Americas CIO View

It's time to make a deal: opportunities exist despite deceleration

More days of shutdown ahead, but not weeks: How much damage to GDP?

It is now 33 consecutive days of U.S. federal government shutdown. This is the 21st government shutdown since the first occurred in 1976. But only six shutdowns prior to this one lasted 10 days or more. The prior record-long shutdown was during Bill Clinton's presidency, which was also during the holidays: December 15, 1995 to January 6, 1996. Before the well-known long shutdowns during the Obama and Clinton terms, there were 5 shutdowns during Jimmy Carter's presidency, each between 8 to 18 days. President Carter still holds the record for most shut-government days while in office.

U.S. GDP and S&P resilient in past shutdowns, but this duration poses risk

We looked at how the S&P 500 and U.S. economy performed during past shutdowns. The average price performance of the S&P 500 during prior shutdowns is -0.5%. During shutdowns of 8 days or longer the S&P fell 1.3% on average. But all S&P declines during all of the long shutdowns occurred during the Ford and Carter administrations, when high inflation and other economic maladies of the time were probably more to blame. During all of the long shutdowns since Clinton, the S&P was stable with a small decline in the first days and then a rally toward the end.

The 1995 shutdown is most comparable; economy was vulnerable then, too

U.S. gross-domestic-product (GDP) growth stayed positive during all the long shutdowns. It might be forgotten that the economy was vulnerable during the 21-day 1995-1996 shutdown. At the time, real GDP growth was 2.7% and the manufacturing Institute for Supply Management (ISM) Purchasing Manager Index steadily fell from 59 in late 1994 to 46 in June of 1995 and was 46 before and through the shutdown. The yield curve was flat to slightly inverted during late 1995. The federal funds rate was hiked to a 6.0% plateau in the spring of 1995 and then cut for the first time that summer and again in December. The cycle's longevity was in question in late 1995. Was softening inflation secular or cyclical? Even though the January 1996 jobs report was weak, the shutdown had a minor effect on the economy and quarterly GDP accelerated to 3% in the first quarter (Q1) of 1996. This episode suggests that even a long shutdown has a small economic effect. However, every day this shutdown continues the more likely it weighs on growth than past shutdowns did and the more difficult to recoup lost growth when the government opens. We are now at the point where an urgency to compromise should exist.

David Bianco
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In a nutshell

- More days of shutdown ahead, but not weeks
- U.S. GDP and S&P resilient in past shutdowns, but this duration poses risk
- The 1995 shutdown is most comparable; economy was vulnerable then too
- Every 10 days of shutdown reduces quarterly GDP by roughly 0.1%
- Disorderly Brexit risk still exists, but March 29th earliest definitive moment
- Opportunities found at corporate credit and U.S. & Asia growth stocks

Every 10 days of shutdown reduces quarterly GDP by roughly 0.1%

Views from our economist Josh Feinman on the likely GDP impact from the shutdown.

The direct effect of the shutdown on measured real GDP occurs through the loss of activity and pay for government workers on furlough and those working without pay. Once the shutdown ends, workers will get their back-pay, and if that happens before the end of the first quarter (Q1), then the part of the loss to Q1 real GDP owing to deferred pay will be reversed. Estimates suggest the direct effect on quarterly annualized GDP from government workers is about 0.1% per 10 days. The indirect effects, which are harder to calibrate, are roughly similar to the direct impact on real GDP, but lower in the initial days and will increase the longer the shutdown.

The shutdown will affect the release of economic reports. For starters, retail sales, business inventories, housing starts, PCE prices are not being released during the shutdown, and, we believe, will be delayed once the government reopens. Second, even some data reports that are being released (e.g., the employment report), may be distorted by the shutdown. The government workers who are working without pay will be counted as employed in nonfarm payrolls in the report to be released on February 1, and the U.S. Bureau of Labor Statistics (BLS) just announced that those who are furloughed (about 380,000) will also be counted as employed (even if they do not receive their back-pay by then). Still, there could be some minor indirect effects on employment if private-sector government contractors and others have been laid off by January 12 (the end of the survey reference week). Like workers laid off in the private sector, furloughed government workers can apply for jobless claims (they must repay benefits if they get back-pay), but are not included in the total headline figures released each week (placed in a separate category). The unemployment rate could be boosted by as much as 0.2% if the furloughed workers are captured in the household survey as “unemployed, on temporary layoff,” which technically they are. The BLS will likely provide estimates of all this when the report is released.

Disorderly Brexit risk still exists, but March 29th earliest definitive moment

Because a Brexit deal isn't likely accepted by parliament until the last minute, investors aren't likely to panic until the last minute. It's possible that the deadline is extended.

Opportunities found at corporate credit and U.S. & Asia growth stocks

A U.S. budget compromise should come soon and actions to stop a further U.S.-China trade-conflict escalation now appear more likely by March 1. Despite the growth deceleration in 2019, these agreements should allow for a long-lasting cycle of moderate growth and low interest rates. In such an environment, we favor opportunities in higher yielding corporate credit and growth stocks that can be found in the United States and Asia.

Performance over the past 5 years (12-month periods)

	12/13 - 12/14	12/14 - 12/15	12/15 - 12/16	12/16 - 12/17	12/17 - 12/18
S&P 500	11.4%	-0.7%	9.5%	19.4%	-6.2%

Glossary

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

Federal funds rate

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

ISM Purchasing Managers Index

The ISM Purchasing Manager Index, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.

Personal consumption expenditure (PCE)

The **personal consumption expenditure (PCE)** measure is the component statistic for consumption in gross domestic product collected by the United States Bureau of Economic Analysis (BEA).

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

U.S. Bureau of Labor Statistics

The **U.S. Bureau of Labor Statistics** is part of the U.S. Department of Labor and is responsible for measuring labor-market activity, working conditions and price changes in the economy.

Yield curve

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

Yield-curve inversion

A **yield-curve inversion** is when the yields on bonds with shorter duration are higher than the yields on bonds that have a longer duration.

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