Shane Oliver, Head of Investment Strategy
& Chief Economist

AMP CAPITAL

The US budget and debt ceiling standoff

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Key points

> The partial US Government shutdown is likely to continue until there is a joint solution to the shutdown and approaching debt ceiling later this month.

> The debt ceiling poses the greater risk to the US (and global) economy given the risk of debt default by the US.

> However, the most likely outcome is a last minute increase in the debt ceiling. And in any event a debt default is unlikely.

> Shares are vulnerable in the short term as uncertainty intensifies, but are likely to rally solidly into year-end once a solution to the debt ceiling is in place.

Here they go again

Political dysfunction around fiscal policy is a regular occurrence in the US, with regular bouts of uncertainty over government shutdowns, debt ceiling increases, etc. The annoying thing for me is that often they take place when I have gone on holidays, and the shutdown that commenced last week was no exception! Such conflicts invariably arise because different political parties to the President control part or all of Congress. At present it's the Republican controlled House against the Democrat controlled Senate and President Obama. Such conflicts seem worse lately because the GFC and the response to it seems to have polarised many politicians to extreme positions.

The current dispute is around the failure to pass a new budget for the financial year beginning October 1 (hence the shutdown) and the need to raise the US Government's debt ceiling (which is expected to be reached by October 17). It has its origins in the Republican dislike for President Obama's health care reforms (Obamacare) and the failure of the fiscal cliff resolution early this year to embrace a 'grand bargain' reducing America's long term budget deficit by closing tax loopholes and cutting back on the growth of entitlements.

Obviously the consequences of the US not increasing its debt ceiling and defaulting on its debt would be bad – many have said catastrophic. Failure to make a debt servicing obligation will see the US sovereign rating lowered to 'Selective Default' (according to Standard and Poors) as Greece was recently. Such an event would likely see a sell-off in US Government bonds, a flow on to the borrowing costs of all US corporates and a stigma that may take the US years to recover from – as Argentina and Russia have found. And of course not increasing the debt ceiling would mean the budget deficit of 4% of GDP would have to be eliminated immediately resulting in massive fiscal drag. All of which would affect confidence and hence economic growth.

However, the odds strongly favour a solution being found and a debt default being avoided, but the next few weeks could be uncertain.

Shutdowns are nothing new in the US

US Government shutdowns are far from new and arise when Congress fails to pass laws funding Government spending. In fact there were 17 shutdowns between 1976 and 1996, lasting an average 7.4 days, with the median shutdown lasting 4 days.

Since they involve non-essential government services (ie, not the whole Government as many items of spending have separate streams of funding) their economic impact is small.

Past US Government shutdowns

Shutdown	Number of days	US S&P 500 % change, during shutdown	US S&P 500 % change, 2 wks after shutdown
30/9/76-11/10/76	11	-2.6	-2.5
30/9/77-13/10/77	13	-2.6	-2.1
31/10/77-9/11/77	9	0.1	3.9
30/11/77-9/12/77	9	-2.0	0.9
30/9/78-18/10/78	18	-1.3	-8.0
30/9/79-12/10/79	12	-3.9	-4.8
20/11/81-23/11/81	3	NA	2.9
30/9/82-2/10/82	2	1.3	9.5
17/12/82-21/12/82	4	-0.9	3.7
10/11/83-14/11/83	4	1.1	0.2
30/9/84-3/10/84	3	-1.5	0.7
3/10/84-5/10/84	2	0.3	3.2
16/10/86-18/10/86	2	-0.3	2.2
18/12/87-20/12/87	2	NA	3.8
5/10/90-9/10/90	4	0.6	0.4
13/11/95-19/11/95	6	1.3	2.3
15/12/95-6/1/96	22	0.1	-0.8
Median	**4**	**-0.3**	**0.9**

Source: Bloomberg, Ned Davis Research, AMP Capital

The current shutdown is estimated to be costing the US economy around 0.1% of GDP a week. But this will be significantly reversed once the shutdown ends and Government spending plays catch-up and currently furloughed workers get back pay. A return to work of around 350,000 civilian defence workers will also reduce the impact. This means only 450,000 Federal workers will remain on furlough, not the 800,000 referred to last week.

Interestingly the impact on share markets is mixed: US shares fell through 8 of the last 15 shutdowns (affecting market trading days) and rose through 7 including the longest in 1995-96. Shares experienced above average gains once shutdowns ended though.

The debt ceiling is a greater risk

The risks are a bit greater this time though as the US economy is somewhat fragile. More importantly, the budget debate is rolling into the need for Congress to increase the US Government's debt ceiling later this month. The US Government will reach its $US16.7trn debt ceiling on October 17 and will run out of an estimated remaining $US30bn in cash by November 1, when it has roughly $US67bn in Social Security and Medicare payments due.

Given that the US Government is running a budget deficit equal to around 4% of GDP, if the debt ceiling is not increased spending would have to be cut back to be in line with revenue. As a result there are obvious fears that this may result in the US defaulting on its debt servicing obligations. On this front the US Treasury has about $US30bn in debt interest payments due on November 15.

However, there are several points to note on all this. First, we have been here before and solutions have always been found. The debt ceiling has been increased 17 times since 1993, most recently in August 2011 when the debt ceiling was last increased but at the last minute and after a round of brinkmanship. And it is worth noting that at Christmas last year the prospects for heading off the fiscal cliff of spending cuts and tax hikes looked bleak only to see agreement reached in the early hours of New Year's Day.

Second, both sides of US politics are aware of the longer term consequences of the US defaulting on its debt servicing. House Speaker John Boehner has repeated that he won't allow this to happen, even if it involves relying on Democrat votes, albeit it will likely require measures to reduce the long term growth in debt. And while President Obama has said he won't negotiate on the debt ceiling, it's hard to see him wanting his legacy marred by letting the US default while on his watch. So a last minute solution remains the most likely outcome for the debt ceiling.

Third, while a last minute solution will likely be found it's a bit too early for it just yet as the political pressure is not great enough. On this front, while it would be good for the shutdown to end soon, the longer the shutdown lasts the greater the odds the Republicans will cave in earlier on the debt ceiling as it's likely they will be politically weakened as Americans will probably mostly blame them for the shutdown. Similarly if President Obama is to back down and negotiate on the debt ceiling he probably won't do so until the very last minute.

However, there are some positive noises starting to appear with some on both sides of politics raising points of negotiation that may lead to a solution. There is further to go though. But after playing hardball for a while (to appease their extremes) Republicans and Democrats are likely to arrive at a solution for the shutdown and debt ceiling that involves some tax reform in return for the start of a process of slowing the growth in entitlements and removing the medical devices tax that is part of Obamacare.

An alternative approach now being considered by the US Senate is to allow President Obama to increase the debt ceiling unless Congress voted against it by a 2/3rds majority in each chamber. Such an approach would allow the Republicans to vote against it but the debt ceiling to be raised anyway as they would not have a 2/3rds majority.

Fourth, even if the debt ceiling is not increased in time, the US Treasury is almost certain to prioritise debt servicing so a partial debt default is very unlikely. In other words the 4% of GDP cut to Government spending that would be required would fall on other areas than debt servicing.

A better position than in 2011

There is no doubt that the political brinkmanship that the US regularly finds itself in has not been helping its economic recovery. As Standard and Poors recently pointed out "this sort of political brinkmanship is the dominant reason the [US sovereign] rating is no longer AAA. Fitch and Moody's may well be tempted to similarly cut the US rating one notch.

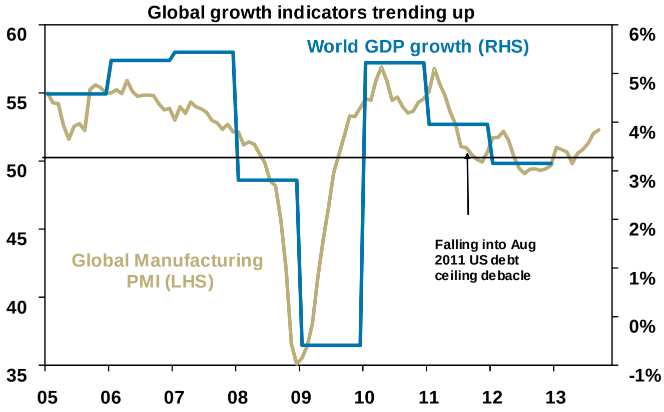
However, it is not all bad and has been leading to a more balanced solution to America's debt problem than would have been the case if either side of politics had complete control. We have been seeing a mix of revenue increases and spending cuts in recent years. For example, the fiscal cliff deal ultimately saw the Bush era tax cuts for high earners end and the so-call 'sequester' spending cuts commence. And the budget deficit has now fallen to 4% of GDP from a peak of 10% in 2010 and the ratio of public debt to GDP actually stopped increasing in the June quarter.

More importantly, it's worth noting that there are now several positives compared to the situation around the August 2011 debt ceiling/sovereign rating downgrade in the US.

First, as already noted the budget deficit is much smaller, such that any forced and immediate budget balancing wouldn't be as bad for the economy.

Second, Fed monetary policy is far more stimulatory with QE3 continuing whereas back in August 2011 the US was suffering from the premature ending of QE2 in June 2011.

Third, global growth is picking up as is clearly evident in an uptrend in business conditions PMIs, in contrast to the situation in August 2011 when they were falling. This included the US where there were fears of a double dip recession at the time whereas now the US seems to be on a stronger path led by private sector activity – notably housing and business investment.



Source: Bloomberg, AMP Capital

Finally, the Eurozone is no longer threatening to implode whereas back in the second half of 2011 the Eurozone crisis was at its peak.

In other words the US and the world is in a far better position today to withstand a debt ceiling crisis than it was the last time around in August 2011.

What does it mean for investors?

Even though a last minute solution remains most likely it won't stop investors fearing the worst in the interim, so the next few weeks could see further weakness in share markets. After a long period of solid gains shares are vulnerable and October is often a messy month for shares anyway. However, while it's too early just yet, weakness on the back of US debt ceiling fears should ultimately be seen as a buying opportunity as a last minute deal is likely to set the scene for a resumption of the bull market and the usual solid seasonal gains into year end.

Bonds are likely to benefit from safe haven buying in the short term but are likely to resume their gradual rising trend once a solution is in place.

US assets may be a relative loser in the short term as current events yet again highlight political dysfunction in the US. This could work against the $US (and boost the $A), US bonds and US shares in the short term. However, such an impact is not likely to last long as the US political system has functioned better through times of crisis than Japan or the Eurozone have.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital