THE SHUTDOWN, THE CEILING, & FUTURE FED POLICY

GOVERNMENT INTERRUPTION WILL PROBABLY BE ADDRESSED QUICKLY ...

I didn't intend to write about a government shutdown this quarter, but since the topic is dominating the news, here's my take on the matter. First, the government shutdown will result in the federal government suspending only a portion of its operations. Governmental efforts involving national security or the protection of life and property do not face closure nor do those branches of the government that generate their own revenues (e.g., the postal service). Programs that the law considers mandatory, such as The Affordable Care Act, are also not at risk. This means that while certain folks working within the Social Security Administration and the U.S. Department of Veterans Affairs will be sent home for a while, workers who are considered to be "essential" will continue processing benefit payments and performing other tasks considered to be essential. The precise impact of the government shutdown is difficult to gauge, but *The Washington Post* estimates half of all federal employees may be furloughed until Congress reaches a budget deal. Aside from the obvious service disruptions, a reduction in the federal payroll is certain to let some air out of the economy to the extent Congress allows this impasse to continue.

... JUST AS THE OTHER 17 INTERRUPTIONS WERE

Under the Congressional Budget Act of 1974, the budgeting process moved from the executive branch to the legislative branch which allowed it to become more politicized, and hence, contentious. This new budget process was first implemented in 1976 and by September of that year an unresolved spending gap resulted in a 10-day shutdown of the federal government. Since the Congressional Budget Act of 1974 came into law, unresolved spending gaps have resulted in 17 interruptions to government operations. Interestingly, 5 of those interruptions occurred while the presidency, the Senate and the House of Representatives were under control of the same party.

HISTORY OF FEDERAL GOVERNMENT INTERRUPTIONS

			CONTROL		
YEAR	BEGAN	# DAYS	PRESIDENCY	SENATE	HOUSE
1976	September 30	10	Republican (Ford)	Democratic	Democratic
1977	September 30	12	Democrat (Carter)	Democratic	Democratic
1977	October 31	8	Democrat (Carter)	Democratic	Democratic
1977	November 30	8	Democrat (Carter)	Democratic	Democratic

			CONTROL		
YEAR	BEGAN	# DAYS	PRESIDENCY	SENATE	HOUSE
1977	November 30	8	Democrat (Carter)	Democratic	Democratic
1978	September 30	17	Democrat (Carter)	Democratic	Democratic
1978	September 30	11	Democrat (Carter)	Democratic	Democratic
1981	November 20	2	Republican (Reagan)	Republican	Democratic
1982	September 30	1	Republican (Reagan)	Republican	Democratic
1982	December 17	3	Republican (Reagan)	Republican	Democratic
1983	November 10	3	Republican (Reagan)	Republican	Democratic
1984	September 30	2	Republican (Reagan)	Republican	Democratic
1984	October 3	1	Republican (Reagan)	Republican	Democratic
1986	October 16	1	Republican (Reagan)	Republican	Democratic
1987	December 18	1	Republican (Reagan)	Democratic	Democratic
1990	October 5	3	Republican (Bush)	Democratic	Democratic
1995	November 13	5	Democrat (Clinton)	Republican	Republican
1995	December 15	21	Democrat (Clinton)	Republican	Republican
	Average	**6 days**			

If history is a guide, Congress will wrangle for a short while before it resolves the issue, but other than the temporary upheaval of those workers who have been furloughed, I expect this wrangling to have no real impact on the capital markets. In fact, I would not be surprised if Congress were to eventually provide some type of retroactive compensation to those workers who have been furloughed.

An existing spending bill favored by the Senate would fund government operations through mid-November. If the House of Representatives gets its way, funding would be assured for an additional 30 days. Either way, this issue could resurface prior to year end.

DEBT CEILING DEBATE — A THORNIER ISSUE

Congress must authorize the level of federal spending for a given budget period. To the extent spending exceeds revenues, the resulting budget deficit normally falls under the purview of the Department of Treasury, which then borrows whatever funds are necessary to bridge the shortfall. Since Congress is also charged with authorizing the maximum amount of debt the U.S. is permitted to carry, one might assume that Congress would automatically authorize the Treasury to borrow whatever funds it might need under the notion that it is simply attempting to pay for a portion of the purchases that have already been authorized by Congress.

Yet, that's not how it works. Instead, Congressional attention regarding an appropriate debt limit generally comes after, and is therefore divorced from, the Congressional spending decisions that cause the budget deficits that later necessitate those hikes in the debt ceiling. In contrast, when individuals behave this way, they eventually might find themselves in bankruptcy court.

GAMESMANSHIP BUILT INTO THE SYSTEM

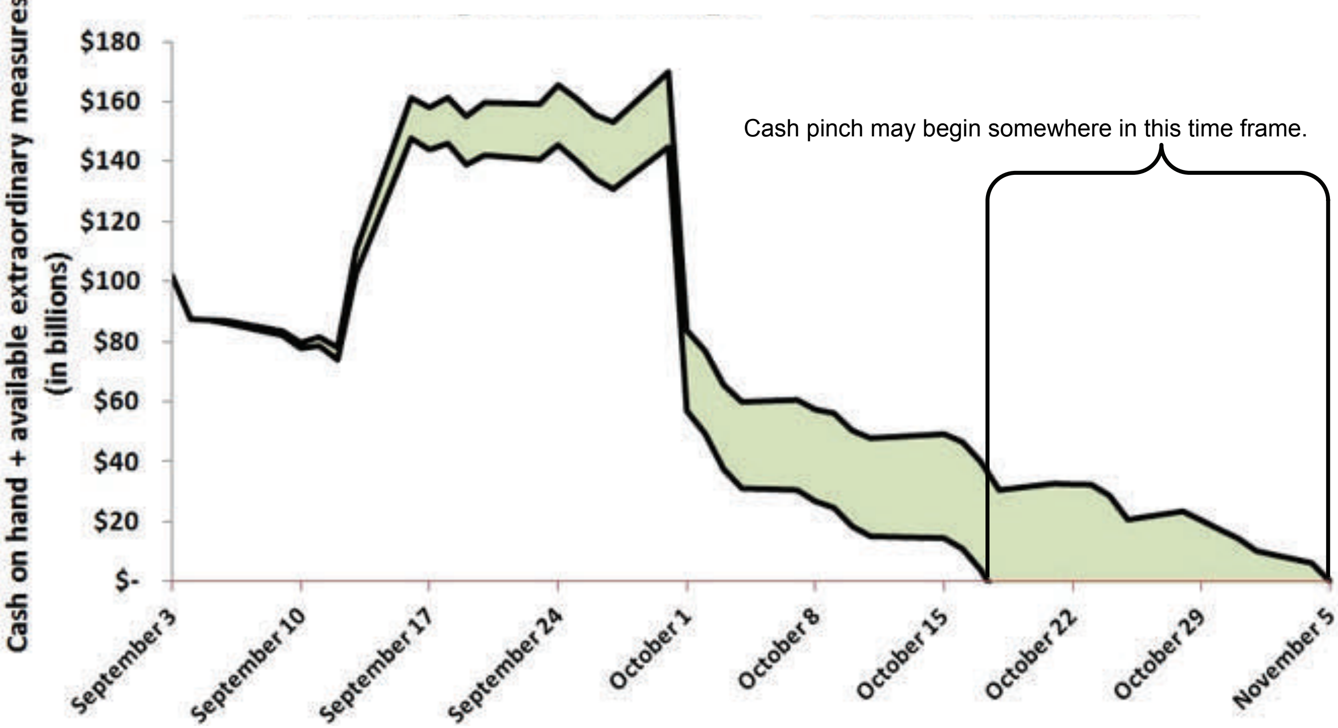
In an environment such as ours, where budgets generally result in deficits, separating the budget process from the debt-ceiling-revision process that is sure to follow lends itself to political gamesmanship. In essence, the problem has become a vicious circle of governance that begins with political pressure for Congress to approve budgets to preserve a status quo that, unfortunately, has a strong preference for spending levels that are not adequately supported by revenues. Commitments are then made based on inflated spending levels and, to the extent revenues fall short, the Treasury is expected to fund those shortfalls by borrowing from the public. This process repeats itself until the Treasury bumps up against its legal borrowing limit which then forces Congress to consider raising the debt limit.

Of course, politicians know that casting an official vote to increase the federal debt ceiling provides an opportunity for others to paint them as being profligate. Consequently, politicians are reluctant to vote for increases to the debt ceiling even though many of those same politicians approve the legislation that necessitates those increases. The end result is a messy cycle of inflated budgets, deficits, and political wrangling with an extra dose of angst due to the gamesmanship and brinksmanship. Currently, Republicans within the House of Representatives are using the budget process as leverage to defund the Affordable Care Act, or to at least delay its implementation.

WHEN WILL THE TREASURY RUN DRY?

Congress has previously authorized the U.S. to carry up to $16.699 trillion in aggregate public debt. The Bipartisan Policy Center, a think-tank whose mission is to examine issues that are nationally relevant and to then propose workable policy solutions, has estimated that the Treasury is on pace to bump into this borrowing limit sometime between mid-October and early November, as estimated in the following graph.

THE TREASURY'S FUNDING POWER



TIME FOR DEBT-CEILING INCREASE #80

On the topic of the U.S. bumping up against its existing debt ceiling, former Congressional Budget Office director, Donald Marron, told lawmakers, "Federal employees, contractors, program beneficiaries, businesses and state and local governments would find themselves suddenly short of expected cash, causing a ripple effect through the economy." Fortunately, the U.S. has not yet bumped into this ceiling and, hopefully, it won't. Lawmakers have approved 79 increases to the U.S. debt ceiling since 1940 (and 10 times since 2001). Sometimes they've raised it by small amounts, other times by large amounts. And, sometimes, they've raised it only temporarily with provisions that it would later reset to some lower level, but lawmakers have tended to raise it.

LESSONS FROM THE DEBT-CEILING MELEE OF 2011

Back in 2011, the Treasury estimated that the borrowing authority of the U.S. would be exhausted by August 2nd of that year. Although budget legislation (the Budget Control Act of 2011) was enacted that same day, *Standard & Poor's* opted to downgrade the credit rating of the U.S. a few days later (the first downgrade in the country's history). Although the downgrade was very slight (from AAA to AA+), it jolted equity markets around the world which then experienced their most volatile week since the meltdown of 2008. The Dow Jones Industrial Average fell 5.6% in one day and prices of U.S. Treasuries surged as investors fled stocks due to dismal prospects within the U.S. and the debt crisis within Europe.

NO FURTHER RATINGS DOWNGRADE THREAT ... YET

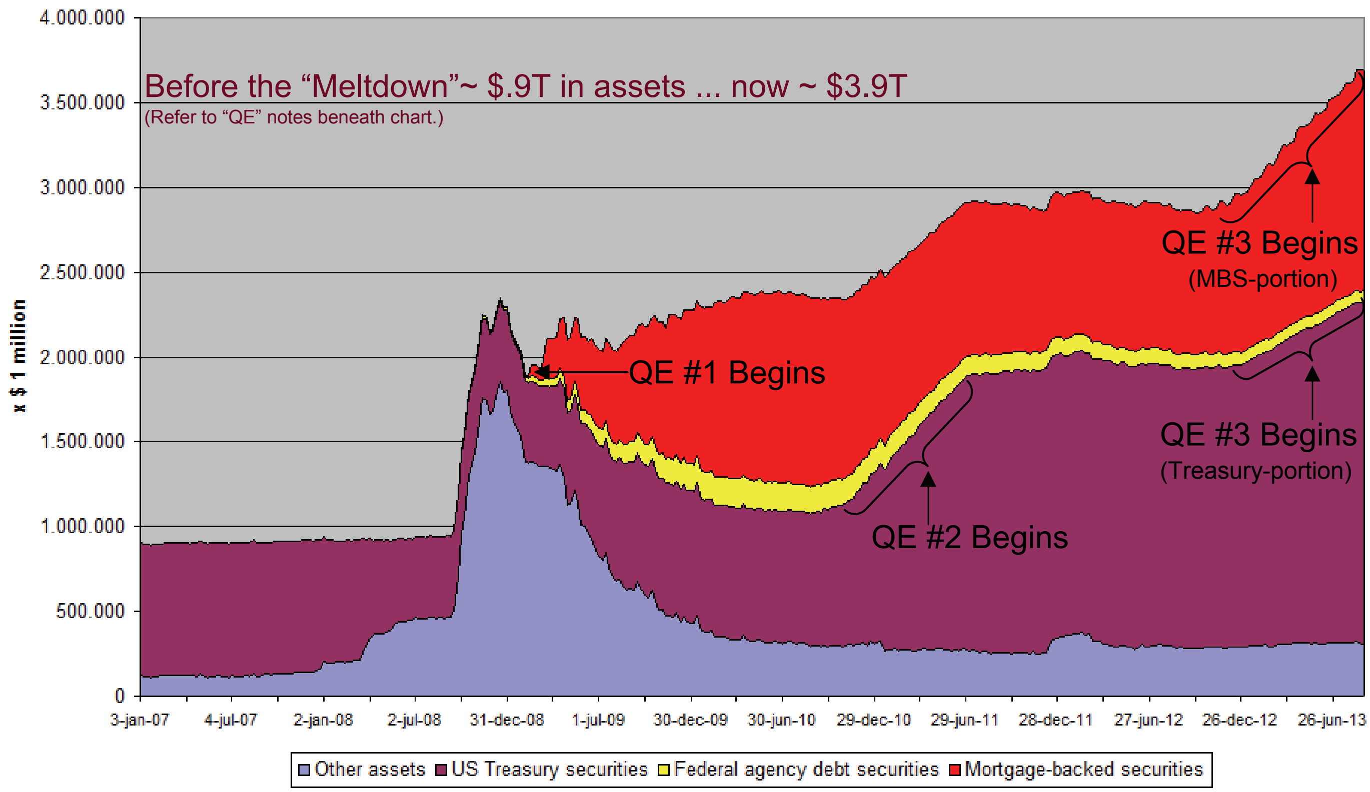
Although *Standard & Poor's* is only one of three major ratings agencies, it was the only agency to have downgraded the creditworthiness of the U.S. in 2011. In a research note published on September 30th, S&P lowered the probability of a further downgrade by writing, "In our opinion, the current impasse over the continuing resolution and the debt ceiling creates an atmosphere of uncertainty that could affect confidence, investment, and hiring in the U.S. However, as long as it is short-lived, we do not anticipate the impasse [will] lead to a change in the sovereign rating." However, S&P did warn that a protracted battle that results in one or more missed debt-service payments could alter its view of the matter. If the U.S. were to miss a debt-service payment, S&P warned that it would then consider lowering the U.S.' sovereign credit rating to "selective default," a ratings classification that would indicate that the U.S. had failed to meet one or more of its outstanding debt obligations. S&P added that, historically, selective defaults result in ratings between CCC (lower "junk-bond" status) and B (higher-rated junk) and that it "would analyze the changes in the political and economic landscape in determining a post-default rating."

One would assume that since a slight ratings downgrade from AAA ("extremely strong") to AA+ (better than "very strong") roiled global equity markets in 2011, a downgrade to the lower end of the ratings scale would be far more upsetting. Consequently, I think it's fair to conclude that Congress has a strong incentive to raise the debt ceiling as necessary.

ON TO A BIGGER ISSUE: THE FED'S BALANCE SHEET

Last quarter, I mentioned that the Federal Reserve will, at some point, begin unwinding the huge amounts of stimulus it has already pumped into the U.S. economy. Prior to the collapse of 2008, the Fed held about $.9T worth of assets. Last quarter, that figure exceeded $3.5T with that figure now likely to exceed $3.8T. The chart on the following page illustrates this increase. I've noted the Fed's quantitative easing efforts on that chart to help illustrate how this expansion came to be. I'll discuss some unpleasant ramifications of a large Fed balance sheet later.

THE FED'S BALANCE SHEET



Quantitative Easing 1 (QE #1)

In November of 2008, the Fed announced its intent to purchase $500B of mortgage-backed securities and $100B of federal agency debt. The Fed more than doubled these quantities in March of 2009.

Quantitative Easing 2 (QE #2)

In the 4th quarter of 2010, the Fed said it would purchase $850 — $900B of long-term Treasury securities. It purchased $600B using *new* funds created by the Fed. It purchased the remaining $250 — $300B using the cash proceeds from maturing mortgage-backed securities the Fed had purchased through previous efforts.

Quantitative Easing 3 (QE #3)

In September of 2012, the Fed declared it would purchase an additional $40B of mortgage-backed securities *per month* in an effort to support the economic recovery and the housing market through low interest rates. Three months later, the Fed also began buying $45B of Treasury securities *per month*. The media generally refers to this two-pronged effort as QE3. The Fed is still implementing this program today, although it has suggested that it may "taper" its buying activity soon.

HOW THE FED MIGHT SHRINK ITS BALANCE SHEET ...

In 2008, the Fed's balance sheet represented less than 9% of the annual economic output of the U.S. Assuming the International Monetary Fund's projections turn out to be correct and the U.S. economy produces $16.2T worth of goods and services during 2013, the Fed's current balance sheet of $3.9T represents about 24% of U.S. annual economic output. That's a substantial percentage, and here's why it matters. To the extent the Fed decides to actually begin removing stimulus from the economy, it could begin selling some of the assets it now holds back to the public. The public would end up with whatever asset the Fed sold, and the Fed would end up with money. The money the Fed receives would then effectively be removed which would result in less money sloshing around the system. When fewer dollars are available to be spent, fewer dollars typically are spent. So, demand for goods and services would likely decline which would then ripple its way through the economy in the form of reduced hiring and reduced overall business activity.

Now, if the Fed were to suddenly unwind, say, $3T worth of stimulus, it would cause an economic contraction on the order of 24%. For the sake of comparison, U.S. GDP declined about 9% during the financial collapse of 2008. So, obviously, the Fed is unlikely to undertake such a dramatic move.

DOES THE FED EVEN NEED TO?

It may. While the Fed is under no particular obligation to unwind any of the stimulus it has already injected into the U.S. economy, the reality is that the Fed might find, at some point, that it ought to. Since the financial collapse of 2008, the U.S. economy has a lot of excess capacity. In essence, people and businesses could be more economically active if demand warranted it, but it doesn't. This excess capacity is one reason the rate of inflation has not been very high. However, let's assume that the recovery within the U.S. continues as projected. The IMF calls for real (inflation adjusted) GDP growth of 1.7% in 2013 and 2.7% in 2014. This growth is likely to cause banks to become more willing lenders. To the extent the economy continues to grow, the tremendous amount of stimulus that already exists could come into play the same way large puddles of lighter fluid sitting just beyond the edge of a growing fire might. The economic equivalent of a flash fire would be inflation.

I'm certainly not predicting rampant inflation, but I do want to stress that if the rate of inflation were to rise beyond a level the Fed regards as comfortable, the Fed might then become relatively more concerned about controlling inflation than increasing employment (as has long been the case).

Recall that the Fed is charged with maintaining a stable price environment and promoting reasonably full employment. With respect to price stability, persistent price declines (deflation) is absolutely unacceptable because it tends to result in economic death spirals (e.g., the depression in the 1930s). High inflation is also unacceptable because it complicates long-range planning and encourages people to spend their currency faster than they otherwise would in an effort to minimize expected losses in spending power. For the Fed, the sweet spot is to have inflation of around 2.0%, or so.

We have that now, so the Fed feels like it can continue to stimulate the economy in an effort to spur employment without too much fear that this stimulation will result in too much inflation. Again, the excess capacity within the U.S. economy makes this possible. However, the Fed is making every effort to get the U.S. economy to grow ... as are other central banks around the world (most notably, Japan). To the extent these growth policies work, this excess capacity will shrink. Those excess pools of stimulus will then be at risk of igniting inflation, which could then force the Fed to unwind.

A FEW NEGATIVES IF/WHEN THE FED DOES REMOVE STIMULUS

A shrinking monetary base means that, on average, less money is likely to be invested in the various asset classes. As money flows away from an asset class, prices would tend to fall. With respect to the $16.7T in debt the U.S. has so far issued, the Social Security Trust Fund holds about 16.2% and is not likely to sell its stake anytime soon (a good thing). However, at 10.2%, the Fed is the next largest creditor — larger than even China (7.7%) and Japan (6.7%). To the extent the Fed (or China or Japan) reduces its stake in U.S. Treasury securities, bond prices would tend to fall which would hurt other investors. Interest rates (all of them) would also rise since yields on Treasury securities are used as the starting point to determine the yields on other instruments. Higher interest rates are also a strong mathematical negative to overall economic activity and the values of other asset prices. Higher mortgage rates would reduce the borrowing power of the average home buyer, so housing prices, would be under pressure, too. Investors have also become increasingly interested in whether or not the Fed will continue stimulating and less interested in outright economic news. On May 21st, interest rates spiked after the Fed merely suggested it was considering reducing the rate at which it was injecting funds into the U.S. economy causing the stock market to shed almost 6% of its value over the next month. I wonder what the reaction might be if/when the Fed suggests that it actually plans to remove some of the existing stimulus. Otherwise, the short-term case for stocks is actually pretty decent. — Glenn Wessel