Crisis averted: Debt-ceiling deal essential for markets

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The United States' debt-ceiling impasse rattled stock, bond and money markets over the last several months, shaking investors' confidence in the U.S. political system in the process. With news that congressional leaders voted to approve and that the president has signed a measure to raise the debt ceiling and cut spending by $2.4 trillion, Federated's chief investment officers weigh in on the impact that the agreement will have on their markets.

View from the equity side

Stephen F. Auth

The conclusion of the debt-ceiling impasse could be the last major hurdle for the equity markets to overcome before a second-half equity market advance. For the past six months, markets have been held hostage by a string of natural, geopolitical and self-inflicted disasters. Incredibly, despite those obstacles, equities are still up modestly for the year. With these hurdles now fading, we anticipate markets to resume their upward march toward our 1,450 target on the S&P 500.

- The spring unfolded with severe weather-related disruptions across the United States slowing consumption, construction and planting. With improved weather this summer, we expect "catch-up" activity in manufacturing and construction to boost Q3 gross domestic product (GDP).
- The Arab spring caused a temporary spike in gasoline prices, taxing already spent consumers worldwide. As new democracies emerge, gasoline prices have retracted from $4 per gallon in May.
- The earthquake and tsunami in Japan disrupted the global supply chain and moved summer manufacturing furloughs, especially those of car makers, to the late spring. As Japan rebuilds from the devastation, the country's GDP will benefit from the full-scale rebuilding mode. And supply chain problems have been resolved as auto makers, among other manufacturers, have employees on the assembly line again and are expected to ramp up more fully in August and September.
- The second Greek debt crisis expanded to Italy and Spain raising concerns, yet again, of "Lehman Brothers, round 2" among investors. With the roll up of euro-wide debt underway via a united credit facility, this hurdle is lower for investors to overcome as European countries with stronger economies have taken a leadership role in what could be a messy process. We expect more noise here, but the overall direction should be constructive.
- Finally, the self-inflicted U.S. debt-ceiling crisis came within inches of the Aug. 2 deadline set by the Treasury secretary for the U.S. to avoid defaulting on its bonds for the first time in history. With the short-term problem of increasing the debt ceiling seemingly behind us and the immediate crisis averted, the country's longer-term debt problems will be fodder for the 2012 election cycle.

With these problems now largely in the rearview mirror, we expect markets to refocus on fundamentals. Will the fragile economic recovery reaccelerate? Will corporate earnings continue to expand to new record highs? We think the odds favor both, and with equities priced for neither, we are maintaining our recommendation to keep equities at 70% max overweight in balanced portfolios.

View from the money markets side

Deborah A. Cunningham

The House and Senate voting to pass the bipartisan debt-ceiling package is largely a positive for money market funds. The overarching positive is that the threat of default by the U.S. government is eliminated. It also appears that this legislation will address the deficit issue with spending cuts to sufficiently satisfy the major credit rating agencies and allow U.S. Treasuries to maintain their AAA rating.

It's important to note, however, that the U.S. Treasury has the highest short-term credit rating and a U.S. debt downgrade would only affect long-term debt; we would not expect a downgrade of the short-term rating. As a result, the AAA ratings for Federated money market funds would be maintained even in the increasingly unlikely event of a credit rating downgrade.

If there is a negative to the resolution of the debt-ceiling stalemate, it is that the sizeable cuts proposed as part of the resolution will be implemented during a period when the economy is still struggling to recover and sustain growth. From an interest-rate perspective, the likely outcome will be that rates will remain at the current extremely low levels through at least midyear 2012.

View from the fixed income side

Robert J. Ostrowski

The “Grand Plan” that seemed out of reach as little as a week ago, seems to have resurfaced in the debt-ceiling deal. While not identical, immediate cuts of $0.9 trillion and special committee cuts of $1.5 trillion combined with the potential savings from troop draw-downs in both Iraq and Afghanistan, the savings could be in the neighborhood of the $4 trillion in cuts sought originally by the “Grand Plan.” The debt-ceiling deal appears to be a win for the “Tea Party” Republicans, as it does not involve a tax hike and does include spending cuts. Ironically, however, most Tea Party members will not vote for the deal because it does not “perfectly” meet their targets. Assuming the plan’s passage, the risk of default on the U.S. government debt is eliminated and the risk of downgrade, while not fully eliminated, should be significantly reduced.

All other things being equal, sending the U.S. budget down a less negative deficit path should be constructive for bonds. Removing the default risk and reducing downgrade risk helps avoid any yield premium that would be required for issuing U.S. bonds. This will put the focus back on fundamentals, which as Friday’s unimpressive GDP report and Monday’s weak Institute for Supply Management report suggest, is also relatively constructive for high-quality assets.

As offsets to the constructive bond story, the removal of some political uncertainty could provide a boost to job creation. The corporate sector, after all, has been very profitable and balance sheets are generally cash-rich and in excellent shape. Also, the premium pricing for Treasury securities over the last few months has driven yields down to unfavorable levels. As of July 31, the yield-to-maturity on the Treasury Index stood at 1.48%, a number which makes inflation-adjusted yields negative at most points on the yield curve.

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The cash-yield curve is a graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

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