Global Markets Research

Research Alert

Congress announced deal to avert a shutdown

Continuing resolution still the mostly likely scenario, but does not extinguish the threat

Impact on GDP dependent on length of shut down; expect less than 0.5ppts cut to GDP

Flight to safety should support short-term demand for Treasuries, gold and the USD

Background

The Congress has announced a deal on the top-line spending level for 2024, an important step to avert a government shutdown on January 19th. After two stop gap measures in recent months, a continuing resolution is the mostly likely scenario but the threat of a shutdown is not extinguished yet. Congress still needs to allocate the money, write the bills as well as pass them, and lawmakers are facing hiccups to pass the international aid packages and border security measures. House Speaker Mike Johnson is facing continued infighting amongst GOP officials and an election-year will raise the odds that Congress may stumble into a shutdown as the Republicans will pander their main electorate support base. As such, this article will shed some lights on the potential impact of a government shutdown, on the economy and financial markets, however unlikely.

History

A shutdown wouldn't be unprecedented. According to the United States of House of Representatives, there were at least 20 funding gaps from 1977, with the longest government shutdown running for 34 days. This occurred from 22 December 2018 to 25 January 2019, and was due to President Donald Trump demanding that any spending bills to include funding for a border wall leading to failure of an agreement.

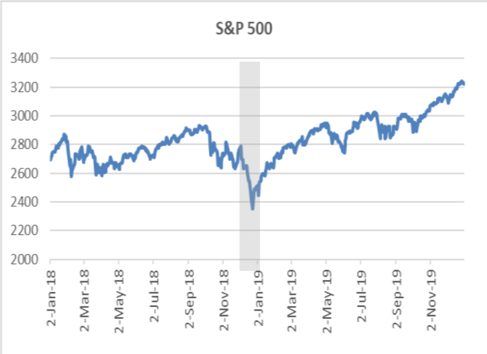
Impact

The impact of a shutdown, if it happens, on monetary policy and financial markets is mostly centred on the dampening effect it has on economic activity and will largely depend on the length of a shutdown. In our opinion and using history as a guide:

1) **Impact on the economy will be two-fold.** Dent in consumer and business sentiment could delay spending. First, it increases uncertainty which makes companies less willing to invest in new plants, equipment and hiring. Secondly, consumers, especially federal workers may postpone spending until they get more clarity about what's going to happen. Thirdly, other disruptions to permitting, licensing, and verifications could lead to delays in lending and trade activity.

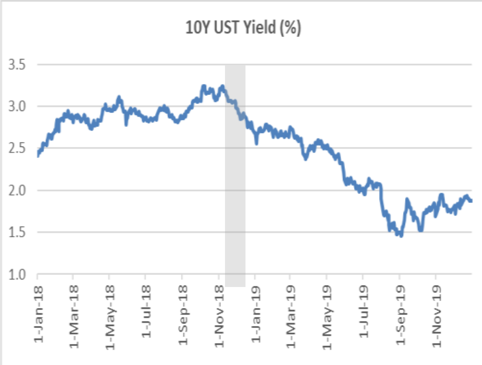
2) The Federal government spending accounts for approximately 7% of GDP calculation but the direct effect on GDP will be smaller given that shutdowns primarily affect discretionary spending (about 27% of total federal spending) and not mandatory spending. In fact, ***during the shutdown in 2018-2019, the Bureau of Economic Analysis (BEA) estimated the shutdown only shaved 0.1ppts of GDP in 4Q of 2018 and 0.3ppts in 1Q of 2019***. In reality, the timing of a shutdown matters for its effect on output. In the absence of any policy changes, the shutdown itself simply delays, as opposed to cancelling, government spending. If a shutdown is brief, then the subsequent catch-up in government spending could occur in the same quarter that spending was delayed.

Figure 1: Equities fell as fear over government shutdown dampened market risk appetite



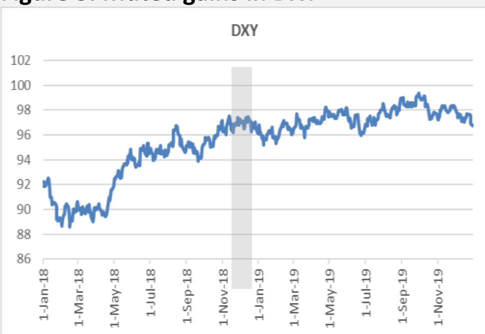
Source: Bloomberg

Figure 2: Risk-off sentiments spurred flight to safety in UST leading to lower yields



Source: Bloomberg

Figure 3: Muted gains in DXY



Source: Bloomberg

3) ***Roughly 340k employees of the federal agencies will be furloughed*** and 460,000 employees will be excepted, that is they were required to work even though they could not be paid until funding was restored.

4) Shutdowns is a waste of federal funds. A 2019 Senate report found that the three ***government shutdowns in 2013, 2018, and 2019 cost taxpayers nearly $4bn.*** Most of the cost was a result of Congress granting back pay to federal employees who did not work during the closure, but some of it came from the financial toll of winding down operations and ramping them up again, as well as extra costs from paying workers to develop contingency plans.

Knee jerk reactions expected

In the financial markets, threats of government shutdown would put a scare in the markets and push investors to safe-haven assets. Key losers will be risky assets like oil and equities. During the 2018-2019 shutdown, the S&P 500 slid 2.7% d/d on 24th December after losing an average of more than 1.0% d/d the week prior to that. Key winners, on the other hand, includes US Treasuries, DXY and gold. The yield on benchmark 10Y UST yield fell 5bps on 24th December 2018, DXY rallied 0.5% two days post shutdown while price of gold which shot up 1.1% d/d on 24th December and were generally on an uptrend subsequent to that.

	1995/96	2013	2018/19
Days of shutdown	21	16	34
S&P 500 (% change)			
D-Day/Day after	-0.2	-0.6	-2.7
1 week after	0.9	-0.9	2.9
10Y UST yields (Change in bps)			
D-Day/Day after	-4	-1	-5
1 week after	-17	Increase less than 1	-7
DXY (% change)			
D-Day/Day after (% change)	-0.1	-0.1	-0.4
1 week after	Fell less than 0.1	-0.4	-0.2
Gold			
D-Day/Day after	-0.1	-0.9	1.1
1 week after	0.1	-1	2.3

https://history.house.gov/Institution/Shutdown/Government-Shutdowns/, BEA, Bloomberg, HLBB Global Markets

Figure 4: Gold prices rallied on haven bids

Source: Bloomberg

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