U.S. Debt Ceiling – If Cooler Heads Do *Not* Prevail

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Our working assumption is that legislation authorizing an increase on the ceiling on federal debt will be enacted in time for the U.S. Treasury to make all of its previously-authorized expenditures. If, however, this legislation is not passed, then the U.S. federal budget will move into balance. In the 12 months ended June 2011, the Treasury had run a cumulative budget deficit of $1.26 trillion. For the sake of argument, let's assume that the August 2011 budget deficit at an annual rate also is $1.26 trillion. At an annual rate, this is the amount that federal outlays would immediately decline. $1.26 trillion is about 8.4% of what U.S. nominal GDP was running at an annualized pace in the first quarter.

With annualized authorized expenditures exceeding receipts by $1.26 trillion, the Treasury would have to make decisions as to what expenditures it would make and what expenditures it would postpone making. Presumably, the Treasury would give first priority to interest payments on the public debt. We have no idea how the other authorized expenditures would be prioritized. But the arithmetic dictates that federal outlays on net would decline by $1.26 trillion or by 8.4% of nominal GDP.

What would be the immediate economic effect of a sudden balancing of the U.S. federal government budget? The $1.26 trillion decline in federal outlays would represent a negative demand shock to the U.S. economy. Some entities who were expecting payments from the federal government would be disappointed. These disappointed entities might have to cut back on some of their planned spending in order to be able to honor their payment commitments to others. Alternatively, these disappointed entities might have to increase their borrowing in order to honor their payment commitments. To the degree that this increased demand for credit was accommodated by banks and the Fed, then the full effect of negative demand shock on economic activity would be tempered. It is unlikely, however, given banks current inabilities to extend new credit, that much of the increased demand for credit emanating from the sudden and sharp contraction in federal spending would be accommodated through the banking system. The net result would be a sharp contraction in U.S. GDP.

What would be the immediate effect on interest rates of a sudden balancing of the budget? Because the Treasury in all likelihood would pay the interest due on its debt, there would be no immediate default-risk-induced increase in interest rates on Treasury debt. With the sharp contraction in U.S. GDP, there would, however, be an increase in the default risk on private-sector debt. This would lead investors to adjust their portfolios away from private-sector debt toward U.S. Treasury debt. This increased demand for Treasury debt at a time when the supply of Treasury debt was falling would drive down the yields on Treasury debt as the yields on private-sector debt would be rising.

We would not expect the federal budget to remain in balance for long. Seeing the havoc inflicted on the U.S. economy from this, we would expect that legislation raising the public debt ceiling would be passed quickly by Congress and signed into law by the president.

Swings in Initial Jobless Claims Partly Tied to Auto Industry Events

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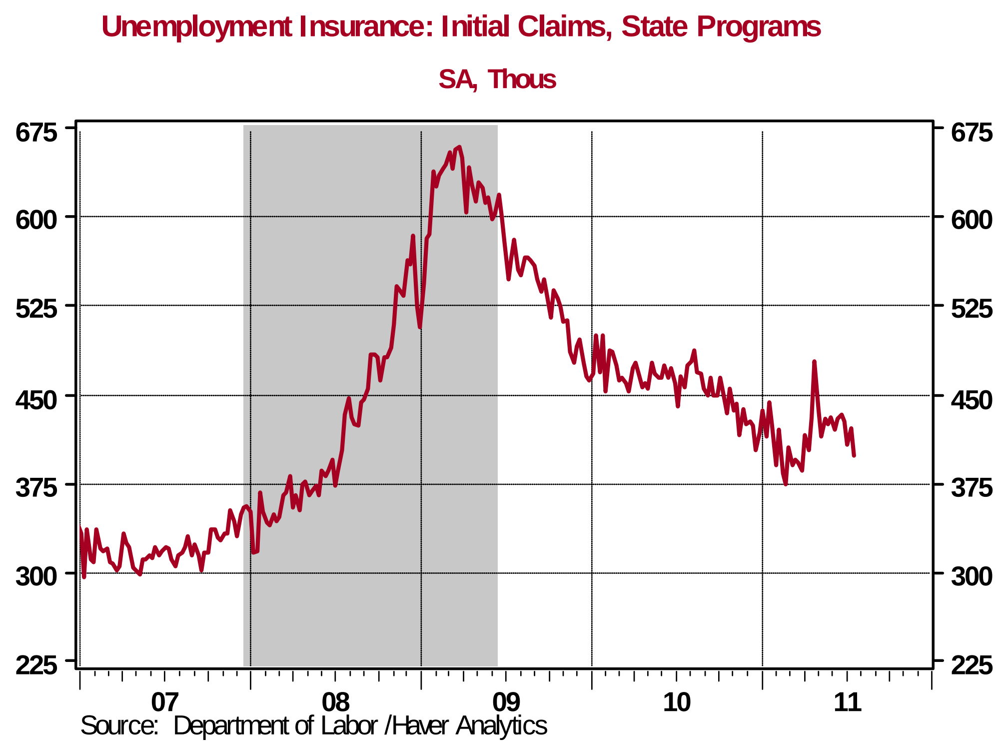
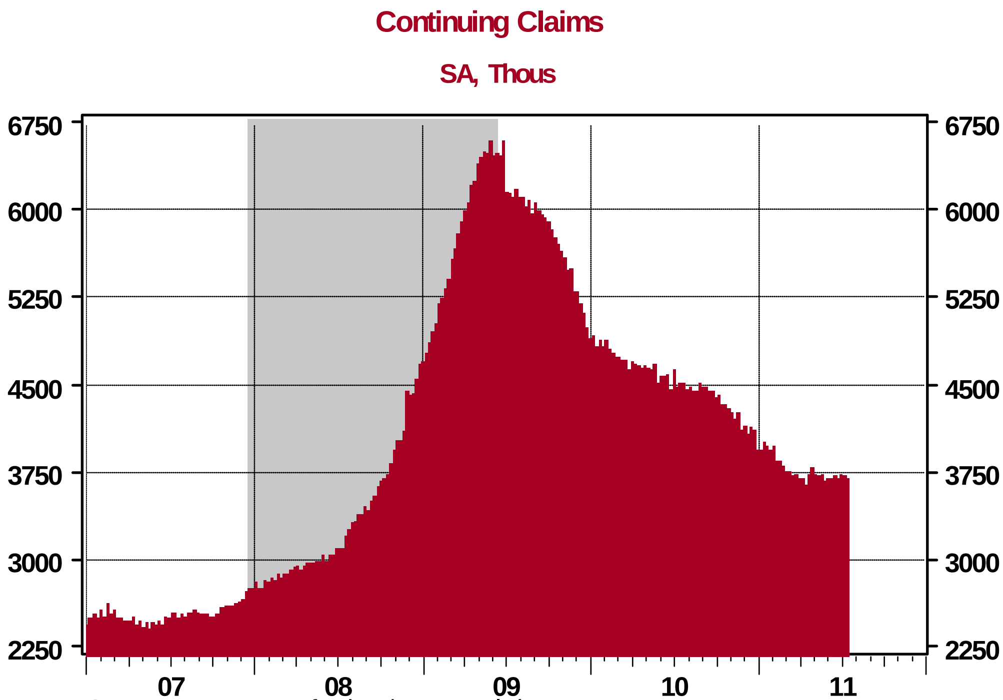
Initial jobless claims fell 24,000 to 398,000 during the week ended July 23. This is the first weekly reading that is below 400,000 since April 2. It is important to recognize that the spikes of initial jobless claims in April and May were related to the natural disaster in Japan that disrupted supply of auto parts and led to layoffs. A resumption of the supply of auto parts has led to hiring again and smaller layoffs in the auto industry. The low for initial jobless claims prior to the earthquake and tsunami in Japan was 375,000 during the week ended February 26. By implication, we will need to see readings below this mark to declare with strong conviction that robust hiring has resumed.

Chart 1



Continuing claims, which lag initial jobless claims by one week, fell 17,000 to 3.703 million. The four-week moving average of continuing claims has moved around 3.75 million since March 2011.

Chart 2

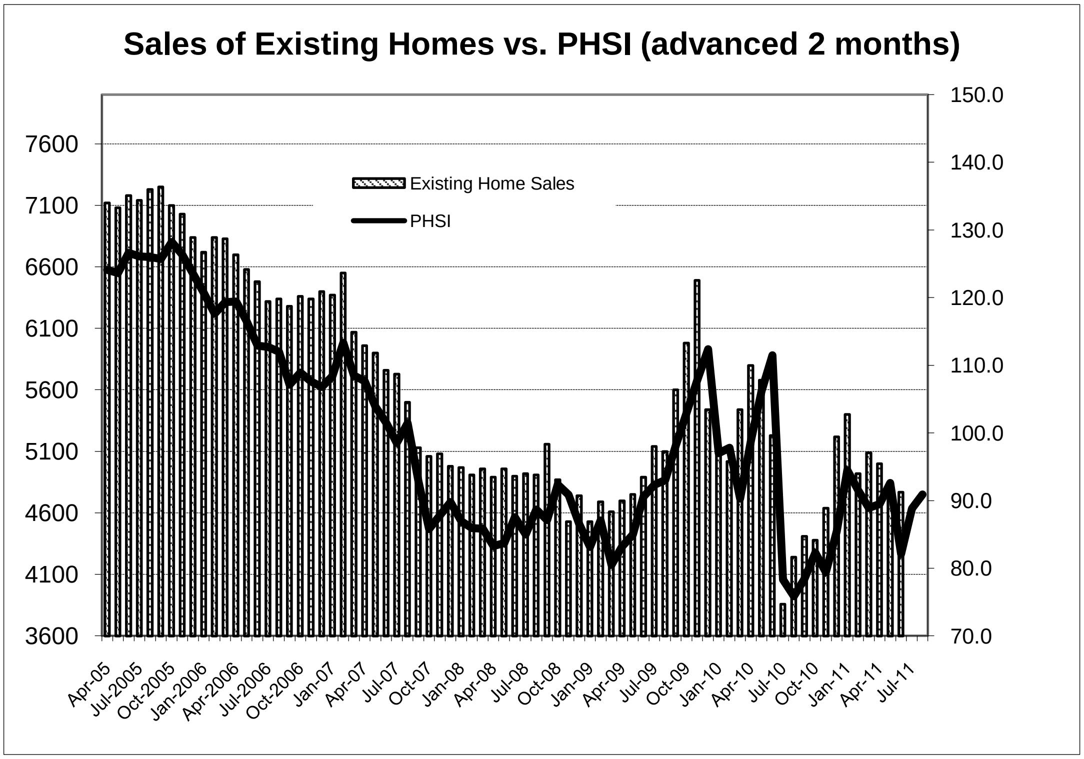


Source: Department of Labor /Haver Analytics

June Pending Home Sales Index– Cautious Interpretation Called For

The Pending Home Sales Index (PHSI) of the National Association of Realtors rose 2.4% to 90.9 in June, following an 8.2% increase in the prior month. The PHSI lags actual home sales by one to two months. The May increase failed to translate into an increase in sales of existing homes in June. Sales of existing homes have declined in each of the three months of the second quarter. It is reasonable to project a likely increase in home sales during July based on the PHSI data. However, in recent months, tight credit conditions and unfavorable appraisals of homes have led to cancellations of home sales. Therefore, cautious optimism is necessary when interpreting the increase of PHSI in the May-June period.

Chart 3



Sales of Existing Homes vs. PHSI (advanced 2 months)
Existing Home Sales
PHSI
7600
7100
6600
6100
5600
5100
4600
4100
3600
150.0
140.0
130.0
120.0
110.0
100.0
90.0
80.0
70.0
Apr-05
Jul-2005
Oct-2005
Jan-2006
Apr-2006
Jul-2006
Oct-2006
Jan-07
Apr-07
Jul-07
Oct-07
Jan-08
Apr-08
Jul-08
Oct-08
Jan-09
Apr-09
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Jan-10
Apr-10
Jul-10
Oct-10
Jan-11
Apr-11
Jul-11