

Key Questions on Government Shutdown

Key Takeaways

- A government shutdown, while disruptive, is **not the same as a government default**.
- The scale of the damage will depend in part on **how long the shutdown lasts**.
- In the past, disruption to the economy and markets has been **modest and temporary**, with losses mostly made up in the months after the shutdown ends.

The U.S. government formally entered a shutdown on Wednesday, October 1, as the two parties could not reconcile differences in healthcare subsidies. Sadly, this is not the first time the government has shut down. In this edition, we answer three questions on investors' minds to make sense of what's next.

What Happens During a Shutdown?

During a shutdown, essential services such as the U.S. Postal Service, Medicare, and Social Security will continue to operate. The majority of federal employees continue working during a shutdown because the services they provide are likely to be deemed essential. On the other hand, non-essential services, which employ roughly 40% of all federal employees (750,000), will be furloughed, and services will be impacted according to an estimate from the Congressional Budget Office (CBO). Examples of non-essential services impacted include food assistance, select defense, the Bureau of Labor Statistics, which puts out the monthly job reports, and national parks, etc.

How Does This Affect the Economy?

Shutdowns generally hurt economic growth as furloughed federal workers are less likely to spend money until their paychecks resume. However, the economy eventually recovers any lost growth after the government reopens.

This time, however, the added threats of mass federal layoffs could leave a more lasting mark by making furloughed employees nervous to spend and thus delaying the eventual recovery.

How Do Markets React?

Historically, shutdowns have had a limited impact on stock and bond markets as they are often short-lived, and essential services and companies continue to function. However, if the shutdown goes on for longer, it will leave investors and the Fed "flying blind" when it comes to being able to rely on critical data, including the jobs report, which is due on Friday.

Longer or repeated shutdowns can also reduce confidence and cause investors to flock away from stocks toward safe-haven assets like cash, short-term bonds, gold, as well as allocate away from the U.S. markets as a whole. We saw this during the longest shutdown in history, which lasted 35 days from December 2018 to January 2019, when the stock markets tumbled 13% and bonds rallied.

Summary

A shutdown is not the same as a government default. During a shutdown, the government can't pay select employees, but it can pay bondholders, a critical difference for functioning markets. The scale of the damage will depend on how long the shutdown lasts. In the past, disruption to the economy and markets has been modest and temporary, with losses mostly made up in the months after the shutdown ends.

Even for skeptics who doubt whether the Fed can engineer a soft landing (i.e., avoiding a recession while keeping inflation in check), history shows that stocks have fared reasonably well post-rate cuts in both scenarios.

While the past is no guarantee of the future, lower interest rates have generally been positive for stocks. Of course, the market never moves up in a straight line, and investors should always be prepared for periods of volatility, as the Fed often cuts interest rates at precarious times in the economy.

AssetMark, Inc.

1655 Grant Street
10th Floor
Concord, CA 94520-2445
800-664-5345

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