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What to Make of the Shutdown?

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The government shutdown in the USA is clearly driving all the headlines these days as well as the markets. We've seen a pretty substantial whipsaw in the last 10 days as rumors have gone from government default to a last second deal. I think this is mostly noise and that none of what's going on in Washington should be altering your long-term or even your short-term playbook.

It's true that the shutdown has the potential to cause some fairly serious economic consequences, however, the most likely scenario is that we'll see a fairly meager overall economic impact. There is an outlier chance that the US government does not pay its bills on time, but I think the much more likely scenario is that a resolution is pieced together and we kick the debt ceiling can down the road a few months. Then we get to revisit this pleasant back and forth at a later date. Overall, I wouldn't expect these debates to result in material budget changes or material economic impacts.

Long story short— Stick to the playbook.

The primary reason why I think we should downplay the broader economic impact is because the shutdown really isn't doing much. It's been estimated that the shutdown hurts spending by roughly $300M per day. But more importantly, I think that we should expect all furloughed employees to receive back pay. So the near-term data might begin to show some negative impact from the shutdown, but that will likely be corrected as later data

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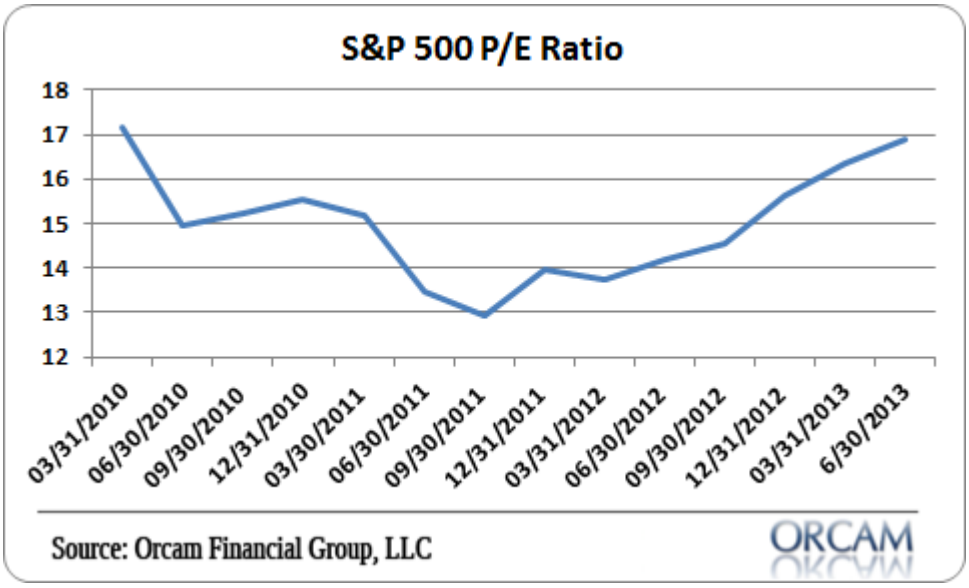
will reflect an eventual agreement and reopening of the government.

That said, I think the playbook is still intact. We remain strategically bullish on equities with the recent move towards a tactically bearish position. This is especially prudent given the upcoming earnings season. Now that the debt ceiling debate should start to subside the markets will begin to focus their energy on corporate earnings as they're reported in the coming weeks.

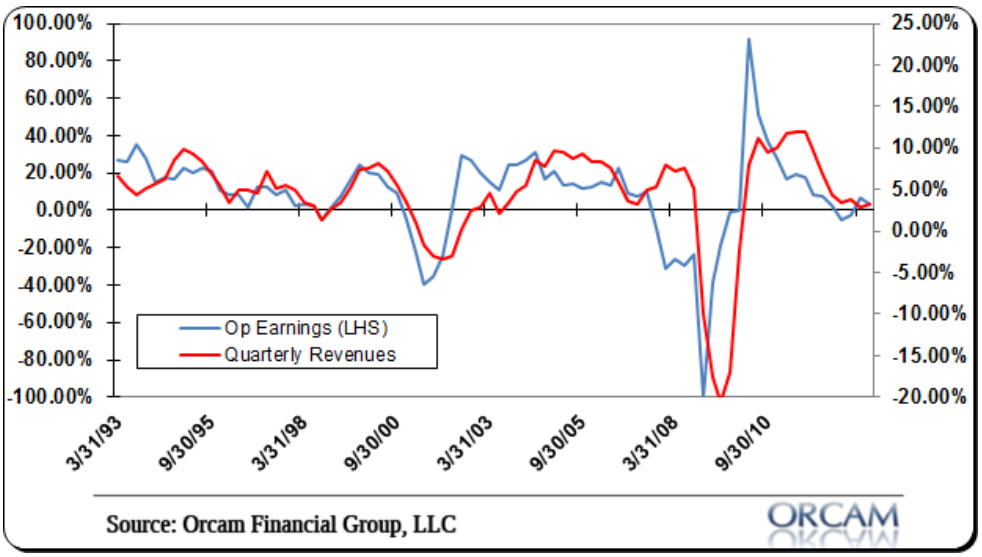
So far, the 2013 rally in equities has been largely psychological as investors have bid up stock prices in the face of falling profits. This has resulted in a multiple expansion (see chart on the right) alongside lackluster profit performance.



As we head into the Q3 reporting season the bar is being set very low as negative preannouncements roll in. A total of 90 S&P 500 firms preannounced negative earnings which is the highest reading since 2006. Overall EPS growth is expected to come in at 3%. That's down from expectations of 6.5% just 3 months ago. Financials are expected to report growth of 9.1% and they lead off the earnings season so don't be surprised if earnings season appears to get off to a get solid start and then the mood dampens as we get further into November.

Revenue growth is expected to come in soft at 2.6%. As you can see in the chart on the next page revenues and operating earnings tend to correlate tightly. The low revenue growth and EPS growth is nothing to start panicking over, but I do have to wonder if investors won't look at the Q3 earnings season as a reason to temper expectations a bit. The rally based on multiple expansion is largely about increased expectations that are failing to materialize. It's a muddle through economic environment and we're now beginning to see the earnings picture

reflect that broader macro trend. We'll see how things progress, but given the weakness in earnings I would be surprised if the market rewards this earnings season with new all-time highs in the short-term. That would appear rather unjustified in my view.



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