The market implications for the failed repeal of Obamacare are likely less than the political implications because the market never really cared about the repeal. The market is far more focused on tax reform and the stimulus package.

The question on everyone’s mind: was the vote on Obamacare a litmus test for the more significant policies?

We think not…at least for now. The amount of disagreement on tax reform within the GOP is likely less than on healthcare. Here’s how the failed repeal could be interpreted by the market on the odds of tax reform, stimulus, and regulatory rollback.

Failed Repeal Increases Odds of WH Policy Enactment
- Urgency to put a yuuuuge win on the board
- Spending more energy on policy details before announcing a date for the vote
- Tax reform is somehow less complex than Obamacare, so easier to pass
- Rather than chasing healthcare reform, the administration can focus on fiscal reform
- Trump cut his teeth on the swamp’s bureaucratic process and now understands better how to navigate the waters

Failed Repeal Decreases Odds of WH Policy Enactment
- GOP is so focused on putting a W on the board that concessions are made and the ultimate policies are diluted (cuts rather than reform)
- The party divide is real and Trump’s combative style during the Obamacare repeal may have burned bridges with Congressional representatives he needs to enact true reform
- The Trump Brand, built on winning and image, suffered a hit and could impact how supporters view the president
- The GOP campaigned for seven years on dismantling Obamacare, if they can’t unite on this issue how likely are they to unite on other issues?
- Is this the first crack in the Republican unity against the Democrats, particularly in regards to Russia?

Perhaps the most immediate effect will be some dissipation of the upward momentum on yields. The market has been on edge, ready to drive yields higher on any progress on the policy front. Maybe the failed repeal will move bond market sentiment to a more neutral position until more information becomes available about taxes/regulatory reform and stimulus.

A few weeks ago we suggested that the real GOP was playing nice with Trump until their conservative agenda was passed, at which time they would throw him to the wolves. A fissure like the one we just witnessed on Obamacare makes us wonder if Trump is already on borrowed time.

Will he be able to keep his eye on the economic ball long enough to pass meaningful reform or will be dragged into the mud by self-inflicted wounds, Democratic clickbait, and tweet wars?
Long Term Fixed Rates

The 10yr Treasury has been range-bound between 2.31% and 2.62%. While the failed vote won’t necessarily push the 10T down to 2.30%, it will be more difficult for the market to ignore weak data if the probability of a full blown tax reform has diminished. The range is likely to hold for the foreseeable future, but the failed repeal opens up the possibility of a short-covering squeeze. The traders that have been holding onto short positions may have a little less conviction than they did a week ago.

Potential Catalysts for Rates Pushing Higher

1. Fiscal policies – a big win on tax reform could drive the 10T to 3.00% in short order

2. Balance sheet normalization – the Fed is spending a considerable amount of energy warning the market about the need to shrink its $4T+ balance sheet.

   Step 1 - stop reinvesting maturing proceeds back into securities, removing one major buyer of Treasurys, Agencies, and MBS bonds.

   Step 2 – actively sell existing holdings (the Fed probably won’t actively sell holdings unless inflation becomes a serious concern).

Given the Fed’s penchant for sending signals for at least a year before actually implementing policy change (first rate hike, QE tapering, etc), the Fed is probably targeting a year end or Q1 2018 implementation. But the market won’t wait for the implementation to start selling bonds, so there is a very real risk of mass Treasury selling.

3. ECB Tapering – this is not getting enough attention in mainstream media. Draghi is casually referencing a tapering to the ECB’s own QE program. Remember what happened when Bernanke first mentioned the word taper? The T10 spiked 1.20% in six weeks.

Given how directly correlated the German Bund and UST are, a similar tapering response on the German bund could give the 10T room to move higher.

Potential Catalysts for Rates Pushing Lower

1. Growing concern that the market overpriced the odds of full tax reform and stimulus

2. Short squeeze – the market is on Treasurys and at some point the traders may throw in the towel and buy Treasurys to cover their shorts.

3. Most of the global economy is still struggling with 0% interest rates

4. Slowing GDP – Atlanta Fed’s GDPNow has revised its forecast lower from 2.8% to 0.9% over the last month.
5. Tightening cycle typically flattens the yield curve

Fed Funds and LIBOR

The Fed has hiked twice in the last three months, a fairly aggressive shift after eight years stuck at 0%. We think the Fed is hiking for three reasons:

1. Because it can – the market isn’t puking over a hike like it did in December 2015.

2. To avoid falling behind the curve and then needing to hike rapidly to catch up, potentially throwing the economy into a recession.

3. Moving further away from 0% provides more ammo in case the Fed needs to cut again.

Note that none of those reasons are because the economy is overheating or because inflation is rampant, the traditional reasons for hiking.

This Week

Relatively quiet week for data until the end of the week, when final Q4 GDP is due as well as a slew of inflation data. Very busy week for Fed-speakers, who we expect will reinforce the notion that the Fed is projecting two more hikes this year and may continue to talk up balance sheet normalization. Obviously, political developments and tweets continue to dominate market movements.