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Here We Go Again: Implications of a Potential Government Shutdown

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The US Government Appears Poised to Shut Down

Little more than four years have passed since the last US government shutdown. Yet, absent a last-minute breakthrough, the federal government is on track to shut down again in the early morning hours on October 1st, as the 2023 fiscal year budget expires. We see a shutdown as nearly inevitable at this point, so our focus has turned to the likely path to reopening, and the probable market implications of these events.

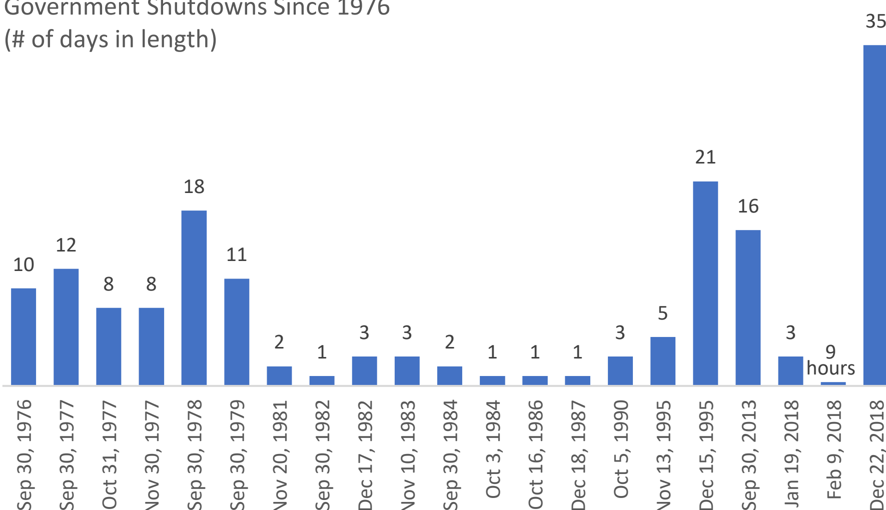
Where the Parties Now Stand

At present there is considerable space between Democrats and Republicans. The Democratic position is the clearest; they hope to hold Speaker McCarthy to the 2024 budget levels he agreed to as part of the May debt ceiling bill and have presented a unified front. The Republican position is still evolving, as a hardline small-government minority has complicated Kevin McCarthy's efforts to pass a counterproposal of his own. At present, McCarthy has adopted a strategy from this group, combining a short-term continuing resolution funding the government 27% below current levels and a series of appropriations bills funding specific Republican priorities. This bill appears too aggressive to win majority support in the House and, as a result, we expect the shutdown to occur with no formal Republican proposal. In the Senate, Majority Leader Chuck Schumer and Minority Leader Mitch McConnell are close to agreement on a bipartisan continuing resolution bill to buy more time, but this bill is not expected to get a vote in the House before a shutdown occurs either and the Senate still expects a final deal to come out of the House.

How We Expect the Shutdown to Play Out

Right now, the balance of power is held by the Republican hardline minority, as McCarthy's 4-vote margin in the House enables them to block any Republican proposal they do not support. When the government actually shuts down and the focus changes from staking out a negotiating position to passing a bipartisan bill, this will change. Social Security payments will continue, but federal assistance programs supporting millions will shut down, and furloughed government employees and closed national parks will increase public pressure on Congress to find middle ground. We expect this to rapidly shift the balance of power towards moderates in both parties. If McCarthy is able to pass a proposal out of the House this week – which we do not expect – his negotiating position may be a little stronger, but otherwise we expect a final deal to occur quickly and be close to the 2024 spending levels set forth in the debt ceiling debate. In that debate, the composition of negotiators was an important tell that the deal would ultimately favor the Biden Administration's position. Here, the bipartisan House Problem Solvers caucus has begun working on a deal to reopen the government and has been in close contact with Democratic Minority Leader Hakeem Jeffries. McCarthy has been struggling on finding consensus within his own party and has not been a major part of bipartisan negotiations.

While the average shutdown has been about seven days, we expect this one to last a little longer due to procedural hurdles within the House. However, the prospect of halts to social assistance programs while household budgets are strained from inflation should keep the shutdown inside two weeks. Other factors could expedite the timeline, however; the last shutdown ended with an air traffic controller strike, and with low staffing levels the appetite of air traffic controllers to work without pay is likely lower than in December 2018.



Source: PBS, Congressional Research Service

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Market Implications of a Shutdown

To a casual observer, a small-government coalition prompting a government shutdown to force budget concessions may look a lot more like a show of unity than a party splitting along internal fault lines. This will make rapid resolution appear less likely, and the emergence of a left-leaning bipartisan compromise seem more surprising than we believe is actually the case. This is a recipe for heightened short-term volatility. Unusually high investor Treasury Bill positions may help dampen this volatility somewhat, but there is currently a strong market consensus for an economic soft landing; a shutdown could cause risk assets to reprice. We do not expect this to be long-lasting, however, and markets should quickly recover as terms of a deal emerge.

Over the next few months, we see several impacts. First, GDP is generally estimated as falling 0.2% for each week the government is shut down in the current quarter; we expect Q4 GDP to decelerate an additional 0.2-0.4%, on top of normalization after an unusually strong Q3, though the full-year impact to growth should be modest. Second, a shutdown along with other economic disruptions (most notably the ongoing UAW strike) should make the Federal Reserve more inclined to hold the Fed Funds Rate unchanged in November and possibly December. While the immediate economic effects of the shutdown will be modestly disinflationary, the bigger issue from the Fed's standpoint is that it will also make it much harder for the Fed to assess the underlying strength of the economy. At a time when their focus is shifting from the current level of inflation to the possibility that this economic strength will lead to a rebound in inflation, this argues for caution. If an additional hike occurs, it's more likely to be in December or January, after temporary impacts of a shutdown have mostly run their course.

Longer term, our base case is that the final 2024 budget deal will look close to the parameters set in the debt ceiling debate in May. These represent a modest decrease in spending from 2023, but these are still historically high government spending and deficit levels. Over the coming decade this will be modestly inflationary and Treasury issuance in particular should continue to pressure long-term interest rates. We continue to believe that the Fed will have a harder time orchestrating a soft landing than the market now expects, however, and it may be some time before we see these effects. Finally, while we do not expect a relatively short shutdown to prompt Moody's to downgrade the Treasury from their highest Aaa rating (as S&P and Fitch have already done), they have indicated they would consider a shutdown a credit negative, and we believe a change of rating outlook is likely. Longer term, the risk of a downgrade increases so long as political gridlock causes even routine funding bills to become exercises in brinksmanship.

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