

US Rate Strategy Notes

I Wanna Be Elected

- **Long the Election** — We recommend a long duration position entering the election on the expectation that President Obama is re-elected. While this may provide modest satisfaction immediately following the election, a slow grinding rally could be expected if his re-election results in slow fiscal negotiations which stretch past year-end.
- **Gamma Hedge** — We also recommend a long gamma position to hedge against a Romney victory.
- **Fiscal Outcome** — We expect that a compromise will ultimately be reached, but that the major market risk is that such an agreement is not reached until after year-end, perhaps as late as March.
- **Deadlines** — While the fiscal cliff is a deadline at year-end it may not be a serious enough of a deadline to ensure legislative action. The debt ceiling and continuing resolution deadlines are far more serious and should ensure that an agreement is reached by March.

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US Rates & Curve: I Wanna be Elected

Next week's US Presidential Election has the potential to significantly impact US Treasury yields both immediately and over the subsequent several months. While the impact of a President on financial markets in general is probably fairly limited, the presence of the fiscal cliff so soon after Election Day suggests that the outcome of this election will have a more immediate impact. We recommend positioning long duration on the expectation that President Obama is re-elected and this leads to a difficult fiscal negotiation. However, we also recommend being long gamma as a hedge against a Romney victory.

Fiscal Negotiations Following the Election

While we agree with conventional wisdom that the re-election of President Obama will be near term Treasury friendly, we think there are a number of subtleties that need to be explored to best position for next week's election. Ultimately we expect a compromise agreement under any election result; however, we think that the pace at which an agreement can be reached could vary substantially under different election results. An agreement reached well after year-end may have minimal economic impact, but it would likely have substantial short-term market impact.

Figure 1. Potential Timeline for Fiscal Negotiations



Source: Citi Research

Obviously, the pace of negotiations will be impacted by the outcome of the Presidential, and to a lesser extent Congressional, elections. We consider three general election outcomes, in order of likelihood:

- **Obama Wins, Modestly** – In this outcome President Obama retains the Presidency under a tight popular vote with little or no coat-tails. The Senate would likely remain under modest Democratic control, while little if any dent would be made in the Republican's control of the House. Under this scenario we would expect yields to fall modestly at first, but grind lower and flatter for the months following the election – subject to a sudden reversal.
- **Romney Wins** – In this scenario we would expect Treasury yields to rise meaningfully in a fairly parallel fashion from the 5yr point of the curve out. This scenario can impact not only the expectations for fiscal negotiations, but also expectations for the Federal Reserve Chairman in January, 2014

- **Obama Wins, Overwhelmingly** – In this scenario we would expect yields to fall at first as with a close victory. However, in the subsequent months we would expect yields to move higher and steeper.

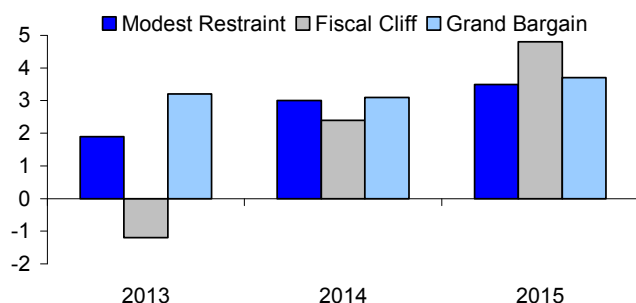
Expedient Resolution of the Fiscal Cliff Requires a Mandate

We think it is a near certainty that the fiscal cliff will be 'resolved' by some legislative agreement. We think that the greater unknown is the pace at which an agreement is reached. The greater the mandate the Presidential winner carries out of the election, the more quickly a deal is likely to be reached. We explore some of the likely (and unlikely) outcomes of negotiation.

- **The Grand Bargain** – This would be the optimal outcome of the fiscal negotiations. This outcome would both minimize near term fiscal restraint and maximize longer-term sustainability. Keeping the draconian fiscal cliff does little to address the longer-term fiscal risks. Under this scenario there would likely be a step-up in economic growth as a veil of uncertainty is removed which overwhelms any near-term fiscal restraint. This outcome should buoy risk assets and drive Treasury yields substantially higher.
- **Modest Restraint** – Certain portions of the fiscal cliff remain in place and others are postponed. This may also consist of certain aspects of the cliff being shifted to other types of restraint. While there are varieties of negotiation paths that could reach this outcome, modest restraint would be highlighted by fiscal tightening of 1-2% of GDP rather than the 4-5% expected under current law.
- **Over the Cliff** – If the full brunt of current fiscal law were to remain in place for all of 2013, the US economy would likely fall back into a recession, unemployment would rise by about 2% and the recovery would be set back several years. This would likely result in a meaningful drop in both risk assets and US Treasury yields.

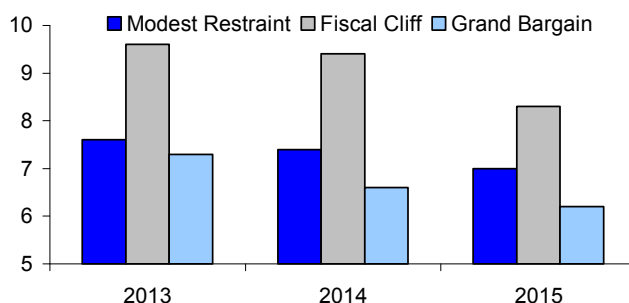
In Figure 2 we show our economics team's GDP forecast for 2013-2015 in each of the scenarios discussed above. In Figure 3 we present their unemployment forecasts.¹

Figure 2. GDP Forecasts Under Three Fiscal Cliff Scenarios



Source: Citi Research

Figure 3. Unemployment Forecasts



Source: Citi Research

While these three scenarios represent general outcomes that exist in the upcoming fiscal showdown, we see the middle scenario, a compromise that results in a more modest fiscal cliff, as the overwhelmingly likely scenario. However, our expectation

¹ For more details on the economic analysis see [The Fiscal Cliff: Assessing the Policy Risks](#), Nathan Sheets, Robert DiClemente, et al, September 21, 2012.

that this is the ultimate solution oversimplifies the path of reaching the solution and does not justify the complacency that we feel investors have about the upcoming fiscal negotiations.

The Path to a Fiscal Deal is Awkward —and Election Dependent

The fiscal deals that have been reached over the past couple of years were all forced by very near-term deadlines which had various catastrophic outcomes associated with them. We expect that this deal will be no different, although it more complicated in several ways:

- **Three Distinct Deadlines** – The fiscal cliff looms at year end. However, there is also a debt ceiling limit which is likely to become fully binding in March or April and a continuing resolution that expires at the end of March.
- **National Elections** – The presence of next week's elections have certainly limited any preliminary negotiations on fiscal issues, with getting re-elected taking front stage. Further, it means that a lame duck Congress will be in place for November and December. Further, a lame duck President could be in place for most of January.

We see two likely election outcomes and evaluate the negotiation path under each:

- **Obama Wins**, Republican House, Democratic Senate – This is the base scenario and it has the advantage that once the Congress is seated on January 3, negotiations could begin in earnest. However, it has the more disadvantageous outcome of creating a faceoff between a President who has indicated he would veto any bill with tax cuts for the wealthy and a Republican House that has indicated it is unwilling to accept any new taxes. This could result in negotiations stretching until late March when the threat of the debt ceiling and the expiring continuing resolution loom.
- **Romney Wins**, Republican House, Democratic Senate – This is the other most feasible outcome. It has the negative feature of Romney not being President until inauguration Day, which is January 20. However, this negative may be more than offset by a President and House that could more easily reach common ground. While the Senate is likely to remain Democratic, it should be very close to split and this body is unlikely to hold up any reasonable proposal.

Therefore, while negotiations could begin later under a Romney election, they also have greater potential for an expedient compromise.

There are Deadlines and Then There are Deadlines

Past experience has taught us that the ability for fiscal compromise is driven by a hard deadline that makes not reaching a deal unthinkable relative to compromising on some core beliefs. In the coming months there are three distinct deadlines that exist – we rank them in order of how catastrophic they seem.

- **Debt Ceiling** – The US Treasury is likely to reach its debt ceiling limit around year-end, although accounting gimmicks can likely push the hard limit into March or April.² If no fiscal deal is reached by then, the US Government would either default on Treasury debt or default on other spending obligations. Either of these

² The US Treasury was vague on this topic in its [Quarterly Refunding Statement](#) released on Wednesday, saying it would likely reach the debt limit “near the end of 2012” but extraordinary actions could extend the limit “until early in 2013.”

outcomes would have longer-term negative consequences associated with them and it is very unlikely the debt ceiling would be breached without reaching a deal.

- **Continuing Resolution** – This is what gives Congress the authority to spend money (in the absence of a formal budget). The current continuing resolution runs through the end of March. Absent a fiscal deal by this date the US Government would be forced to shut-down all non-essential functions. While perhaps not as serious as a debt ceiling breach, this also brings negative consequences and is fairly unlikely to be breached.
- **Fiscal Cliff** – The immediate outcome of the fiscal cliff are more limited and targeted than the other two deadlines. Defense cuts could result from the BCA sequester and this could lead to layoffs in this industry. A suspension of the WARN Act has already been put in place to mitigate this impact. Taxes would rise on individuals in a variety of ways. However, if the Treasury were to authorize unchanged withholding tables, the impact of this on workers would be delayed. While going off the cliff is not a great outcome, the fiscal cliff may not be a strong enough deadline to guarantee that a deal is reached by January 1.

The more difficult-to-estimate catalyst for a deal is if financial markets react in a way that makes not compromising too unpalatable for legislators. The oft-cited example is the passage of TARP soon after the failure to pass TARP resulted in an immediate and significant drop in risk assets. This is a very plausible path to a deal in the current environment as well. However, unlike TARP, we don't see a discrete event that leads to an immediate drop in risk assets. It is more likely that a slow grind lower would accompany the passage of time into 2013 with a likely deal.

The Fed Chairman in 2014 and Beyond

A completely separate, yet potentially market moving issue that is likely to be considered following the election is that Chairmanship of the Federal Reserve. Bernanke's term expires in January 2014 and there is a strong degree of likelihood that he will not be renewed as Chairman. The re-election of President Obama would most likely result in the appointment of someone of similar philosophy (Janet Yellen as an example) and should result in no concerns about an abrupt shift in monetary policy.

However, Romney has been a frequent critic of Bernanke's aggressive policies and is more likely to appoint someone from outside of the current Fed. This creates the risk of an abrupt shift in monetary policy in 2014. This could call into question the validity of the 'on hold' guidance which extends well past Bernanke's term. It could also call into question the path of the balance sheet in 2014, which could begin to shrink rather than continuing to expand. Ultimately we think that as a President, Mr. Romney would be less hawkish than he has been as a candidate. While the market may react (a bear flattening of Treasuries on this issue) we think the risk of an abrupt change in Fed policy in 2014 is limited.

Ultimate Election Positioning

We recommend a long duration position on the expectation that President Obama is re-elected and this produces a cumbersome path to a fiscal deal. While a compromise is ultimately likely to be reached, it could be after the US falls over the fiscal cliff in January and Treasury yields fall gradually as concerns rise. We also recommend long gamma positions to hedge against a Romney victory.

Appendix A-1

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