INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

GAD

4 November 2013

MONTHLY UPDATE

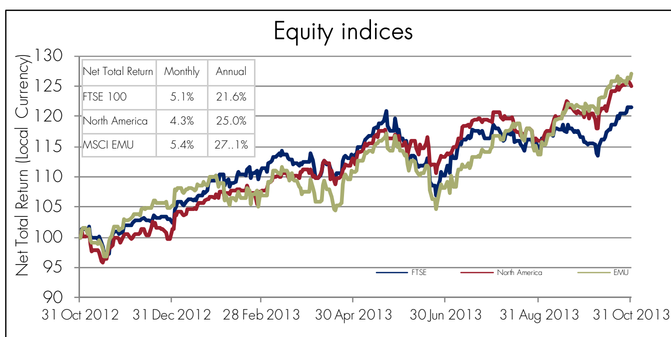
Overview

3-Month UK GDP growth has risen again to 0.8%, up 0.1% on the previous quarter. Alongside this, Mark Carney has spoken of growing evidence of a 'robust recovery' in the UK, pointing to strong increases in employment, improved business surveys and rising house prices. This has led to widespread speculation that the 7%-unemployment-level-triggered interest-rate hike could happen earlier than first predicted. In other UK news, with the assistance of higher tax revenues, borrowing fell in September down to £11.1bn compared to £12.1bn at the same point in 2012.

In the US, a range of economic indicators including weaker than expected non-farm payroll data point to slow-ish 2% growth, strengthening assumptions that Fed monetary policy will continue to be accommodative for longer than previously expected. This buoyant news for equity markets remains checked by continued uncertainty over the US debt-ceiling as congress push the deadline, along with any necessary decisions, back to early 2014—see overleaf.

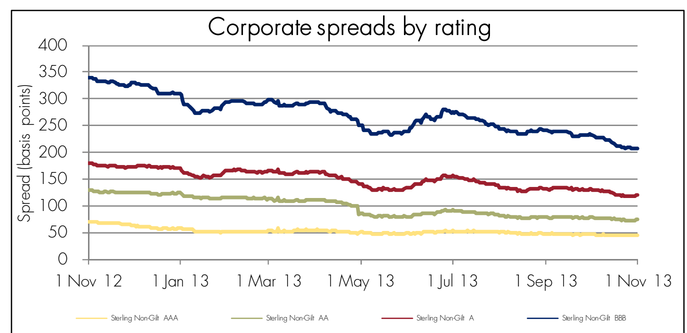
President Obama nominated Janet Yellen as chair of the Federal Reserve. If she receives approval from congress she would replace outgoing chair Ben Bernanke and be the first woman to serve in this capacity. She would also be the first Democrat to hold the post in nearly three decades. Many suggest that, coming from her current role as deputy, she would represent continuity in terms of policies for the near-term but the impact of her potentially imminent arrival remains to be seen.

Equity markets rose over the month



Net Total Return	Monthly	Annual
FTSE 100	5.1%	21.6%
North America	4.3%	25.0%
MSCI EMU	5.4%	27..1%

Credit spreads narrowed further this month

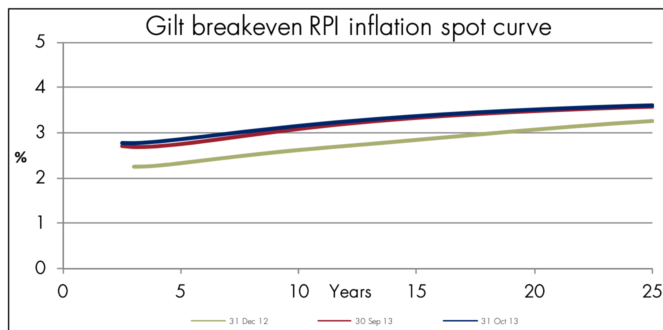


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase September (%y/y)	2.7%
Halifax house prices Sept (%m/m)	0.3%
IPD TR property index Sept (%m/m)	1.2%
PPF 7800 funding ratio August	90.7%
VIX (volatility) index	13.8
$/£ exchange rate	1.61

Numbers as at the end of month unless stated

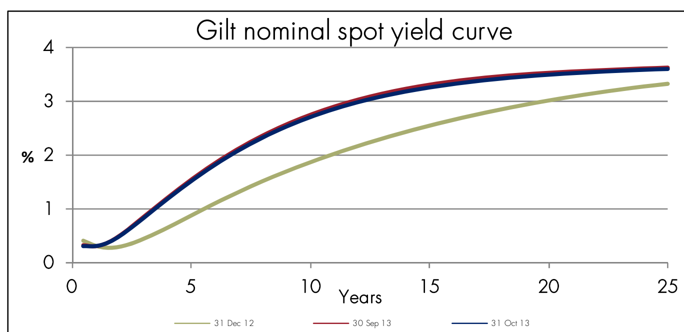
Breakeven inflation stayed largely static



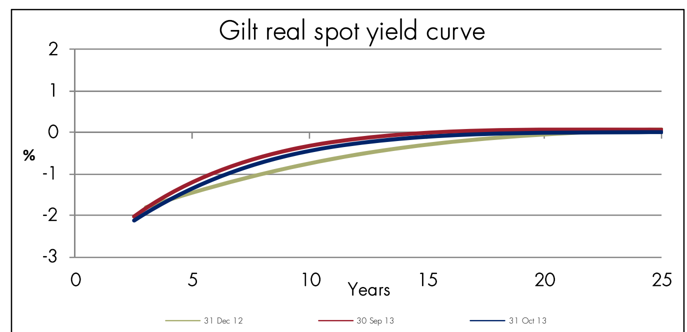
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	7th November
UK Trade	8th November
RPI / CPI	12th November
Labour Market Statistics	13th November
Bank of England Inflation Report	13th November
Minutes of MPC meeting	20th November

Nominal yields were mainly unchanged this month



Real yields decreased slightly



All chart data sourced to Bank of England, Merrill Lynch, Financial Times, MSCI & Standard and Poor.

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INVESTMENT NEWS

GAD

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MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

4 November 2013

US Debt Ceiling

Earlier this month, lengthy discussions between the House of Representatives and the Senate meant that there was a risk that the US would breach its debt ceiling that could have led to a default on its debt obligations. Below we discuss what the issues were , how significant the risk of default was and what the consequences could have been.

What are the issues?

Like all other governments across the globe, the US government issues debt in order to meet expenditure on healthcare, pensions, defence, debt interest and other government expenditure not covered by tax revenues. The 'debt ceiling' caps the total amount of US government debt that the US government can issue and is set out in law. It currently stands at $16.7trn—equivalent to over 100% of US GDP compared with current UK debt levels of around 90% of GDP. If the debt ceiling is reached then the US government is unable to borrow further and has to either cut expenditure, raise taxes or raise the debt ceiling in order to finance spending.

The debt ceiling was last reached in May. Following lengthy discussions between the Republican controlled House of Representatives and Democrat controlled Senate, the US Treasury was able to put a number of 'extraordinary measures' in place to continue to raise funds. These measures were due to expire on 17 October 2013, but the two houses were able to reach an eleventh hour agreement to continue the extraordinary measures and thus avoid a default. However, it is likely these measures will only last until January 2014, when the debt ceiling may require raising again. In all, the debt ceiling has now been raised on 77 separate occasions since 1962, and some commentators expect further increases of up to $23trn in the next five years.

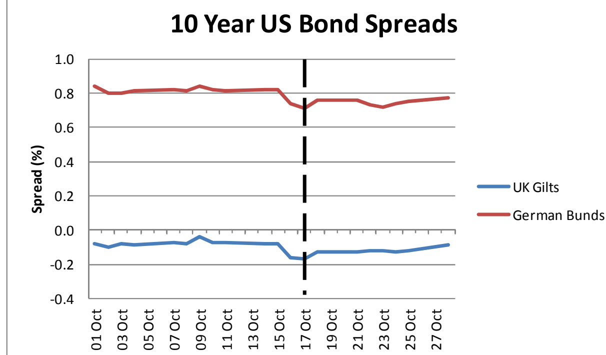
What is a default?

Large economies such as the US are often considered to have a negligible risk of default, based on their strong historical record of repaying debt obligations over long periods of time. For example, most commentators agree that the US has only come close to a default on three occasions in the past—in 1790, 1933 and 1979.

Even when a government comes close to defaulting, it is not always clear cut as to whether a country does or doesn't default. For example, in the lead up to the 17 October agreement, the US Treasury discussed the idea of prioritising bond payments and rolling over maturing stock. Whilst this would have meant that the US would have paid bond holders, some commentators argue that such an event would technically be classified as a default. The debt restructurings in 1790 and 1933 are similar examples of where it is not clear cut as to whether there was a default or not.

Many commentators suggest that the chance of a US default, of any kind, is limited because the US government would want to avoid the potential repercussions discussed below. This view appears to have been shared by the market on this occasion (see Box 1), where the spreads over other government yields were relatively unmoved.

Box 1—How did the market react?



Source: FT

The chart shows the yield spread of US Treasuries over Bunds and Gilts issued by the German and British governments respectively. Spreads were largely unchanged before and after the deal was agreed. In general there has been investor relief in reaction to the ending of the shutdown and raising of the debt ceiling. However, some commentators maintain that the long stand-off has damaged the economy and delayed the problem, rather than solved it. Ratings agency Standard and Poor's estimate the shutdown will cost the American economy $24bn and will significantly cut growth in the fourth quarter.

What might the consequences be?

It is unknown what the consequences would be of a US default. However, the technical glitch of 1979 gives some indication that the consequences are likely to be severe. On that occasion, a technical glitch led to the late payment to some holders of Treasury bills. Whether or not this technically counted as default, the error had a significant impact on the cost of US government borrowing at the time despite the fact that the error was small, accidental and only related to a tiny proportion of the outstanding debt.

Whilst recent discussions between the two houses of congress were on-going, many commentators started to speculate what the potential consequences of a US default might be. What is almost certain is that holders of Treasuries would see a reduction in the value of the bonds they hold and that the US government would be required to make drastic cuts in federal spending or try to raise taxes, or both. Although there are a wide variety of views on the wider economic impacts, given the US status as the world's largest economy and the use of the dollar as the reserve currency of the world, most commentators suggest that:

- Yields on US government debt would rise, following falls in the price of Treasuries.
- It is likely that there would be a flight to 'safer' assets, such as gold or other government bonds.
- There would be significant market volatility—on equity markets but also on currency markets.

In addition there may be other practical issues and difficulties—for example central banks who peg their currency to the dollar or try to manage large fluctuations against it may face challenges or investors may have to find alternative sources of collateral for derivatives where Treasuries are currently used.

What next?

Although the houses of congress reached an agreement to avoid default, it is likely that the debt ceiling will need to be raised in January. Indeed many suggest that the muted market response reflects the belief that the October agreement has only delayed the problem, rather than solved it and that markets across the world will be watching closely as the next deadline approaches.

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