Cornerstone Macro

Economics, Policy & Strategy

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Policy Research

Macro Policy Themes For Remainder Of Year

Fiscal Policy. The travel delays caused by the furlough of air traffic controllers illustrates that President Obama does not have the leverage to force major changes to the sequester even when the public is inconvenienced. Therefore, the sequester is likely to remain in place for the rest of this year and next year's funding level for the government is likely to remain much closer to the sequester level than the pre-sequester level. This step function decline in federal spending is negative for defense companies, DC-heavy REITs, and medical tools companies dependent on the NIH budget. The discretionary part of the federal budget is in secular decline and will remain so until a national security threat, a Democratic takeover of the House, or some other major event shifts the political dynamic.

Higher revenues may push out the need for legislation to raise the debt ceiling from a July/August time frame to September/October, according to an estimate last week by the Bipartisan Policy Center. So rather than resolving the issue before the August recess, a deal coinciding with the beginning of the next fiscal year (October 1) now seems more likely. Therefore, budget issues may stay on the back burner throughout the summer (so policy-related volatility will likely remain low for the next few months). Some Republicans are warming up to the idea of tying tax reform to raising the debt ceiling, but we see tax reform as unlikely. Special tax breaks that favor REITs, MLPs, housing, energy companies, and municipal bonds, among others, are relatively safe. The debt ceiling may be raised without incident, but the risks of a technical default (no agreement before the deadline to raise the debt ceiling) are not negligible as fiscal hawks in the House may not support a compromise Obama is willing to sign and the White House may be less flexible than in the last major debt ceiling fight in the summer of 2011.

Fed. Fed policy is very supportive of risky assets and is likely to remain so for a long time. Low interest rates support earnings in a number of ways — through low borrowing costs but also to different extents through higher sales, higher discount factors, and better dollar translation of foreign profits. The Fed can compress longer-term interest rates through two levers — QE and the communication of its intention to keep short-term rates near zero for years to come. Of the two, communication is probably the most effective. Even if the Fed tapers off QE before the end of the year, as was its intention at the time of the March meeting, short rates are likely to remain near zero for another couple of years at least, putting downward pressure on the whole yield curve and upward pressure on equity prices. We would not be afraid of a tapering off of QE. If it happens before the end of the year, it will be because the economy will have remained on a solid footing, and that would be a bullish development, not a bearish development. To be sure, the eventual tapering of QE might induce some market volatility, but it would not be reason enough to alter an otherwise constructive outlook on the equity market. See our thoughts on this week's FOMC meeting on page three.

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Europe. The macro outlook for Europe is challenging, and there is little help on the horizon on the policy front. On the fiscal side, investors may look forward to some relaxation of fiscal targets and of the strongest austerity measures, but fiscal policy will remain a strong headwind for the EZ economy. On the monetary policy front the ECB is likely to ease further (see page three for our thoughts on this week's meeting) but in ways (rate cuts and relaxation of collateral rules) that are unlikely to make a material difference. Measures that would have a chance of restarting the flow of credit (such as purchases of ABS backed by small business loans) are too politically controversial to be adopted in the near term.

Energy. The State Department will probably approve the Keystone XL pipeline this summer, but there is a real chance it could require more time to study the issue. The administration will probably approve another major project or two to export LNG (to countries with which the US does not have a free trade agreement) within the next few months. Whether to allow crude exports is an issue over which very little consideration has been given in Congress. Upcoming energy-related hearings in both the House and Senate may shed some light on this and other issues. The EPA is likely to take an aggressive approach across a wide range of pending rules, which will not only ensure it is not economical to build coal-burning utilities, but may also lead to the closures of many existing coal-fired power plants. Some rules, especially the one limiting ozone, could have much broader implications.

Health Care. The main elements of the ACA (coverage mandates, Medicaid expansion, exchanges, exchange subsidies, minimum benefits package requirements) take effect next year. The higher employer costs and uncertainty about those costs have subdued hiring, but it is difficult to measure by how much. Because of the law's look-back provisions, the employment impact is already being felt. It doesn't appear likely a large number of employers will dump those currently insured into the exchanges, although some companies with lower-wage workers may reduce the workweek to below 30 hours to avoid the mandate. A number of studies suggest that the costs of health care on the exchanges (for those who don't get subsidized coverage) could be a third higher than in the individual market today.

Housing. Overall, policy developments are likely to lead to slightly tighter lending standards during the next two years due to a consensus that Fannie Mae and Freddie Mac's market share ought to shrink, the insolvency of FHA, and new rules required by Dodd-Frank. The slightly tighter credit conditions won't stall the housing recovery, but they will make it less likely the normal pro-cyclical easing of lending conditions occurs. A major new program to help distressed or underwater borrowers is unlikely.

Geopolitics. National security experts believe Iran is behind the cybersecurity attacks at major US banks, an apparent escalation of cyberattacks from Iran. Decisions in the US and Israel whether to use force to stop Iran's nuclear program will probably come in the next 12 months. Pressure is growing for a stronger response to developments in Syria, but US involvement is likely to be limited. The bluster out of North Korea is probably just that, but the regime is insular and unpredictable.

Politics. President Obama has made winning a Democratic majority in the House a top priority, hoping to pass much of his second-term agenda during his last two years in office. History is not on his side as no president's party has won more than a handful of House seats in his sixth year in office. On average, second-term presidents lose six Senate seats, exactly the amount the GOP needs to win a majority in the upper chamber. It's a long way from the mid-terms, but Obama's approval rating is more consistent with Democratic losses in the Senate rather than big Democratic gains in the House.

FED TO STAY THE COURSE, ECB LIKELY TO EASE MORE

The Fed and the ECB both meet this week. There is very little doubt that the Fed will continue its QE program at the existing pace of $85 billion per month tomorrow. The informative part of the statement will be the language that the FOMC will use to characterize the growth and inflation outlook. The outcome of the ECB meeting Thursday is more in doubt, but we lean towards a 25-basis point cut in the main refinancing rate. With economic conditions that continue to deteriorate in the EZ, the ECB is feeling the pressure to try to ease financial conditions further. A rate cut would likely be well received by markets but would not materially alter the macro outlook.

FOMC meeting. The minutes of the March meeting indicated that the debate at the time was squarely on when to taper off QE, with the committee divided mostly between June and September. Since then growth and employment data have been on balance disappointing, and price data have pointed to inflation remaining well below the Fed's 2% target. This combination is likely to shift the discussion away from tapering QE and to even induce more serious talk about stepping up the pace of QE if weakness persisted.

Typically, though, the Fed does not change course abruptly after just a month or so of weak data. As such, we don't expect clear indications from the statement that QE is likely to continue for much longer than previously indicated (the minutes should be more informative on that). However, if the tone of the statement on growth, employment, and inflation were to be downgraded materially, it would be a sign that the FOMC is leaning towards a longer and larger QE than it foresaw in March.

We expect subdued language changes that would leave options wide open for the Fed (in both directions) in coming months. The idea of tapering off QE in September probably represents a strong prior for the FOMC, shared even by several "doves," which would be hard for the Fed to abandon quickly. From a market perspective, though, the Fed will have to acknowledge the recent weakness, and markets might be quick to translate that into expectations of a larger QE. That could make for a trading opportunity, but longer term we would caution into reading too much from just one statement. Just like a month of weak data is creating expectations of more QE, a future month of stronger data would put a September tapering squarely back in play. That is, the future of QE is as data-dependent as ever.

ECB meeting. Since January we have seen progressively more inclination on the part of the ECB to ease policy. With the EZ economy continuing to deteriorate and with even German inflation dropping sharply, we think Thursday is a good opportunity for the ECB to cut rates by 25 bps. The value of that move would be more symbolic than anything else given that overnight rates are already well below the ECB's target and that banks are very reluctant to lend anyway. But we would expect a rate cut to be reflected into a somewhat weaker euro and into higher asset prices (the temporary resolution of the Italian political situation should continue to contribute to upside market risk in Europe as well).

Looking ahead, another rate cut in coming months can't be excluded, and we expect another easing of collateral rules to try to encourage small business lending. These moves would be similarly well received by markets. However, they would not alter the bleak EZ macro outlook. Policy moves that would, such as purchases of freshly-minted ABS backed by small-business loans, are simply too politically controversial for the ECB to implement in the near term.