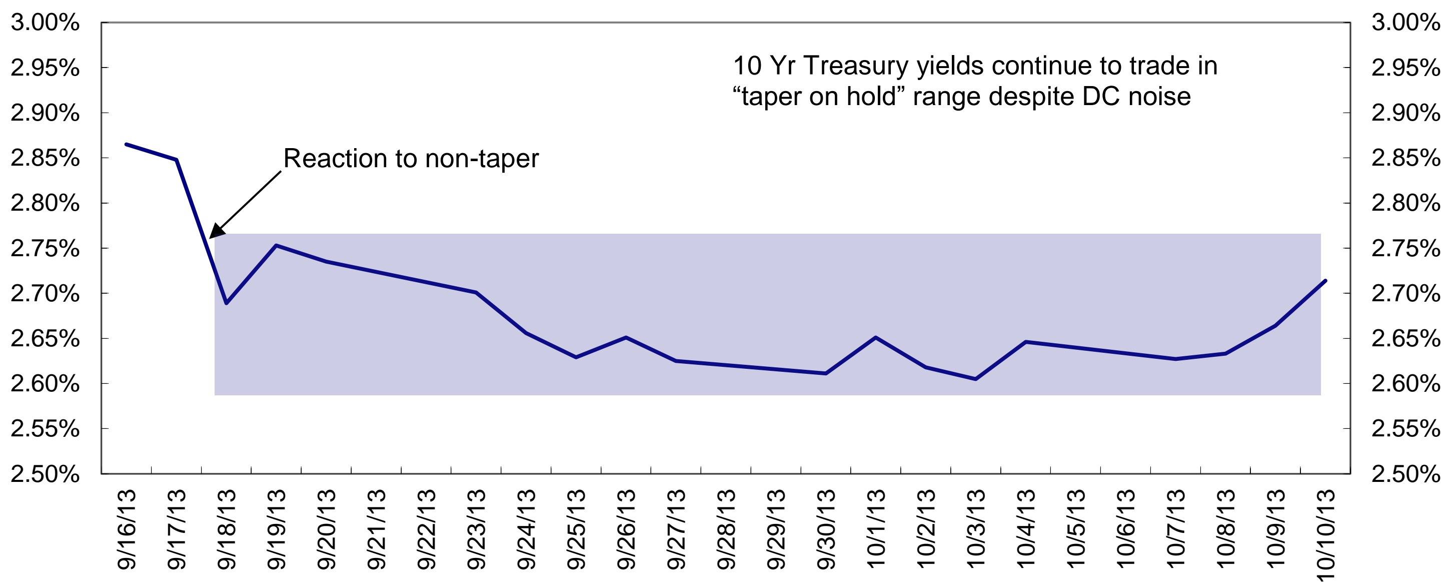
Silence Was Golden

The conspicuous absence of DC distractions for the first 5 months of 2013 provided the backdrop for stocks and bonds to perform well amid a slowly improving economy and consistency in monetary policy. But that did not last.

- The prospects of a QE3 exit strategy, i.e. "tapering", rattled bonds in May and June.
- The late August return of Congress renewed bickering and uncertainty about first the shutdown and then the debt ceiling.
- The Fed threw a September curveball with its decision to hold off tapering.

As of this writing, we continue to witness a Federal Government shutdown that began October 1st, but late word from Washington finds a "willingness" to set conditions for a short term increase in the U.S. debt ceiling. All the while, yields on 10-Year Treasuries remain in a "taper-on-hold" range.



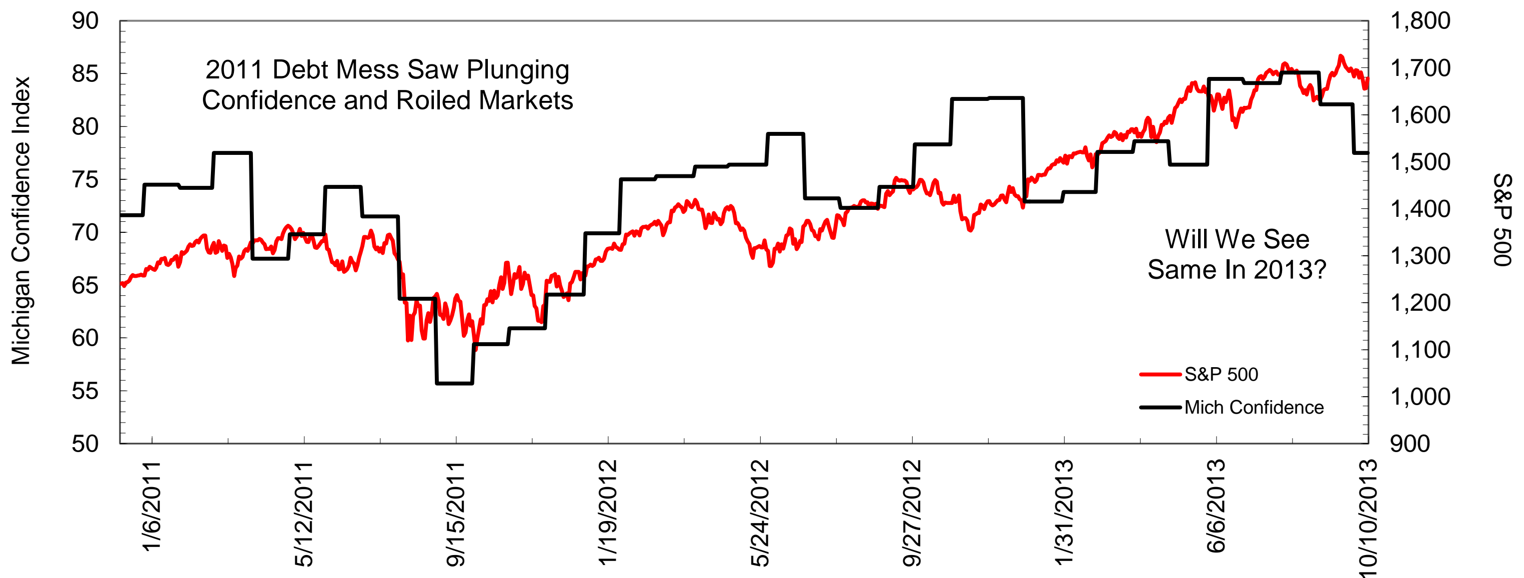
Source: Bloomberg

To help chart the course for the next few weeks, here are risks, scenarios, and allocations for you to consider.

What are the Risks?

Immediate concern: The immediate issue remains the outlier risk that we experience some form of default on US Debt, though we think this is very unlikely. The exact consequences of such an event are unknown but severe.

Intermediate and longer-term concern: Confidence. A persistent drag on economic recovery over the past few years has been the unsteady confidence of investors and decision makers. The mess in DC, slightly higher interest rates, and a jittery stock market may shake consumer confidence and constrain overall economic growth. We've already seen confidence deteriorate since Congress returned in September. This brings us to a broader thesis that the dysfunction in Washington is a major impediment to an improving economy, and with mid-term elections not until late 2014 it's hard to see an improvement in rhetoric.



Source: Bloomberg

Current Caprin positioning: Leading up to the Fed's expected September "taper", we had implemented defensive strategies with shorter duration targets to minimize the impact of a slow but steady increase in interest rates. Unexpectedly, the Fed stepped back and longer rates fell somewhat. As we digested this decision, we chose to maintain our defensive and flexible positioning as we remain cautious about the ultimate destination of interest rates with a possible "taper" resurrection in a few months.

Potential Debt Ceiling Outcomes:

Most Likely: Short term extension of Debt Ceiling (~6 weeks)

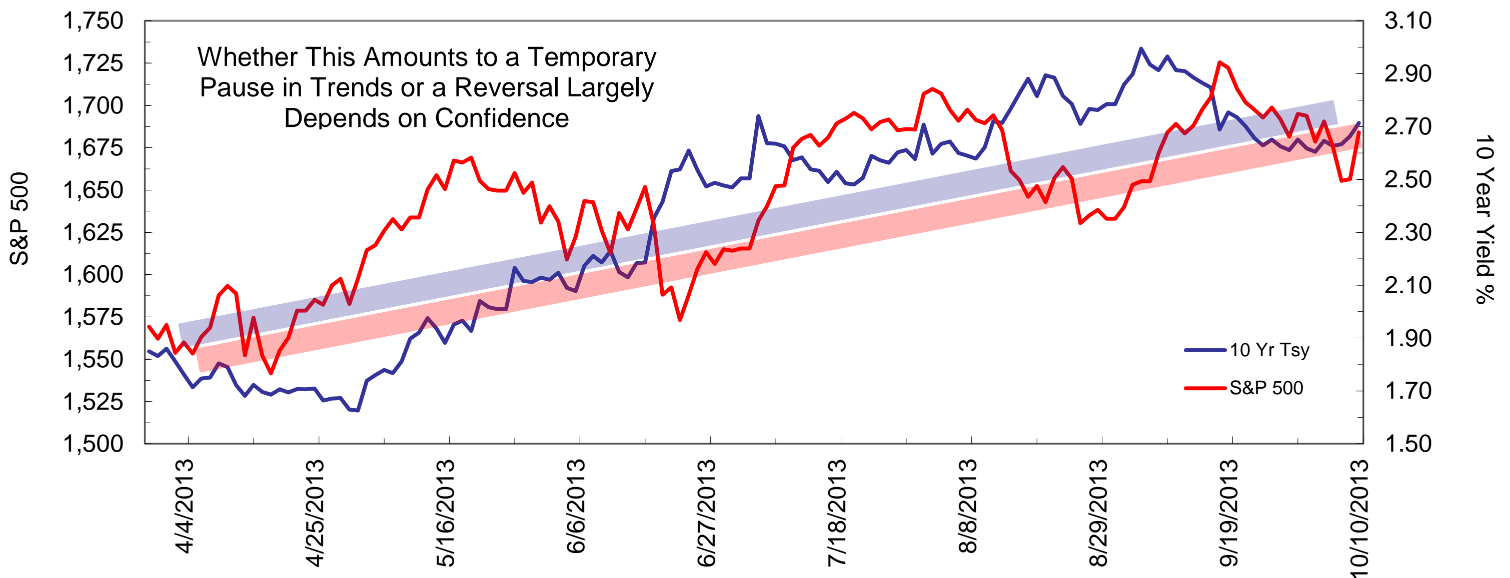
Details: Congress and White House agree on terms (details pending) for negotiating fiscal concerns and the debt ceiling during the next several weeks. While the risk of an immediate breach eases, the market meanders and likely brings participants in a few weeks to where we are today. We expect the most likely end game for this interim episode to be a 2014 Extension (see Scenario 2 below).

How to position: Yesterday (10/10) we saw an immediate pop in equities and selloff in bonds as markets stepped back from the worst case scenario, but these reactions may be short-lived. We are wary of "band-aid" maneuvering in DC that just sets up another round of brinksmanship. We see a modest increase in cash as prudent until the outlier risk is off the table for the foreseeable future.

Less Likely Near Term: Debt Ceiling increase through 2014 election

Details: Congress and White House agree to take the debt ceiling issue off the table for an extended period of time. We doubt this can be achieved by 11/2013, but cosmetic commitments could lay the foundation. For a 2014 solution, we would expect compromises from both parties that might include health care, entitlement reform, spending cuts and tax increases.

How to position: The investment consequences of a broader solution are multifaceted. Initially, fiscal and tax policies would likely constrain economic activity. However, if investors and decision makers are comforted by a less interventionist Federal government, then Private Consumption and Gross Investment may flourish. Add to that the dovish tendencies of the new Federal Reserve Chair desiring some accommodation to ensure solid economic footing, then we see lower cash, a slight overweight to equities and a slight underweight to bonds. The key will be how confidence strengthens.



Source: Bloomberg

Extremely Unlikely: No Debt Ceiling extension

Details: Extremes on both sides dig in and block a short term compromise. In this unlikely scenario, we do not see a Treasury default because of reported constitutional restrictions preventing such by branches of the U.S. Government. This opens up several solutions including unilateral White House action or a bail out by the Federal Reserve. Though emergency measures are not sustainable, we doubt the Treasury misses a principal or interest payment.

How to position: Markets may take this latest brinkmanship as a sign that Congress and the White House do not take sovereign debt obligations seriously, creating global investment turmoil. We could see a violent spike in interest rates as US Treasuries are no longer the risk-free asset. We could see all risk assets fall in value. Short duration fixed income and cash would be over-weighted until new equilibriums are established.

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