LPL RESEARCH

TIMELY TOPICS

KEY TAKEAWAYS

The government reopened following a January 19 shutdown, but the next government funding deadline of February 8 is looming.

Government shutdowns have not historically had long-term impacts on the economy, stocks, or bonds.

We expect further political wrangling in coming months, but we encourage investors to look past these distractions and focus on long-term economic fundamentals when making investment decisions.

February 7 2018

WHAT DO GOVERNMENT SHUTDOWNS MEAN FOR INVESTORS?

John Lynch, *Chief Investment Strategist, LPL Financial*
Shawn Doty, *Senior Analyst, LPL Financial*

Government shutdowns, events that mark the closure of nonessential offices of the U.S. government due to lack of congressionally approved funding, have the potential to increase headline risk and temporarily weigh on investor sentiment. Although these events can be worrisome, we encourage investors to view shutdowns through the prism of history, and consider both long- and short-term impacts. To that end, we look to key financial market indicators such as solid fundamentals supporting growth in economic activity and corporate profits, while appreciating the limited impact that government shutdowns have historically had on the economy and markets.

WHAT'S TO COME?

The term "government shutdown" has undoubtedly become familiar to investors in 2018. Headlines may prove more unnerving than reality, but recent volatility has shown that investors are nervous following the relentless rise of the bull market, and are on the lookout for catalysts that could move markets lower. Politics can affect sentiment and investors must be prepared for this possibility.

While it is rare for a shutdown to occur when a single party controls the White House and both houses of Congress, midterm election years typically witness heightened political hostility. Congress failed to pass a continuing resolution (CR) to extended government funding on January 19, 2018, resulting in the 19th government shutdown since our great democracy celebrated its 200th birthday as a nation in 1976. Three days later, a deal was reached to reopen the government, but funding was only provided through February 8, 2018. The House of Representatives was able to pass a CR that would fund the government through March 23, though the Senate seems set on a different path. There appears to be optimism that the two groups may be able to come together in time for a deal, but there are no guarantees. So now, almost halfway through fiscal year 2018, and after four CRs, we find ourselves confronted with the possibility of yet another government shutdown.

HOW DO SHUTDOWNS IMPACT THE ECONOMY?

Government shutdowns have rarely caused economic dislocations. In fact, there have been 5 recessions over the past 42 years in the United States and a government shutdown has never been the catalyst. The government shutdowns in 1981 and 1990 occurred when the economy was already in recession and the 1982 occurrence took place as the U.S. economy was just emerging from recession.

History has also shown that any near-term economic effects resulting from shutdowns were temporary, and economic readings improved in ensuing quarters as government employees and contractors were paid and economic activity resumed. As shown in [Figure 1], gross domestic product (GDP) has averaged 3.46% in years that experienced a government shutdown since 1976. Recent history shows a similar result, as the three shutdowns prior to January 2018 (1995, 1996, and 2013) witnessed calendar-year annualized real GDP growth of +2.7%, +3.8%, and +1.7%, respectively, which were largely in line with trend during those respective times.

Economic data releases from federal agencies may face delays during shutdowns. Considering that businesses, consumers, and investors tend to make decisions on all available information, the lack of data is universal, and therefore little additional economic or investment risk tends to result. We continue to look for U.S. real GDP growth in the range of +2.75% to +3.00% in 2018 compared to the 2.2% average during the expansion, powered by steady personal consumption and increased business investment.

1 PAST SHUTDOWNS HAVEN'T HAD A LARGE EFFECT ON GDP GROWTH

Year	GDP YoY % Change
1976	5.40%
1977	4.60%
1978	5.60%
1979	3.20%
1981	2.60%
1982	-1.90%
1983	4.60%
1984	7.30%
1986	3.50%
1987	3.50%
1990	1.90%
1995	2.70%
1996	3.80%
2013	1.70%
Average	3.46%

Blue Indicates Recession

Source: LPL Research, Bloomberg 1/26/18

FOCUS ON FUNDAMENTALS

While shutdowns tend to make for good headlines, they are short-term events. We believe the longer-term focus should be on the massive federal spending package. Here are a few key developments to note:

- In late 2017, Congress enacted sweeping tax reform legislation is reported to provide ~$200 billion of tax cuts in 2018, or 1.0% of GDP.
- Congress is also negotiating a major spending package in 2018, which could provide up to $250 billion of new government spending. Initial estimates are reported to include $60 billion in defense spending, $60 billion in non-defense spending, $30 billion in infrastructure spending, and $80 billion in hurricane relief.
- Because major appropriation bills require 60 votes in the Senate, it will be interesting to see which fiscal legislators were in favor of deficit spending in December 2017, but against it in 2018, and vice versa.

U.S. TREASURIES AND THE DOLLAR

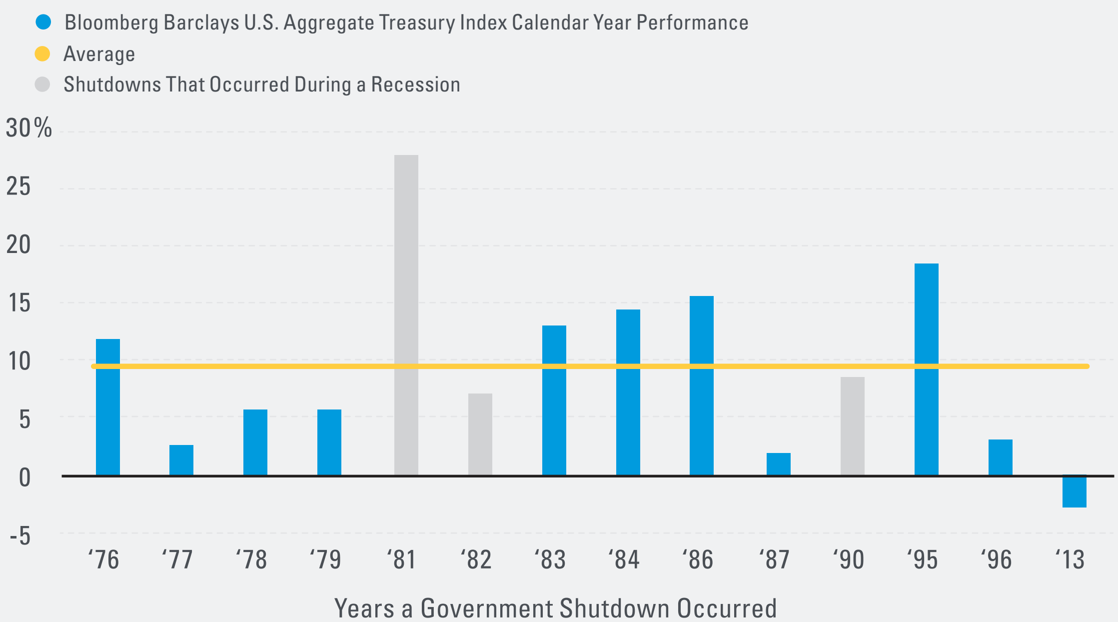
Many factors, including overall economic growth, inflation, and Federal Reserve (Fed) policy impact bond returns. However, history shows that government shutdowns typically haven't had much longer-term impact on the U.S. Treasury market [Figure 2]. In fact, the total calendar-year return for the Bloomberg Barclays Aggregate Treasury Index has averaged 9.5% in shutdown years, though we would note that many of these years happened during the 35-year bull market in bonds, and we wouldn't expect similar performance moving forward.

During periods when investors anticipate some sort of disruption, 10-year Treasury notes tend to rally. However, this didn't happen in the run-up to the January 2018 shutdown, and yields actually moved higher, This has also broadly been the case as we approach the February 8 deadline, outside of a decrease in yields during the February 5 pullback. High-yield and investment-grade bond spreads also widened during the pullback, but remain low relative to history.

A related area of focus during government shutdowns is the U.S. dollar. Despite the uptick in market interest rates, the U.S. dollar continued to weaken as the January 19 shutdown loomed. A similar situation played out through the beginning of February, though since that time the dollar has seen some limited strength. Global investors may need further confirmation on the success of the tax cuts, more clarity on recent dollar comments from

* As noted in our *Outlook 2018: Return of the Business Cycle*, we forecast flat to low-single-digit returns for the Bloomberg Barclays U.S. Aggregate Bond Index, based on our expectations for a gradual pickup in interest rates across the yield curve. We also expect the 10-year Treasury yield to end 2018 in the 2.75 – 3.25% range, based on our expectations for a modest pickup in growth and inflation.

2 **SHUTDOWNS HAVEN'T BEEN A KEY DRIVER OF FULL-YEAR TREASURY PERFORMANCE**



Source: LPL Research, Bloomberg, 01/26/18 administration officials, or a sense of urgency from the new leadership at the Fed to see the dollar move markedly higher.

Our 2018 projections for three interest rate hikes by the Fed, and a year-end range of 2.75% to 3.25% for the 10-year Treasury yield, remain unchanged.* We will continue to monitor how credit markets are reacting to the political environment through credit default swaps and corporate bond spreads (see our recent *Bond Market Perspectives*, "Bond Market Not Stressing About Higher Yields," for more information on these metrics), as well as any currency developments. Recent market turmoil has actually caused the Treasury yield curve to steepen, in line with our view that the flattening trend seen in recent months is primarily the result of global sovereign bond valuations and not an indication of a looming recession.

Investors should keep in mind that government shutdowns, though high in drama, rarely provide lows in economic or financial market activity.

3 SHUTDOWNS HAVE HISTORICALLY BEEN A NON-EVENT FOR STOCKS

Start Date	S&P 500 Return During Shutdown	S&P 500 Total Return 12 Months from Start of Shutdown
09/30/76	-3.4%	-8.3%
09/30/77	-3.2%	6.2%
10/31/77	0.7%	0.9%
11/30/77	-1.2%	0.2%
09/30/78	-2.0%	6.6%
09/30/79	-4.4%	14.8%
11/20/81	-0.1%	12.6%
09/30/82	1.3%	34.8%
12/17/82	0.8%	18.1%
11/10/83	1.3%	1.8%
09/30/84	-2.2%	9.6%
10/03/84	0.1%	13.5%
10/16/86	-0.3%	18.0%
12/18/87	0.0%	10.9%
10/05/90	-2.1%	22.4%
11/13/95	1.3%	23.4%
12/15/95	0.1%	18.2%
09/30/13	3.1%	17.3%
01/19/18	0.8%	
Average	-0.5%	12.3%

Blue Indicates Recession

Source: LPL Research, Bloomberg 1/26/18

ASSESSING IMPACT ON THE STOCK MARKET

The 19 government shutdowns since 1976 have proven to be non-events for the stock market. Indeed, including the most recent event in 2018, the S&P 500 Index has on average lost just -0.5% during periods of closure, and in previous instances has gone on to return an average of 12.3% in the 12 months following the start of the shutdown. [Figure 3].

In a sign that investors may have become desensitized to these events, the S&P 500 saw annual total returns of +37.5%, +22.9%, and +32.4% during the three government shutdowns prior to January 2018 (1995, 1996, and 2013).

However, as the recent pullback highlighted, markets are closely monitoring risks, and if the government is unable to work out a funding deal by the February 8 deadline, another shutdown may provide a catalyst for volatility. Nonetheless, the fundamentals supporting growth in output and profits suggest to us that any shutdown-related market pullbacks may provide buying opportunities for suitable diversified investors.

Considering solid global demand, moderate interest rates and the improved outlook for corporate profits, we continue to view fair value for the S&P 500 in the range of 2,850 to 2,900 in 2018. Though within a handful of percentage points from current levels, we believe a market price-to-earnings (PE) multiple of 19 to 20 times our S&P 500 operating earnings forecast of $147.50 is justified in what is still a low inflation environment. As we obtain further clarity on the impact of tax cuts on corporate profitability in 2018, the risks to these forecasts could prove to be on the upside.

CONCLUSION

Investors should keep in mind that government shutdowns, though high in drama, rarely provide lows in economic or financial market activity. Thanks to strong global growth and the $200 billion in tax relief Congress delivered this year, we suspect the economy is well positioned to see continued strength. However, as the budget deadline looms, investors also need to keep in mind that the debt ceiling is expected to be reached in early March. The best outcome would be for a combined budget and debt ceiling deal, but prolonged uncertainty in this area is a potential threat investors should be watching for.

The government has its work cut out for it in the coming weeks, with defense and non-defense funding, hurricane relief, Deferred Action for Childhood Arrivals (DACA), border security, and the debt ceiling all on the agenda. A comprehensive deal could be a lot to expect, especially during an election year, though recent comments suggest that these items may be debated separately, perhaps increasing the odds that progress will be made. We remain hopeful that our elected officials will reach an agreement to avoid another shutdown after February 8. But even if they don't, we would encourage investors to look past short-term headlines and focus more on the long-term fundamentals that have historically driven markets.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual security. To determine which investments may be appropriate for you, consult your financial advisor prior to investing.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

DEFINITIONS

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, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Bloomberg Barclays U.S. Aggregate Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).