TrendMacro

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MACROCOSM

Debt Ceiling Crisis Over -- Now What?

Tuesday, August 2, 2011

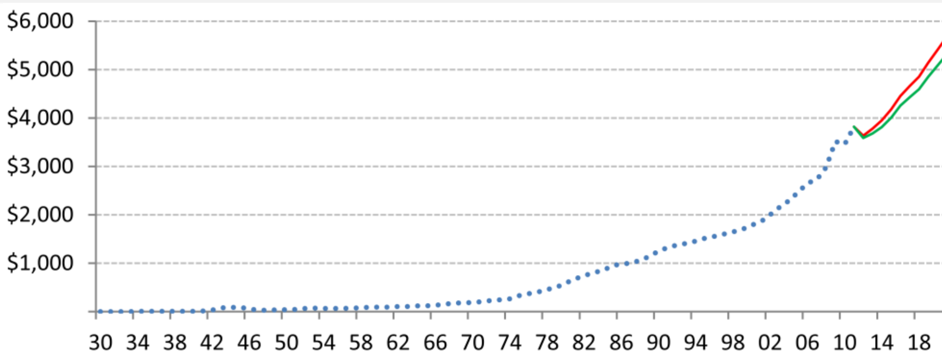
Donald Luskin

It's the third blow to the economy this year. Can confidence ever be restored?

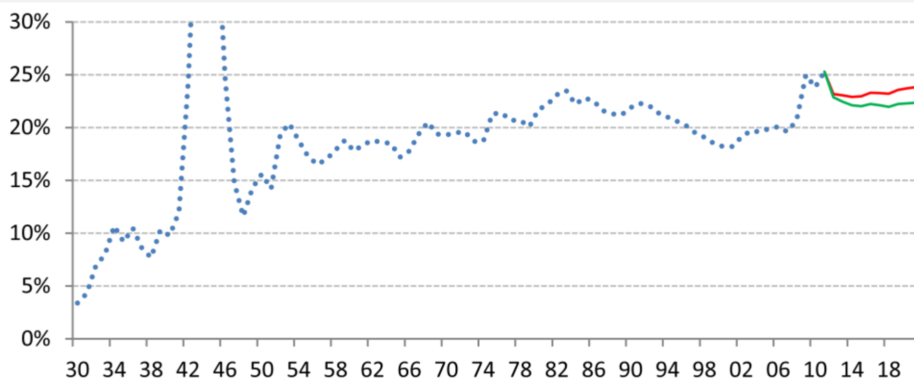
Assuming the Budget Control Act (BCA) passes the Senate later today, the debt ceiling drama is over. It will have ended as we've been saying it would, which was how it *had* to -- with bipartisan centrist support, giving the GOP modest spending cuts and no new taxes, and the Democrats relief from blackmail over the debt ceiling until after the elections. These are positives for the economy -- but markets don't seem happy about it.

As has been widely commented, the BCA doesn't actually *reduce* spending -- it *decelerates* it (please see the chart below).

Federal spending ••• Historical — CBO baseline — Budget Control Act
Nominal, $billions



Percent GDP



Source: CBO, OMB, TrendMacro calculations (pace of JSC cuts set same as statutory)

Update to strategic view

US MACRO, US STOCKS: The debt ceiling drama in Washington has been a global blow to confidence, and the repercussions of it will linger. But the worst is over -- and this has been an important victory in the long-term battle for the restoration of a pro-growth policy environment. Stocks are near the bottom of the year's narrow trading range while forward earnings are surging. We just can't be bearish here.

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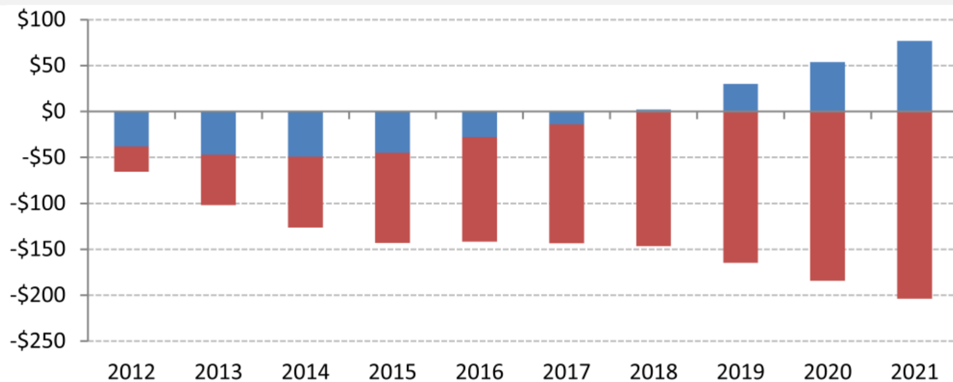
- That said, *as a percentage of GDP*, the BCA *does* reduce spending by nine tenths of a percentage point (the CBO baseline has it about flat). But BCA does not even come close to returning the spending share of GDP to where it was before the Great Recession.
- The reason is mostly the relentless rise in "mandatory" spending -- that is, entitlements. The BCA actually *does* reduce "discretionary" spending in absolute terms -- that is, not just as a share of GDP (please see the chart below) -- but it's not enough to overcome the growth in entitlements.

Change in discretionary spending versus 2011 Nominal, $billions, fiscal year
■ **Statutory spending caps** ■ **Joint Select Committee cuts**



Source: CBO, TrendMacro calculations (pace of JSC cuts set same as statutory)

We're surprised and disappointed that markets haven't reacted more positively. We expected a relief rally and more (see "On the Debt Ceiling Deadlock" July 25, 2011) -- and we still think we should get it.

- Obviously, *tactically*, a very dangerous Sword of Damocles has been removed. No government shutdown, no Treasury default -- and mechanisms are now in place to rule out such risks until 2013.
- *Strategically*, this is the third risky political skirmish that has been won by the forces of pro-growth policy (see "Tax Cut Endgame" December 13, 2010; and "Growth Wins Another Skirmish" April 11, 2011). This indicates that last year's fundamental change in the political climate in favor of capital, capitalism and capitalists is powerful and durable (see "To Get Rich is Glorious Again" December 7, 2010).
- The bruising political process has been a *policy* victory for the GOP, and it has been more *politically* damaging to Democrats than to Republicans. It sets up for a 2012 election favoring continuation of political realignment away from the destabilizing anti-growth policy environment of 2008 and 2009 (see "The Pendulum Swings Back" November 2, 2010).

So why have markets acted so poorly?

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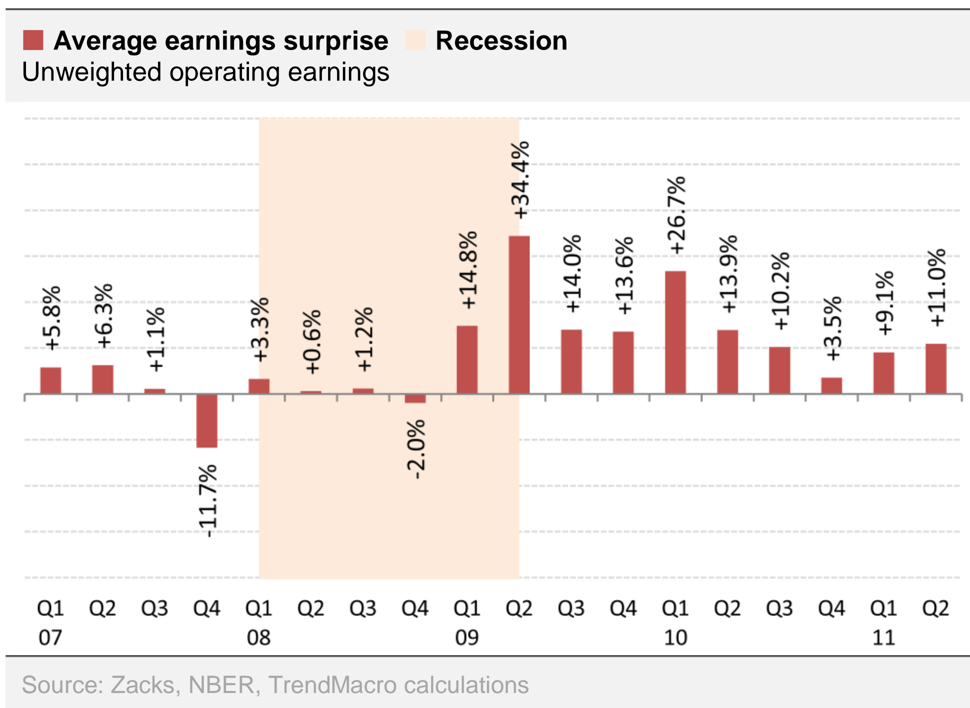
[About us]

- We don't put much stock in the idea that the spending cuts in BCA will be contractionary. Even if you fully accept the Keynesian basis for such fears, the front-end cuts just not big enough to have much effect one way or the other.
- We think the crux of the matter is sentiment. The drama in Washington has been a disgusting -- and terrifying -- display of reckless opportunism and brinksmanship by all sides. The game theory dynamics of politics necessitated this. Nevertheless, it has been a blow to confidence on a global scale -- after all, at stake was a potential default in US Treasury securities, the cornerstone of the world financial system. And no amount of after-the-fact faux comity -- even kissy-face with Gabrielle Giffords -- is going to disguise that reality.
- Even the very positive fact of political alignment that we put so much reliance in has a dark side. The Tea Party, which has been so essential in anchoring the process, has clearly revealed a dangerous fundamentalist streak. In the debt ceiling drama its most visible avatars have been almost gleefully willing to countenance an economically catastrophic and morally repugnant Treasury default as a means of achieving debt reduction. Such means do not justify such ends. We warned about this over a year ago (see "Republicans and the Populist Temptation" February 9, 2010).
- This is the third major blow to the global economy this calendar year -- following the surprise jump in oil prices in January, and the Japanese earthquake in March (see "Footprints of the Black Swans" June 30, 2011).
- We think it has particular epistemic consequences for Europe -- a US political crisis about sovereign debt aggravating the perceived risks of the ongoing European political crisis over sovereign debt. If a *single* government can't get it together to support its debt securities, then how is an *ad hoc* group of 17 governments supposed to do it? At the moment they're *not* doing it, with Spanish and Italian yields rising while the ECB fails to intervene, and the powered-up EFSF -- as yet still ungratified -- is unable to intervene (see "Europe, Living on the Edge" August 1, 2011).
- This week's votes in Congress don't end the matter entirely. BCA calls for a joint select committee to define specific spending cuts beyond the statutory caps immediately imposed. We can be sure that the committee's work will be rancorous. There is nothing structural that prejudices the committee in favor of tax-hikes -- nevertheless, we can be sure that Democrats will use the committee to plead for them, and so there is no escaping the fact that they will be in play -- it seems they have become an obsession for our wounded president. This will all occur without the specter of default -- but it won't inspire confidence.
- And nothing in BCA guarantees that the debt of the US government won't be downgraded. Its promised deficit reductions are not enough to meet Standard & Poor's putative requirements. It remains to be seen whether S&P will in fact follow through on its downgrade threat. In the nature of things, it has the discretion to moderate its present stance for any rationale it chooses -- we think it will feel itself under tremendous pressure to choose on the side of

forbearance. And we're not at all sure it substantively matters one way or the other. Nevertheless, the threat is a residual inhibitor of confidence.

- Yesterday's ISM Index, coming just below bottom of the range of expectations and showing almost no growth in the US manufacturing sector, was a vivid reminder that the 2011 soft-spot is ongoing.

For all this, US stocks have managed to stay in a narrow trading range year-to-date. They are at the lower end of that range now, even as we wrap up what has been an almost inexplicably successful earnings season. Beats have outnumbered misses by more than 2-to-1, with the average surprise (including both beats and misses) at a robust 11%, the best showing of the last four quarters (please see the chart below). The top-line has beaten on average by 3% -- the biggest beat we can remember. Upgrades to year-ahead earnings have sharply accelerated as they continue to make all-time highs (see "A New EPS High-water Mark" May 11, 2011).



The bullish outlook we had for 2011 hasn't materialized. But the bearish outlook -- which we continue to see as the overwhelmingly strong consensus -- hasn't materialized either. Considering all that has gone wrong, that's really quite remarkable. We don't interpret that as meaning that stocks are overdue for a fall. Rather, it means that they are cheap, as they have to be with prices flat all year as earnings have grown considerably. They're overdue for a rally, not a fall.

In fact, the whole economy is cheap. It's discouraging to have learned last week that US GDP has yet to make new highs, two year after the trough of the Great Recession -- before the revisions came through, we'd thought it

already had (see "On Q2 2011 GDP -- and On the Debt Ceiling Deadlock, Volume 3" July 29, 2011). But that just means that the already enormous "output gap" is even larger than we'd thought. In other words, the gap between what we are producing and what we are immediately capable of producing -- the latent, easily accessible potential in the economy -- is at a level of enormity unprecedented in our lifetimes. All it takes to unlock that potential is confidence.

And in the meantime, however long it takes for confidence to be restored, it means that the economy will be highly resilient to shocks. Yes, shocks can keep growth from igniting, but it will be difficult for them to cause a recession. In other words, we're still on the runway. So at least we don't have to worry about stall speed.

Bottom line

The debt ceiling drama in Washington has been a global blow to confidence, and the repercussions of it will linger. But the worst is over -- and this has been an important victory in the long-term battle for the restoration of a pro-growth policy environment. Stocks are near the bottom of the year's narrow trading range while forward earnings are surging. We just can't be bearish here.