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Institute Alert

FIRST ANALYSIS

News or events that may affect your investments **September 13, 2023**

Gary Schlossberg
Global Strategist

Jennifer Timmerman
Investment Strategy Analyst

What a looming government shutdown means for investors

Key takeaways

- Government shutdowns in the past 30 years have ranged from a few days to over a month. If one occurs later this year, we believe it has the potential to last at least a few weeks because of hardened positions in an increasingly polarized Congress.
- Historically, U.S. Treasury yields have fallen around government shutdown periods. This time, we think yields are susceptible to increased volatility as a shutdown converges with other economic headwinds.

What it may mean for investors

- Although equities have logged positive returns in the past as government shutdowns were resolved, we are closely monitoring the event as yet another catalyst that could spark increased volatility and extended weakness in stocks, given the underlying vulnerabilities we see in the broader economy.
- We encourage investors to look beyond the market's twists and turns in the weeks before, during, and immediately following a potential shutdown by aligning with our more defensive portfolio guidance, positioning for an economy approaching an anticipated recession.

Policy déjà vu

Another budget impasse is leaving the federal government on track for a shutdown at the start of the fourth quarter, just months after an intense debt-ceiling debate left the U.S. Treasury on the verge of default and the government with another downgrade in its credit rating. A threatened budget impasse is part of a mosaic of renewed student-debt repayments, a looming United Auto Workers strike, rising fuel costs, a yawning fiscal deficit, and higher interest rates. In our view, each weighs on housing, consumer finances, and government financing expenses in adding to recession risks during the closing months of the year.

Odds of a shutdown by the government have increased in the past month following disagreements between House Republicans and Senate Democrats. Those demands center around deep cuts in non-defense spending proposed soon after the debt-ceiling accord, resumption of border-wall construction, and an increased number of border agents.

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None of the 12 appropriations bills to fund the government have yet cleared Congress, making it nearly impossible to approve a budget between the September 11 end of the House recess and the September 30 start of the new fiscal year. Only those departments with appropriations bills passed by Congress would avoid closure, so the economy will be faced with a full government shutdown if the impasse continues. Five of the 12 appropriations bills had already been passed at the start of the long, 35-day closure between December 2018 and January 2019, limiting the shutdown's impact on the economy at that time.

The focus of the budget debate has turned to a continuing resolution that extends funding at current spending levels through early December, according to some proposals, to keep the government open while the spending debate continues through the end of fiscal 2023. Talks are complicated by riders proposed for the spending resolution, including added aid to Ukraine and cost-of-living adjustments to current spending on food stamps and other programs to account for unexpectedly high inflation. Debate over any of these proposals could hold the spending resolution hostage in an increasingly heated debate.

How bad would a shutdown be? It would not mean the complete loss of the federal government's 25% share of the economy. Mandatory, or entitlements spending accounting for over 65% of outlays in fiscal 2022, would be exempt, including Social Security, Medicare, and Medicaid. And only that portion of discretionary spending deemed nonessential would be affected by the shutdown, including the government's data mills. Delayed or incomplete economic reports would make it far more difficult to monitor the economy — notably for the Federal Reserve at a crucial juncture in monetary policy.

Essential services (largely related to public safety) would continue, including defense and border protection, in-hospital care, air traffic control, law enforcement, and power grid control. However, the economy would bear the full impact of the shutdown on discretionary spending — over 26% of the budget this past fiscal year — because payments for essential, appropriated services would be made only after those bills have been approved. And if the past is any guide, absenteeism among stretched, essential-service employees could impair those services remaining open.

The long and the short of it

Government shutdowns in the past 30 years have ranged from a few days to over a month. If one occurs later this year, we believe it has the potential to last at least a few weeks because of hardened positions in an increasingly polarized Congress. However, a few guardrails likely will limit the risk of an open-ended confrontation:

- The political parties in Congress are very likely to feel increasing pressure the longer any shutdown goes on, especially now that the election season has begun.
- There is also the issue of the 1% across-the-board spending cuts if all appropriations bills are not passed by the end of the year. The cuts are not implemented until April 2024, but leverage among conservatives would be greatly diminished by the arithmetic of those cuts: made from current spending levels, the changes would have the effect of reducing defense spending from fiscal 2024 proposals but increasing non-defense outlays.
- A prolonged government shutdown could create the kind of financial turbulence that, in the past, has quickly resolved fiscal disagreements.

What it may mean for investors

So how would a government closure affect investors? No two shutdown episodes since the mid-1990s have been the same, occurring at different stages of the business cycle, with often unique forces shaping the economic outlook at the time. Commerce Department and consensus estimates of lost real gross domestic product (GDP) during the three long shutdowns by private economists vary, but average to roughly 0.5% of GDP. One recent

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forecast puts the real GDP loss in a full shutdown next month at 0.2% each week, largely recouped soon after a reopening.[1]

The economic damage in past shutdowns has come from the direct and indirect ripple effect of lost spending on the economy by the government, its workers, smaller-business vendors, and other federal contractors. Moreover, consumer and business sentiment has suffered from the inconvenience and uncertainties created by lost government services, apparent from the divot in consumer sentiment indexes during each of the three longer shutdowns since the mid-1990s.

Historically, Treasury yields have fallen in weeks before, during, and after the three long shutdowns depicted in Table 1. Treasury yields did rise in the month following the 2013 shutdown on debt-ceiling concerns, however. We see the potential for this pattern to be repeated (temporary upward pressure on yields) following a shutdown this year, either due to a pullback from investors dissatisfied with rising deficits and interest expenses, or because of slowing foreign investment responding to recent U.S. dollar strength and rising yields abroad. The dollar, reacting to lower yields and uncertainties over the U.S. economic outlook, has weakened modestly in the past two shutdowns. We think a shutdown this time around could weigh on the dollar if it is viewed as symptomatic of fiscal weakness threatening longer-term growth potential.

Table 1. Asset performance around long government shutdowns*

	1995 – 1996**	2013**	2018 – 2019**
S&P 500 Index	5.9%	6.2%	2.6%
% Change in U.S. dollar	3.6%	-0.9%	-0.8%
Change in 10-year Treasury yield	-24 basis points***	-21 basis points	-37 basis points

Sources: Wells Fargo Investment Institute and Bloomberg. *Performance period includes cumulative change three weeks prior to the government shutdown, during the shutdown, and four weeks after the shutdown. **The 1995 – 1996 government shutdown occurred between December 16, 1995 and January 6, 1996. The 2013 government shutdown occurred between October 1, 2013 and October 17, 2013. The 2018 – 2019 government shutdown occurred between December 22, 2018 and January 25, 2019. *** One basis point equals 0.01%. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

From an equity standpoint (Table 1), the market (as measured by the S&P 500 Index) typically sagged immediately before and through the early part of the longer shutdowns in 1995 – 1996, 2013, and in 2018 – 2019, but it did not take long for stocks to regain composure after the government reopened in each instance. In fact, a healthy gain, on average, after the past three longer shutdowns has been broad-based across the S&P 500's 11 sectors[2], paced by more economically sensitive Information Technology, Industrials, and Consumer Discretionary, while the more traditionally defensive Utilities and Consumer Staples lagged overall returns. Moreover, market volatility has historically been contained. This time, however, a shutdown risks aggravating other potential body blows to the economy, mentioned earlier, leaving stocks more exposed to volatility and to extended weakness.

Government shutdowns can stop outlays to industrial firms, but we remain favorable on the Industrials sector when we consider the sub-industries. First, aerospace and defense may be affected by a shutdown but account for only about 20% of the Industrials sector. The commercial and professional services sub-industries (roughly 15% of the sector) has expanded and, in our opinion, has grown in quality in recent years. In none of these sub-industries do we believe that a shutdown of a few weeks is likely to change the combination of positive and negative trends already in place. The Transports sub-industry is more tied to the overall economy, which is still growing. Most of all, however, we believe the strongest theme in the Industrials sector is the long-term structural buildout in

1. Goldman Sachs, "How much does a U.S. government shutdown cost the economy?" September 1, 2023.
2. 1995 – 1996 shutdown returns for S&P 500 Real Estate sector are unavailable.

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business capital goods spending and infrastructure improvements, which is unlikely to be derailed by a temporary shutdown.

In our view, any stock market pullback likely would be muted by the knowledge that the direct impact of past government shutdowns has been quickly reversed after the reopening. For that reason, we encourage investors to look beyond the market's twists and turns in the weeks before, during, and immediately following a shutdown by aligning with our more defensive portfolio guidance, positioning for an economy approaching an anticipated recession. That includes a focus on quality and liquidity in equities, as well as a similar bias to investments in the fixed-income space split between short- and long-term securities.

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