Philequity Corner (October 14, 2013)
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Sutdowns and Debt Ceilingsh

Recently, finance headlines have all been about the US government shutdown and debt ceiling. Last October 1, the US experienced its 1st government shutdown in 17 years**.** Since the shutdown of October 1, the US stock market had been down almost every day while global stock markets experienced a roller coaster ride. This changed last Thursday when a glimmer of hope started to surface. Over the weekend, American politicians engaged in marathon discussions to solve the US government shutdown and the US debt ceiling problem.

Despite the gravity of the situation in the US, some of our readers and investors are still not familiar with it. They have been asking us how this will affect our economy and stock market. Philequity Corner was conceived with a mission of educating the investing public. As part of our educational mandate, we shall discuss in this article the problems that the US is experiencing. Moreover, we shall explain how these might affect the global economy, global stocks and in particular, the local stock market.

What is the US government shutdown?

A government shutdown takes place when the US Congress fails to allot funds for the incoming fiscal year. This last happened in October 1995 and this current shutdown started in October 1. To date, the US government has been shut down for almost 2 weeks already. The shutdown closed certain parts of the US government that are deemed non-essential. Some examples of these are national parks and monuments, certain services for veterans and medical research into life-threatening diseases. Because of this shutdown, around 800,000 employees of the federal government were furloughed without pay and suspended indefinitely until government funding is reestablished.

What are the effects of a US government shutdown?

A prolonged government shutdown would hurt an economic recovery that is still quite fragile. This will be quite painful considering that the US economy grew at 2.5% in 2Q2013. Note that the US economy grew at this pace because of the aggressive monetary policy easing of the Fed.

Why did the US government shutdown happen?

This government shutdown was caused by the deep disagreement between Republicans and Democrats over key government policies. The Republicans have always advocated spending cuts to balance the budget. With that in mind, the Republicans have demanded the defunding and delay of the Obama administration's health care policy by at least a year. The Democrats, on the other hand, are insisting on tackling the government funding and debt ceiling issues in a separate light. Note that these 2 opposing political parties have traditionally used the government funding and debt ceiling issues to haggle important concessions on contentious government policies.

What is the US debt ceiling?

The US is one of the very few countries that has to raise its debt ceiling in order to increase government debt and fund the government. The debt ceiling sets the maximum amount of outstanding federal debt that the US government may incur. Increasing the debt ceiling will allow the government to fund obligations already legislated by the Congress. A country like the US, which runs on a budget deficit, must raise its debt limit in order to refinance maturing debt and fund government expenditures. The US debt ceiling is currently at $16.7T.

When was the US debt ceiling last raised?

The debt ceiling has been raised more than 70 times since the 1960s. This limit was last raised in August 2011. During that time, the US debt ceiling was raised only hours before a US government debt default. This showed how dysfunctional politics in the US can negatively affect the global economy and global stock markets. This led to the historic downgrade of US sovereign debt by the S&P and a vicious correction in global stocks.

Why did global stock markets drop when these problems started to surface?

The US is the biggest economy in the world while the US dollar is the world's reserve currency. The US is also home to the biggest stock and bond markets in the world. If something dire happens to the US, it would certainly have far-reaching economic and financial impact. This is why global investors sold stocks down when the US shutdown and debt problems started to surface.

What will happen if the US debt ceiling is not raised?

The US government is expected to exhaust its borrowing capacity by October 17 or a few days thereafter. This means that the US government may actually miss debt payments if it fails to issue new debt before it runs out of cash. If this happens, it will constitute a technical default of the US government on its debt.

Will the US default on its debt obligations?

The US government defaulted on its debt in 1790 and 1933. However, considering the economic and financial impact of such a default now, it is unthinkable for the US to let this happen again. A US debt default would have grave and serious consequences for global financial markets and the global economy. It can lead to another downgrade for US government debt, thereby leading to higher borrowing costs for the US government.

How can the US government shutdown affect our economy?

A prolonged shutdown of the US government would negatively affect the US economy. Although US economic growth is positive, it is still relatively slow and fragile. Moreover, slower US GDP growth would dampen global economic growth. If this happens, it would be hard for emerging market (EM) countries like the Philippines to continue growing strongly.

How can a possible US debt default affect our stock market?

A US debt default, if it happens, would be an unprecedented black swan event. Because of the size of the US economy, the US bond market and the US stock market, a US debt default would be a disastrous event that would negatively affect global markets and the global economy.

Aside from this, most global investors consider US Treasuries to be the safest among all safe havens. They deem it unthinkable that the US government would default on its debt at this point in time. A US debt default, if it happens, would therefore shake the foundations of global finance.

If it is any indication, S&P's historic downgrade of US government debt caused extreme volatility and triggered a vicious correction for global stocks. It stands to reason that a US debt default would result to something more grave and far-reaching. It may very well lead to a panic selldown of global bonds and stocks.

Why did global stock markets go up towards the end of last week?

As of this writing, the Republicans and the Democrats have softened on their demands for negotiation. Considering the dire consequences of these issues, both sides have recently started to hold constructive discussions. Moreover, they have been more willing to compromise in order to solve the government shutdown and debt ceiling problems. Given this, many investors anticipate that a solution to these problems may be forthcoming. This is why the Dow surged 323 points last Thursday, its steepest rise since January 2. This was followed by a 111 point increase for the Dow last Friday.

Given the potentially disastrous effects of a US debt default, what should we do now?

Until the debt ceiling is raised, the default risk for the US, however small, cannot be completely eliminated. As of this writing, it is not yet clear if the US political drama will be solved sooner than later.
All this time, we have been advising investors to buy slowly and buy in tranches. Even in the unlikely event of a default, we believe that a final resolution will still be passed.

On the other hand, a breakthrough in the most recent discussions between US President Barack Obama and the Republicans would be a boon to global stocks. It would allow the US government to go back to work and stimulate the US economy. It would also allow corporates to run their businesses without this overhang. Lastly, rather than worrying about uncertainties caused by political bickerings, investors would again be able to concentrate on buying stocks based on the fundamentals of companies.

For those who are watching the markets more closely, it pays to note that our stock market has been resilient despite the looming problems in the US. This is a testament to the strength of the Philippine economy and the attractiveness of Philippine stocks. Considering this, investors should focus on buying local companies that can continue growing despite the problems in the US and other global headwinds.

Educational Seminars at the Philequity Office

One of our main thrusts at Philequity is to educate the investing public. This is why we hold weekly educational seminars at our office. We would like to invite our investors and readers who would like to know more about the basics of investments to attend these. We conduct these seminars every Thursday at 4pm. We are located at Suite 2004-A, East Tower, Philippines Stock Exchange Centre, Exchange Road, Ortigas Center, Pasig City. If you are interested in attending these, please confirm your attendance by calling 6898080 or via email at sales@philequity.net.

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