RBC Global Asset Management

U.S. Government Shutdowns: Everything Old is New Again

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Everything old is new again

After the U.S. Congress narrowly avoided a government shutdown in May of this year, we find ourselves again at the threshold of another by the end of September. In May, congresspeople were focused on debt ceiling limits whereas today we see budgetary and spending jurisprudence taking the forefront of debates. Regardless of the recent history here, it may be easy for investors to lose sight of the fact that U.S. governmental shutdowns have become quite commonplace since the 1970s. Indeed, shutdowns are often weaponized by both political parties to enact policies that are important to members of Congress and their revered constituents. In fact, there have been fifteen U.S. government shutdowns since the beginning of 1981. These shutdowns vary in length from a single day to longer than a month. There are myriad unfortunate ramifications resulting from these shutdown periods, from furloughed government employees to the cessation of various normal operating procedures. That said, it is our view that investors in money market and short duration investment strategies heavily weighted toward government-backed securities need not fret amidst the noise emanating from Capitol Hill. **Throughout the history of these shutdowns, the U.S. government has never missed a single coupon or principal payment on outstanding Treasury debt.**

Given that the debt ceiling was successfully increased in May to fund scheduled borrowing to the year 2025, the regular servicing of all scheduled P&I on U.S. Treasury bills, notes, bonds, strips, and TIPs will continue as scheduled. However, to keep paying the bills during shutdown periods government agencies utilize what officials and market participants alike consider to be special "contingency" plans. These contingencies include but are not limited to:

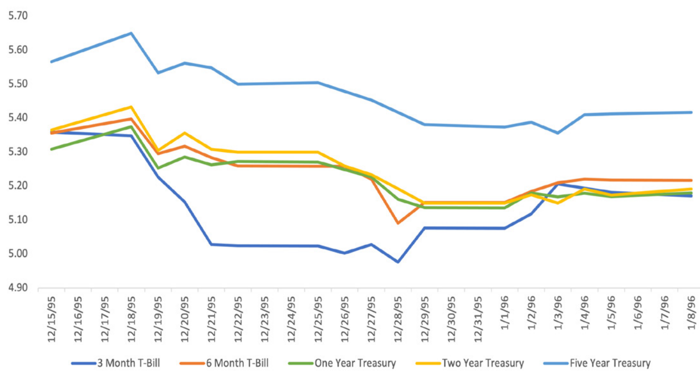
- Congress pre-emptively approves funding for some critical agencies and programs; this occurred in late 2022, these will remain open (think Medicaid and the department of Veterans Affairs)
- "Non-essential" government programs can be halted (early childhood education programs, Environmental Protection Agency activities, Food and Drug Administration inspections, Small Business Administration operations)
- Nearly 900,000 government employees may become subject to furlough
- Those serving in the military may be expected to continue to report for duty while their paychecks have ceased

The fact that there is a clear playbook for officials to utilize during shutdowns, by way of these special contingencies, is a testament to how frequent they have become.

Steady as she goes

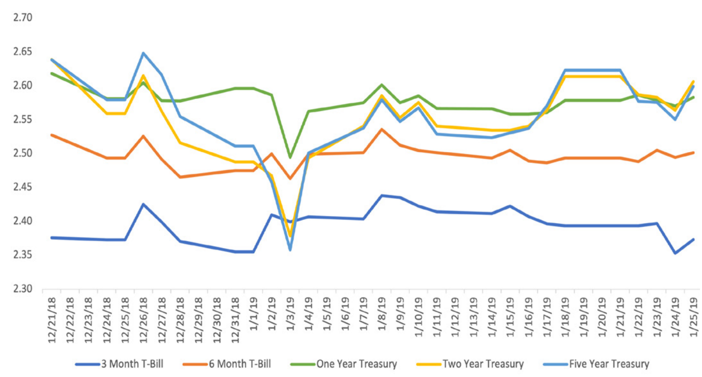
Recent negative ratings actions on the U.S. Government from the Nationally Recognized Statistical Rating Organizations (NRSROs) were anticipatory of the political parties' inability to cooperate with each other regarding budgetary matters in a way that is bifurcated from party-line politics. Although the language and actions from Moody's, S&P, and Fitch are clearly negative – the fact remains that U.S. Treasurys are still highly rated at AA (still AAA at Moody's). This translates to an exceptionally high degree of creditworthiness and ability of the U.S. government to pay its debts as interpreted by the NRSROs. Given these dynamics, one can assume the U.S. government is "money good." With that established, we are posed with a more interesting and nuanced question: how can we expect short U.S. rates to behave if we hit a protracted government shutdown?

Fig. A Second Clinton Shutdown - 12/16/1995 - 1/6/1996



Source: Bloomberg L.P.

Fig. B Third Trump Shutdown - 12/22/2018 - 1/25/2019



Source: Bloomberg L.P.

To this end, it is helpful to decompose how Treasurys performed during previous shutdown periods. Analyzing this data could help serve as a barometer as to how short Treasurys may perform in any potential future shutdown.

Figures A and B portray the changes in yields on short duration Treasury bills and notes during recent shutdowns that lasted longer than a few days. We chose a shutdown period during a Democrat's presidential term in office (Clinton) and a Republican's (Trump) to obtain a fair look at shutdowns elicited by both major political parties. In both scenarios, short Treasurys rallied (prices increased, yields decreased) shortly after the onset of the shutdown. After a bit of a trading range, yields settled back into a level either lower or similar to where the shutdown started by the time the government resumed normal operations. All of this is likely due to a "risk-off" sentiment taking hold during these shutdowns as market participants digested the noise coming from Capitol Hill. Investors flocked to assets such as shorter Treasurys in size, increasing their prices. This also bodes well for strategies with lower interest rate risk (shorter duration) as opposed to strategies that have longer duration during these periods. Additionally, credit spreads on the Bloomberg Barclays US Corporate Bond index (LUACTRUU) exhibited a bit of choppiness through these periods of time and ended both shutdown phases a bit wider than where they began. This further implies a dynamic at-hand where market participants favored short U.S. Treasurys during shutdown periods versus risk assets.

Where is Gerry? Mandering.

Importantly, we continue to expect the primary mark-to-market fluctuations of U.S. Treasury securities to be driven by changes in inflation expectations and other macro considerations. All of this will transpire independent of any government shutdown; protracted or otherwise. With that said, the data here does suggest that Treasurys trade firmly through shutdown periods, all-else equal.

Elected officials will continue to utilize a no-holds-barred approach toward forwarding political agendas and bolstering their reputations with their respective constituents. This includes pushing the U.S. government toward a potential shutdown. One could expect elected officials to buy time, negotiate, argue, and gerrymander for as long as human beings populate our branches of government. With that said, it is clear the government and its various agencies have a well-defined and time-tested playbook at-hand to navigate these periods of uncertainty. We believe this playbook will continue to ensure the orderly behavior, liquidity and even potentially performance of the broader Treasury market.

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