CIO Insights
MEMO

January 10, 2019

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Deepak Puri – CIO and Head of WD Americas, Matt Barry – Investment Strategist Americas

Government Shutdown Enters Day 20

How Did We Get Here?

Partial shutdown continues - Since December 22nd, the federal government has been partially closed, making this shutdown one of the longest in U.S. history. This shutdown is likely to surpass the previous record of 21 days which happened during the 1995-1996 holiday season. Historically, government shutdowns are the result of a political calculus done by one or both parties in which one side will try to make the other side look unreasonable to ultimately shift most of (or all) of the blame in order to get their way. In this case, President Trump has called upon congress to fully fund his border wall which he argues is a necessity for national security. Meanwhile the opposing Democrats have remained united in blocking any funding bill that provides the full $5.7bn requested. At the onset of the shutdown, the President's Republican party held control of both Houses of Congress but the White House still needed some Democratic Senators' support in order to reach the 60 votes necessary for a long-term funding bill. However, with the start of the 116th congress (which began on January 3rd), Congress is now split between the two parties with the Democrats now in control of the House. Talks between the White House and Congress have so far yielded no progress with neither side ready to compromise. President Trump is now debating on whether he should use his presidential authority to reopen the government and fund his boarder wall by declaring a state of emergency. This approach will most likely open a broader debate to the legalities of a president authorizing or directing funds under a National Emergency and would most certainly create more political drama in Washington.

As for the first concern, a series of key deadlines may push the President or the Democrats to a compromise. First off, approximately 800K federal workers will soon miss their first pay check. Next, the shutdown will break the previously mentioned record on January 12th - just before the President is scheduled to travel to Davos for the World Economic Forum. Following Davos, the President will be giving addressing the State of the Union, and as we enter the following month, taxpayers will be uncertain if the IRS will be able to begin processing tax refunds as the standard protocol prohibits this. So far, the implications of a partial government shutdown have been moderate, but this will not be the case if the shutdown continues; with stalled government contracts, continuation in delayed economic data, and the combined income loss of furloughed salaries and delayed tax refunds, we could potentially see downside risks to our current GDP forecasts for the first quarter.

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Market Reaction – Equity Markets Rebound

While the S&P 500 had fallen to the lowest level since July 2017 leading into the shutdown, the equity market has largely looked passed the volatility in Washington thus far. In fact, the S&P 500 is now up +7.1% since the start of the shutdown, which marks the fifth best 11 trading day rally over the last five years and the best since February 2018. With respect to fixed income, while this may not solely be due to the shutdown, there has been a modest flight to safety in the fixed income market as the 10 Year Treasury yield (+2.71%) has declined 8 bps since the start of the shutdown. Gold has also caught a bid, as Gold is now at the highest level ($1291) in over six months.

Outlook – Domestic Strength to Overshadow Washington Volatility

As the United States is now in day 20 of the Government shutdown, it is unclear when/how this current shutdown will end and if it will become the longest shutdown on record. However, the resilience of the market thus far throughout the shutdown is consistent with the prior 20 shutdowns throughout history, as the market has historically looked past these political events as they have had little economic impact. While the current shutdown is longer than this historical average (~7 days on average), past shutdowns have had minimal impact on economic growth as consumer and business spending have remained resilient. However, the longer the shutdown persists, the greater the threat for the political stalemate to stall economic momentum. This is evident as Council of Economic Advisor Chairperson Kevin Hassett estimated that growth could be hampered in the near term if the shutdown were to continue longer. In addition, we will pay particular attention if the shutdown spills over into February, as this is typically when the IRS begins to pay out tax refunds. While the Government has signaled that the IRS will continue to process and pay out refunds during the shutdown, if refunds were delayed, this could pose near term downside risk to our current +2.6% 1Q19 GDP forecast. An additional item to also keep an eye on is that the shutdown could lead to delays in the release of future economic data. Ultimately, despite these risks, we believe that the domestic strength of the U.S. economy (i.e. elevated consumer and business confidence, falling gasoline prices) will outweigh these risks and the continued noise emanating from Washington. We continue to forecast that the U.S. economy will grow 2.4% in 2019 with little risk of recession over the next 12 months.

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With respect to the equity market, while the shutdown will likely continue to drive headlines, the key drivers for equity markets going forward will likely be the progress of trade discussions between the U.S. and China, the trajectory for future Fed policy and the outcome and future guidance provided during the 4Q18 earnings season. However, if the shutdown continues longer term and persists into March, asset classes may come under pressure if the shutdown debate spills over into fears of a failure to raise the debt ceiling. As Fitch warned earlier this week, a debt ceiling argument could spark fears of a potential debt downgrade which could have an impact on interest rates and equity markets. Ultimately, we continue to believe that the underlying strength of the domestic U.S. economy and solid 2019 earnings (albeit slower than 2018) should push the S&P 500 higher to 2,850 by year end 2019.

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Glossary

The U.S. Congress or the United States Congress is the bicameral legislature of the Federal government of the United States.

The Democratic party is one of the two major contemporary political parties in the United States, along with the Republican Party.

The Republican party, also referred to as the GOP, is one of the two major political parties in the United States.

The State of the Union is an annual message presented by the President of the United States to a joint session of the United States Congress.

The IRS or the Internal Revenue Service is the revenue service of the United States federal government. The government agency is a bureau of the Department of the Treasury, and is under the immediate direction of the Commissioner of Internal Revenue, who is appointed to a five-year term by the President of the United States.

The S&P 500 or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

GDP or Gross Domestic Product is a monetary measure of the market value of all the final goods and services produced in a period of time, often annually or quarterly.

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