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Another Government Shutdown?

What it could mean for the economy and markets?

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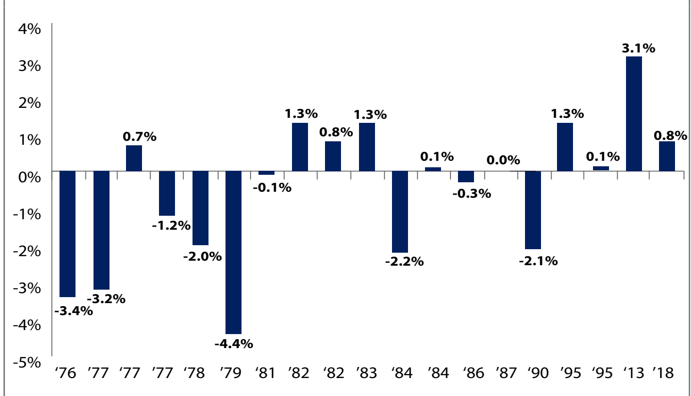
Washington could be headed for a government shutdown. Amid intense pressure on border security and providing $5 billion for constructing a wall on the Mexican border, the administration appears to disagree on a spending measure that would fully fund the Department of Homeland Security and other federal agencies, thus setting the stage for a partial shutdown of the U.S. government starting immediately after midnight on December 21. Historically, most federal shutdowns have been relatively short-lived, lasting between one and five days with limited disruption to government operations. The longest episode lasted for 21 days in late 1995-early 1996, and more recently, the shutdown in October of 2013 persisted for 16 days. Both of these episodes resulted in furloughs for large numbers of federal employees, though neither had a significant market impact.

For the government's fiscal year ending September 30, 2019, most of the government's spending has already been addressed by Congress. Five appropriations bills have been passed that account for about 75% of government spending. Seven remaining spending bills – accounting for 25% of government spending – have not be settled for the current fiscal year and temporary funding is in place only through December 21. The scope of a shutdown would be limited to a small portion of the government.

Typically, the impact of a government shutdown on economic growth likewise has also been minimal, as the average length of a funding gap has been less than seven days since 1981.

And even when the government does "shutdown", mandatory programs like Medicare and Social Security are maintained, as are other essential functions, such as air traffic control, law enforcement, and security activities. Likewise, the operations of the Federal Reserve and U.S. Treasury are largely unaffected. So-called "non-essential" activities—aka, opening national parks, processing passport applications and updating government websites—are halted with only nominal effects, in our view, although certain departments such as the IRS may furlough employees during a shutdown (as the Treasury and the IRS are part of the seven spending bills that have not yet been resolved).

Exhibit 1: S&P 500 Performance During Shutdowns/ Funding Gaps: 1977-2018



Source: Congressional Research Service.
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The bottom line

In the event of a shutdown starting on December 22, we are monitoring the potential effect on financial markets.

Equity market performance during shutdowns has historically been positive about half the time and lower the other half of the time, reflecting a minimal median change during shutdowns from 1976-2013. On an average basis, the S&P 500 has dropped only 0.5%, and during the shutdown in 2013, the S&P 500 initially dipped but recovered its losses, closing 3.1% higher at the end of the 16-day funding gap (see Exhibit 1 on first page). Given the high level of event risk with Fed policy and the U.S. China trade negotiations, equity markets are already on edge. A potential government shutdown would add further uncertainty and likely weigh on prices in the short term, in our view.

Looking forward – Divided Government

While neither political party wants to be blamed for shutting down the government, each looks to place blame on the other. When pain or public pressure gets too big, the party most at fault generally falls on its sword, capitulates, negotiates or compromises and the government reopens. In an odd turn of events, this time neither party may take the blame. Instead, it may fall squarely on the President who declared, “I am proud to shut down the government for border security”.

Regardless, the inability to agree on government funding may foreshadow larger and more frequent political battles, with potentially far broader consequences. The most significant being the debt ceiling which is suspended until March 1 (but likely does not need to be resolved until the fall of 2019). Other items that need to be addressed range from renewing a number of expired tax provisions to ACA taxes, to Defense and Non-defense discretionary spending caps under The Bipartisan Budget Act of 2018. On the heels of the midterm elections and even before the Democrat controlled 116th Congress commences on January 3, 2019, the question on many minds: is this what divided government looks like?

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