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

David Bianco
Americas Chief Investment Officer
DWS

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: Dec 15 1995 to Jan 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 Purchasing Manager Index (ISM) 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 Fed Funds rate was hiked to a 6.0% plateau in the spring of 1995 and then cut for 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 minor effect on the economy and quarterly GDP accelerated to 3% in 1Q96. 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.

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

Views from our economist Josh Feinman on the likely GDP impact from 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. If workers get back-pay once the shutdown ends, as has happened in the past, then the 4Q18 GDP loss will be reversed in 1Q19. 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 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. Government workers who are working without pay will be counted as employed in nonfarm payrolls in the report to be released on February 1, but those who are furloughed (about 380k) will not, unless the shutdown ends in time for them to receive their back-pay by January 28. 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 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.

Best opportunities found at corporate credit and US & Asia Growth stocks

A U.S. budget compromise should come soon and actions to stop further US-China trade conflict escalation now appear more likely by March 1st. Despite 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 US and Asia. We maintain above normal equity allocation and raise our high yield corporate credit allocation from 3% to 4% and lower our short duration Treasury allocation to 6% from 7%.

Contributor: Ju Wang, Investment Strategist & Portfolio Analyst

Economist Spotlight: Josh Feinman on U.S. government shutdown

Josh Feinman
Managing Director
Chief Economist

Direct and indirect effects of the shutdown could have a significant impact on real GDP

The direct effect of the shutdown on measured real gross domestic product (GDP) in the United States occurs through the loss of pay for government workers on furlough and those working without pay, as well as the loss of hours worked for workers on furlough. (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 effects on real GDP from these impacts on government workers run on the order of 0.1% per 10 days or so, which means that if the shutdown lasts for the entire quarter it would directly shave nearly 1% off real GDP.

Then, there are the indirect effects (lost output and wages for private-sector government contractors, multiplier effects on other spending, etc.), which are much harder to calibrate, though they surely grow the longer the shutdown lasts. Estimates here range from a low impact on real GDP of roughly the same order as the direct one from the government workers, to as high as more than double that impact. Even using the more conservative (and we think, more realistic) estimates would suggest the shutdown could shave another 0.1% or more off real GDP growth every week or so, and these effects are likely to grow the longer it lasts. So if the shutdown lasts through the quarter, you could get total impacts of 2% or more taken off real GDP – though the uncertainty surrounding this estimate is substantial. Also, at this point, we have little visibility on when the shutdown will end. When it does, much of this lost output is expected to be restored (though perhaps not quite all). All told, at this point, we have refrained from making major changes to GDP estimates for Q1 (still expect growth of about 2%). But this figure will come down if the shutdown lasts longer, and especially if it starts to look like it will last much of the quarter (in which case there will be little time for the losses to be recouped until Q2).

Private-sector data could also be impacted

Finally, the shutdown may impact other data. For starters, some data (e.g., retail sales, business inventories, housing starts, personal consumption expenditure (PCE) prices) are not being released during the shutdown, and will take time to be released once the government reopens, reducing visibility on economic trends. Second, even some data 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, but are not included in the total headline figures released each week (they are in a separate category; also, once they get back-pay, they are required to return their jobless benefits). 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. And we can look to surveys of consumer and business confidence to see what impact the shutdown may be having on sentiment.

Monetary-policy implications

As for U.S. Federal Reserve (Fed) policymakers, the government shutdown, and the added uncertainty it imparts to an already cloudy outlook, reinforces their inclination to hunker down in "wait-and-see" mode.

Contact Information

David Bianco 212 250-8169, david.bianco@dws.com

Ju Wang 212 250-7911, ju.wang@dws.com

Jamie A. Serio 212 454-0554, jamie-a.serio@dws.com

Definitions

The federal funds rate is the interest rate at which banks actively trade balances held at the Federal Reserve.

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

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

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.