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ON WASHINGTON

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The Washington Update

# The Federal Government Shuts Down: Now What Happens?

Washington insanity reached new heights yesterday as Congress failed to agree on an appropriations bill to keep the federal government running, even though it had known about the September 30 deadline for over six months. This inaction brings Washington dysfunction to a new high (or low). Up until now, Congress had arrived at each fiscal precipice and averted catastrophe with a compromise. Now, finally, Congress has gone over the edge.

How did we get to this point? Initially, the House Republican leadership sought to introduce a "clean" bill that would fund the government for another few months. But the conservative (tea party) wing of the Republican Party demanded that the appropriations bill remove funding for Obamacare, the President's signature health care reform law. That condition (as the Republicans well knew) was unacceptable to the Democratic-led Senate and the President. The Senate, as it said it would do, stripped out the Obamacare defunding provision and sent the bill back to the House. The House thereupon inserted new conditions—including the deferral of Obamacare implementation for a year—and sent the bill back to the Senate. Once again, the Senate made clear that any changes to Obamacare were unacceptable and the government shut down.

A few thoughts before we discuss what happens next:

- The Republicans seem to be fighting the last war. Obamacare was passed by Congress, signed by the President and upheld by the Supreme Court. Obama was re-elected to a second term. The Republicans have long said they will use "forcing events" such as funding the government to get the President to accept deficit-reducing spending cuts. But the House bills proposed no meaningful spending cuts, just further attacks on Obamacare, which the President and the Democrats simply will not accept at this point. The futility of the Republican action is demonstrated by a bizarre coincidence. The very day the government shut down, Obamacare's health care exchanges (marketplaces) went live, the most visible first step to the law becoming effective in January.

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- Defunding Obamacare is largely illusory anyway. The great bulk of funding—premium subsidies for lower- and middle-income people purchasing health insurance—is already funded under the law and cannot be stopped without a full legislative repeal. The funding now in play is only for administration, and agencies can move money around to meet implementation needs in any event.

- The Republican actions arguably hurt only their own cause. Segments of the country might remain skeptical of Obamacare, but polls show that large swaths of the electorate are unhappy with a government shutdown and more people blame the Republicans. The last government shut down, between November 1995 and January 1996, resulted from disagreements between newly elected Speaker Newt Gingrich and President Bill Clinton. Most observers believe Congressional Republicans bore the brunt of the blame then, helping Clinton secure election to a second term later that year. Republican actions now similarly might complicate the party's efforts to take over the Senate next fall, while retaining the House majority.

- Both parties seem largely leaderless at this point. Speaker Boehner realized that a clean extension of funding was in the best interest of his party (not to mention the country), but was unable to get the Republican rank and file to follow his lead. At almost the same time, the President asked Congress to authorize military action in Syria and approve Larry Summers as Fed chairman, and the *Democrat* rank and file refused to follow his lead. This lack of leadership will make future negotiations more difficult.

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The most concerning aspect of the situation is the lack of an end-game strategy. Arguments over spending cuts and tax increases can be compromised, but threats to derail Obamacare are non-starters with the Democrats. It is difficult to see how a compromise can develop without the Republicans (or the Democrats) backing off their fundamental position.

And next up is the debt limit. Treasury officials now estimate the United States will need to borrow additional money by mid-October. But the government cannot borrow more unless Congress increases the total debt the nation is allowed to issue. Failure to increase the debt limit will render the United States unable to pay interest on the debt already outstanding, resulting in a default.

There is a thin silver lining in the current situation. At least the Republicans drew their line in the sand over a shutdown—which has bearable, albeit negative, economic effects—rather than over a debt default. A compromise on the latter is likely if the Republicans shift their focus from Obamacare to their more typical demand of spending cuts, demands that succeeded the last time the debt limit was negotiated in August 2011. The President has said he will not negotiate over the debt limit. But if negotiations are couched as addressing the dual needs to reopen the government and raise the debt limit, a compromise is foreseeable. I continue to believe the United States will not default on its debt.

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Since early this year, I have been predicting volatile markets in the fall as the country approaches the twin deadlines of funding the government and raising the debt ceiling. That time is now upon us. Because I believe the United States will not default on its debt, any downturn based on Washington dysfunction should be temporary, reversing when a compromise is reached. This is not to suggest that investors should sell equities in anticipation of a downturn, because they will not know when a compromise is imminent so they should buy back in. But market volatility due to a perception of Washington dysfunction may be a buying opportunity.

# Portfolio managers offer perspective on the U.S. government shutdown and the looming debt ceiling debate

**Richard Bernstein**
Founder, CEO, Chief Investment Officer,
Portfolio Manager
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- Up to this point, the looming government shutdown has been strictly a political—and not yet an economic—issue. Hopefully, it will stay that way and the matter will be resolved quickly.
- Now that a government shutdown has occurred, it is likely to become more of an economic issue (in terms of its potential impact on headline U.S. GDP growth) the longer it lasts.
- The upcoming debt limit debate is another story. If lawmakers fail to increase the debt limit by the October deadline and the U.S. defaults on its obligations, it could create significant volatility in the global financial markets.
- As we have said many times, politicians crave the spotlight. It is unfortunate that investors watch the show. We believe investors should keep their eyes on economic and market fundamentals, not on Washington. (Of course, this statement assumes that government statistics offices won't be closed.)

**Eric Stein, CFA**
Vice President, Co-Director,
Portfolio Manager
Global Income Group

- We view the government shutdown as more of a sideshow than something very meaningful. This shutdown will probably not have long-term consequences.
- Assuming this will be resolved quickly, we expect any market impact to be limited. It's our belief that markets are becoming more immune to Washington's dysfunction.
- From a philosophical perspective, less government spending doesn't necessarily mean the economy is worse off, but this presents yet another headwind to headline GDP growth in the U.S.
- Unfortunately, it is likely that we will continue to see this never-ending noise coming out of Washington with the U.S. set to reach its debt limit in October.
- The bigger risk, in our view, is that Washington proves to be so dysfunctional that it cannot take on longer-term structural challenges.

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Andrew H. Friedman is the Principal of The Washington Update LLC and a former senior partner in a Washington, D.C. law firm. He speaks regularly on legislative and regulatory developments and trends affecting investment, insurance and retirement products. He may be reached at www.thewashingtonupdate.com.