The Implications of a Government Shutdown

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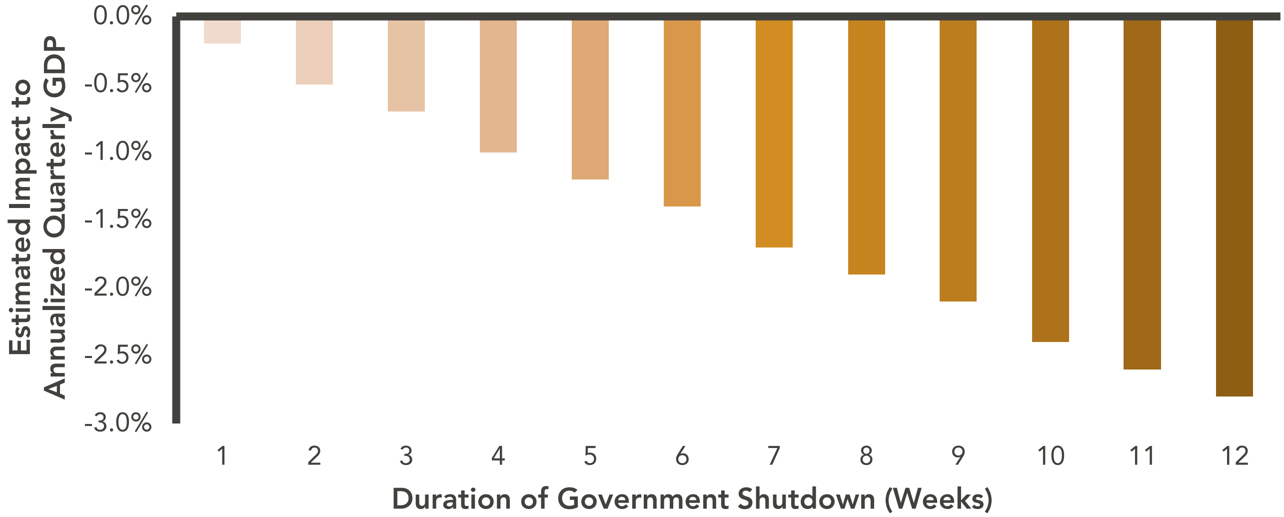
The federal government will shut down if Congress is unable to pass funding legislation by October 1, and a bill appears increasingly unlikely amid contentious debates among lawmakers regarding levels of future spending. While some essential government employees (e.g., law enforcement personnel) will be unaffected and benefits like Medicare and Social Security will continue to be paid, other disruptions will likely arise as a result of a shutdown. This newsletter seeks to outline these disruptions and the potential implications of a prolonged stoppage on certain functions of the federal government.

In the event of a shutdown, millions of federal government employees will see their paychecks delayed, including roughly two million civilian workers across the country. The processing of applications for passports, small business loans, and other government benefits will also be delayed, while businesses connected to the federal government (such as tourist services around national parks) could experience downturns. A shutdown will also likely leave Federal Reserve policymakers without key data at a crucial time for setting future monetary policy. Fed Chair Jerome Powell has previously stated that the bank will take a "data-dependent approach" to future interest rate decisions, which would be made difficult with the closure of the Bureau of Labor Statistics, whose reports include those on the Consumer Price Index and the domestic labor market. In light of these dynamics, many economists believe the Fed may hold its policy rate constant at the next FOMC meeting given the already significant challenge of engineering a soft landing amid an autoworkers strike and the resumption of student loan payments.

The economic impact of a government shutdown could be meaningful and is largely dependent on how long the closure persists. According to Bloomberg, a shutdown would produce a drag of roughly 0.2% on annualized quarterly GDP growth for each week that it lasts, which would likely be followed by a reversal once federal funding is restored. Based on the current Bloomberg estimate of 0.4% GDP growth for the fourth quarter, a prolonged shutdown may push the figure for the coming period into negative territory. Exhibit 1 below highlights the expected hit to annualized quarterly GDP resulting from a government shutdown based on its ultimate length. For context, a total of eight government shutdowns have occurred since 1982 and lasted an average of roughly 10 days. The longest of these shutdowns continued for five weeks and began in 2018.

Exhibit 1: A lengthy government shutdown could present challenges for U.S. GDP growth



Source: Bloomberg as of September 22, 2023

A prolonged government shutdown could also have consequences for the labor market, since furloughed federal employees will be counted as unemployed if they are not back to work by the second week of October. This being the case, Bloomberg expects the reported unemployment rate, which currently sits at 3.8%, to increase by 0.2% in the event of a month-long shutdown. Changes in nonfarm payrolls, however, are likely to be more muted since furloughed workers will receive backpay when the shutdown ends and are thus still counted as employed in that survey.

As it relates to securities markets, it is important to note that a potential shutdown is not viewed by most investors as significant a threat as a U.S. default, which lawmakers avoided by raising the debt ceiling earlier this year. To that point, the federal government will continue to make payments on Treasury bonds and other forms of debt during a shutdown. 10-year Treasury yields currently sit slightly below 4.5%, a 15-year high, and are expected to help buoy portfolios via today's higher coupon rates. On the equity side, stock indices are not typically impacted significantly by government shutdowns. In the week prior to the previous 8 shutdowns since 1982, during which investors had the chance to price in the reality of stoppages, the S&P 500 index returned an average of -0.4%. That said, performance for the bellwether U.S. equity benchmark was actually positive during each of those shutdowns at an average of 1.4%. These figures suggest that government shutdowns are usually not portents of equity market instability.

With all of the above in mind, it is not unreasonable to anticipate a mild economic impact due to the (likely) government shutdown. Fourth-quarter GDP figures may be lower depending on the length of the shutdown, though the drag will likely not persist into subsequent quarters. To that point, the nonpartisan Congressional Budget Office estimated this to have been the case during and after the most recent government shutdown which began in 2018. Economic sentiment will likely see a dip in the near term as well, but forecasters do not anticipate it to reach a point at which businesses will meaningfully curtail hiring and capital expenditures, nor are U.S. consumers expected to slash discretionary spending. Any significant cuts to spending over the coming weeks will come from furloughed federal employees, who will recoup lost earnings when the shutdown ultimately comes to an end. Using history as precedent, impacts to securities markets will likely be minimal, though market participants will be paying close attention to future actions of the Federal Reserve, which may find its job more difficult should a funding bill not come to pass. Although volatility may spike and headlines could spark further fear, it is important for investors to remain disciplined through the latest drama in D.C.; those that retain a long-term focus and manage their portfolios accordingly stand to achieve their risk and return goals with the least amount of disruption.

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