THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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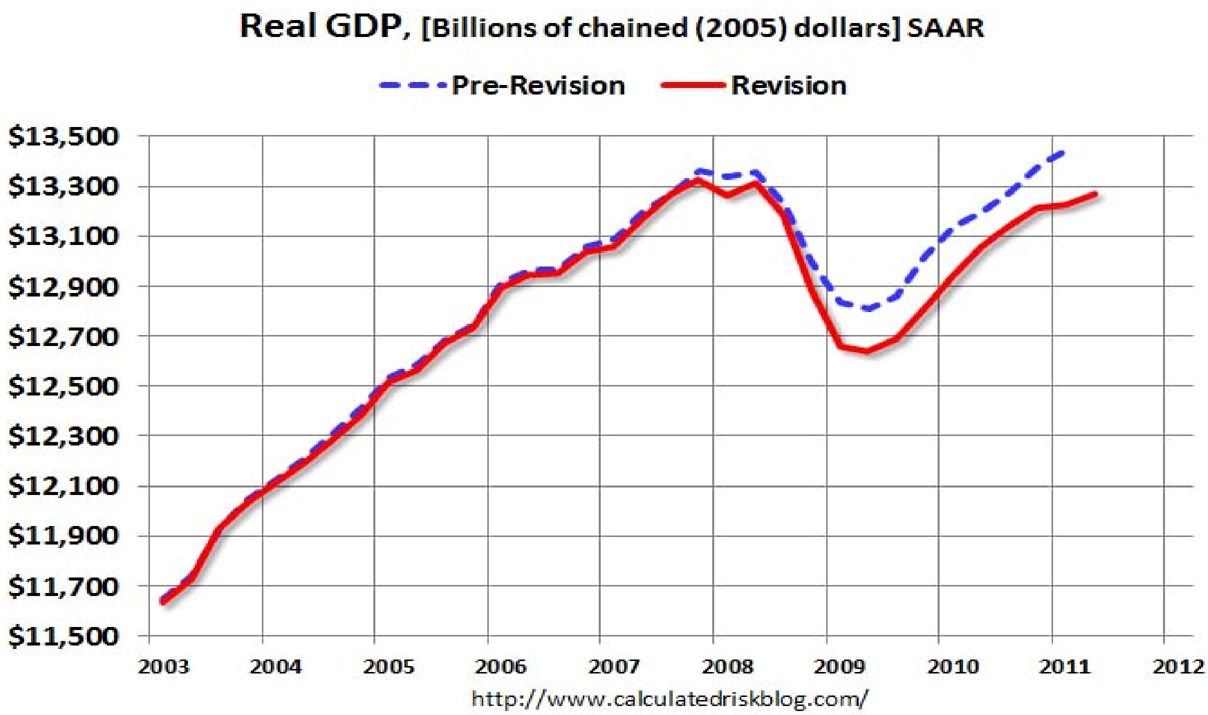
Debt Ceiling 'Catastrophe' Likely Averted

- It appears that a compromise plan has been reached to raise the debt ceiling and avert immediate self-inflected economic disaster caused by default or immediate draconian spending cuts to avoid default. The House is scheduled to vote on the plan Monday evening, and the Senate either Monday night or Tuesday morning. If, contrary to our expectations, Washington fails to pass the compromise plan and/or our technical stops are triggered, we intend to implement our risk reduction plan and become much more defensive.
- While nearly everyone has focused on the August 2nd deadline for raising the debt ceiling, we do not believe that the US runs out of money precisely on that date. We believe that funding exists for government operations for several more weeks. That said, we expect that the compromise plan will be passed and the debt ceiling will be raised. Risk assets, such as stocks and foreign currencies, will likely rally in relief that disaster was averted, but the rancorous nature of the negotiations and the ongoing economic 'soft patch' will continue to depress both consumer and business confidence, in our view. The plan ensures that tax and spending policies will remain in flux until after the 2012 election, which will likely combine with low consumer confidence, solvency issues in Europe and lingering emerging market inflation to prolong anemic US economic growth. In this scenario, we think stocks will continue to grind higher due to strong earnings and a friendly Federal Reserve, but the potential for a significant year-end rally looks less likely.
- If the plan is rejected, President Obama will not allow the country to default on its debt obligations. Rather, the Treasury has prepared a specific plan that will allow the US to pay interest and principal on debt obligations, mainly by delaying or reducing social security payments, salaries of government employees, and unemployment benefits. Such a sudden contraction in government spending is likely to prompt renewed recession in the US and cause a sharp sell-off in risk assets. Ironically, this US fiscal policy mismanagement will likely trigger a rally in Treasury bonds due to the impact of these budget cuts on short-term economic growth and inflation.
- Some legal scholars believe that the President has constitutional authority to prevent default under any circumstances. Thus, Obama may choose to ignore the debt ceiling even if Congress fails to authorize additional borrowing. Additionally, to raise funds without violating the debt ceiling, the Treasury could create an 'overdraft' account with the Fed or perform 'coin seigniorage' (creating coins with an arbitrary face value that has no relationship to the value of the coins' metal). If Obama adopts such strategies (he has shown no inclination so far), risk assets would likely rally since both default and short-term budget cut scenarios are avoided. However, the removal of short-term spending restraint would likely prompt sharp sell-offs in Treasuries and the dollar.
- The downward revision to US economic growth since 2007, which leaves the economy 0.4% below its 2007 peak (see Weekly Chart), was our most salient takeaway from last Friday's second-quarter GDP report. Prior to the revision, the economy was considered to be in an expansion phase; now, it appears that the economy is still recovering. The biggest revision was in 2009, where the economy contracted 3.5% versus the original estimate of a 2.6% decline. This produces a much wider output gap of 7% below potential GDP versus about 5% before the revision. The wider output gap helps explain why unemployment has remained stubbornly high and why bond markets remain unconcerned about inflation. We also found the record high proportion of GDP accounted for by corporate profits noteworthy. By taking a bigger share of the economic pie, companies have been able to grow earnings despite a weak economy.
- More recent data show weakening economic growth. First-quarter GDP was revised down to 0.4% growth from 1.9% due to lower inventories and higher imports. Second-quarter GDP growth accelerated to 1.3%, but was below expectations, as consumer spending — the bulk of the economy — was flat. Trade and investment contributed to meager second-quarter growth, but state and local government cutbacks continue to overwhelm any contributions

from federal spending and investment, which also face cuts. The July ISM manufacturing survey helps confirm that the slowdown is persisting into the second half, with the index declining 4.4 points to 50.9 (readings above 50 indicate an increase in business activity). Notably, new orders, a leading component, fell 2.4 points to 49.2.

- While the downward revisions to GDP increase the risk of a double-dip recession, there are significant elements of potential support for the US economy. The trade-weighted dollar is close to record lows, which increases the relative attraction of US goods and services to foreign trading partners and boosts the potential for trade and earnings of US multinational corporations. This support from exports could be most prevalent in the emerging economies, which account for about three quarters of global growth. Short-term US interest rates are close to zero, and the Federal Reserve has indicated that it intends to keep short rates low for the foreseeable future. This has served as an anchor for holding longer-term Treasury yields at historic lows, and thus the yield curve, which has inverted before every recession, is near record levels of steepness. Corporate profits are strong — S&P estimates second-quarter S&P 500 earnings are up 19% year over year — and balance sheets appear healthy since many companies are holding large amounts of cash. Retail sales appear to be more robust than indicated in second-quarter GDP. The ICSC/Goldman Sachs Retail Chain Store Sales Index has surged to new highs in recent weeks and is up 4.2% from last year, the high end of its 2005 through 2007 growth rate. This is reflected in the performance of S&P's retail index, which has beaten the S&P 500 by more than 7% on a relative basis since the first quarter of 2011. Thus, despite a week full of disappointing news, the S&P 500 remained within our 1250 to 1365 decision box (see *Weekly View*, 7/25/11).

The Weekly Chart: Economic 'expansion' revised back to 'recovery'



Peak to trough, real GDP declined 5.1% during the recession versus the pre-revision estimate of a 4.1% decline. The recovery from the trough has been about the same magnitude, although its pace has slowed since the fourth quarter of 2010 relative to what was previously thought.

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