August 7, 2023

Brian Gardner
Chief Washington Policy Strategist
bgardner@stifel.com

WASHINGTON POLICY STRATEGY

Potomac Perspective

The possibility of a government shutdown in October will confront Congress when it returns to Washington after Labor Day. Headlines regarding a potential budget impasse will grow, and there could be a whiff of panic in the air, but investors should take all of this in stride. Markets tend to ignore the impact of a government shutdown. We take a look at some recent shutdowns and the market's reaction to them.

Looming headlines of a possible government shutdown could spook investors. However, **past shutdowns suggest investors should not panic and shutdowns do not always pose the political risk that some fear**. We explain the politics of the upcoming government spending debate and look at how the S&P 500 has performed during shutdowns over recent decades.

The federal government's fiscal year ends of September 30. In order to keep many governmental functions operating, Congress needs to pass 12 appropriations bill or a short-term funding bill (aka a Continuing Resolution or CR). It appears unlikely that Congress will be able to finish the appropriations bills on time, and a faction of House Republicans could pressure Speaker Kevin McCarthy (R-California) to resist a CR, which would in turn shutdown unfunded portions of the government.

A potential shutdown could occur a few weeks following Fitch's announcement that it downgraded the United States' Long-Term Foreign-Currency Issuer Default Rating to "AA+" from "AAA" and cited "a steady deterioration in standards of governance over the last 20 years, including on fiscal and debt matters." Fitch's downgrade is likely to be cited by both sides during the upcoming budget debate as a justification for competing policy positions, but the downgrade is unlikely to actually impact Congress's action to either keep the government open or allow a shutdown.

The September 30 deadline is still eight weeks away, so it is possible that a deal on the spending bills can be reached, and a shutdown can be averted. Key principals in Congress are also expressing confidence that spending bills can be passed on time. However, there are very few legislative days when Congress returns, therefore the chances of passing the spending bills on time – coupled with the pressure that Speaker McCarthy will feel on his right – suggests that the odds of a shutdown are greater than 50/50.

If there is a government shutdown, the political world will react with a degree of panic. There will be extensive media coverage of closed entrances at national parks and other government facilities. Government salaries will not be paid on time which is, certainly, a hardship for some families. However, much of the country will operate as usual. For example, the military will continue to safeguard the country and air traffic controllers will continue to work and to make sure that travel and commerce continue. Once Congress agrees to reopen the government, the government will make up missed paychecks, so economic activity would be deferred but not eliminated.

Looking at past shutdowns, investors seem to understand the limited economic impact. We look back at shutdowns going back to 1978 and examined the S&P 500's performance from the last trading day before the government shutdown to the day that Congress voted to reopen the government. We only looked at shutdowns that lasted at least five trading days. There were other shutdowns, but most of these last two or three days and typically occurred over weekends, when the markets were closed. **There have been six shutdowns since 1978 that lasted five days or more, and as the table below shows, markets sold off during shutdowns in 1978 and 1979. Markets rose, however during the other four shutdowns.**

STIFEL

During the most recent shutdown (2018-2019), the S&P 500 rallied by over 10%. The December 2018 shutdown coincided with the Federal Reserve (Fed) raising the Fed funds rate by 25 basis points. A review of the minutes of the December Federal Open Market Committee Meeting does not indicate the Fed even discussed the potential impact of a shutdown.

Shutdown Start Date	**Length of Shutdown**	**S&P 500 Performance During Shutdown**
October 1, 1978	17 days	-2.00%
October 1, 1979	11 days	-4.42%
November 14, 1995	5 days	1.24%
December 16, 1995	21 days	0.34%
October 1, 2013	16 days	3.07%
December 21, 2018	34 days	10.27%

Source: Bloomberg and Stifel Washington Policy Strategy

The conclusion seems to be that investors ignore the political noise generated by government shutdowns and, instead, focus on other information such as indicators of economic activity, fiscal maneuvers, catalysts for monetary policy actions, fundamentals and other, more impactful, geopolitical risks.

SUBSCRIBE TO OUR PODCAST!

Season 2 of the Potomac Perspective podcast is underway. To access a broader discussion of these and other topics, please download and listen to the latest episode of our Potomac Perspective podcast.

DISCLAIMER

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com 0823.5862003.1

STIFEL