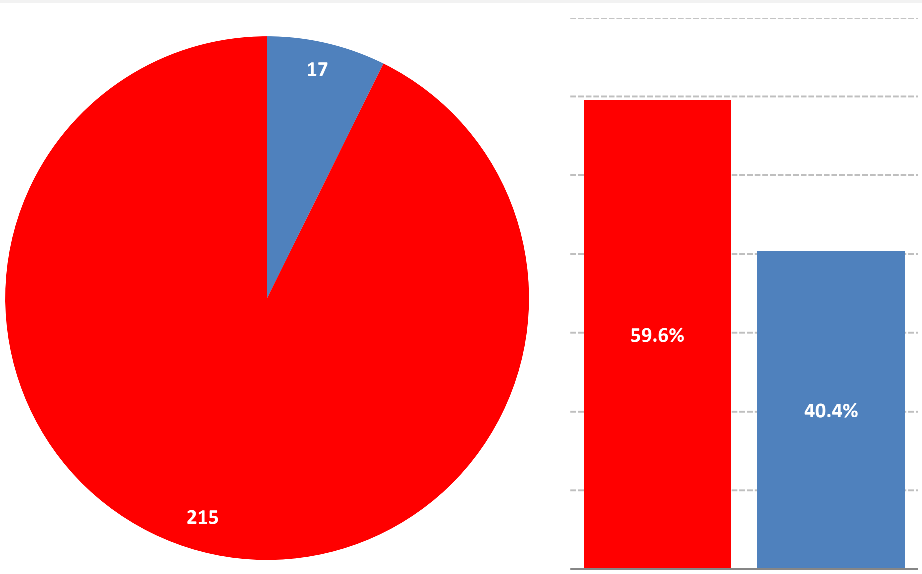
[About us]

- Versus most of what is being written on this subject, we are aware that this view seems fantastical. But the same dynamic worked in the two most recent examples of crises analogous to this one -- the 1995-96 shutdowns and the 2011 debt limit crisis. Both are widely believed to be GOP political failures, but when properly benchmarked, neither actually was.
- Both set the GOP up for better-than-average results in the following elections (see "On the 2012 Election" November 7, 2012).
- *We think it will play out that way again this time, in spades, because this time the post-crisis election will be a mid-term.* It won't be a presidential election -- such as 1996 and 2012 -- in both of which a Democratic president was running with the nearly unbeatable advantage of incumbency, and with coat-tail effects accruing to his party's congressional candidates.
- *The political demographics of the 2014 mid-terms are especially suited to the kind of political theatrics that we've just seen, designed to excite a loyal base eager to make an impact while the opposing party controls the White House*.
- Out of 35 Senate races in 2014, 12 are competitive. Only two of those involve seats currently held by the GOP, and none is in blue states that voted for Obama (please see the chart on the previous page). Ten competitive races involve seats currently held by Democrats -- seven are in red states that voted for Romney, and in three of those the incumbent is retiring.
- In the House, of the current 232 GOP members, only 17 -- about 5% of the total -- come from blue districts that voted for Obama (please see the chart below). Overall, on average, in the 2012 election (in which the GOP lost 7 seats on net), the average vote-share for Democratic candidates was only 40.4%.

Republic House members, by 2012 vote in district ● Obama ● Romney
Average 2012 vote share in GOP districts ■ Obama ■ Romney



Source: Cook Political Report, TrendMacro calculations

- *In many client conversations this week we've heard the fear that the GOP could now lose the House in 2014.That would usher in two years of one-party rule like we had in 2009 and 2010, resulting in large-scale anti-growth policy errors like the Affordable Care Act and Dodd/Frank. <u>Even if our thesis that this crisis will help the GOP is wrong, we regard losing the House as virtually impossible.</u>*

So now the crisis is over. It proved to be a risk-on opportunity, as we expected (see "On the Pending Government Shutdown" September 30, 2013). But not an especially large one. Other than the front end of the Treasury curve, markets didn't really pay the crisis much mind (from top tick to low, the S&P 500 corrected less than 5%). Any bounce-back effect is over with. It's just noise now. The good news is out -- so move along folks, nothing to see here.

- But thinking in more strategic terms, the very fact that markets reacted so little reinforces our new secular view: the fundamental structure of global economic and investment sentiment is changing for the better (see "A Major Upgrade to our Strategic Outlook" September 12, 2013).
- This is yet another well-publicized crisis in 2013 which -- unlike the multiple crises of 2007 through 2012 -- the markets did *not* automatically assume to be globally contagious, producing spasmodic risk-off episodes.
- *For all the talk about the effect of the government shutdown on Q4 GDP and on consumer sentiment, we think the net result for the economy and the markets will be just the opposite.*
- *This crisis proves that the markets believe the global economy is fundamentally robust. <u>On that platform of greater certainty, the mean equity risk premium can continue to fall. Economic growth rates and forward earnings growth rates more like we've seen in past expansions can come back.</u>*
- All the more so if we're right that, despite all appearances, this supposed fiasco will in fact turn out to be a victory for political forces more supportive of pro-growth policy.

Bottom line

The shutdown and default crisis is over, with the debt limit suspended till February, and the next default deadline pushed out to at least March. Pro-growth GOP policy gains were minimal. We stand against the dominant narrative that the crisis damaged the GOP. The sequesters are intact, and will be effective leverage for coming budget battles. And by playing to its base, the GOP has set itself up well for the political demography of the 2014 mid-term elections. Most important, the minimal reaction by markets through the crisis supports our new secular view that the global economy now presents a robust platform for risk-bearing. The mean equity risk premium should continue to fall as earnings growth picks up, with both higher stock prices and higher bond yields.