David Malpass
with Wing Chow
212-876-4400
dmalpass@encimaglobal.com
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Next Up, the Debt Limit Crisis

We have been expecting several of the major worries to get resolved favorably in the near term, causing a sizeable global shift from bonds to stocks. That shift will deepen if U.S. GDP growth picks up -- we were pleased by this morning's above-consensus 61.1 Chicago PMI (anticipated in yesterday's piece on the positive implications of Japan's rebound for U.S. PMIs.) ISM comes out tomorrow and may add to the sense that the manufacturing slowdown was mostly Japan-related, with PMIs rebounding first and jobless claims probably falling in the second half of July.

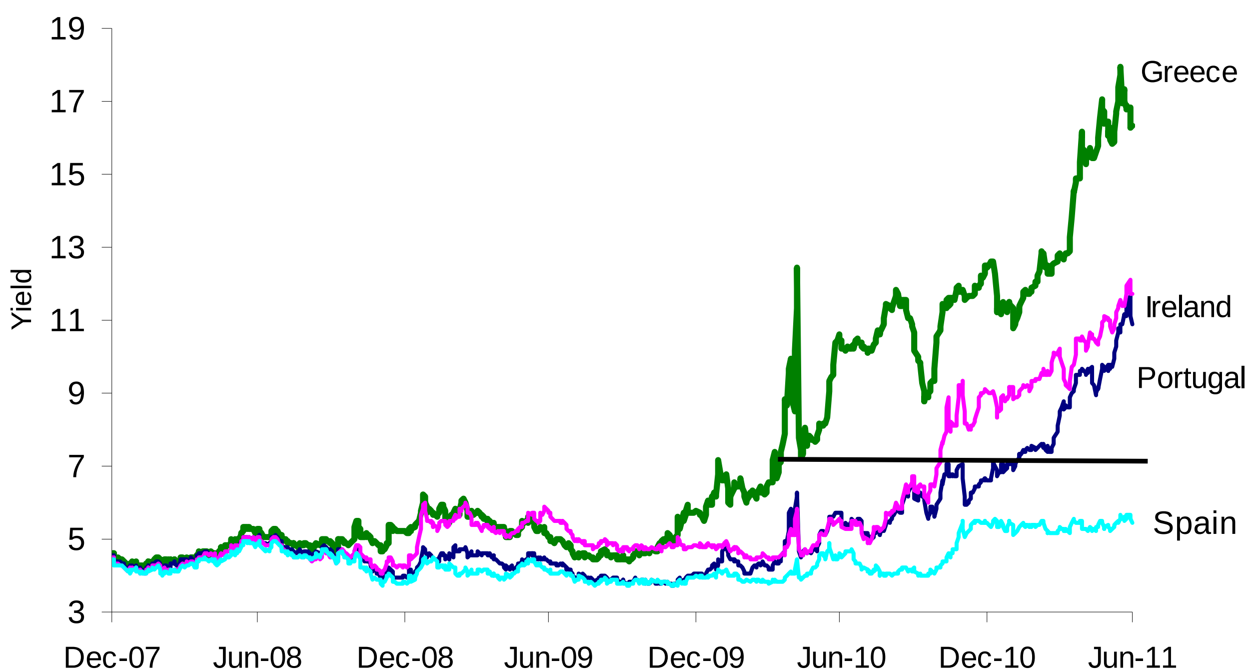
- **QE2 is ending like Y2K with no trauma other than the expected unwind of the bond squeeze that was partly caused by price-indifferent Fed bond purchases.** The world is overflowing with liquidity. The ECB is likely to hike to 1.5% on July 7 and remain in a tightening mode, a sharp contrast with the Fed. We expect fresh demand for U.S. Treasuries to materialize now that the Fed has stopped buying them at inflated prices. The ten-year yield, which has ticked up from 2.9% to 3.2%, should move somewhat higher (say to 3.5%) as the debt limit crisis is resolved and then to 4% as U.S. growth resumes.

10 Year US Treasury Yield (last obs. June 30, 2011)

Source: Federal Reserve; Encima Global

- **The Greek debt restructuring is on track to push the problem into 2012**, with German and French banks negotiating this week with their governments over their share of the losses. There will probably be more such restructurings over time (e.g. Portugal.) As with the Latin debt crisis, the menu of bank options will vary country to country and the country outcomes will range from good to bad (Brazil, Argentina, Mexico and Venezuela all had debt restructurings but dramatically different results, in our view based on leadership, currency policy and privatization of key sectors like oil.)

Select 10 Year European Yields (last obs. June 30, 2011)



Source: Bloomberg; Encima Global

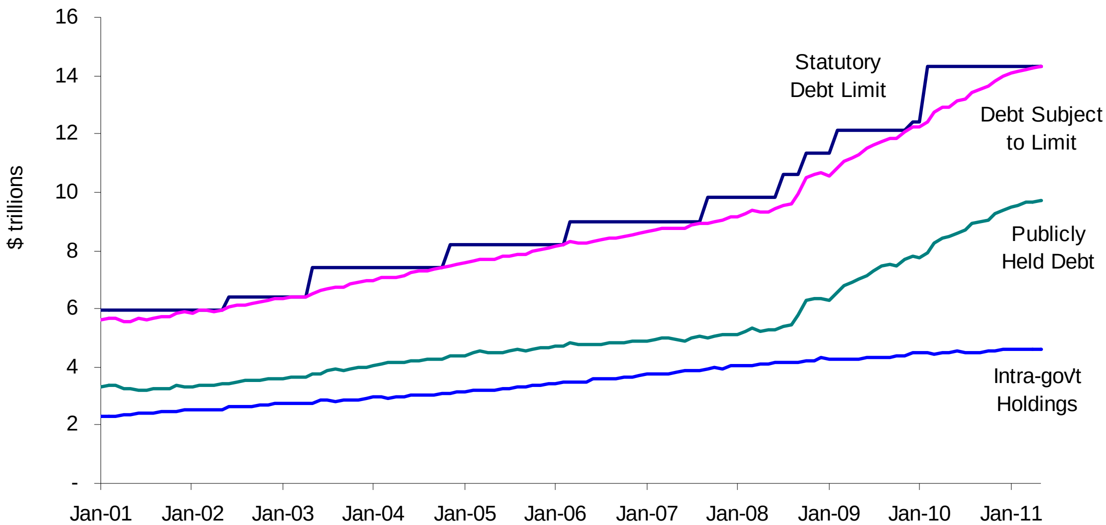
- **China's slowdown is still generating daily predictions of a hard landing and catastrophic collapse. We think it will only slow to 9%-10% from the 12% peak in 2010.** It is making progress toward market liberalization, increased consumption and higher-value-added capital formation. It's a modified communist economy, not broadly market-based, so there's a glass ceiling on living standards -- but for now we expect continued rapid gains in living standards. We study the China hard landing predictions, but the problems seem to be the same ones raised in the 1995, 1998 and 2004 hard landing predictions. These include bad bank loans, real estate bubbles, hot money trying to get into China from weak-currency countries, excess fixed asset investment, faulty data and accounting irregularities and the under-developed financial system. These are true at various times, but China has demonstrated mechanisms to handle them. It slowed to 6% yoy in 1999 after most of neighbors were dragged into the Asia devaluation crisis; and to 6.2% in 2009 as exports plunged during the Great Recession. But it has recovered fast, with our expectation that the current slowdown will bottom above 9%.

Next Up, Debt Limit Crisis

The debt limit is still a major problem, but should get resolved favorably by August. Our view:

- The August 2 deadline is a relatively hard deadline. In past debt limit fights, the Administration frustrated Congress by moving the deadline forward. Congress responded by passing laws limiting Treasury's flexibility under the debt limit (for example, by prohibiting the disinvestment of the social security and Medicare trust funds which would create over $2 trillion in new headroom if allowed). We think something will be done by August 2. A temporary or short-term increase in the debt limit is possible, but both sides seem to recognize the downside of fighting the battle twice.

Public Debt, Limit and Intra-govt Holdings (last obs. May 2011)



Source: U.S. Treasury; Encima Global

- The debt limit itself is faulty because it tries to limit debt caused by past spending commitments. Treasury Secretary Geithner's June 29 letter explains: "The debt limit applies to past decisions of Congress. Increasing the debt limit is necessary to allow the United State to honor obligations previously authorized and appropriated by Congress… Increasing the limit does not increase the obligations we have as a Nation; it simply permits the Treasury to fund those obligations Congress has already established."

- The debt limit is a weak vehicle for attaching spending cuts because the enforcement mechanisms in the current debt limit – either default or selective non-payment of government obligations – are too destructive. We've advocated replacing the current limit with a debt-to-GDP ceiling requiring spending cuts and enforced by escalating penalties on Washington when over the limit. We think the president should be held more accountable for over-spending and given more power to under-spend Congressional appropriations. We don't think the current approach -- closed room negotiations over unpopular spending cuts and tax increases – will improve the fiscal outlook.

As the deadline approaches, we think the Administration will turn up the heat to force a debt limit increase.

- S&P said yesterday that it would immediately downgrade the U.S. if interest payments due August 4 were missed. (While some still talk about a benign "technical default", we think it would be catastrophic and won't happen nor will there be an actual bond rating downgrade, just threats of one.)

- The IMF said yesterday: "The federal debt ceiling should be raised expeditiously to avoid a severe shock to the economy and world financial markets."

- Secretary Geithner's June 29 letter said the Republican proposal to cap the debt and prioritize payments was "a radical and deeply irresponsible departure from the commitments by Presidents of both parties, throughout American history, to honor all of the commitments our Nation has made." We expect former Treasury Secretaries to weigh in in favor of raising the limit.

- The president will try to use press conferences and the media to frame the issue as a choice between tax breaks for the rich or service cuts for the needy. Republicans will try to make the issue tax increases versus spending cuts. We think the Administration will be more effective in communicating its interpretation that the Republicans are irresponsible for advocating non-payment of federal obligations. **In the end, we think the debt limit will get increased with few spending cuts or tax increases.**

- **We expect ultra-loose monetary and fiscal policy to continue. This favors dollar weakness, commodity strength (though they got ahead of themselves during the QE2 hype about money printing) and foreign equity outperformance.**

Key issues to watch:

- Vitally important for the dollar, does the debt limit increase cause any significant process change that will limit future spending growth or cause CBO forecasts of future deficits to go down? We don't think there will be a material change in spending trends, though there might enough of a 10-year agreement that CBO lowers its baseline outlay estimates even though the agreement is unenforceable on future Congresses and unlikely to be adhered to. However, we don't think the eventual deal will improve CBO's "alternative baseline" which gives a more politically realistic read on the deficit. It shows marketable debt climbing above 100% of GDP and probably won't come down much after the debt limit increase is enacted -- the negotiations haven't focused on process changes that would alter Washington's tax and spend culture.

Budget Variations

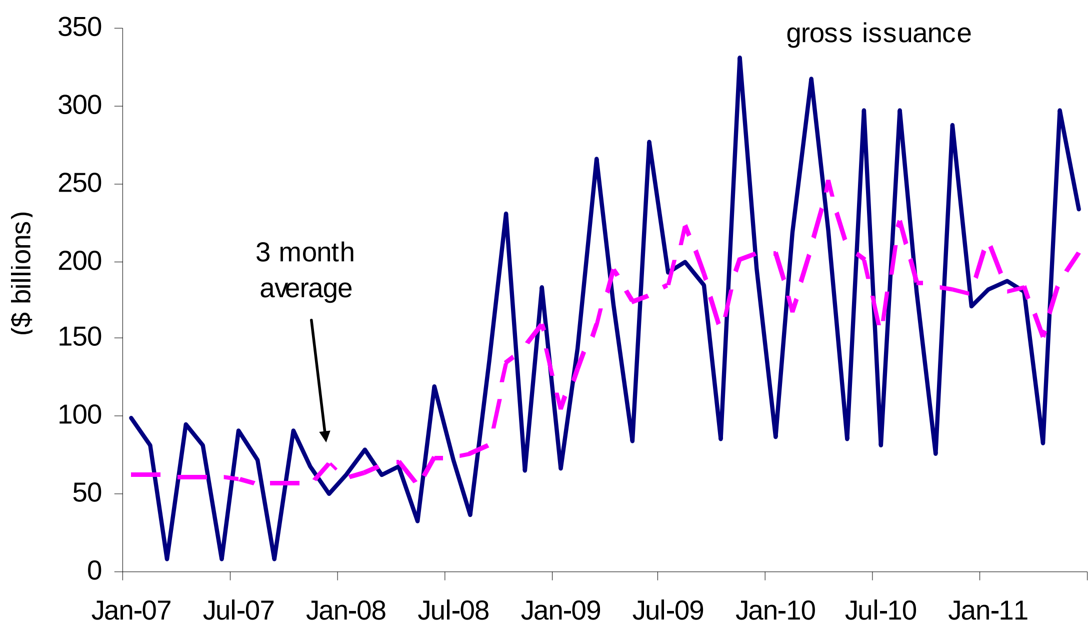
	FY 2012		Sept 2012	FY 2012 – 2021		Sept 2021
	Outlays ($ trillions)	Deficit ($ trillions)	Debt per GDP	Outlays ($ trillions)	Deficit ($ trillions)	Debt per GDP
CBO March Baseline	3.6	-1.1	73.4%	45.8	-6.7	75.6%
CBO Alternative Baseline*	3.6	-1.1	74.5%	46.1	-12.6	101.3%
White House Re-Estimated	3.7	-1.2	74.3%	46.2	-9.5	87.4%
Ryan Budget	3.5	-1.0	72.8%	40.0	-5.1	67.5%
Debt Limit Deal?*	3.6	-1.1	74.5%	44.1	-10.5	95.0%

*assumes current tax rates are extended, i.e. no tax increase for AMT, Bush rates, subsidy reduction.

Source: CBO; House Budget Committee; Encima Global

- Are any Treasury auctions cancelled due to lack of headroom? We think there won't be.

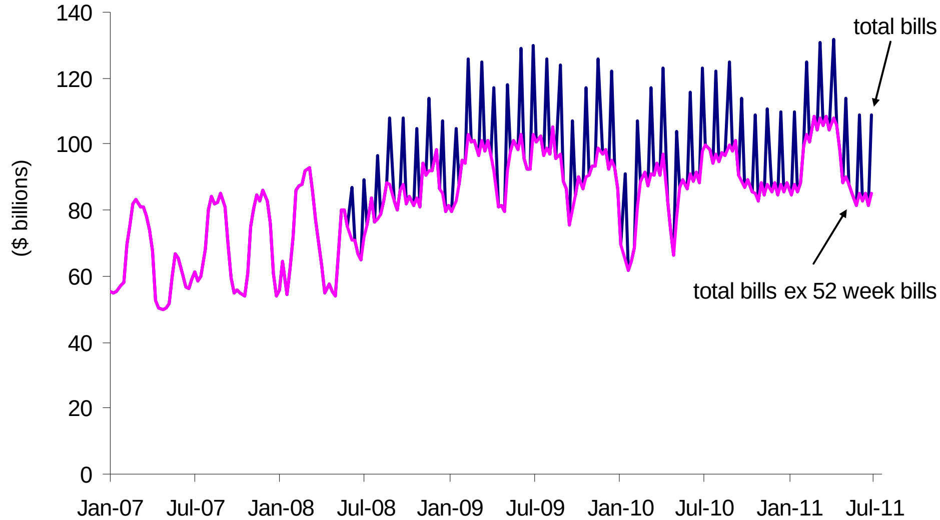
Notes and Bonds Issuance (last obs. May 2011, estimate for June 2011)



Source: Office of Debt Management; Encima Global

- Will Tbill issuance fall in order to create room for Treasury note auctions under the debt limit ceiling? We think issuance will fall, with minor disruptions in the short end of the Treasury curve due to the shortage. The yield on one-month Tbills was negative this week – the only other such instance was December 2008 – and might go more negative if there's a scarcity.

Total Bills Accepted (last obs. June 28, 2011)

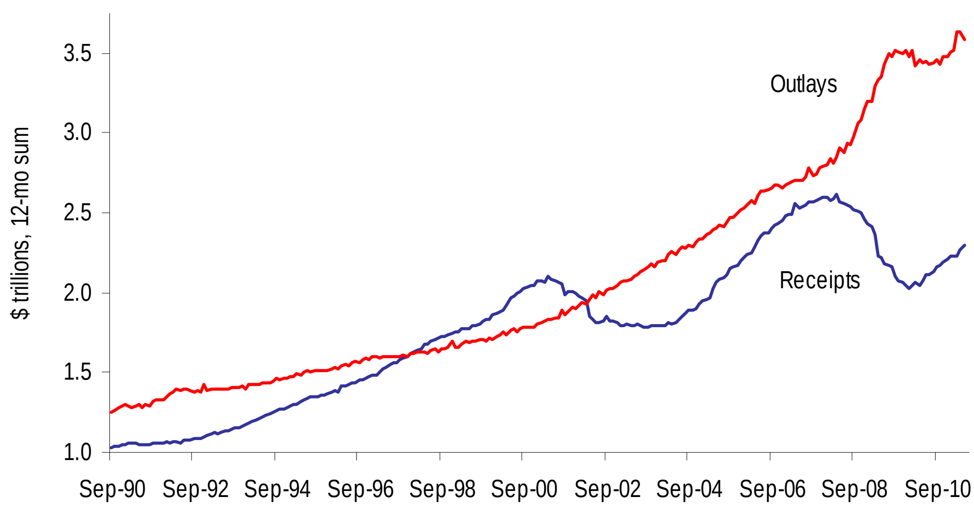


Source: Bureau of Public Debt; Encima Global

- Also of interest in the final deal, how many programs are cut or asset sales agreed on? We don't expect much, but there might be some token offerings so both sides can claim progress on the deficit.

- Will any tax loopholes be closed? We're not sure how this will come out. Both sides want to claim a principled stance on this – the president wants to attack corporate jets while most fiscal conservatives want to say there are no tax increases or loophole closing in this particular deal.

Federal Government Receipts and Outlays (last obs. May 2011)



Source: CBO; Encima Global