



Weekly Market Commentary

July 18, 2011

Debt Ceiling Debate Outcomes and Market Impact

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Highlights

We update the probabilities of the four potential outcomes emerging from the debt ceiling debate over the next two weeks.

We continue to believe the most likely outcome by Aug 2 contains spending cuts totaling \$1–2 trillion over 10 years, but no substantive entitlement reform or tax increases.

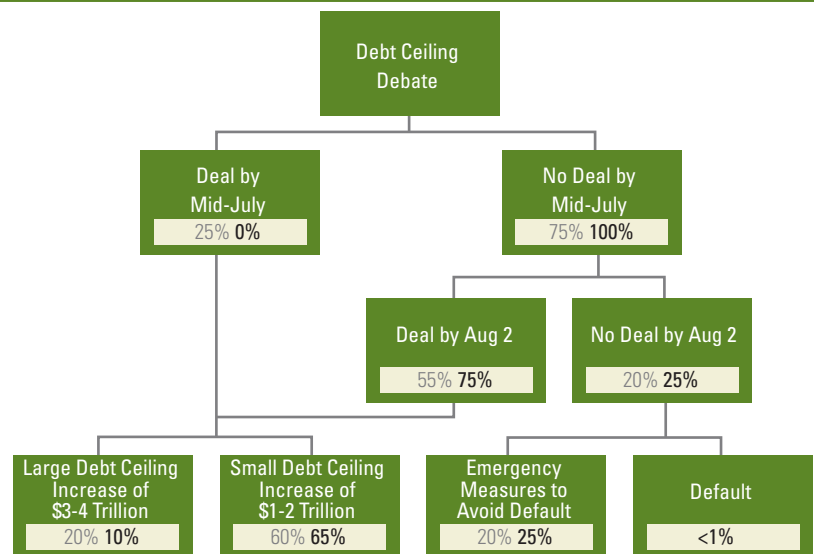
The markets have largely priced in this outcome and are unlikely to make a major move in either direction if this is the result. However, dramatic moves are likely in the event of alternative outcomes.

The longer the uncertainty lingers the worse the market may fare, as last week's performance attests.

The S&P 500 dropped 2.1% last week. The index retreated after posting the biggest two-week increase since 2009. The lingering impasse in Washington on the debt ceiling weighted on the market and prompted bond rating agencies Moody's Investors Service and Standard and Poors to say they may cut the United States credit rating. Concern that the debt problems in Europe were spreading also fueled the selling. Positive earnings reports were no help even as the first week of reports resulted in 11 of the 13 S&P 500 companies that released results beat projections.

Over the next two weeks, increasingly the major issue for the markets will be the debt ceiling negotiations. A deal may need to be reached this week to have time to pass congress by August 2. If a deal is not reached the markets may "hit the ceiling" as the United States is forced to default on its obligations or must undertake emergency measures to avoid a default.

Debt Ceiling Debate Outcomes and Probabilities as of July 18*



*Grey numbers denote July 5 probabilities

Pruning the Tree

There are four key updates to the decision tree we published on July 5.

- **No deal was struck by mid-July, as we thought was most likely.** As of August 2, the United States will have exhausted its ability to borrow under the existing federal debt ceiling of \$14.3 trillion.



- **The large debt ceiling increase of \$3–4 trillion is still possible, but we are lowering the odds to 10% from 20%.** To achieve \$3–4 trillion in savings over 10 years this outcome would likely involve major entitlement reform, substantial tax cuts and some revenue increases, and would put the United States on a path to fiscal sustainability. The likelihood of this outcome went down as both sides have made it clear what that tax hikes and major entitlement cuts were largely off the table. However, rating agency Standard and Poor's indicated last week that a deal of this size is important to sustaining the U.S.'s AAA credit rating. Also, the President has been pushing for a large deal and the House Republicans have proposed such a large deal. This maintains some possibility that a deal of this size could still be reached. In the event of this outcome, the stock market would likely post a sizable double-digit gain over the following weeks with companies in cyclical sectors such as Consumer Discretionary winning out over defensive sectors that may bear the brunt of the cuts, such as Health Care. High quality bonds would also rally although the already low yields would limit overall gains to a few percentage points. The dollar would likely strengthen sharply, leading to declines in commodity prices ranging from gold to oil.
- **The probability of a smaller \$1–2 trillion deal containing only spending cuts went up to 65% from 60%.** On Friday, President Obama said he would sign a deal that may include only spending cuts. This outcome appears to make a large dent in Federal spending, it defers tough decisions on entitlements and taxes to the next Congress (after the 2012 election when the Republicans may control both houses of Congress), and provides a victory for members of both parties going in to the 2012 elections. The markets have largely priced in this outcome and are unlikely to make a major move in either direction if this is the result.
- **The risk of no deal by August 2 went up to 25% from 20%.** Emergency measures have been increasingly proposed such as a vote by Congress to give power to the President to unilaterally raise the deal ceiling. Whatever the method, if no deal can be reached, congress or the Treasury may take emergency steps to prioritize debt payments to avoid default on the U.S.'s debt. This would be a negative outcome for the markets, but not devastating. With the two sides unable to reach a deal with so much on the line, confidence among investors (and consumers and businesses) would likely plunge. Stocks could experience double-digit pullback as the impasse lingers. Treasury yields would rise as bond prices fell on rising fears of default. Precious metals may rise as investors seek a safe haven alternative to Treasuries.

For more details on these outcomes please see our July 5 *Weekly Market Commentary* entitled "Will Markets Hit the Ceiling?"

What if?

But what if the deadline passes and the United States defaults? The global financial system seizes up as Treasuries become illiquid. The economy lurches back toward recession. Stocks may enter a bear market as defined as a



20% or more decline and Treasury interest rates would soar as bond prices plummeted. Gold and other precious metals would likely be beneficiaries of the flight from other assets to a safe haven other than Treasuries.

We still believe that default, the worst outcome by far, has very little probability of coming to pass. To answer the “what if” question more completely requires some context that highlights why we believe a deal is likely and becomes self-reinforcing as the deadline gets closer.

Because Federal government revenue is not collected evenly throughout the year, spending in most months vastly exceeds revenue. If there was no debt ceiling increase deal reached and implemented by August 2 funds would fall short of the \$307 billion in planned spending for the remainder of the month by \$134 billion, or 44%. This would not be business as usual for anyone.

The prospect of a 44% reduction in spending starting August 3rd on everything including: social security, military pay, food assistance, interest on the national debt, Medicare and Medicaid, educational aid, housing programs, unemployment benefits, federal salaries, etc, would have career-ending backlash for legislators.

Under a scenario where the stock market falls 20% or more, draconian spending curbs of 44% kick in, and the economy spasms, voter outrage with all parties would cause members of congress to quickly reconsider voting for a compromise deal on the debt ceiling.

Both sides can declare victory with the smaller \$1–2 trillion dollar package of spending cuts and debt ceiling increases that do not raise tax rates or involve material entitlement program cuts and that kicks the tough decisions on these issues down the road until after the 2012 elections.

Republicans can deliver on campaign promises to reduce spending and hold firm on tax increases. And a minor tweak to entitlements, such as re-indexing Social Security benefits to inflation rather than wage growth, shows they are serious about eventually dealing with the issues on longer-term fiscal sustainability.

A deal that involved raising revenue through closing some tax loopholes used by corporations or wealthy Americans would offer democrats a chance to declare victory, as well. A deal of at least a trillion would also demonstrate some fiscal restraint popular with voters ahead of a tough Senate race next year.



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