Markets and the debt ceiling negotiation

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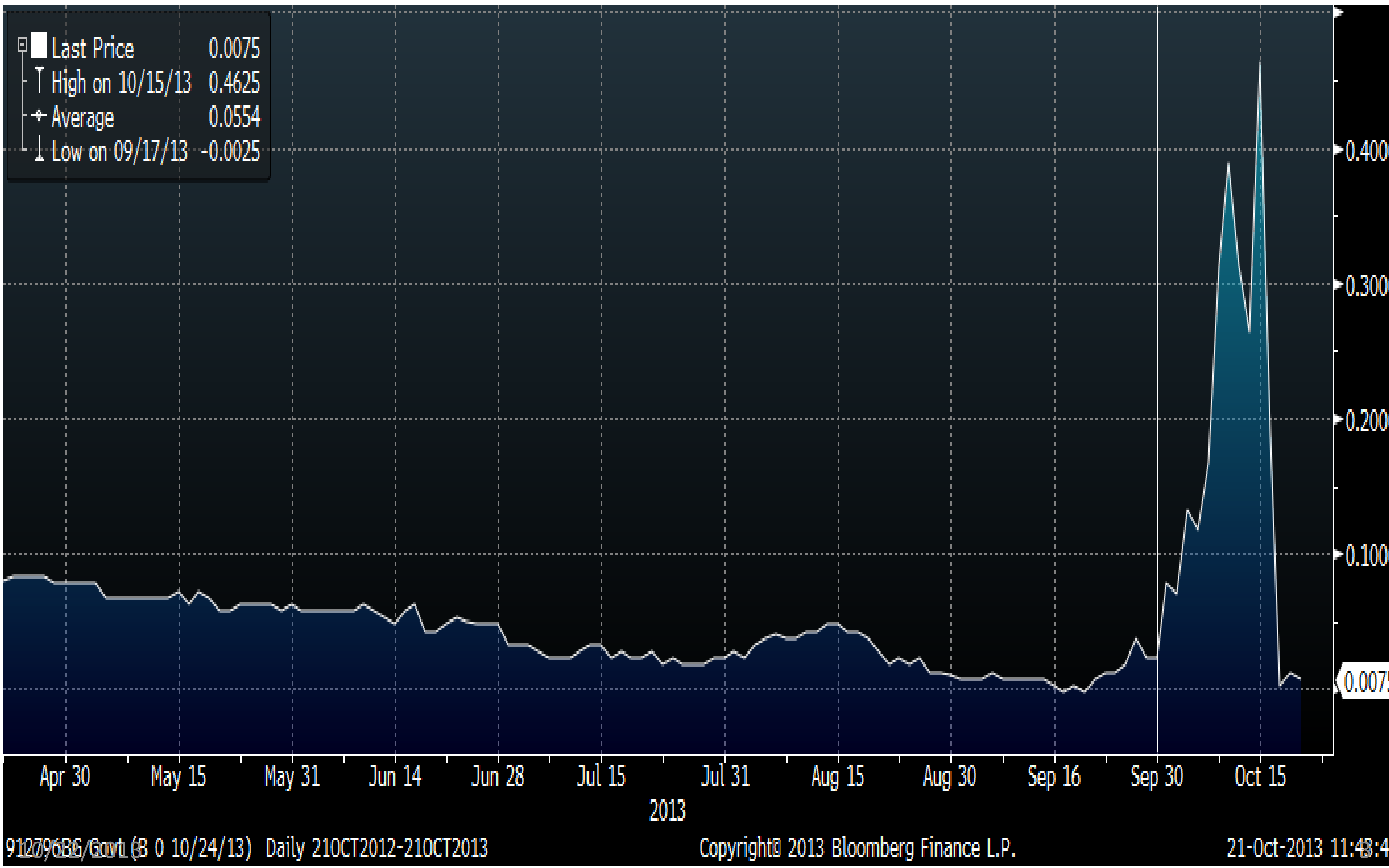
* Views expressed here are my own and do not represent, in any way, those of the D.E. Shaw Group.

- What did markets do?
- How is this different from the euro area?
- Could there be any medium term consequences?

Concern about near term disruption
T-bill maturing Oct 24



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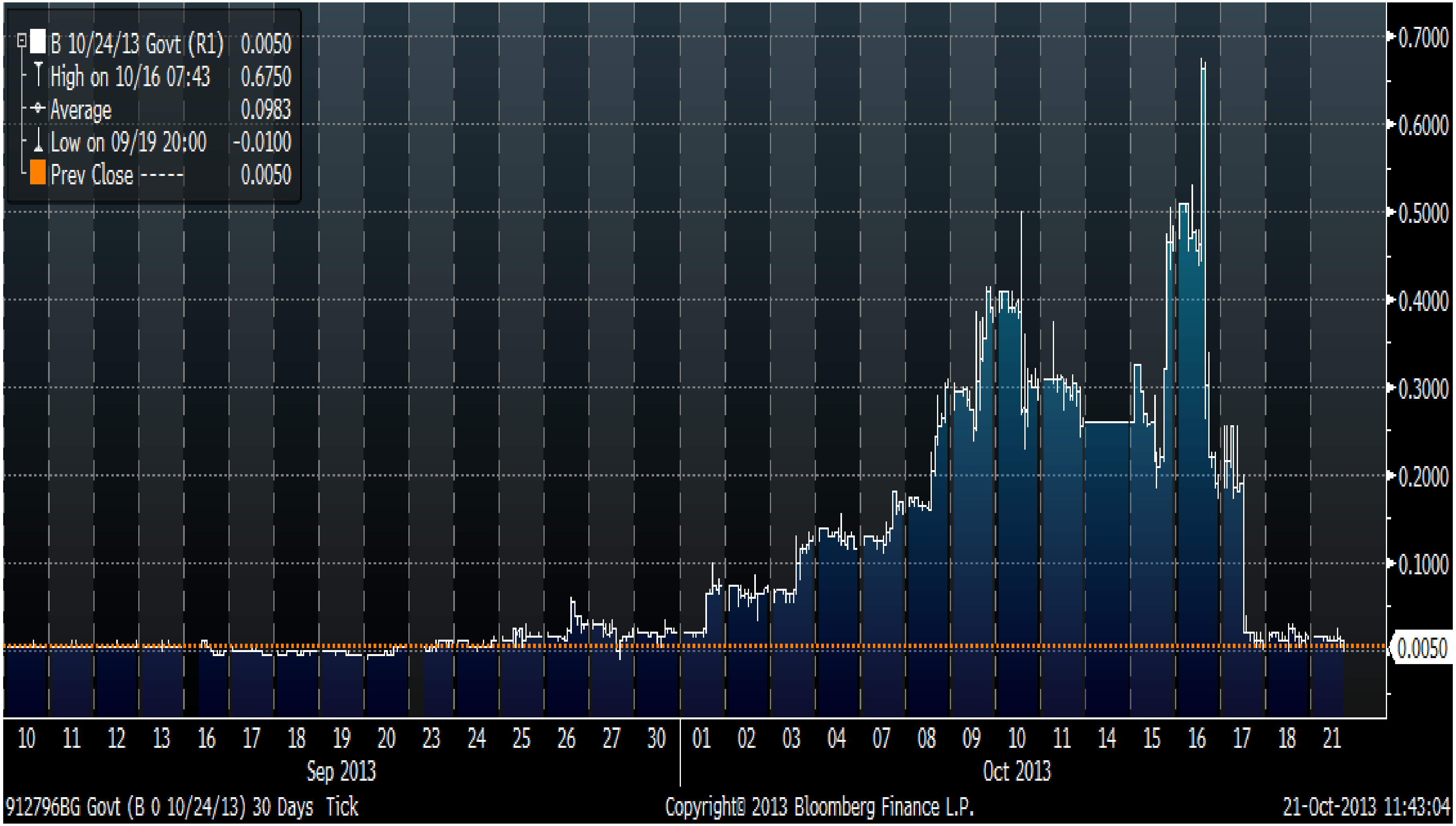
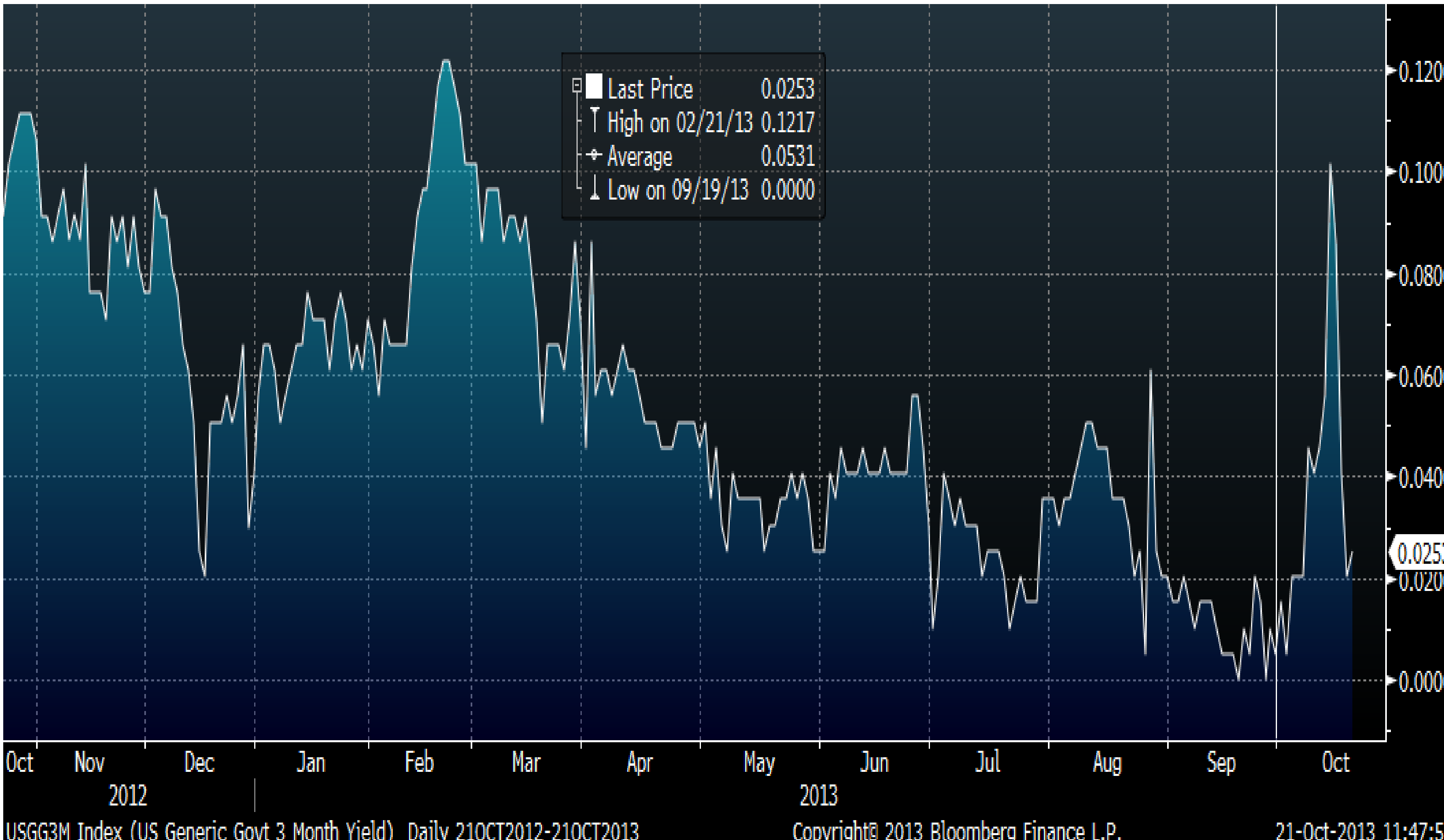
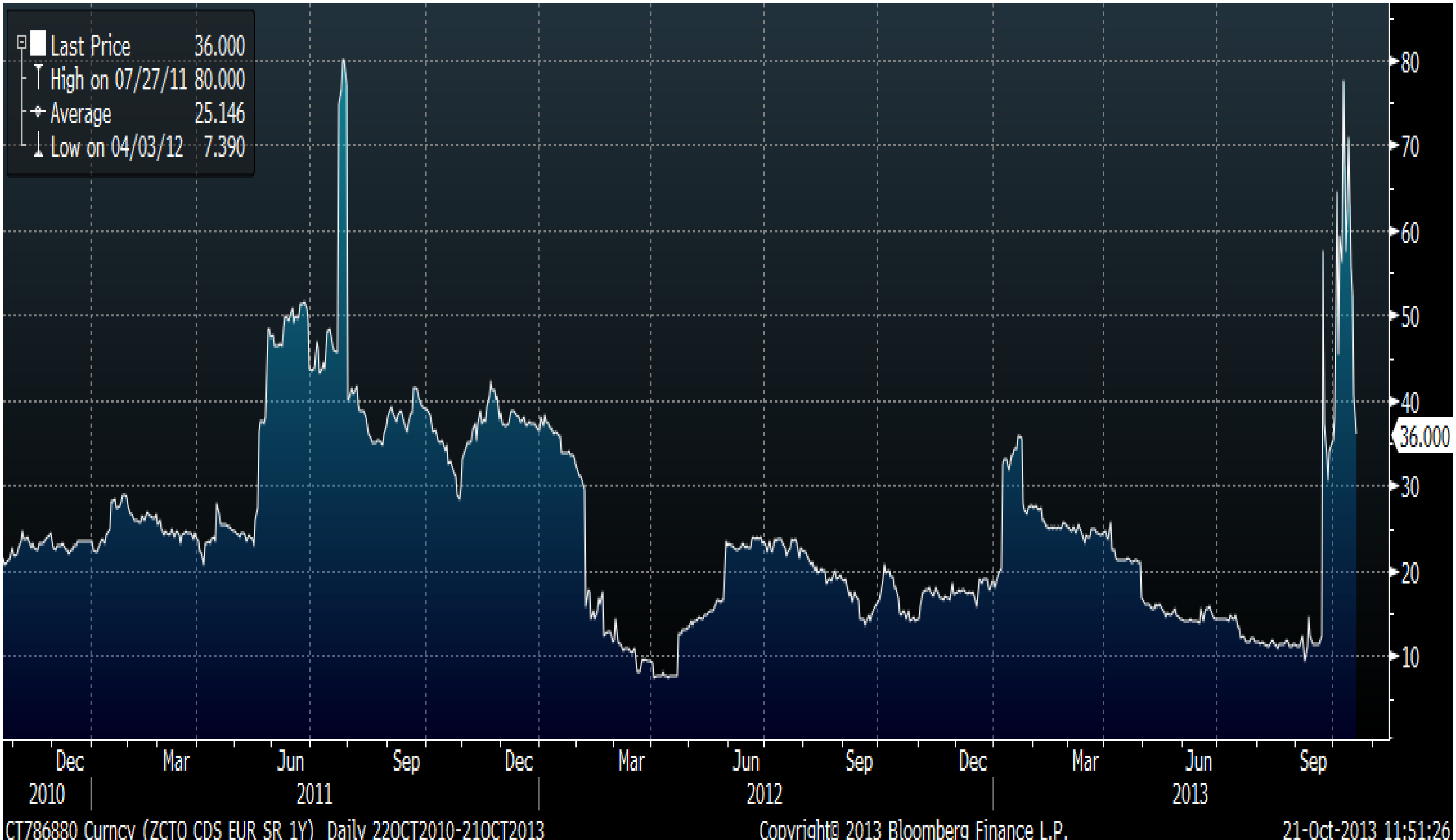


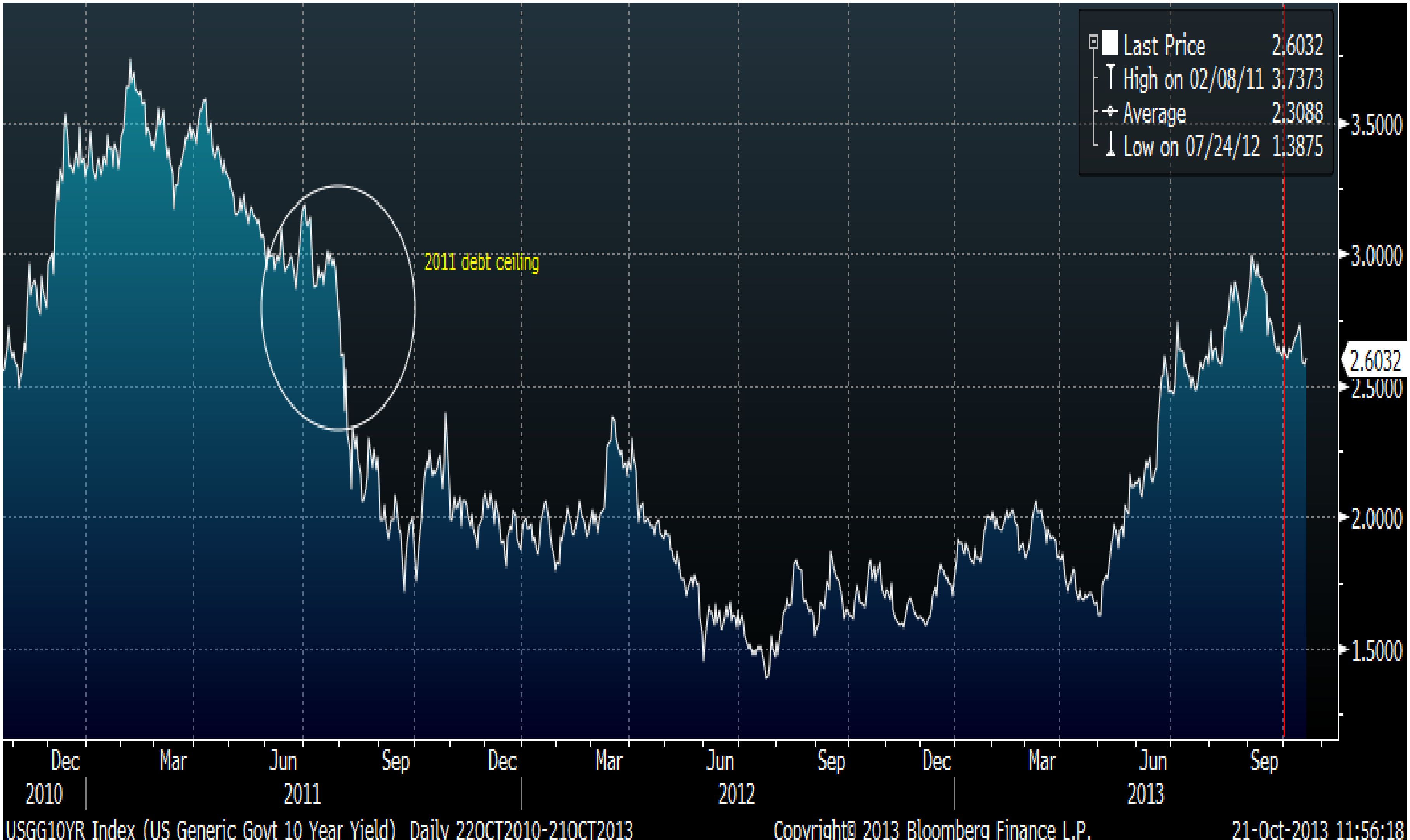
There was some contagion to 3m bills



1 yr CDS – not back to "normal" yet

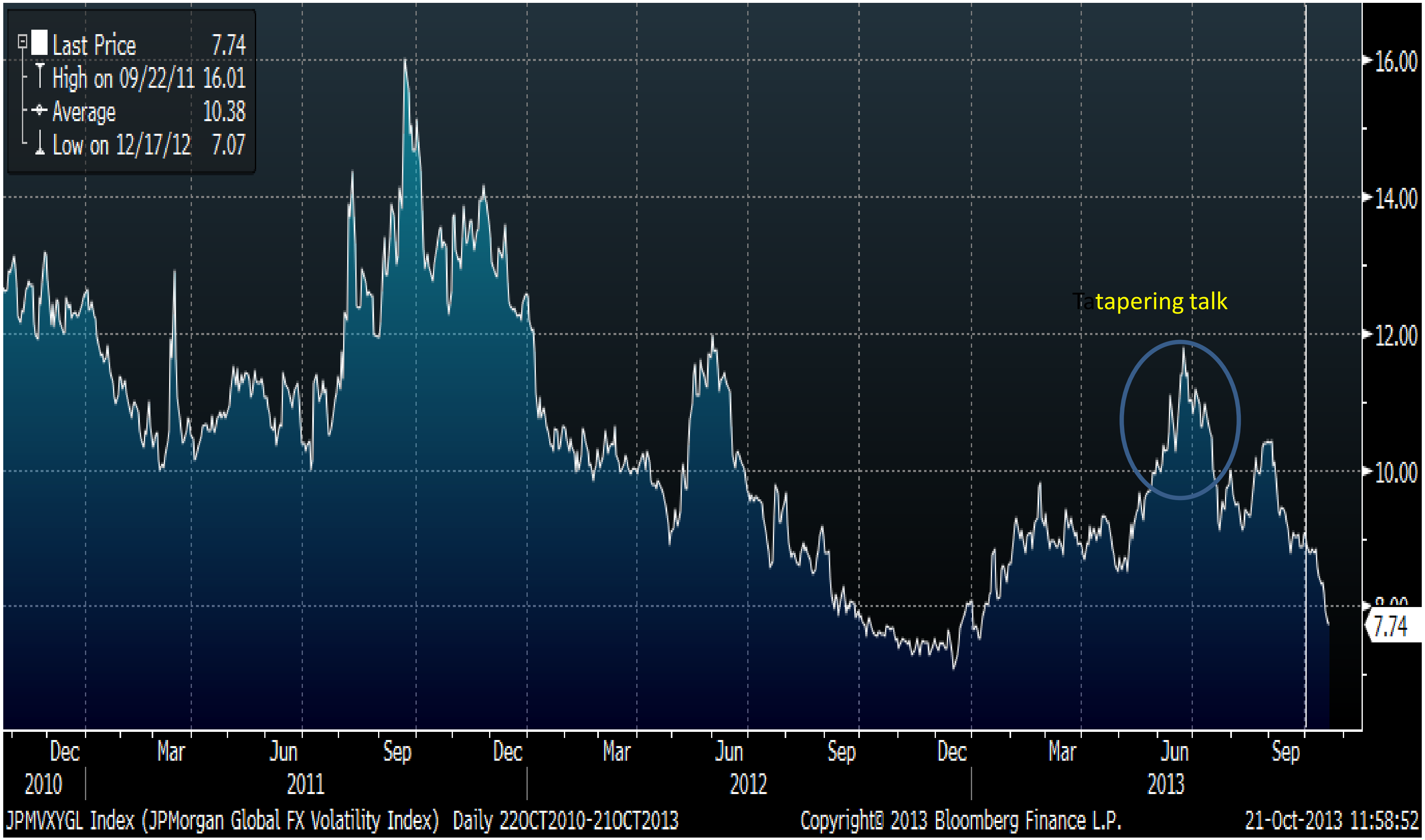


But 10 yr yield not affected

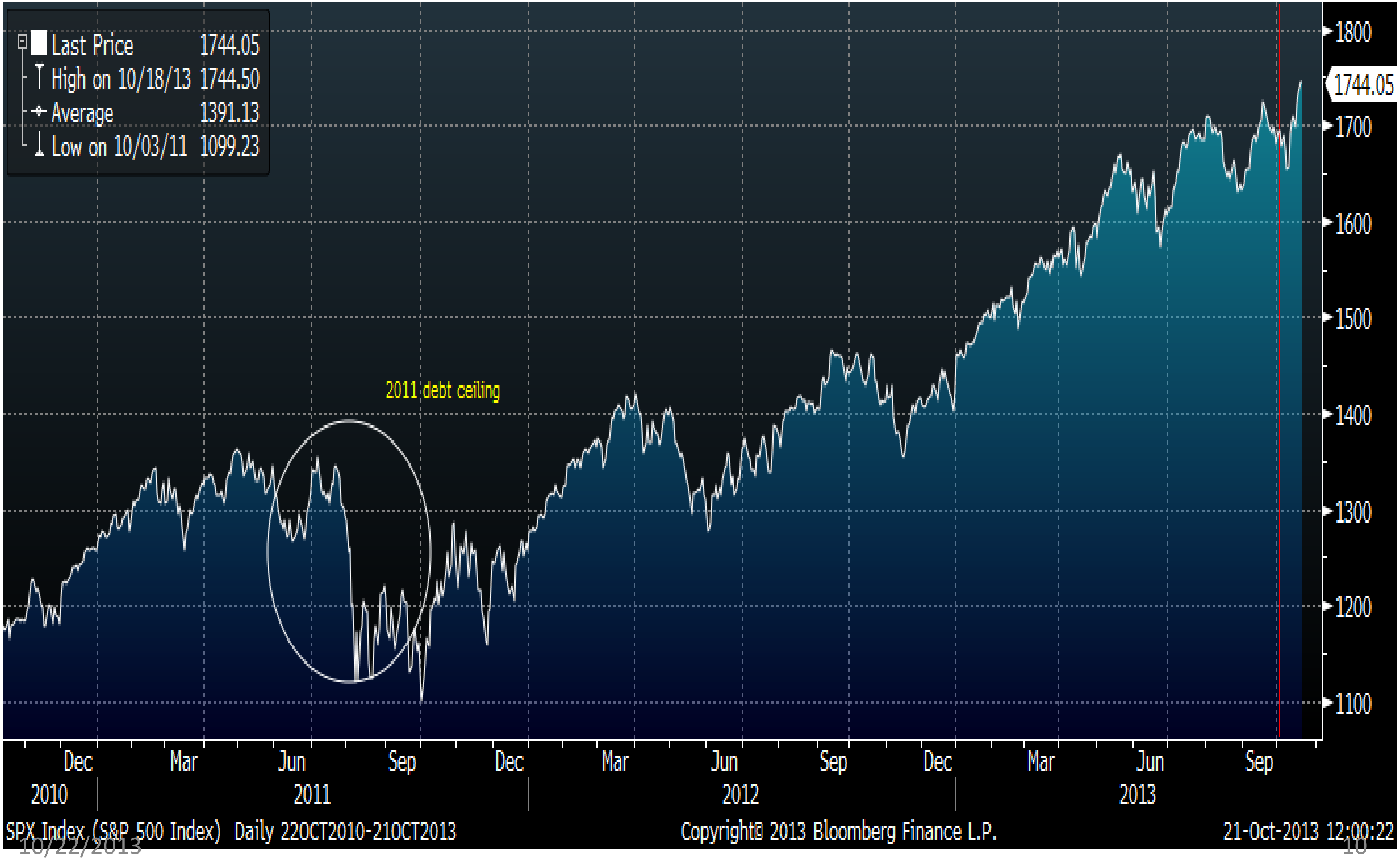


USD not affected- taper talk more important

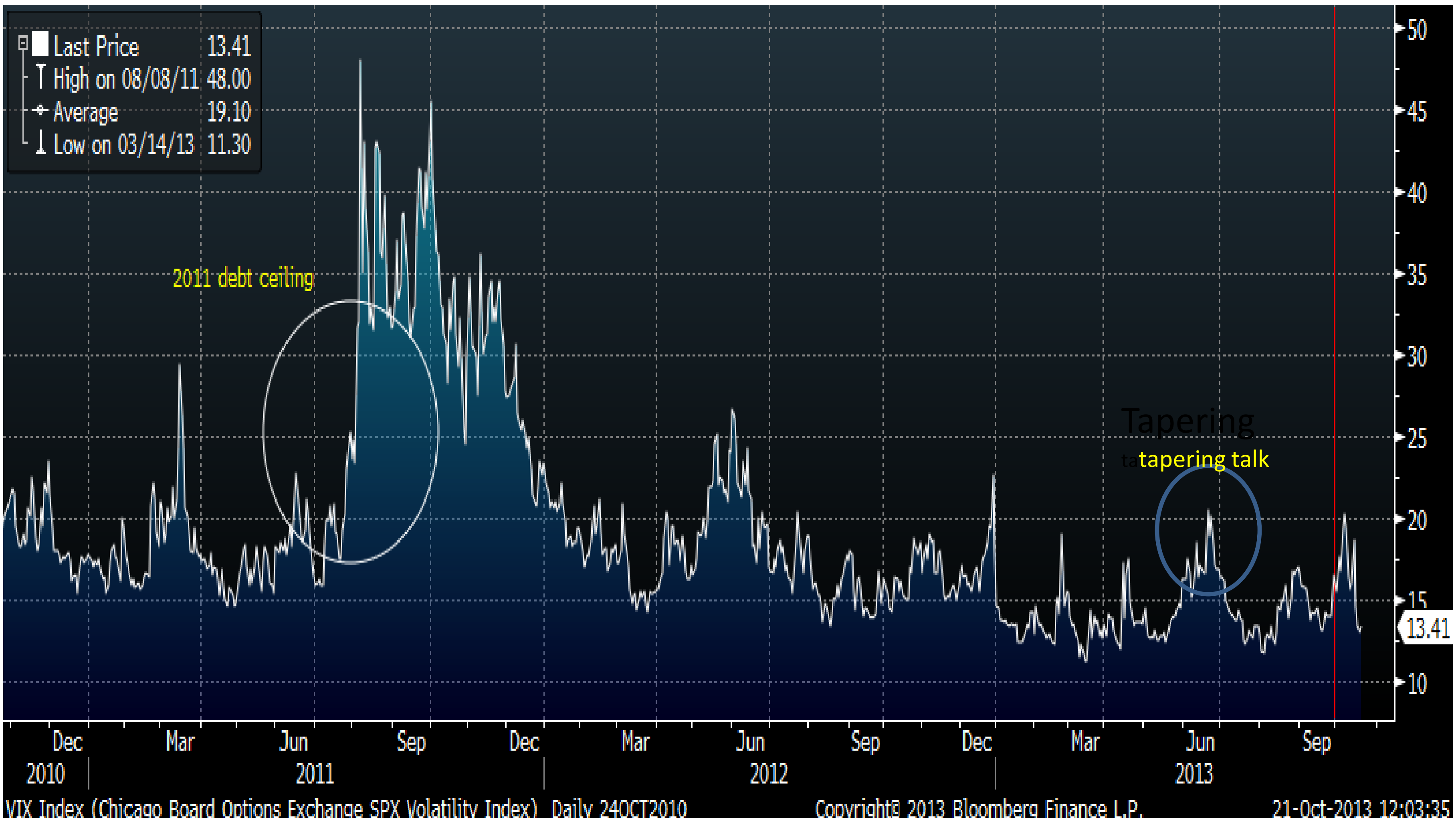
FX volatility lower- taper talk more important



Stocks (S&P) not affected



Stocks volatility (VIX) – similar impact to taper talk



Small market impact. But backdrop changes potentially more important

- Reports of clearing houses asking clients not to post Oct bills as collateral
- Reports of institutions starting to rewrite documentation to allow for write down of collateral values
- Reports of market infrastructure adapting to handle delays in coupon payments
- Discussion of potential ratings actions
  - Likely "Selective Default" (like Greece post PSI) – then nobody knows

Were markets complacent?

- Markets were pricing some disruption risk.
- But it appears markets also anticipated a policy response to contain tail risks
- It could increase risks
  - Less market pressure – higher odds of accident
  - Worse impact if accident

How does this compare to the euro area?

- Similar – political strategy of pushing it to the brink. Crises as integral part of negotiation. Long term cost due to uncertainty and hedging needs.
- Different - The Fed
  - Still doing QE
  - Not threatening to stop if Congress continues along this road
  - No doubt Fed will continue to accept Treasuries as collateral – USTs still considered risk free

What if USTs become non risk free

- Gorton et al (2012), Gourinchas and Jeanne (2013) : Risk free assets are informationally insensitive - key for collateral use
- If USTs were to become non risk free – we've seen it with ABS and euro area periphery bonds
  – Bonds become credit – procyclical interest rates
  – Very sharp deleveraging
  – What would the Fed do? Haircuts on collateral?

Final thought

- We are already moving towards a multi reserve currency world – will these recurrent fiscal crises accelerate the trend
- "Exorbitant privilege" remains for now, but for how long?
  - COFER data – share of global fx reserves (Sept 2013)
    - USD: 62 percent
    - EUR: 24 percent
    - GBP, JPY: 4 percent each
- Note: USD share has declined from 72 percent in 1999 to around 62 percent today.
- Note: EUR share increased from 18 percent in 1999 to a peak of around 28 percent in 2009. 24 percent today.
- If USD and EUR share resume its convergence, USD could have a long way to decline.

Thank you