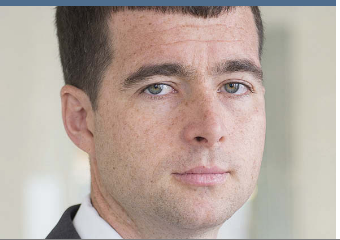

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POLICY MATTERS

A Silver Lining in a Government Shutdown?

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Investment Management Strategy Analyst John L. Bellows, PhD, discusses the federal government shutdown and its implications for the economy, markets, and the debt ceiling debate.

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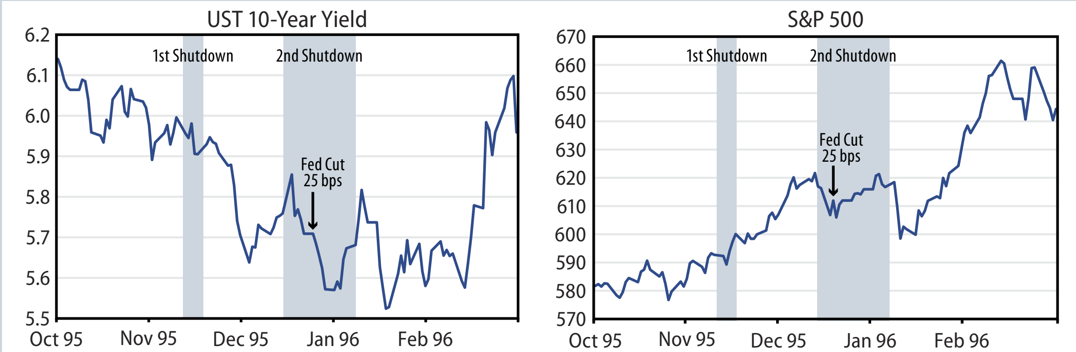
This morning the federal government started a partial shutdown after yesterday's negotiations failed to produce an agreement between Democrats and Republicans. While it is not the first time that this has happened—this will actually be the 18th shutdown since 1976—the current shutdown represents a heightened level of tension between President Barack Obama, Senate Democrats and House Republicans. As investors assess the implications of the current impasse, it is important to distinguish between the shutdown and the debt limit. The debt limit is by far the more important of the two. Unlike a government shutdown, which is more of a political event than an economic one, a failure to increase the debt limit has the potential to be extremely disruptive for the economy and for markets. The "silver lining" of the shutdown may be that it can smooth the debt limit negotiations, thereby making it less likely that the debt limit will be hit later this month.

A. Impact of a Government Shutdown

A government shutdown only affects discretionary spending, which accounts for less than 40% of total noninterest federal spending. The much larger mandatory portion of federal spending, which includes Social Security, Medicare and Medicaid, will not be affected. Similarly, debt interest payments will not be affected by a government shutdown. Even within discretionary programs there will be a number of exceptions for "essential" activities that will allow departments to perform their most important functions. As a consequence, the practical impact of a government shutdown will be limited to furloughing a large number of federal employees, closing national parks, delaying applications for visas and firearms, etc.[1] The macroeconomic impact of a government shutdown will likely be limited, although it depends on the length of the shutdown, whether pay for employees is restored after the government re-opens, and the broader impacts on confidence and markets. At the moment, forecasters estimate that a shutdown will reduce 4Q13 GDP by 0.1% to 0.3%, depending on how events evolve.

Given the potential for a limited macroeconomic impact, a government shutdown will not necessarily be a major event for markets. In fact, the most recent experience with a government shutdown suggests that markets may not react very strongly. During the fiscal year 1996 federal budget negotiations between President Bill Clinton and Speaker Newt Gingrich there were two government shutdowns: one from November 13 to 19, 1995 and then another one from December 15, 1995 to January 6, 1996. Exhibit 1 shows the US Treasury 10-year yield and the S&P 500 around those two dates. Note that the Federal Open Market Committee cut the federal funds rate by 25 basis points on December 19, 1995.

Exhibit 1
1995/6 Shutdowns



Source: Bloomberg

Bond yields were falling throughout this period, but that was due in part to the Federal Reserve cutting rates at the same time. There do not appear to be lasting movements in bond yields around the major shutdown dates. The S&P 500 took a pause during the second shutdown, but quickly resumed its upward trend later in January 1996. Although the 1995/6 experience was a very significant political event, it appears to have been of limited significance for financial markets.

B. The Debt Limit

In contrast to a government shutdown, hitting the debt limit has the potential to be significantly more disruptive. As background, the US Treasury actually hit the debt limit last May and since then has been using "extraordinary measures" to continue borrowing. This past week Treasury Secretary Jack Lew sent a letter to Congress advising that the "extraordinary measures" would be exhausted no later than October 17, at which time Treasury would have approximately $30 billion in cash and no additional capacity to borrow.[2] At that point, Treasury would be forced to try to meet incoming liabilities with incoming tax receipts. However, because the US federal budget has a significant deficit, Treasury would not be able to meet all of its liabilities with incoming tax receipts for very long.

Exhibit 2 shows the major payments due from Treasury from mid-October to mid-November. Even if Treasury were able to manage its cash balances for a few weeks, it would almost certainly not have enough cash to meet the large payments due on November 1 (Social Security, Medicare and government pensions) or on November 15 (quarterly interest payment for Treasury securities).[3]

Exhibit 2
Scheduled Cash Outflows from Treasury

Dates	Amount (bn)	Payment
October 16	$12	Social Security
October 23	$12	Social Security
October 31	$6	Debt interest
November 1	$67	Social Security, Medicare, Government Retirees
November 13	$12	Social Security
November 15	$30	Quarterly interest payment for Treasury Securities

Source: Congressional Budget Office

What would happen if the debt limit hasn't been raised in time for these scheduled outflows? Nobody really knows, which is the problem. Treasury would have a few options, although none of them would be very good. One option would be "prioritization," whereby Treasury would prioritize some payments (say, debt interest, Social Security, payments for troops) while delaying other payments. Another option would be "first in, first out," whereby liabilities would be met with available cash in the order that the liabilities came in.[4] Note that in either case Treasury would be in technical default on at least some of its obligations.

In addition to the fact that Treasury would be in technical default, there are a number of very significant problems with any such scheme. First, it is unclear whether Treasury has the internal systems to manage prioritization on a day-to-day basis. Second, Treasury doesn't have the constitutional authority to elevate some liabilities above others, because US government obligations don't have a seniority structure. Third, during this period Treasury would still be conducting auctions to roll existing debt, and those auctions would be in danger of failing or at least being very expensive (investors would naturally be skeptical of lending to any entity currently in default). Finally, in stopping or delaying payments Treasury would be taking a significant amount of demand out of the economy, which would have a severe contractionary impact on economic activity.

The bottom line is that this would be unchartered territory with significant downside risks. At the extreme, a period of technical default could undermine the status of US Treasury securities as the world's "safe haven asset," which could be destabilizing for various parts of the financial system that rely on Treasuries as risk-free collateral. Therefore, not raising the debt limit is a much more frightening outcome than a government shutdown.

C. Implications of a Government Shutdown for the Debt Limit Debate

So, returning to the initial point above, how does the prospect of a government shutdown relate to the debt limit? Some commentators may conclude that the shutdown foreshadows an even more problematic debt limit debate. While such an extrapolation may make intuitive sense, there could be a much more positive outcome from the current dysfunction. As explained below, it is possible that a shutdown could actually smooth the way for resolving the debt limit. That would indeed be a significant "silver lining."

The first thing to keep in mind is that the White House and Republicans have started from seemingly irreconcilable positions on the debt limit. The White House has said it will absolutely refuse to negotiate over raising the debt limit, while the Republicans have insisted that negotiations over the debt limit are appropriate and have committed to seeking policy concessions in order to raise it. One potential way out is for the negotiation to take place over the shutdown and broader fiscal issues, but to have the eventual deal include an increase in the debt limit. This would allow the White House to save face (it didn't negotiate over the debt limit) at the same time that the Republicans could claim victory (they did get some concessions).

The second thing to keep in mind is that timing is important. The debt limit debate will effectively start today, because legislators will naturally roll the two issues together now that the shutdown has occurred. That means there will be two weeks, or possibly as many as four weeks, for the two sides to work out some kind of compromise on the debt limit. Two weeks is a pretty long time for DC, and it is much better than having a last-minute debate on the debt limit, which would risk a policy "accident" that would result in a technical default.

Finally, and perhaps most importantly, a shutdown has the potential to act as a release valve for some of the current tension in DC. The acrimony in DC has been running high for quite a while, and bringing that to a head could be potentially transformative for both sides. Consistent with this idea, over the weekend Politico reported that, "The threat of a shutdown is proving somewhat cathartic for conservative Republicans, many of whom were elected in

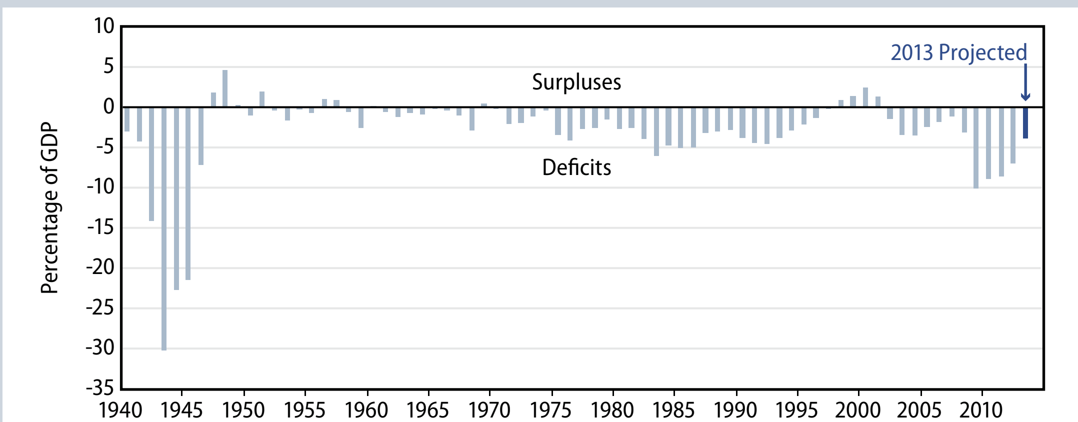
2010, promising to do everything they can to kill off Obama's health care law."[5] A related point is that a government shutdown could motivate influential outside groups to put more pressure on policymakers to move forward and compromise. For example, Wall Street CEOs were very vocal last December, which may have contributed to the final deal on the fiscal cliff, but they have been relatively quiet this time around. Should they choose to get involved, they would presumably advocate for an early resolution to the debt limit, which could be a positive development.[6]

D. What about the bigger fiscal picture?

One thing that is striking about the current debate is the absence of any discussion about the deficit. The final proposal from the House included government funding at current levels, which is actually an increase in spending levels relative to what was scheduled in the sequester. Moreover, the Republicans' policy demands have focused on delaying the individual mandate in Obamacare, which would have virtually no impact on the deficit. For their part, Senate Democrats have advocated for a slight increase in spending levels, and have all but given up on their previous position of offsetting higher spending with higher taxes. Both sides still pay lip service to corporate tax reform, but there is no serious proposal on the table and momentum seems to have stalled.

Part of the shift in the debate is understandable. The deficit has come down sharply over the past few years. The Congressional Budget Office (CBO) forecasts that the federal deficit will decline to 3.9% of GDP in FY2013, 3.3% in FY2014, 2.1% in FY2015, and then will remain below 3% until 2020. This is a remarkable correction in the US fiscal position—remember that only a few years ago the deficit was more than 10% of GDP! (Exhibit 3[7])

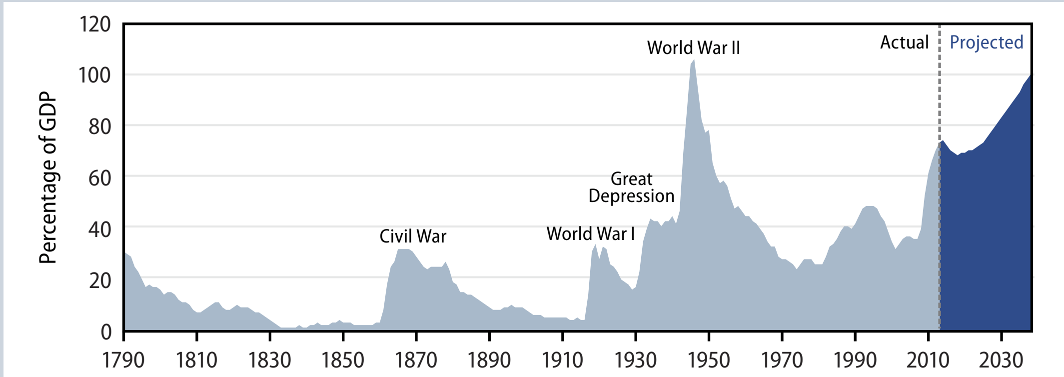
Exhibit 3
Total Deficits or Surpluses



Source: Congressional Budget Office

At the same time, it is concerning that DC policymakers appear to have missed the moment to enact long-term structural budget reform. While the near-term deficit picture looks stable, the longer-term deficit still looks worrisome. The cuts to discretionary spending, which were responsible for much of the near-term decline in deficits, did not really address the issue of health care spending, which is the driver of long-term deficits. Due to an aging population and forecasts for steadily increasing health care costs, the CBO projects that the current decline in the deficit will be temporary and that by 2020 the US debt will start increasing again[8]. (Exhibit 4)

Exhibit 4
Federal Debt Held by the Public Under CBO's Extended Baseline



Source: Congressional Budget Office

While policymakers are certainly aware of these alarming forecasts, there is only a limited chance that they will be addressed in the current debate cycle. At best, the current debate may result in some modest changes to long-term programs (for example: changing the indexing of Social Security benefits to chained CPI, which would reduce the annual growth rate of affected benefits by about 0.3%) in exchange for some relief from the sequester. While such reforms would go in the right direction, and could potentially boost confidence in US policymakers, this would fall well short of solving the long-term issues.

E. Outlook

Now that the shutdown has become a reality, there are two broad questions facing investors: how will events unfold from here and how should portfolios be positioned?

Over the next few days policymakers will attempt to re-open the government with some kind of short-term "patch." While well-intentioned, any attempt at a short-term patch will likely run into a number of obstacles. Most importantly, both Democrats and Republicans may quickly turn their attention to the debt limit. Faced with the reality that the debt limit needs to be raised by mid-October, policymakers may conclude that it is better to start those negotiations now, rather than passing a short-term patch that simply requires them to return in a few weeks and do the whole thing over again. This means that the shutdown could drag on for awhile.

If the shutdown drags on, the debate between Republicans and Democrats will likely broaden to include longer-term fiscal issues. The idea would be that finding some compromise on these longer-term fiscal issues could unlock an agreement on both the shutdown and the debt limit. Ultimately, the prospects for such a deal look promising. As discussed above, the shutdown may actually make this process somewhat smoother. In addition, the consequences of hitting the debt limit are too extreme for the leadership on either side to seriously contemplate that as an acceptable outcome.

As far as portfolios are concerned, the recent events are a good reminder of the importance of diversification. Should the tensions in DC escalate, diversifying positions—such as an overweight to interest rate risk—would likely outperform and help stabilize overall portfolio returns. In addition, investors should keep in mind that the impasse in DC has likely already been reflected in prices. The tension between Democrats and Republicans is not a new development, although it may be more prominent in today's headlines, and the underlying US fiscal situation has not changed dramatically. Finally, investors should attempt to distinguish between political events and events that have more significant economic and market implications. In this regard, distinguishing between the shutdown and the debt limit debate becomes extremely important. We will be watching carefully to see how events unfold, and to see if there is indeed a "silver lining" to the current shutdown.

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