CHIEF INVESTMENT OFFICE

Investment Insights

January 2019

Government Shutdown

What it could mean for the economy and markets

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The House and Senate were unable to reach an agreement on a spending bill on December 21, 2018, leading to a government shutdown that has left the Department of Homeland Security and other federal agencies only partially funded. 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.

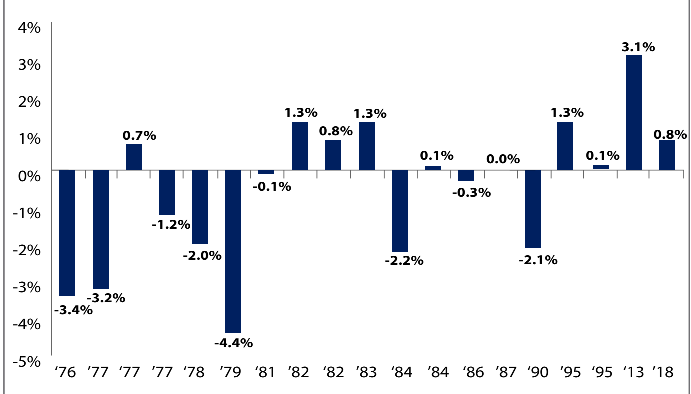
For the fiscal year ending September 30, 2019, most of the government's spending has already been addressed by Congress. Five appropriations bills have been passed that account for about 75% of government spending. Seven remaining spending bills – accounting for 25% of government spending – have not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

Typically, the impact of a government "shut down" 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). While during previous government shutdowns, the IRS generally has not issued refunds, it announced on January 7 that refunds would be issued during the current shutdown.

Tax changes will cause additional complications this year, with more taxpayer questions expected due to the significant change in tax laws and the introduction of new and revised tax forms. Taxpayers will need to wait until January 28, when tax filing season begins, to get those questions answered.

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



Source: Congressional Research Service.
Past performance is no guarantee of future results.

The bottom line

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.

Looking forward – Divided Government

The inability to agree on government funding may foreshadow larger and more frequent political battles, with potentially far broader consequences. The most significant may be 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 with the new Democrat-controlled 116th Congress, the question on many minds: Is this what divided government looks like?

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It is not possible to invest directly in an index.

Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets.

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