Weekly Market Commentary

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The "Kick-the-Can" Pattern Keeps Giving to Investors in September

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Highlights

After kicking the can on Syria, a new Fed chairman, and now tapering, the market is beginning to wonder if the government funding deadline and debt ceiling are the next cans to be kicked by those in Washington. This week, the headlines will focus on the possibility of a government shutdown and the debt ceiling impasse, perhaps setting up another buy-the-dip opportunity ahead of an 11th hour compromise.

The Federal Reserve (Fed) "kicked the can" on tapering by unexpectedly postponing any reduction in the $85 billion pace of monthly bond buying at its policy meeting last week (see this week's *Weekly Economic Commentary: Communication Breakdown*). On Wednesday, the Fed said it needed more evidence of durable improvement in the economy and noted that a rise in interest rates threatened to slow the economy. Bond yields fell and stocks rallied, led by emerging markets (to understand why, see last week's *Weekly Market Commentary: Emerging Markets and the Fed—What's Attractive and What to Avoid*) and interest rate sensitive industries like housing stocks. The S&P 500 jumped to all-time highs on the news. By postponing tapering, the Fed added to the list of stock market-friendly actions to kick the can this month by those in Washington.

After kicking the can on neutralizing chemical weapons in Syria, a new Fed chairman with Bernanke's term expiring in just four months, and now tapering, there are key issues this week that are next in line. Market participants had expected concrete actions on the aforementioned issues in September, leading to relief when instead Washington kicked the can. Markets are beginning to price in the threat that Washington may not kick the can in the upcoming fiscal fights.

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The euphoria in stocks seen on Wednesday gave way to selling on Thursday and Friday as investors' attention shifted to the looming budget issues: a continuing resolution (CR) to fund the government after the current fiscal year expires on September 30, and the debt ceiling, which will be hit in October. Worries increased on Friday when the Republican-controlled House of Representatives passed a CR to fund the government until December 15, but excluded funding for Obamacare—making it unlikely to pass the Democratic-controlled Senate.

Until the end of last week, markets did little to price in any risk of a government shutdown despite the end-of-the-month deadline. This may be because the previous two government shutdowns were short-lived. The shutdown lasted five days in November 1995 and was followed by 21 days in January 1996. Neither episode was particularly negative for the stock market. However, that may have only been the case because they were not immediately followed by a debt ceiling fight that held much higher stakes for investors.

If Washington does not kick the can by the end of September and there is no 11th hour resolution to the CR, it may shake investors' confidence that

the debt limit will be increased in mid-October. In contrast to the relatively mild consequences of government shutdowns, the debt ceiling has been a big threat to the stock market. In August 2011 when it came down to the wire on the debt ceiling, from July 7 to August 10, U.S. stocks (S&P 500) fell 17%. We have the makings of a stalemate again, given that this time there has been little pressure on Congress by investors to push up the debt ceiling, that it is the last chance seen by some House Republicans to defund Obamacare ahead of the October 1 open enrollment date, and that polls show voters more likely to blame Republicans than President Obama for any shutdown or breach of the debt limit.

The kick the can pattern has worked well this month for investors willing to buy the dips: an upcoming decision that leads to short-term volatility that is followed by kicking the can on the issue and a relief-driven rebound in the markets.

That said, we expect Washington to kick that can again and form some compromise to fund the government and extend the debt ceiling. This week, the Senate may pass the House bill to fund the government through December 15 — after stripping out the Obamacare provision — and send it back to the House for an 11th hour vote. At the same time, the House Republicans may present a debt limit increase proposal that includes approval of the Keystone oil pipeline, a project that President Obama has been critical of and that is under State Department review. But at least it gets the discussions going.

This week, the headlines will focus on the possibility of a government shutdown and debt ceiling impasse, perhaps setting up another buy-the-dip opportunity ahead of an 11th hour compromise that kicks the can until later this year. The kick the can pattern has worked well this month for investors willing to buy the dips: an upcoming decision that leads to short-term volatility that is followed by kicking the can on the issue and a relief-driven rebound in the markets.

Volatility is not going away. After all, kicking the can does not resolve an issue — just postpones it. Actions to neutralize chemical weapons in Syria, selecting a new Fed chairman, the Fed's bond-buying program, and the fiscal challenges all are likely to be addressed this year. It is noteworthy that the December 15 cut-off date for government funding in the House-passed CR sets up yet another fiscal fight around the holidays, and is at about the same time as the Fed's December 17 – 18 meeting, when the central bank is increasingly likely to announce tapering.

With the markets welcoming kicking the can on issues of monetary and fiscal policy, Washington is likely to take the easy way out and continue to temporarily delay the tough decisions. We continue to recommend using any volatility as a potential buying opportunity. While these issues have the potential to induce some short-term volatility, they are unlikely to impact longer-term fundamentals of an improving global economic backdrop, rising indicators of revenue and profit growth, and stock market valuations that remain well below bull market peaks. ■

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