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Budget Chaos, but Little Lasting Impact

We don't think the budget chaos will result in substantial new spending restraint. If that's the case, it should have little lasting impact on the current outlook for markets or the economy – where we expect a gradual U.S. recovery due to pent-up demand and earnings growth, super-loose U.S. fiscal and monetary policy, a weakening dollar, momentum-driven commodity price increases, and foreign economic and equity outperformance as in 2010.

Gold Price (last obs. April 8, 2011)

Source: Wall Street Journal; Encima Global

Today's fight over FY11 spending is a skirmish, setting the stage for the bigger battle in May and maybe June over the debt limit increase. We don't expect meaningful medium-term spending restraint or structural reform, and we think that's how financial markets view the situation too.

- The most likely outcome is that today's fight, with or without a brief shutdown, weakens the political momentum for forceful spending restraint. This leads to a polarized fight over the debt limit. Once the increase is accomplished (by mid June), we expect higher bond yields, a weaker dollar, even higher commodity prices and foreign equity outperformance.

- **If today's fight, or the May fight over the debt limit, were to result in medium-term restraint on federal spending, it would be a market surprise and would strengthen the dollar, attract capital back to the U.S. and bring lower commodity prices.**

- If there's a long federal shutdown (past Wednesday), we think it would further polarize the situation, raising the risk of someone making a mistake either now or during the May showdown over the debt limit increase. Thus, a long shutdown would begin to strengthen the dollar, pushing commodities and Treasury bond yields down and weakening equities – the risk-off trade -- until the eventual increase in the debt limit.

10 Year U.S. Treasury Bond Yield (last obs. April 8, 2010)

Source: Federal Reserve; Encima Global

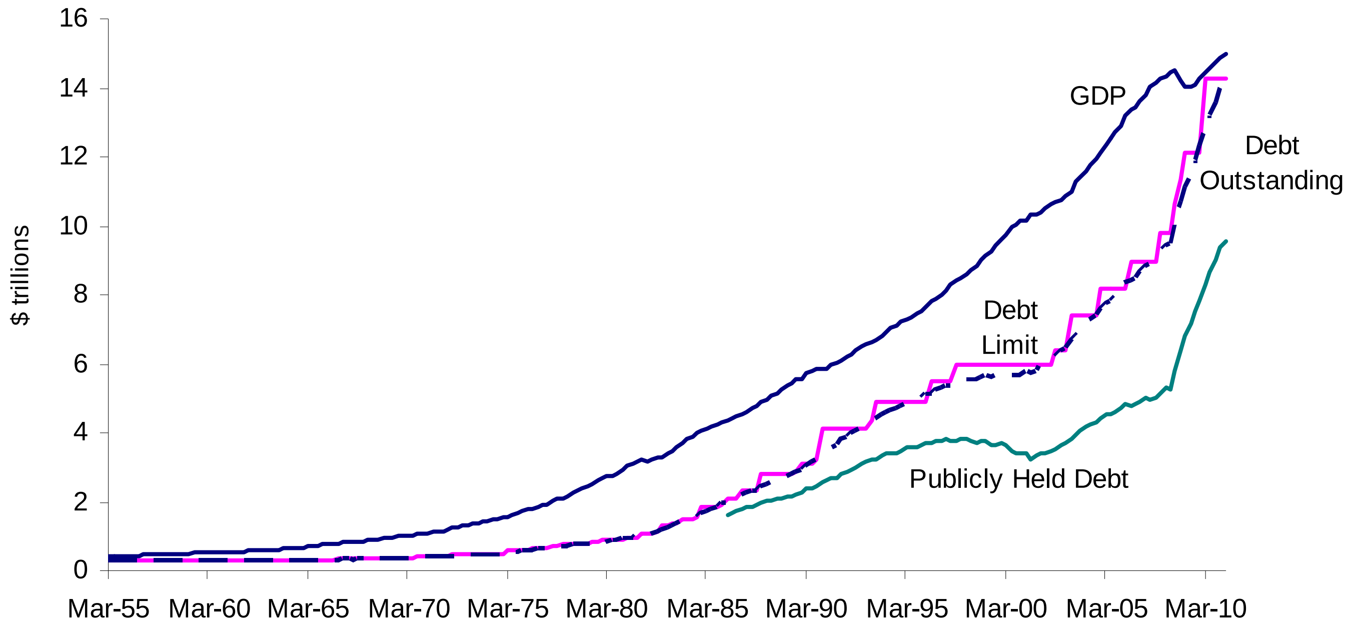
Treasury has said the debt limit must be increased by May 16. In the past, Treasury has had leeway, but Congress has reduced Treasury's wiggle room in recent decades.

- There's a clear requirement for more borrowing authority by the middle of June when big payments are necessary to the trust funds. The trust fund debt is counted in the statutory debt limit but not in the $9.5 trillion marketable debt used for the debt-to-GDP measurements.

- The statutory debt limit is currently $14.3 trillion but is expected to rise by roughly $2 trillion by the late 2012 presidential election.

- The marketable debt-to-GDP ratio is currently 65% heading toward 87% in 2021 in CBO's reestimate of the OMB budget. We think Congress and the president should put a ceiling on the debt-to-GDP ratio enforced by escalating requirements (or penalties) on the executive branch and Congress in when debt exceeds the debt-to-GDP ceiling.

Debt Limit and GDP (last obs. Q4 2010, estimated for Q1 2011)



Source: Bureau of Economic Analysis; U.S. Treasury; Encima Global

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