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WASHINGTON POLICY STRATEGY

Potomac Perspective

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Chances of a government shutdown have increased materially since the House rejected a Continuing Resolution (CR) last night. If there is a shutdown, it could be a very short one – maybe just the weekend. We look at how markets typically react to shutdowns (“Shutdown? What shutdown?”) and what the political implications of the CR debate could be as these are likely to impact policy in 2025.

Depending on how the CR is ultimately resolved, this might be our final note for 2024 (TBD). If so, Merry Christmas, Happy Hanukkah, and Happy New Year to our valued clients and colleagues! Thanks for a great 2024 and we wish you health and prosperity in the coming year.

WHAT'S NEXT FOR THE BUDGET?

Following last night's rejection of a CR, the House is back at the drawing board trying to write a bill that will keep the government open past tonight. If Congress cannot reach a deal by midnight, “nonessential” parts of the government will shut down. There is no clear path forward yet, but there are a few scenarios. Among them:

1. Congress reaches a last-minute deal to keep the government funded for several months;
2. Congress passes a CR that lasts several days (maybe a week) while it continues negotiations over a longer-term bill;
3. The government shuts down at midnight, Congress reaches a deal over the weekend, and the government reopens on Monday;
4. Congress fails to pass a bill and there is a shutdown that lasts beyond the weekend.

It seems unlikely that policy initiatives that were dropped from the original CR, or were not included in that bill, will be resurrected in a revised CR. China outbound investment rules, the BIOSECURE Act, and changes to Pharmacy Benefits Managers are all unlikely to be included in whatever new deal Congress reaches, but stakeholders and investors should continue to monitor developments because any of these items could be used as an inducement to gain votes for the broader bill.

The other big issue included in the CR was an extension of the debt limit, which had previously been suspended and will be reinstated at the start of 2025. An extension of the debt ceiling is unpopular among many Republicans. President-elect Donald Trump, however, wants to either eliminate the debt limit or suspend it for a long time, so that his administration does not have to deal with it. Some Democrats probably support suspending the debt limit, but they would prefer a short-term suspension. They know debt ceiling votes make Republicans uncomfortable, and they want to keep political pressure on the GOP. It is possible Congress could suspend the debt ceiling for two years (maybe longer), but an elimination of the debt ceiling seems like a long shot at this point.

SHUTDOWNS AND THE MARKET

It is possible, if not likely, that the government could shutdown at midnight tonight. Congress could work on a bill that would

reopen the government on Monday, so there would be no economic interruptions. What if Congress fails to pass a spending bill and the government closes for an extended time? There could be economic disruptions as agencies suspend work. For example, the Securities and Exchange Commission could halt its review of registration statements, so capital markets activity could decline. Also, the Small Business Administration could suspend its work on small business loan applications. These are but two examples of work that could cease during a shutdown. Also, depending on how long a shutdown would last, government workers, including the military, would not be paid. Workers would be made whole when the government reopens, but there could be some disruption for these households. Generally, the economic impact is limited and temporary, and based on market reactions to past shutdowns, investors seem to understand this.

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 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 lasted 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. 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 that 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

POLITICAL FALLOUT LEADS TO POLICY FALLOUT

At this point, it seems likely Representative Mike Johnson (R-Louisiana) will fail to be re-elected Speaker of the House on the first ballot when the new Congress meets on January 3, 2025. Republicans will start the session with a 219-215 majority, and Johnson will need a majority of those present and voting to be elected. Assuming all members are present, Johnson will need 218 votes. All Democrats will oppose him, he has already lost one Republican, and it appears others are likely to vote against him. Mr. Trump might still publicly back Johnson, but Trump backed the CR the House rejected last night, and 38 Republicans ignored him. On some issues, Trump's influence will go only so far, and it seems unlikely he will be able to save Johnson. The question will then turn to how many ballots it will take to either elect Johnson as Speaker or for him to step aside.

The length of time needed to elect a Speaker will underscore a few points:

1. Even in the wake of President-elect Trump's election, Republicans will continue to be fractured and will struggle to govern. This will delay their legislative agenda, including the tax bill.
2. Republicans will not automatically fall in line behind Mr. Trump. Thirty-eight Republicans voted against Trump on the CR. Expect to see this dynamic play out during 2025.
3. In Washington, D.C., it is easier to play defense than to play offense. Elon Musk and Vivek Ramaswamy were very effective in defeating the original CR. Passing a revised CR proved to be much more difficult. We are likely to see this repeated in the coming years. Their Department of Government Efficiency might have more success in blocking unpopular proposals than in actually passing legislation needed to enact some of their suggestions.

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