First Eagle Investments

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Insights

US Government Shutdown: Is There Signal in the Noise?

A strong feeling of déjà vu permeated markets in late September as lawmakers in Washington stared down the barrel of yet another deadline of their own devising.

Unlike the debt-ceiling standoff earlier this year, however, a government shutdown is neither unprecedented nor likely to have catastrophic impact on the economy or markets. That said, it bears the same stain of dysfunction and raises similar troubling questions about the country's fiscal trajectory and political polarization. Moreover, these factors suggest the risk of a negative reaction to the shutdown may be greater than it has been in the past.

Current Circumstances Aren't That Unusual

Prior to the October 1 start of each fiscal year, Congress is required to pass 12 appropriations bills to fund various federal agencies and discretionary spending programs for the coming year.[1] These appropriations, which are intended to reflect the terms of a previously agreed-to budget resolution, support a wide range of government services, from the National Parks Service to the Securities and Exchange Commission to the Centers for Disease Control.

As federal agencies generally are prohibited by law from spending yet-to-be-appropriated funds, those who do not receive an appropriation by October 1 must shut down. Each agency has its own shutdown procedures, but essentially all activities considered noncritical to national security or the protection of lives or property are discontinued. Employees deemed inessential are furloughed (and the services they provide curtailed accordingly), while those considered essential work without pay until funding resumes.[2]

The appropriation timeline historically has proven more aspirational than practical; Congress has completed the process before the start of the fiscal year only three times since fiscal 1977, most recently for fiscal 1997.[3] To avoid annual shutdowns and disruptions to government function, Congress often passes temporary spending bills known as "continuing resolutions" that provide agencies with interim budget authority in lieu of regular

[1] Source: Brookings Institution ; data as of September 17, 2023.
[2] Source: Government Accountability Office; data as of September 26, 2023.
[3] Source: Government Accountability Office; data as of November 3, 2022.

appropriation. Since fiscal 1977, Congress has enacted one or more continuing resolutions in all but three fiscal years, including every one since 1998.[4] These stopgap measures vary in duration and may be extended through subsequent continuing resolutions as regular appropriation bills continue to be hammered out. They also may expire without an appropriation bill in place, resulting in a shutdown.

As of September 29, the country appears poised to ring in fiscal year 2024 without any appropriations bills enacted into law or any continuing resolutions adopted. While this is a rapidly evolving situation, it seems quite likely the federal government will go into a partial or perhaps full shutdown on Sunday, October 1.

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(It's important to note that a government shutdown does not impact mandatory spending that falls outside the appropriations process, including entitlements like Social Security, Medicare and Medicaid, and sovereign debt service—i.e., about 80% of annual federal outlays.)[5]

The Shutdown May Have Limited Near-Term Impact on Markets and the Economy...

Non-defense discretionary outlays by the federal government have averaged about 3.6% of GDP over the past 20 years, and not all of these expenditures would be effected by a shutdown.[6] A shutdown decreases government spending for its duration and thus weighs on economic output for that time period. The impact historically has been relatively small, however, and since shutdowns merely delay government spending as opposed to canceling it, the catchup in spending occurs soon after the shutdown ends. The Congressional Budget Office estimates that the most recent (and longest) government shutdown—a partial closure that ran from December 22, 2018, through January 25, 2019—cost the US economy $11 billion, of which $3 billion (or 0.02% of GDP) was not expected to be recovered.[7]

Similarly, the shutdown may result in a temporary spike in unemployment data, depending on its timing and duration. Furloughed government employees are classified as "unemployed, on temporary layoff" if they are not working during the upcoming reference period of the employment survey, which in 2023 is October 8–14.[8] Once the shutdown ends and these employees go back to work, jobs data normalize.

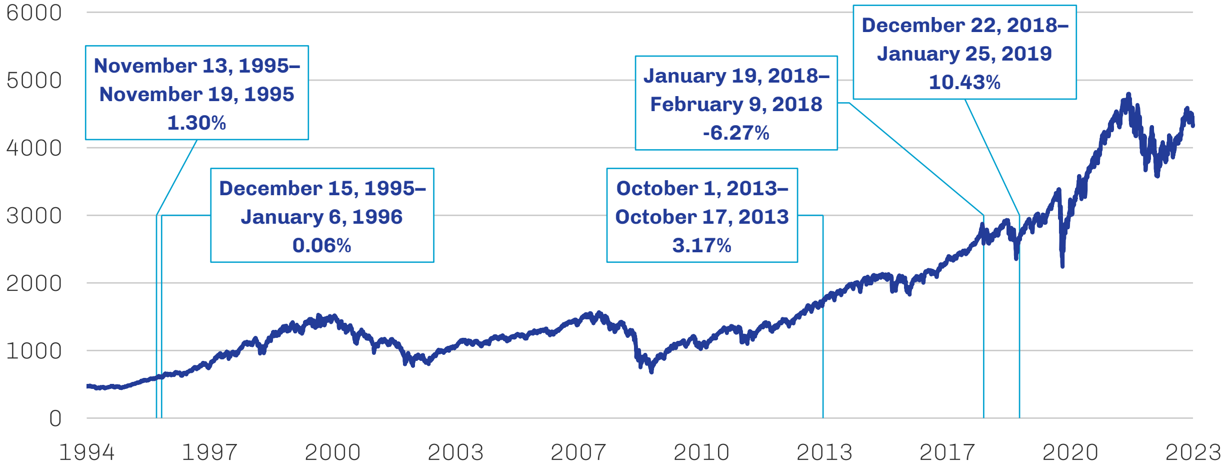
Shutdowns may also have indirect effects on economic activity. Federal workers going unpaid may decrease spending while between paychecks, though this impact may be muted by their expectation of retroactive pay after the shutdown ends. A lengthy shutdown could weigh on consumer and investor sentiment more broadly and serve as a headwind to private consumption and investment. Closed federal offices may also disrupt the provision of permits, licenses and loans, potentially impacting the operations of private businesses. The delayed production and/or distortion of certain government economic data could complicate the decision-making processes of private actors or even the Federal Reserve.[9]

Equity, bond and currency markets have been relatively stable in the weeks leading up to the current deadline, perhaps not surprising given the muted historical impact of past shutdowns. Though past performance is no guarantee of future results and every investment environment has its own nuances to consider, Exhibit 1 depicts the trajectory of the S&P 500 Index over the past 30 years and its behavior during the five shutdowns that occurred over that period. The bidirectional nature of the stock market across these shutdowns suggests other factors likely were driving performance. Interestingly, the longest shutdown on record, in late 2018, coincided with a very strong rally in US equities. Movements in Treasury yields during these same shutdowns—which ranged from a decline of 9 basis points to a rise of 19 basis points—point to similar blasé reactions by bond markets.

[4] "The Congressional Budget Process Timeline," Congressional Research Service (July 27, 2023)..
[5,6] "The 2023 Long-Term Budget Outlook," Congressional Budget Office (June 2023).
[7] "The Effects of the Partial Shutdown Ending in January 2019," Congressional Budget Office (January 2019).
[8,9] "Economic Effects of Government Shutdowns," Congressional Research Service (September 22, 2023).

Exhibit 1. Past Shutdowns Haven't Disrupted the Trajectory of the Equity Market

S&P 500 Index Level; January 1, 1994, through September 26, 2023



Source: FactSet; data as of September 25, 2023.

...But It Highlights the Country's Unsustainable Long-Term Fiscal Path

All of the above is not to say that there is no meaning to be found in the shutdown sideshow nor that the associated are risks inconsequential. In our late-May paper about the potential impact of US sovereign default, we noted that "it's hard not to see parallels between today's crisis and the circumstances that prompted Standard & Poor's to issue its downgrade of the US in 2011."[10]

We weren't the only ones to notice these parallels; two months after lawmakers broke their impasse over the debt ceiling, Fitch Ratings cut its long-term credit rating on US sovereign issuance from AAA to AA+.[11] Perhaps not coincidentally, Moody's—the only major ratings agency to maintain a top-tier rating on US debt—recently warned that a government shutdown combined with a continued lack of a cohesive fiscal policy response to troubling debt trends "could lead to a negative outlook, potentially a downgrade at some point."[12]

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We've frequently voiced our concerns about the US debt and its likely trajectory given the apparent the lack of political will to enact the spectrum of measures necessary—including tax hikes, entitlement reforms and cuts to discretionary spending, as well as supply-side reforms to promote productivity growth—to rein it in. Fiscal consolidation requires bipartisan work, and continued dysfunction in a US political system marked by an abhorrence of compromise suggests repeated party-line standoffs may be far more prevalent than concrete progress on this front.

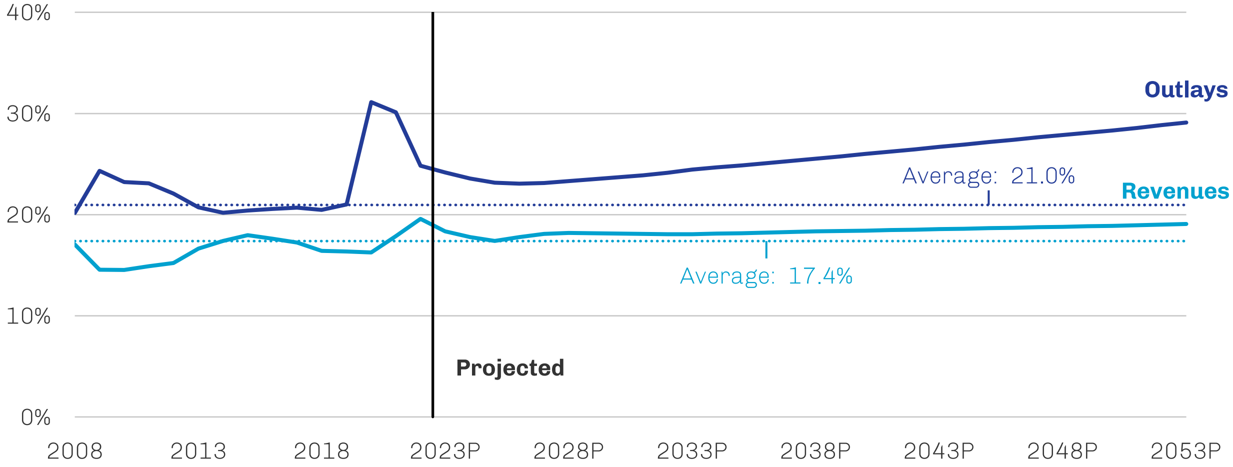
Though public debt outstanding has improved by a few ticks since its 2020 peak as spending related to pandemic relief waned and economic growth resumed, the Congressional Budget Office (CBO) forecasts debt to GDP to eclipse its historical peak by 2029 and get even worse from there, as shown in Exhibit 2.[13] While the current appropriations battle is being waged over non-defense discretionary spending levels, it is growth in mandatory

[10] Please see our paper "Will Debt-Ceiling Drama Turn into a Debt-Ceiling Debacle?" from May 25, 2023.
[11] Source: Fitch Ratings; data as of August 1, 2023.
[12] Source: Reuters; data as of September 25, 2023.
[13] Source: Congressional Budget Office; data as of June 28, 2023.

spending and net outlays for interest on government debt that the CBO expects to drive persistent deficits and expanding debt balances in the future.[14] Mandatory spending—which is dictated by existing laws and includes major entitlement programs like Medicare and Social Security—is projected to increase over the next few decades due to rising healthcare costs and the aging of the US population. Net outlays for interest are projected to increase on the back of higher interest rates and expanding debt; while this cost has averaged 2% of GDP over the last 50 years, the CBO forecasts it to reach 3.6% over the next decade.[15] Notably, the CBO's forecasts assume the December 2025 expiration of the individual income tax cuts and some business tax cuts from the 2017 Tax Cuts and Job Act, as written under current law. Extending these tax cuts would add another $3 trillion to the deficit over the 2024–33 period, excluding debt-service costs; this represents roughly 1% of GDP annually and is likely to be a focus of legislators after the 2024 elections.[16]

Exhibit 2. With Outlays Far Outpacing Revenues, US Debt Is Forecast to Increase

As a Percentage of GDP, 2008 through 2053



Note: Average reflects 1973 through 2022. Data for 2023–2053 are projections.

Source: Congressional Budget Office; data as of June 28, 2023.

To us, the swell of public debt outstanding in the US combined with a general lack of fiscal discipline has made Treasuries an increasingly shaky proposition—even as the lack of term premia suggest markets may not agree.[17] More broadly, the regime change in interest rates and shrinking global liquidity has exacerbated our concerns about sovereign credibility across major economies and highlights what we believe are pronounced vulnerabilities in today's financial system.

> The regime change in interest rates and shrinking global liquidity has exacerbated our concerns about sovereign credibility across major economies, including the US.

[14,15] "The 2023 Long-Term Budget Outlook," Congressional Budget Office (June 2023).
[16] "Budgetary Outcomes Under Alternative Assumptions About Spending and Revenues," Congressional Budget Office (May 2023).
[17] Source: Federal Reserve Bank of New York; data as of September 28, 2023.

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