Weekly Market Commentary

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What to Watch for a Breakthrough or a Breakdown

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Highlights

The impasse in Washington may linger this week. But the past week of intraday swings suggests that stocks may rebound sharply when a breakthrough is announced.

Last week stock market investors continued to cling to, if not actually climb, the wall of worry. Stocks were flat for the first week of the government shutdown, but that masks the intraday volatility seen last week as drops were quickly reversed each day. The market moves last week were in part prompted by reports and rumors emanating from Washington, D.C. on the state of the negotiations over funding the federal government and lifting the debt ceiling.

The funding for the federal government ran out at the end of the fiscal year, September 30, with the expiration of a continuing resolution that was passed in March of this year. With no agreement on a new funding bill, the federal government has partially shut down. In addition, the Treasury's borrowing capacity has been at the current limit since May 2013, although it has employed extraordinary measures that allow it to borrow additional funds without breaching the debt ceiling, which now stands at $16.699 trillion. Those measures will likely be exhausted in the next couple of weeks. Both of these issues have the capacity to weaken the economy and investor confidence.

The impasse in Washington may linger this week. But the past week of intraday swings suggests that stocks may rebound sharply when a breakthrough is announced. In the meantime, market declines apply more pressure in D.C. to find a resolution.

Key Support Levels and Dates

Market watchers often look for key levels on the major indexes that, when reached, may act to prompt a reversal or a breakdown. Key technical support for the S&P 500 Index can be found between the 50- and 100-day moving averages at 1680 and 1662. Last week, this range held and prompted rebounds. However, if these levels are breached, there may be more downside in store for stocks.

We are also focused on key dates on the calendar that could prompt a breakthrough and lead to a rebound for the stock market. But if these dates are breached without a deal, there may be more downside for stocks. Some key dates include:

- October 17–22 — The Treasury crosses into uncharted territory where not all obligations can be paid. The Treasury estimates that its ability to borrow will be exhausted no later than October 17, leaving a cash balance of approximately $30 billion. The Congressional Budget Office projects that the Treasury will exhaust all its borrowing authority, as well as its cash balance, between October 22 and the end of the month. Government spending is likely to average about $10 billion per day over the next several weeks while the inflows from tax remittances typically average about $7 billion per day. However, both can vary significantly from one business day to the next—making it difficult to specify the precise date a default or delayed payment on a federal obligation may occur.

- October 23 — Social Security benefit payments are to be paid totaling about $12 billion. Most of the benefit payments involve redeeming securities from a trust fund, allowing the Treasury to reissue those securities to the public without increasing the total amount of debt beyond the ceiling in order to raise the required cash.
- October 31 — Payment of interest on Treasury securities totaling about $6 billion becomes due.
- November 1 — Payments of Social Security benefits normally paid on the third of the month, which falls on a Sunday, of about $25 billion are due along with payments to Medicare Advantage and Medicare Part D plans totaling about $17 billion. In addition, pay for active-duty members of the military and benefit payments for civil service and military retirees, veterans, and recipients of Supplemental Security Income are owed, which total about $25 billion. These payments total $67 billion, but most of the payments involve redeeming securities from a trust fund and reissuing them to the public to raise the required funds without impacting the total amount of debt subject to the debt limit.
- November 13 — Payments of additional Social Security benefits are due of about $12 billion.
- November 15 — The large quarterly interest payment on Treasury securities is owed, totaling about $30 billion.

In the event the Treasury runs short of funds, it does not have the explicit authority to pick and choose which debts get paid. The House of Representatives passed a bill earlier this year that would allow the Treasury to continue to make payments on debt to avoid a default and to Social Security recipients in the event of a stalemate over the debt ceiling. However, the Senate did not take up the bill. Nevertheless, there is some ambiguity leading to a range of potential solutions that the Treasury could take. A FIFO, or First In, First Out, method seems to be favored by Treasury officials based on recent statements and comments from back in 2011, when the debt ceiling was last the subject of a battle in Washington. This would suggest each day's bills get accumulated along with tax remittances until a full day's debts could be paid. Such an approach would result in delays for all, from government contractors to welfare recipients to holders of Treasury bonds, as funds run short.

While the threat of spending delays or a default and the accompanying economic drag is worrisome, investors have been used to climbing a wall of worry this year. The stock market has easily overcome a series of threats this year, including battles in Washington that resulted in the fiscal cliff tax increases and sequester spending cuts, high oil prices, the Boston bombings, Federal Reserve tapering concerns, downward revisions to earnings growth rates, rising interest rates, an election debacle in Italy, a bank bailout in Cyprus, and rising geopolitical tensions, among others. Yet, investors have found confidence in continued economic growth.

It's Not All About Washington

In this context, it is important to note that last week's economic data seemed to matter to the markets as much as the developments in Washington. For example, on Tuesday the better-than-expected manufacturing Purchasing Managers' Index (PMI) report helped to lift stocks while Wednesday's disappointing ADP jobs report weighed on stocks, as did Thursday's non-manufacturing PMI report. On Friday, stocks acted as if job growth exceeded the 180,000 estimate, though no report was released due to the federal government shutdown. This week, some well-known companies report earnings results as we kick off the third quarter reporting season. Companies are likely to post better sales and earnings growth than we have seen during the first two quarters this year, especially with the widely watched and profit-leading PMIs of the United States, Europe, and Japan all above the breakeven level of 50 and rising together for the first time since late 2009/early 2010. The market may welcome positive news on earnings.

Selling stocks into short-term political uncertainty has been costly for investors this year as stocks rebounded from shallow dips and the bull market continued. We expect to see a resolution on funding the federal government and lifting the debt ceiling before the Treasury needs to selectively default or delay payments on U.S. obligations. We believe this is not a time to be indiscriminately selling stocks. Instead, for those who are underweight stocks relative to their long-term allocation targets, this may be a time to seek opportunities to buy in anticipation of a continued bull market. ■

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The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

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INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

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