UOB

Investment Insights

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Wall and Ceiling: a new season of US debt drama

The seventh season of Game of Thrones, a popular fantasy television series, reached a breathtaking close in August. While waiting for the next season to swing by in 2019, US drama fans can tune in to something that is even closer to home, which also comes by every two years and too involves a wall – the US debt ceiling debate. Although the event has been postponed, this issue will continue to be a concern in the months leading up to the end of year.

[Warning: minor spoilers ahead!]

What is the debt ceiling?

The debt ceiling is a legislative limit on the amount of national debt that can be issued by the US Treasury. Once reached, it can only be raised or suspended with approval from the Congress.

In the past, the debt ceiling bills have always been passed to avoid defaults on government debt. However, what causes delays in addressing the debt ceiling is its value as a bargaining chip. Although theoretically separate from policy debates, in reality, the debt ceiling has often been used by both Democrats and Republicans in the Congress as a way to push their own political agenda. This is illustrated in Figure 1 below.

Figure 1: Summary of recent debt ceiling episodes.

	2011	2013	2015
Government shutdown?	No	**Yes, on 1 October 2013**	No
Resolution date	2 August 2011	16 October 2013	2 November 2015
Action on debt limit	Raise	Suspend	Suspend
What happened?	Republicans in Congress refused to raise the limit without a spending cut attached Delay in sparked downgrades of US sovereign ratings and widespread risk-off sentiments	Impasse between two parties led to a temporary government shutdown	Relatively amicable and the debt limit was suspended until March 2017

Source: UOB PFS Investment Strategy, 1 September 2017

Inside

Should you have any queries, please contact your UOB Banker for more information.

Who's involved? Introducing the main cast

Theoretically, the current political setup should be quite constructive to passing the debt ceiling bill as the Republican party controls both the White House and Congress. However, the split in the Republican party is likely to complicate dynamics. Figure 2 provides a snapshot of the general stance of major participants involved in the debt ceiling debate.

Recent developments

After the suspension of debt ceiling ended on 15 March 2017, the US Treasury has been running on extraordinary measures to pay its bills and avoid default. According to US Treasury, the Treasury was projected to run out money to foot its bills around 2 October 2017. Hence, the debt ceiling issue needed to be resolved by 30 September to keep the government running. However, major participants were locked in discussion because of conflicting agenda as shown in Figure 2.

The arrival of Hurricane Harvey tipped the scales, as the need to run aid program without disruptions became a key priority. In an interesting twist of events, President Trump chose to support the Democrats' call for a three month extension of the debt ceiling.

Figure 2: Position for major participants in the debt ceiling debate.

				HOUSE FREEDOM CAUCUS	
Cast	**President Trump**	**US Treasury**	**Moderate Republicans**	**Freedom Caucus** (a part of the Republicans)	**Democrats**
Stance	Supports clean debt limit increase But also mentioned he wanted to attach funding for **US-Mexico border wall**	Treasury Secretary Mnuchin is pushing for **clean and earlier debt limit increase**	Support **clean debt limit increase** with no conditions attached	**Raise debt limit only with spending cuts**	Support **clean debt limit increase** with no conditions attached, but may ask for concessions

Source: UOB PFS Investment Strategy, 1 September 2017

Preview of outcomes

Now that we have laid down the basics of the debt ceiling debate, the natural question would be how these factors could affect the final result when it comes around again. Figure 3 below gives a simple summary on the potential outcomes for the debt ceiling debate.

Our base case remains that the US debt ceiling will be raised or suspended as most of the lawmakers and the White House do agree that the debt ceiling needs to be resolved and the spending bill addressed. They also want to minimise impacts to financials markets.

...but there could be strings attached

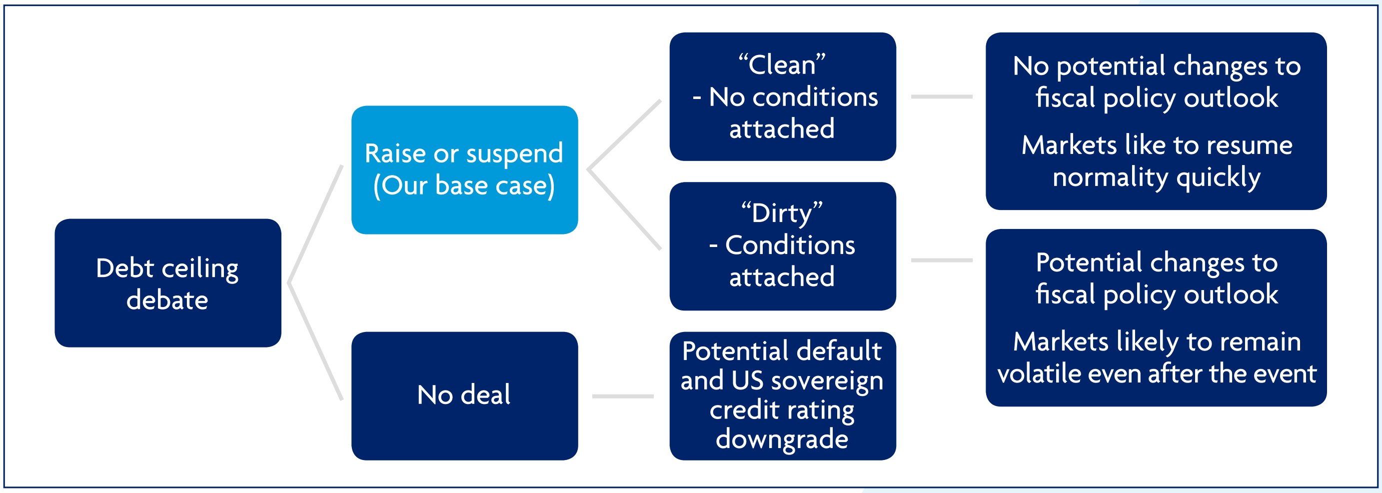
The more important question would be whether any conditions will be tagged to the bill (a "clean" resolution versus a "dirty" resolution), and if so, what are the conditions imposed. A "clean" resolution would basically mean status quo, with little changes to the fiscal policy outlook. Accordingly, a "dirty" resolution could potentially have impacts on the fiscal policy outlook and therefore markets could see pickup in volatility as participants reassess the implications of the changes.

The type and magnitude of impact under a "dirty" resolution would depend on the exact conditions attached. As discussed previously in Figure 2, the different participants have conflicting goals and this suggests that negotiations could drag until the last hour.

The other "what if"

Although unlikely, the alternative to our base case would be a no deal scenario. This raises the probability of default on US debt, which could trigger a sell-off in US debt and the US sovereign credit rating could also be at risk of a downgrade.

Figure 3:



Source: UOB Investment Strategy, 5 September 2017

Implications for investors ▶▶

Pickup in volatility

To understand the behaviours of markets around the debt ceiling debate, we can look towards the past episodes of the debt ceiling debate. Figures 4 and 5 illustrate market reactions in the period just preceding and after the respective resolution dates.

Figure 4: Short term treasury market volatility 60 days before and after resolution date

In 2015, increase in short term yield after the resolution date could be attributed to expectations for Fed rate hike, which eventually came in on 16 December 2015.

Figure 5: Equity market volatility 60 days before and after resolution date

In 2011, the heightened VIX Index after the resolved date was more closely linked with renewed fears about slowing global economic recovery after release of bleak economic reports.

In 2015, the debt ceiling debate was mostly a non-event, inciting limited movement in the markets.

Figure 4:

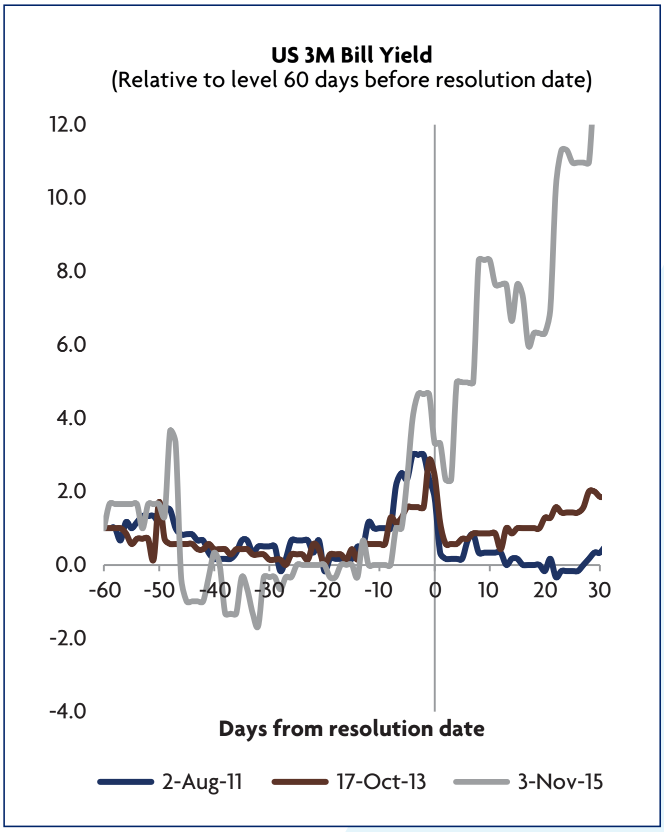
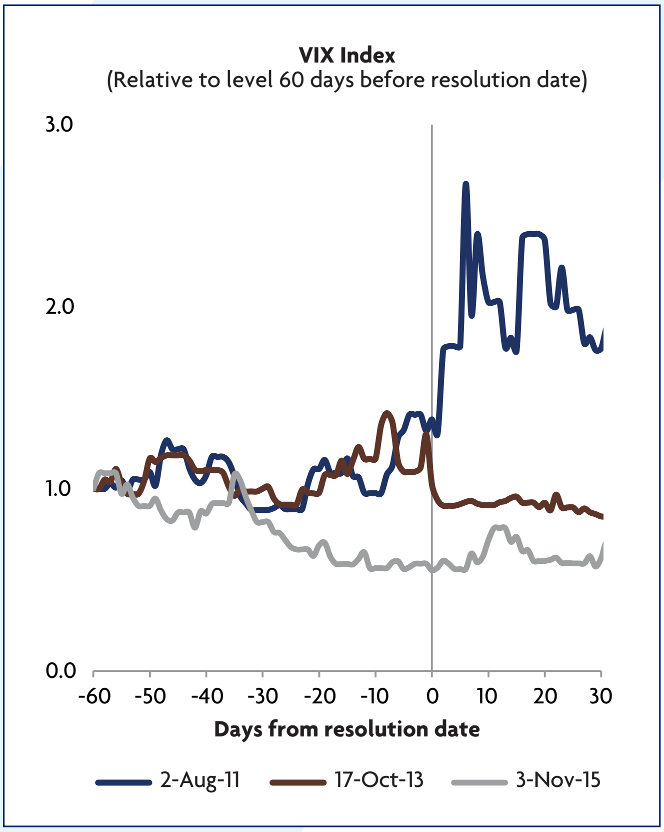


Figure 5:



Source: UOB Investment Strategy, Bloomberg, 4 September 2017

As per Figure 4, in the fixed income markets, movements were pronounced in the short term bonds. In the past three instances of debt ceiling debate, short term yields rose substantially around ten days prior to the resolution date (i.e. short term bonds sold off). However, levels soon normalise towards the resolution date and in the few days thereafter.

In Figure 5, we see that movements in the equity markets, volatility generally picked up prior to the resolution date. Movements after the resolution date were less clear. However, we note that in the 2013 episode, which resulted in a government shutdown, volatility levels quickly normalised after the resolution date.

More policy uncertainties

President's Trump's decision to side with the Democrats could have further reduced his political capital within his own party. Worsening divide between the Republicans could reduce the Trump Administration's ability to push through the tax reform agenda. This could introduce additional uncertainty in policy direction and weigh on market sentiments.

The bottom line

In summary, we expect volatility to pick up in coming months and especially prior to the resolution date. Normalisation should set in reasonably quickly after the resolution date, barring other external factors. The key to navigating the situation is to focus on risk management, rather than turning completely risk-off. Investors can consider allocating new funds to core products that have diversified mandates, which should help to mitigate excess volatility while allowing investors to stay invested.

Ultimately, this season of debt ceiling debate could be like the Game of Thrones – lots of dramatic build-up but one where the main characters were spared from the axe.

Market Outlook and Strategies ▶▶

Macro

Global Growth	**The medium term US economic outlook has been downgraded** as many of Trump's pro-growth policies are likely to be delayed. However, other regions like Europe and China picked up the slack.
Monetary Normalisation	Following Fed's monetary policy path, **ECB may just turn the corner and gradually move towards normalisation**. BOJ is likely to continue their asset purchase programs.
Inflation & Rates	**Inflationary pressure stay subdued**, partly due to tepid wage growth. **The Fed is still on track to announce BSR in September and raise rates 3 times in 2017**, with the last one likely to be in December.

Risks

China Policy Missteps	China needs to balance between growth and structural reforms. **Overly aggressive tightening may cause increase in default rates and hard landing risks**.
Trump Disappoints	Short term extension to debt ceiling could **delay and complicate tax reforms**. As markets have priced in the positives, the failure of implementing such policies is likely to unsettle investors.
North Korea Tension	**Tension between the US and North Korea escalated recently.** Further provocative moves from North Korea may trigger military intervention. If that happens, risk assets could be sold off.

Strategies

Tactical Strategy		Key Proposition	Key Risks
Position for higher rates.	**Short duration high yield bonds**	• Lower sensitivity to interest rates and offers attractive yields versus longer-dated Treasuries.	• Default risks could rise if economic conditions worsen. However, economic outlook remains constructive.
	Subordinated bonds	• Higher yields versus senior bonds while enjoying the same credit risks.	• Recovery is lower than senior bonds in the event of default. However, the default rate for IG issuers is very low.
	Fund-linked structured note	• Access to fixed income markets via a diversified, actively managed underlying and provide additional participation on performance.	• Though there will be additional issuer credit risk, stringent selection of issuer should help to mitigate this risk.
Participate in Asian growth story.	**Asian equities**	• Attractive valuations over DM equities, with improving fundamentals over the year.	• China slowdown could pose risks but we expect the process to be controlled.
Recovery and policy shifts in DM offer opportunities.	**European equities**	• Attractive discount versus US and tailwinds from improving economic activities.	• Elections in Germany could pose risks, but unlike the French elections, it is expected to be less controversial.
	Quality equities	• Tend to experience less drawdowns during sell-offs and outperform broad equity markets over longer investment cycles.	• Hefty valuations could increase probability of short-term corrections. However, global recession risks remain low.
Healthcare sector shows potential for long-term growth.	**Global healthcare equities**	• Attractive valuations and recent outperformance is likely to be sustained due to better-than-expected earnings.	• Repeal and replacement of Affordable Care Act (ACA) could affect outlook for industry, but we expect most provisions to remain intact.

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