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Is the decoupling of the U.S. economy from Europe & China sustainable?

The big story of 2018 was the decoupling of the U.S. economy from the slowdown in Europe and Asia. In our view, the big question, the million-dollar question in fact, as we head into 2019 is whether this decoupling is sustainable or not. We are skeptical. Barack Obama famously said, "Elections have consequences." The recent midterm election has produced a new gridlock in Washington. The last time Washington went into a gridlock was in 2011, following the midterm elections of 2010. The Republican Party engaged in brinksmanship with President Obama in order to force budget cuts. When those were not forthcoming, the battle over the debt ceiling nearly brought the country to the verge of default. The debt ceiling crisis culminated in the U.S. losing its triple-A credit rating status in August that year. And we saw extreme volatility across financial markets, especially with respect to the dollar, which went down sharply because investors started to raise questions about the dollar's reserve currency status.

We think 2019 could follow a similar script. The debt ceiling will have to be raised early March. We think Secretary Mnuchin will be able to buy a few months by resorting to emergency measures. But sometime in early summer, the Republicans and Democrats will have to compromise in order to raise the debt ceiling.

What does this mean for investors?

We think that battle ahead is not going to be easy. In fact, we think it's very likely to be destabilizing...destabilizing to the extent that it could actually undermine confidence. And certainly it might basically lead to investors requiring a higher risk premium for holding U.S. dollar assets. As a result, we see gridlock risk as posing potentially the single greatest risk to the decoupling view next year and therefore also for the U.S. dollar.

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