



There is always a well-known solution to every human problem — neat, plausible, and wrong.

- H.L. Mencken



Summary:

The financial markets seem very complacent regarding the looming debt ceiling debate in the United States. I am however quite concerned and anticipate a period of sustained volatility during September and October, as the debate intensifies. If the “debt ceiling” were not raised in time, the government would run out of money to pay interest on the debt, write Social Security checks and make millions of other routine payments. I don’t see the US missing payments on Treasury debt, as that would be catastrophic, however, I suspect missing payments on social security would also be not taken kindly and could send financial markets into a tailspin. US House Minority Leader Nancy Pelosi has called for passage of a “clean” debt ceiling bill without any conditions. You can be sure there are enough Democrats who want to extract concessions from the Trump administration and enough Republicans who want to cut federal spending - that this could thwart raising the ceiling in time. US Senate majority leader Mitch McConnell likes to tout he has his troupes under control, but as we all know, he couldn’t get Trump’s Healthcare bill passed. Nothing about the performance of this Republican Congress to date offers any reason for optimism that it can now deal with this issue. Beware a sell-off in risk assets starting mid-September, if not before.

US Debt ceiling crisis looms

The US Constitution states that the US Congress has to authorize the issuance of any debt obligations by the US Treasury. On the other hand, before anyone in the US government can spend any money, Congress must pass the respective spending authorizations (the Appropriation Bills). Controlling spending requires Congress to decide what spending gets cut and what doesn’t. Railing against the “debt limit increase” does not require any actual cuts. We will therefore see a lot of posturing on this issue and the next round of this charade is upon us.

United States Treasury Secretary Steven Mnuchin has indicated that the debt ceiling needs to be raised by September 29 or the government risk running out of money. As Mnuchin puts it -“This is not about spending money. This is about paying for what we’ve spent”. US Congress’ unwillingness to raise the “debt ceiling” is akin to dining at a restaurant and then leaving before the bill arrives. *The Wall Street Journal* reports that US Treasury’s cash balance is expected to drop to near \$25 billion in September—a precariously low level, especially in the event of some unforeseen shock, such as a severe natural disaster, global crisis or unexpected drop in tax revenues. The Treasury Department has been employing cash-conservation measures since March when borrowing hit the formal ceiling of nearly \$20 trillion. Those measures are expected to run out in early to mid-October.

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Complicating matters is Mick Mulvaney, the current Director of the Office of Management and Budget (OMB). As co-founder of the congressional Freedom Caucus (considered as the farthest-right grouping within the House Republican Conference), Mulvaney favors attaching strings to any debt ceiling increase, and he still seems to be far less alarmed by the prospect of a failure to raise the ceiling than Mnuchin. “I do believe that defaulting on America’s debts would have grave worldwide economic consequences,” Mulvaney said in a written response to Senators in January. “I do not believe that breaching the debt ceiling will automatically or inevitably lead to that result.”

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Before he became President, Donald Trump was fond of saying that he loved debt because it could finance his many projects. And he wasn’t afraid to use the bankruptcy laws to help him. His businesses experienced no fewer than four bankruptcies. During the 2016 presidential campaign, he briefly floated the idea of giving US bondholders a “haircut”—not paying them all that they’re owed—as a way of saving the government money. He quickly clarified (read retracted) his remarks.

I am certain that the US Congress will eventually raise the debt ceiling, as not raising would be unthinkable. However, the longer the process takes, the more uncertainty and volatility it will beget. You will recall in 2011, Congress refused to raise the “debt ceiling” unless this was also accompanied by spending cuts. US debt was subsequently downgraded, and the cost of borrowing soared. The downgrade cost the country \$18.6 billion, according to the Bipartisan Policy Center, a US think tank. Eventually, Congress raised the debt ceiling, and disaster was averted.

Senate majority leader Mitch McConnell likes to tout he has his troupes under control, but as we all know he couldn’t get Trump’s Healthcare Bill passed. Congress, and in particular the Freedom Caucus are fixated on cutting entitlement spending. They have made it clear that if the House leadership balks of their demands for major cuts in the 2018 budget,

they will refuse to vote on raising the debt ceiling.

It's clear that Mnuchin, a Goldman Sachs veteran, understands how dangerous that kind of talk is. We'll find out soon if the rest of Congress gets it too. Nothing about the performance of this Republican Congress to date offers any reason for optimism that it can now deal with this issue. Beware the risk of a sell-off in risk asset starting mid-September, if not before.

Where to invest?

While I may sound very bearish in the above section, it's more down to the precarious state of US politics than economics. Any bearishness is only tactical, and I do not see any "debt ceiling" related sell-off lasting for long. Tactical trades would be to buy JPY, to buy PUT options on the S&P 500 Index (SPX) or raise cash and wait to buy on the dip. Reports indicate Norway's \$970 billion wealth fund has been ordered to raise its stock holdings to 70% from 60% - that's \$97bn of new equity buying

The normalization of monetary policy in Europe and in the US will proceed very slowly and nothing has changed on that front. Central banks have printed the money and bet the farm on avoiding a debt crisis. Now they just have to figure a way to get back to "normal" and it's not going to be easy.

The US unemployment rate is now at a 16-year low but wages are not picking up. One reason for this according to research from the Federal Reserve Bank of San Francisco is that "while higher-wage baby boomers have been retiring, lower-wage workers, sidelined during the recession, have been taking new full-time jobs. The vast majority of these new workers earn less than the typical full-time employee, so their entry pushes down the average wage." Wage growth, therefore is being held down by compositional changes in employment associated with the hiring of less experienced workers. As long as employers are able to continue with this practice unhindered, labor cost pressures for higher price inflation could remain muted for some time. The implications are very obvious - the US Federal Reserve (Fed) will stay put and raise interest rates very slowly and this in turn will keep the risk assets from selling off.

Fed Chairwoman Janet Yellen and European Central Bank (ECB) President Mario Draghi will speak at the Jackson Hole economic symposium this Friday. Some expect Draghi to lay the groundwork for reducing the stimulus it is providing in 2018. The Eurozone's jobless rate has fallen to 9.1% (the lowest level since 2009), the GDP growth rate has picked up to +2.2% and consumer price inflation stands at +1.3%. Does that mean the Euro area is on a strong footing? Far from it.

Amid the fanfare regarding Europe's comeback, labor-market scars and policy challenges persist. *The Wall Street Journal* reported last week that the situation in Spain—the poster child of Europe's recovery and a country on track to record its third year of +3%-plus growth—is anything but rosy. Although Spain has created around 1.6 million jobs since 2013, the recovery has come at a price. Around 90% of the new jobs are temporary, some lasting only several days, according to government figures. In Italy, nearly 60% of the unemployed—or 1.2 million people—have been out of a job for at least a year, the highest of any large Western economy, according to the OECD. A third of all Italian adults are inactive. The reality is no amount of fiscal or monetary accommodation can compensate for the necessary structural reforms in the Euro area. While Spain overhauled its labor laws in 2012, neither France nor Italy has made much progress although French President Emmanuel Macron has pledged to take action in September. The only problem is Macron's approval rating has collapsed to 37%, about the same level as that of President Trump.

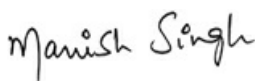
On the equities front, I continue to be overweight the US with sector biases for Financials (XLF), Technology (XLK) and Healthcare (XLH). I prefer to be underweight Europe and I suspect the EUR/USD has one more leg up to the debt ceiling crisis before USD strength picks up again. Emerging Market equities continue to be a good hold as - US GDP growth stabilizes, Europe growth hits +2%, oil prices remain sluggish and a strong USD continues to be less of a threat.

One last thing, in the past few weeks I have been asked many times what I think of Bitcoin. To be honest, despite the sky rocketing prices (or perhaps because of it), it has never crossed my mind that I should buy Bitcoin. I can't define irrational exuberance for you, but I know it when I see it. If you are a Bitcoin buyer you are also well advised to read up on Tulip mania (1636-37) a period in the Dutch Golden Age during which contract prices for bulbs of the recently introduced tulip reached extraordinarily high levels and then dramatically collapsed. Professional traders, cobblers, carpenters, bricklayers and woodcutters, were all indulging in frenzied trading of tulip bulbs. Some bulbs even changed hands up to 10 times during the course of a single day. In January 1637, the price of a single bulb of Semper Augustus Tulip stood at 10,000 Guilders. Historian Mike Dash in his book *Tulipomania* puts the sum in context: "It was enough to feed, clothe and house a whole Dutch family for half a lifetime, or sufficient to purchase one of the grandest homes on the most fashionable canal in Amsterdam for cash, complete with a coach house and an 80-ft (25-m) garden – and this at a time when homes in that city were as expensive as property anywhere in the world."

Do not confuse price with value. Bitcoin has no intrinsic value. It only has a price. It doesn't exist except in cyberspace and is always quoted in a real currency such as US dollars. I however highly value blockchain – the technology that bitcoin uses. Just as shipping containers revolutionized international goods trade in the 1960s, blockchain is the new database technology that will revolutionize data processing over the Internet.

In terms of stocks I like: JP Morgan (JPM US), Bank of America (BAC US), Citi (C US), BNP Paribas (BNP FP), Barclays (BARC LN), VISA (V US), Blackrock (BLK), Allergan (AGN UN), Celgene (CELG UW), Gilead Sciences (GILD US), Eiffage (FGR FP), General Electric (GE US), BAE Systems (BA LN), Boeing (BA UN), Apple (AAPL UN), Google (GOOG US), Microsoft (MSFT US), Amazon (AMZN UW), Alibaba (BABA US), Baidu (BIDU US), Salesforce (CRM US), Comcast Corporation (CMCSA), Home Depot (HD UN), CBS Corp (CBS US), Pfizer (PFE US), Publicis Groupe (PUB FP), Estee Lauder (EL US), Johnson & Johnson (JNJ), Walgreen Boots (WBA US), Glencore (GLEN UN), Rio Tinto (RIO LN), Freepoint McMan (FCX US), Pioneer Natural Resources (PXD), Schlumberger (SLB US)

Best wishes,



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