Weekly Market Commentary

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Highlights

While the issues that threatened to take the United States to the brink of disaster have been pushed out to early next year, we think we are unlikely to see a reprise of the brinkmanship and economic disruption of the past few weeks.

Back to Work

The budget crisis in Washington is over—for now. The 11th hour deal lifts the debt ceiling through February 7, 2014, and funds the government though January 15, 2014, returning furloughed government workers to their jobs. The bill passed both the Senate and the House by a wide margin and on bipartisan support.

But what about early next year—are we going to have to go through the same fiscal fight again? To some extent, the answer is yes; and after all, deadlines have been set and it will be primary season for the mid-term elections. But we think it is unlikely to be a reprise of the brinkmanship and economic disruption that threatened to take the United States to the brink of disaster.

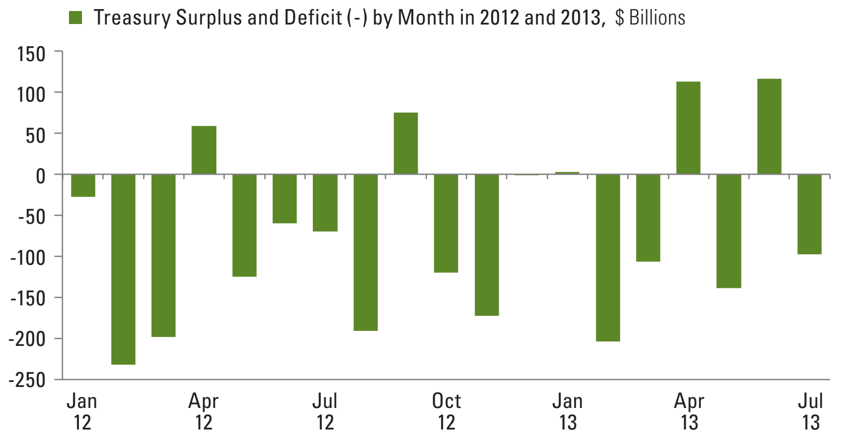
Avoiding the Sequester II

The January 15 date for funding the government in the debt ceiling deal was chosen because that is the date of the next round of automatic sequestration spending cuts. These cuts kick in unless Congress scraps the cuts mandated by the Budget Control Act of 2011 or enacts other specific cuts to bring the spending subject to sequestration down to the $967 billion cap for 2014.

The amount of the spending cap in last week's deal is frozen temporarily for three months at the fiscal year 2013 level of $986 billion. The Senate and President Obama want to increase that amount to $1.058 trillion. Republicans want to keep the cuts but ease those on defense spending. A compromise may involve trading discretionary spending cuts in 2014 for longer-term cost savings on entitlement programs.

While the downside of the cuts that are coming may not actually be that hard to deal with since they only total another $19 billion (the federal government spent over $3.2 trillion in fiscal year 2013), the focus may shift to the economic upside of eliminating them and even rescinding some of the 2013 budget cuts. In any case, we are unlikely to see tax increases play a role in closing the gap as talk shifts from how to deal with the cuts to how to improve growth.

1 The Surge in Tax Receipts in April Often Results in Treasury Surplus That Might Push Out Next Effective Debt Ceiling to Spring



Source: U.S. Treasury 10/18/13

Avoiding Another Debt Ceiling Showdown

Last week's deal lifted the debt ceiling until February 7. Of course, the Treasury would still be able to use "extraordinary measures" to stay below the ceiling beyond February 7, perhaps longer than usual given strong tax receipts resulting in a Treasury surplus in April [Figure 1]. But we may avoid another clash over the debt ceiling.

The debt ceiling has now been lifted twice since the August 2011 debacle, without any spending cuts or other policy changes attached to it, making it less likely that another push for changes in early 2014 would be worth the political and economic cost of a showdown. The Republicans saw enough negative impact on polling results to make them wary of another showdown in an election year. In addition, the desire for a bipartisan solution can be seen in the 87 House Republicans that voted for the bill to end the shutdown and suspend the debt ceiling even though less than 20 Republican votes were needed.

Refocusing on the Positives

Market participants are already back to work pushing the stock market higher into year-end as they refocus on the positives:

Reports coming in for the third quarter will likely show that S&P 500 companies have posted the strongest earnings per share growth in a year.

- A return of focus to the fundamentals of improving profit growth and away from the sausage-making in D.C. should help to boost investor confidence in a sustained recovery in profits. Reports coming in for the third quarter will likely show that S&P 500 companies have posted the strongest earnings per share growth in a year.
- Retail sales slowed to a crawl in the past few weeks. But with the 16-day government shutdown and threat of default behind us, consumer confidence is set to rebound and drive retail spending, aided by gasoline

prices that are down more than 10% from their peak this year and 12% from a year ago along with a surging stock market.

- The Federal Reserve (Fed) remains committed to providing stimulus with little chance of tapering its bond-buying program at the October 28–29 meeting. (See this week's *Weekly Economic Commentary* for more details on the impact of the shutdown on the Fed.)

We expect more new all-time highs for the S&P 500 in the coming months with Washington out of the headlines for a while and an improving growth backdrop. ■

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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