September saw the Federal Reserve (Fed) postpone tapering of Quantitative Easing due to insufficient economic growth, low inflation and concerns about financial conditions and fiscal policy uncertainty. This uncertainty became reality with the government shutdown in October. We believe the shutdown will have a limited effect on the economy unless it is prolonged. We see the debate over the debt ceiling as more critical to growth, with fiscal uncertainty and indirect effects from sharp fiscal tightening having a more lingering influence.

The Fed's September Surprise: No Tapering, Yet

In a major surprise to most market participants and economic forecasters, the Federal Open Market Committee (FOMC) refrained from tapering its Quantitative Easing program at the September meeting. It gave four primary reasons:

- Economic growth was not strong enough
- Inflation remained below the Fed objectives
- Tighter financial conditions in recent months (higher mortgage rates) raised concerns about the strength of future growth
- Fiscal policy uncertainty also raised concerns about the strength of future growth

Markets initially reacted very favorably to the non-taper decision, but slipped modestly following the initial move.

Fiscal Policy Uncertainty Has Become Reality

Fed concerns regarding fiscal policy uncertainty have become reality as the House and the Senate have thus far failed to agree on funding for the government, resulting in a partial federal government shutdown since the beginning of October. This will likely have a very limited effect on economic activity unless a prolonged shutdown inhibits raising the federal debt limit in a timely manner. The federal government has nearly exhausted its borrowing authority, as it will approach the statutory debt ceiling later in October. The possibility of a failure to lift the debt ceiling has led to broader economic concerns, fears of a potential Treasury default and the financial turmoil that would follow without an agreement to authorize additional Treasury borrowing.

The primary near-term effect of the partial government shutdown is that an estimated 800,000 federal employees have been furloughed, thus reducing their personal income. Most estimates suggest the effect of these reductions is the equivalent of about 0.1% of gross domestic product (GDP) per week. So even if the shutdown dragged on for an entire month, the effect on fourth quarter GDP growth would likely be less than 0.5%. Furthermore, Congress has already agreed to compensate these employees for time missed due to the shutdown, which should further mitigate its effect on economic performance. But failure to reach agreement on the debt ceiling would have a far greater effect.
Hitting the Debt Ceiling

Through the first 11 months of fiscal year 2013, the federal government ran a budget deficit of just over $750 billion, increasing accumulated debt outstanding to the statutory limit of $16.7 trillion. If the federal government could not borrow additional amounts, the federal budget would need to be balanced once the debt ceiling is reached. This would severely reduce the pace of federal spending and negatively affect economic activity. The current deficit represents roughly 4.8% of GDP, so suddenly moving to a balanced budget would likely result in a sharp economic downturn because the annualized effects of such a move would be immediate. The direct economic effects would also likely quickly reverse once budgetary agreements were reached, but policy uncertainty and indirect effects from a sharp fiscal tightening could possibly have a more lingering influence.

Deficit Has Narrowed, but Remains Historically Large

Source: Office of Management and Budget. Data from 2000 to 2012.

One possible indirect effect of failure to increase the debt ceiling is the potential for technical defaults in the Treasury market. The press has frequently suggested such a possibility and depicted its catastrophic effects. No doubt, a true solvency concern regarding the federal government would have unparalleled consequences in the financial markets, but this is not the situation today. The federal government has ample resources for debt repayment. Failure to raise the debt ceiling does not inhibit nor prohibit the Treasury department from issuing new debt to repay maturing Treasury obligations, and there is more than sufficient recurring federal revenue available to the Treasury to pay interest on the stock of outstanding debt obligations.

Questions exist as to the Treasury’s technical capabilities and legal authority to fully prioritize payments, but the Treasury could likely ensure that sufficient cash is available to make interest payments on Treasury securities. There is no direct connection between the debt limit and default, or the ability to service debt obligations. The debt limit, if not extended, would severely limit aggregate federal government expenditures. This would ultimately result in less Treasury debt outstanding and support Treasury credit quality on an intermediate- to longer-term basis.
Debt Outstanding Continues to Rise: Estimates

![Debt Outstanding Continues to Rise: Estimates]

Source: Office of Management and Budget. Data from 2000 to 2011. Data from 2012 forward is an estimate.

The political battles surrounding the budget and debt ceiling will probably intensify over the next couple of weeks. Most likely, some temporary agreement will be reached when pressure builds (perhaps when the debt limit is reached) that will continue pre-shutdown operating levels contingent upon negotiations toward future deficit reduction agreements. If events evolve along these lines, the effect of the shutdown on economic performance should be fairly limited and the economy should continue to perform in line with the trends of the past several quarters.

Economic Data Send Conflicting Messages

Economic data from governmental data sources will be limited until all governmental offices are reopened, but data leading into October were mixed with indicators sending conflicting messages. Overall, the data remain consistent with the 1.6% growth trend in place over the past year.

Certain indicators – particularly the monthly manufacturing activity indices at the regional and national levels – showed further improvement in growth. The ISM manufacturing index posted its sharpest four-month increase since 2009. This likely reflects better economic conditions abroad and exports, as well as some inventory building among manufacturers. Purchasing managers indices have increased in both Europe and China as well, highlighting some improvement in the growth environment abroad. Initial jobless claims were another source of strength in the economic data with weekly claims falling to a new cyclical low of 294,000 in September and rising only modestly since.

Third quarter data available to date covering consumer spending, business fixed investment, residential investment and net exports suggest that third quarter growth remains near the 1.6% average of the past year. Weaker housing starts and building permits, a slower pace of consumer spending growth, soft small business sentiment and slower growth in non-manufacturing activity have muted the benefit of more robust manufacturing readings in recent months. The government shutdown will not affect third quarter GDP (aside from delaying the report) and as noted earlier, should have only a modest effect in the fourth quarter, provided it does not extend beyond the next couple of weeks.
Fed On Hold Until December

Given the four reasons the Fed provided for maintaining its current policy at the September FOMC meeting, we expect further continuation at the October FOMC meeting. The economy has not shown signs of material acceleration, inflation remains below the Fed’s objective at just 1.5% on a year-over-year basis, and fiscal policy risk is playing out. The mortgage market is one area of improvement, as average rates have moved modestly lower but applications for mortgages have not yet improved in response to the modest decline in rates.

This suggests the Fed will most likely consider beginning the tapering process at the December or January FOMC meetings. It will likely seek to contain any anticipated effect on mortgage rates as a result of tapering by focusing on short-term policy rate guidance.

Slow Earnings Growth Expected to Continue

Aside from policy developments and economic trends, third quarter earnings reports will be released in the coming weeks. The broad economic data trends suggest slow earnings growth will continue in the third quarter. Earnings pre-announcement trends have been negative and consensus expectations for third quarter earnings have declined significantly over the past three months. This has likely lowered the bar sufficiently to allow a majority of companies to beat expectations at the reporting date. Given policy uncertainties, earnings reports seem unlikely to be a source of major market movements in the near term.

Earnings performance in other developed markets that are in earlier stages of their respective economic cycles should outpace the performance of U.S. companies in the coming quarters. Consensus estimates expect earnings-per-share (EPS) growth in most foreign markets to equal or exceed that of domestic companies. We see expected returns favoring international equities, particularly developed markets in early stages of economic improvement, given the generally lower valuations that prevail across these markets.