MLC Investment Management

Investment insight

Dancing on the ceiling: a temporary resolution to the US political deadlock

18 October 2013

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The utterly dysfunctional nature of US fiscal policymaking is likely to remain an ongoing source of uncertainty for financial markets.

What's been agreed?

Yesterday both houses of the US Congress passed a bill that ended the partial shutdown of the US government and raised the debt ceiling (the upper limit on the US Treasury's borrowing capacity). Funding for the US government has been provided to 15 January 2014, and the debt limit raised until 7 February 2014.

The agreement that produced the bill also allows for the establishment of a bipartisan panel (yet another one) to come up with a deficit reduction package by 13 December.

How was agreement reached?

The bill was the result of intense negotiations between the Democrat and Republican leadership in the US Senate.

While the bill received overwhelming and mostly bipartisan support in the Senate, its passage through the House of Representatives depended on the overwhelming support of the minority Democrats. Most Republican members voted against the bill, despite the Republican leaders in the House urging support.

What's been the impact on markets?

Financial markets were remarkably relaxed about all this in the days and weeks leading up to the apparent deadline for an agreement (17 October). This was because markets had generally expected that a deal would eventually be done to avoid the real threat of the US Treasury being forced to default on its debt obligations.

This outcome would have been catastrophic for financial markets, given the role of US Treasury bonds as the ultimate safe haven in global financial markets.

Despite this, there has been a significant 'relief rally' on world share markets, and a decline in US Treasury bond yields.

What happens now?

While the immediate risk of a crisis has been averted, passing the bill can hardly be called a resolution. There has been no formal budget agreed for several years now – the US government has been financed by a series of short-term agreements, each reached under duress.

The utterly dysfunctional nature of US fiscal policymaking is likely to remain an ongoing source of uncertainty for financial markets. Yes, getting an agreement is a relief, but the deal is unsatisfactory.

We could very easily face another government shutdown in January, and another fight about raising the debt ceiling in February, unless the bipartisan panel comes up with a budget deal by the 13 December deadline.

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They almost certainly won't.
The Republican panellists won't countenance raising taxes, and even if they would, a large group of their lower house colleagues clearly won't. Democrats will be extremely reluctant to accept any significant reforms to welfare entitlements (read: cutbacks) unless revenue measures, most notably higher taxes for the rich, are also on the table.

One major reason to be optimistic that we won't be in for another round of this nonsense next year is that the US mid-term Congressional elections are due in November 2014.

Opinion polls clearly show the US public has allocated the lion's share of the blame for this situation to Republicans. Another government shutdown, and more disagreement over the debt ceiling, could see the Republicans lose their lower house majority in those elections.

Common sense suggests that having another go at this in January and February would be both futile and politically costly for the Republicans. Then again, political common sense seems to be a very scarce commodity in the US.

What does the deal mean for investors?

The fact that financial markets approached all this with remarkable calm and that markets have performed well since the deal is clearly welcome news for investors.

At MLC, our debt portfolios have had minimal exposure to the US Treasury market for some time, but even if there had been a full-blown crisis, few investments would have provided a safe haven for investors.

Whether financial markets will be able to shrug off a repeat of this debacle next year is unclear.
It's yet another reason why being very well diversified, and actively managing risk, is so critical in this investment environment.

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