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US Government shutdown: Deal or no deal in three weeks?

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After five weeks of a US government shutdown, the longest in history, President Trump has called to re-open the government for a span of three weeks. If history is an indicator, economic growth will rebound once the government is opened again, although we are watching for impacts on consumer confidence and small business optimism. More broadly, we see the bitter divide between Democrats and Republicans underscored during this five-week period.

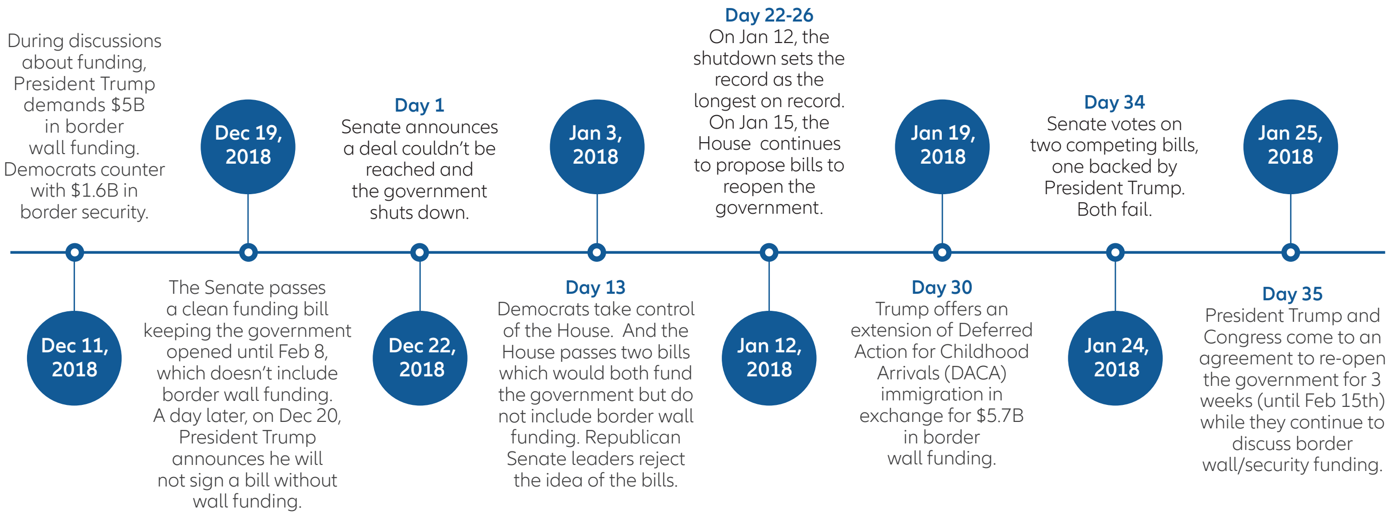
1. S&P returns over the 35-day shutdown period were **+10.3%**, the best performance during a shutdown historically.
2. We will be looking for any lingering negative impact on consumer and business confidence, which may have both economic and market implications.
3. With this political backdrop domestically, we see President Trump perhaps incrementally more inclined to get a "win" in trade, as he can execute this more unilaterally.
4. If the impact on the US consumer is contained during this shutdown, the US economy maintains its expected 2.5% growth rate and earnings grow in the 4-6% range, we continue to see a positive, albeit modest, return environment in 2019.

After the longest US government shutdown in history, President Trump has called to re-open the government for a span of three weeks. At the heart of the matter, President Trump believes in the need for a physical border wall at the US southern border, while Democrats, who support border security, push back on the notion for the need of a physical structure. Notably, in his address to the nation, President Trump seemed to concede that features such as smart walls, enhanced port security and input from border patrol were of importance as well.

With this latest three-week reprieve in place, furloughed employees will now receive back-pay as soon as possible, according to the President, and government agencies should return to full operations. Per our observations from historical shutdowns, the negative economic impact should reverse fairly quickly, although uncertainty will remain elevated over the coming weeks as a final resolution is reached.

On the next page, we explore the impacts and implications of the government shutdown and current funding status.

Exhibit 1: Government shutdown timeline



Impact of a 5-week shutdown

The shutdown began on December 21, 2018 and became the longest shutdown in US history on January 12, 2019, when it surpassed 22 days. About 380,000 non-critical employees of nine major agencies were sent home without pay (of which 50,000 were called back to work without pay). As the shutdown stretched on, many were looking for part-time work to pay bills.

In addition, there were 420,000 critical employees who had been reporting to work without pay, bringing the total count of furloughed employees to 800,000. On January 11, Congress passed a bill to reimburse federal exempt employees for lost wages once the shutdown ends, although contract workers will not be reimbursed.

The impact of the shutdown ranged across government agencies and services, including homeland security, national parks, treasury and transportation sectors **(see Exhibit 2)**.

Historical context

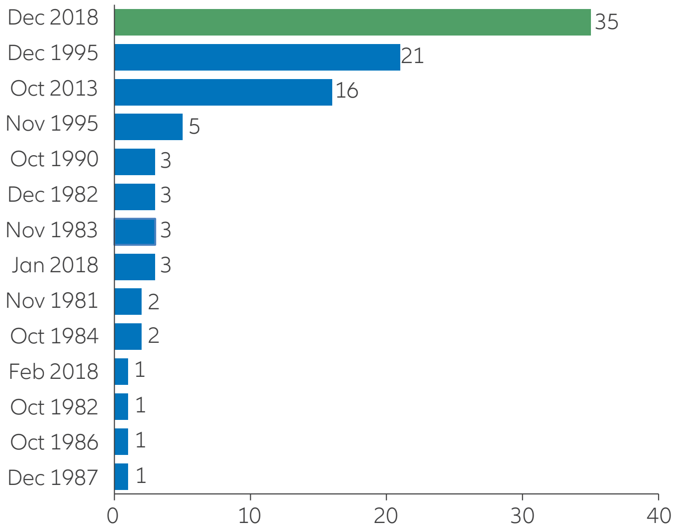
The US federal government has been shut down 14 times since 1980 with an average of 6.8 days, and the previous record was set in 1995 when the shutdown lasted 21 days. Ten out of 14 shutdowns have been for three days or less.

Shutdowns were more frequent before 1995, although they were also shorter in duration. Since then, there have been only five shutdowns: 1995 (which lasted 21 days), 2013 (which lasted 16 days), and three in 2018 with the

Exhibit 2: Furloughed government workers by department

Department	Workers	% Furloughed	Operational impact
Agriculture	95,383	40%	Farmers can't get loans processed; March food stamps could be cut.
Commerce	47,896	87%	Reports from the Bureau of Economic Analysis are delayed.
Homeland Security	232,860	13%	Companies can't verify a worker's immigration status.
Housing and Urban Development	7,497	95%	Rental assistance for the elderly and disabled is delayed.
Interior (NPS)	68,469	78%	National Park Service maintenance has decreased; the department loses $400,000 a day in fees.
Interior (EPA)	13,872	95%	Environmental Protection Agency is largely shutdown; climate research and pollution monitoring are among affected areas.
Justice	114,154	17%	Federal civil cases and immigration court cases are delayed; Federal District Courts may stop hearing civil cases beginning January 25.
State			42 % US workers, 26% US employees posted abroad
Treasury	87,267	83%	Workers are being called back so refunds aren't delayed.
Transportation	54,230	34%	Some security screeners have called in sick; this created delays in some airports.
Other			Many smaller agencies and administrations were shut down, e.g, 95% of NASA employees were furloughed; it took more than a week to repair the Hubble Space Telescope.

Exhibit 3: Total length of historical government shutdowns
Number of days US Government is shut down (since 1980)



Source: Congressional Research Service.

most recent spanning the end of 2018 into the beginning of 2019 (**Exhibit 3**).

Historically, markets have held up well during shutdowns, as most market participants see these events as temporary and with little to no longer-term ramifications. In addition, any decline in economic growth during a shutdown has historically recovered once the shutdown is over (as government employees are paid retroactively and government spending resumes fully, for example).

Notably, despite this being the longest US government shutdown in history, S&P returns over the 35-day period were +10.3%, the best performance during a shutdown historically. Also of note, the average returns in the 6 and 12 months after the end of a shutdown were 11.5% and 14.4%, respectively.

Economic Effect

According to the Congressional Budget Office, the total cost of the shutdown over the 35-day period was $11 billion, including lost productivity, delayed spending and private sector loss of business. However, economic growth does typically rebound once the government is opened again, as employees receive back-pay and government spending fully resumes. Estimates for a permanent loss is thus lower at $3 billion, or about 0.2 percentage points of GDP.

Thus, in our view, while there will be some negative impact from reduced economic activity over the 35-day period, this ultimately may be minimal if the government continues to function beyond February 15. We could see GDP dip slightly below 2.0% in Q1 and, depending on the lag effect of this rebound, we could see some positive spillover into Q2 of this year, with GDP expected to be 2.4%. What we will be watching closely is any lingering negative impact on consumer and business confidence, which may have both economic and market implications.

Beyond the wall

From a political and geopolitical calendar, 2019 is front-end loaded with many key dates and events. We explore below the impact that the ongoing US shutdown and temporary funding status may have on these.

- **The Fed:** The Federal Reserve will begin its 2019 meeting calendar on January 30. Each meeting will now be accompanied by a press conference with Fed Chair Jerome Powell. Notably, investors will be listening for any commentary from the Fed on the impact of the shutdown

Exhibit 4: S&P 500 Index returns during and after historical US government shutdowns

Begin date	End date	Number of days	Return during shutdown	Return 6 months after shutdown	Return 12 months after shutdown	President	Senate	House
11/21/1981	11/22/1981	2	0.0%	-5.6%	10.3%	Reagan (R)	Republican	Democrat
10/1/1982	10/1/1982	1	0.0%	25.4%	36.2%	Reagan (R)	Republican	Democrat
12/18/1982	12/20/1982	3	-0.9%	24.1%	18.9%	Reagan (R)	Republican	Democrat
10/1/1984	10/2/1984	2	-0.6%	10.8%	12.5%	Reagan (R)	Republican	Democrat
10/4/1984	10/4/1984	1	0.0%	9.9%	12.5%	Reagan (R)	Republican	Democrat
10/17/1986	10/17/1986	1	0.0%	20.1%	18.4%	Reagan (R)	Republican	Democrat
12/19/1987	12/19/1987	1	0.0%	8.6%	11.9%	Reagan (R)	Democrat	Democrat
10/6/1990	10/8/1990	3	0.6%	19.7%	21.4%	Bush (R)	Democrat	Democrat
11/14/1995	11/18/1995	5	1.8%	10.9%	22.8%	Clinton (D)	Republican	Republican
12/16/1995	1/5/1996	21	0.1%	8.0%	21.3%	Clinton (D)	Republican	Republican
10/1/2013	10/16/2013	16	1.6%	9.5%	8.2%	Obama (D)	Democrat	Republican
1/20/2018	1/22/2018	3	0.8%	-1.1%	-7.0%	Trump (R)	Republican	Republican
2/8/2018	2/9/2018	1	1.5%	8.9%	0.0%	Trump (R)	Republican	Republican
12/22/2018	1/25/2019	35	10.3%	—	—	Trump (R)	Republican	Rep/Dem(changed control)
Average		6.79	0.4%	11.5%	14.4%			

Source: Allianz Global Investors, Congressional Research Service.

(on both growth and employment), and if they also believe that growth may rebound as the shutdown concludes.

- **China/US trade negotiation:** There is a looming trade deadline of March 1st between the US and China, and despite recent comments from Wilbur Ross on a deal being "miles and miles" apart, the pre-work for a final deal seems to be in motion. This includes a delegation from China visiting the US towards the end of January. Notably, President Trump was able to open the government ahead of this visit, which at least optically, reduces the political uncertainty in the US as the two parties continue negotiations on US soil.
- **A new divided Congress:** Midterm elections last year resulted in a divided Congress, and on January 3rd, the newly elected House and Senate were sworn in. If the divisiveness we have seen over the five-week shutdown is any indication, odds seem incrementally lower for future legislation, such as infrastructure reform or a reduction in drug pricing, particularly as neither party seems keen to give the other a "win" ahead of 2020 presidential elections.

Political fallout and implications

We remain cautiously optimistic in our base case that the US government will remain open after Feb 15th and we will not re-enter a second government shutdown. We believe that if President Trump is not satisfied with committee proposals, he will take unilateral executive action to make amends, including either 1) re-appropriating funding from the Defense budget for funding for a wall or 2) declaring a national emergency to fund the wall. The President's rhetoric thus far all points to a belief that the country is facing a crisis at the border, and thus he may be laying the ground work to declare a national emergency.

More broadly, we see the bitter divide between Democrats and Republicans underscored during this five-week period. As the new Congress was sworn in on January 3rd, there were increased hopes for potential deals around infrastructure and drug-pricing; in our view, these are now incrementally less likely. Both parties continue to seem reluctant to give the other a "win" as the 2020 presidential elections now start to come to the forefront.

With this political backdrop domestically, we do see President Trump perhaps incrementally more inclined to get a "win" in trade, as he can execute this more unilaterally. Although an initial trade deal may be more focused on the trade imbalance, the more complex structural issues of intellectual property rights and technology transfer practices may become part of later ongoing negotiations.

From an investor perspective, the urgency from the President and his administration to keep the US economy afloat and perhaps get a deal done on trade (or at the very least not exacerbate the trade situation further) may provide a positive backdrop for risk assets. If the impact on the US consumer was contained during this shutdown and the US economy maintains its expected 2.5% growth rate, with earnings growing in the 4-6% range, we continue to see a positive, albeit modest, return environment in 2019.

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