Rabobank

Shutdown

US special

RaboResearch
Global Economics & Markets
mr.rabobank.com

Philip Marey
Senior US Strategist
+31 6 13 89 29 58

Contents

Summary

- If Congress does not pass a continuing resolution by September 30, there will a government shutdown on October 1. Since the Senate and the House of Representatives are sticking to their own continuing resolutions, which are difficult to reconcile, it looks like we are heading for a government shutdown on Sunday.
- This shutdown should be attributed to an internal Republican conflict, rather than a conflict between Democrats and Republicans. In particular, the House Freedom Caucus is at odds with the rest of the Republican Party.
- A government shutdown is likely to have a negative impact on economic growth and longer-term rates, delay the publication of key economic data and therefore complicate the Fed's decision making, and would further undermine the financial reputation of the US.

Introduction

It's that time of the year again. With the end of the current fiscal year (FY2023) in sight, Congress has to provide legislation on funding the federal government for the next fiscal year (FY2024). However, because the House of Representatives failed to agree on the 12 necessary appropriations bills before October 1, Congress needs a stopgap measure (a continuing resolution) to keep the government funded through overtime. If no agreement is reached on a stopgap measure, the government will be forced to shut down, at least partially, at the start of the new fiscal year, on October 1.

When the US debt limit was raised in early June, it was assumed that a government shutdown later this year was averted as well. After all, the debt limit deal included sequestration in the form of a 1% cut in spending if all appropriations bills for fiscal year 2024 (which starts on October 1, 2023) are not passed by the end of this calendar year. This would surely encourage both parties to compromise on the necessary spending bills before December 31. However, the design flaw was that we still need a continuing resolution to keep the government funded from October 1 until the end of the year or at least until agreement is reached on the budget for FY2024. Given the constructive bipartisan deal in June, a continuing resolution was supposed to be a stopgap measure that both parties would agree on.

However, the House Freedom Caucus decided they want something in return for a continuing resolution and this could be difficult to swallow for the Democrats. On September 17, the Freedom Caucus and the more moderate Main Street Caucus came up with their own short term proposal, which would extend government funding until October 31. However, this proposal would cut discretionary spending levels by about 8% for most government programs, except defense and veterans programs. This would certainly be rejected in the Democrat-controlled Senate and thus cause a stalemate that could ultimately lead to a government shutdown on October 1. In fact, even in the House of Representatives there was not enough support for the proposal. Now House Speaker McCarthy is making a last week attempt to get a continuing resolution.

Table 1: Balance of power in Congress

	Democrats	*Republicans*	*TOTAL*
Senate	51*	49	100
House of Representatives	212	221	433**

Source: senate.gov, house.gov

*) incl. 3 independents **) 2 vacancies

House Freedom Caucus conditions

The Senate has already passed all 12 of the required appropriations bills on a bipartisan basis. In contrast, the House has passed only one. Therefore, Senate Majority Leader Chuck Schumer (Dem) and House Speaker Kevin McCarthy (Rep) wanted to adopt a **continuing resolution (CR)**, which would extend current funding levels for a few months, to buy time for the House to pass the remaining appropriations bills.

However, the House Freedom Caucus did not want a 'clean' CR, instead they wanted to attach three provisions: a House-passed border security bill, address politicization of the Justice Department, and social policies in the military.

On September 17, two large groups of House Republicans, the hard-right **Freedom Caucus** and the more-centrist **Main Street Caucus**, came up with their own **CR proposal**, which would extend government funding until October 31. However, this proposal cuts discretionary spending levels by about 8% for most government programs, including agriculture, labor, environment and homeland security. The cuts would not apply to defense or the Department of Veteran Affairs. However, the proposal does not contain additional aid for Ukraine, as requested by the White House ($24 billion). The proposal does include parts of the border security act that passed the House in May, which would increase spending on personnel and equipment, make it harder to seek asylum and resume construction of the southern border wall.

Essentially, the Freedom Caucus has a lack of trust in McCarthy's willingness to put appropriations bills on the floor that cut spending. The only appropriations bill that passed the House, on veterans and military construction, had no spending cuts. The defense appropriations bill shot down on September 21 also did not include cuts. Therefore, they are using the need for a stopgap measure to get some concessions. However, the September 17 proposal did not seem to have enough support in the House of Representatives either.

Meanwhile, McCarthy was still trying to get a **defense appropriations bill** through the House. However, on September 21 Republican hardliners blocked a vote to advance this bill. The 212-216 vote on the rule to open the debate on the defense bill showed how divided Republicans are at the moment, as they usually like to spend money on the military. After the shock vote, McCarthy sent the House home for the weekend, scheduling no additional votes on Thursday or Friday.

Last week attempt

In response to the September 21 debacle, McCarthy has proposed 4 appropriations bills that include spending cuts to convince the Freedom Caucus to also approve a continuing resolution. To persuade the hardliners, **McCarthy's CR proposal** extends government funding on the condition of strict border security measures and excluding any new support for Ukraine. The stopgap measure would cut spending to a $1.471 trillion annual rate. The exact time period of the extension is still under discussion, but could range from 2 weeks to 2 months.

Any CR would give the House more time to debate the **four appropriations bills**, containing full-year funding for defense, Homeland Security, the State Department and agriculture. So far the House only passed one appropriations bill, funding the Department of Veterans Affairs and military construction, without spending cuts. The Senate has already passed the 12 appropriations bills.

Meanwhile, the Senate was forced by the lack of similar progress in the House of Representatives to adopt its own stopgap measure. The **Senate bipartisan CR proposal**, supported by Senate Majority Leader Chuck Schumer (Dem) and Senate Minority Leader Mitch McConnell (Rep), extends government funding at FY2023's more than $1.6 trillion annual pace through November 17, while also providing $6 billion for Ukraine and $6 billion for disaster relief. The Senate proposal does not contain any border measures, but these could still be included through amendments that are being prepared by senators Sinema (Independent, but caucusing with the Democrats), Collins (Rep) and Tills (Rep).

The current Senate proposal has been rejected by House Majority Leader Steve Scalise (Rep) because it does not contain border provisions. House Speaker Kevin McCarthy (Rep) said the Senate proposal is "picking Ukraine over Americans." If McCarthy puts the Senate stopgap bill on the House floor, his speakership will likely be challenged by the Freedom Caucus. In fact, under this year's new rules, it only takes one Representative (and that will probably be Matt Gaetz) to file a motion to remove McCarthy from his speakership. Therefore, McCarthy is going ahead with his own stopgap proposal with strict border security measures and excluding any new support for Ukraine. However, with only a small (221-112) Republican majority in the House, the Republican CR bill could easily be derailed, as could the four appropriations bills. The House vote on McCarthy's CR is expected on Friday. If it fails, or if it passes and the Senate does not pass a CR with similar conditions, the government will shut down on Sunday. Since the Democrat-controlled Senate is not likely to accept the conditions attached to the CR by the House Republicans, a government shutdown seems difficult to avoid.

Table 2: US credit ratings

Agency	*Current US rating*	*Highest rating*
S&P	AA+	AAA
Moody's	Aaa	Aaa
Fitch	AA+	AAA

Source: Bloomberg

Impact on economy and markets

During a shutdown, each government agency has its own contingency plan about which employees are essential and the extent to which operations will continue. Many employees will be sent home without pay, while the military will continue to work, but without pay. The issuance of permits will be delayed, slowing down infrastructure projects and clinical trials in medical research. Air travel and trash collection will be disrupted. Environmental and food safety inspections would be limited, causing increased risk to the public health. With federal government spending at almost 7% of US GDP, a shutdown will slow down **GDP growth**. Federal workers sent home would see a delay in their salaries, but federal contractors are not guaranteed back pay for missed work. Not all damage to GDP will be recovered after the shutdown ends. What's more, a shutdown would come at a vulnerable stage of the US economy. It would add to the cracks in the economic expansion that is visible in the PMIs and consumer confidence. A government shutdown would further undermine consumer confidence, which is already weakened by a softening of the labor market, high gasoline prices, the restart of student loan repayments on October 1, depleted pandemic savings and high interest rates. Therefore, a shutdown could lead to a significant deterioration in the US economy. Note that we still expect a recession in 2023Q4-2024Q1.

The impact on the **financial reputation** of the US may even be longer lasting. Keep in mind that on August 1, Fitch downgraded US sovereign debt, to AA+ from AAA. According to Fitch "the rating downgrade of the United States reflects the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to AA and AAA rated peers over the last two decades." Another government shutdown would not help improve the perception of US governance, even if the aim of the Freedom Caucus is to cut spending. It would only strengthen the perception of political dysfunction and the inability of Congress to get its financial house in order. As we said in Random Downgrade, "this leaves Moody's as the only major ratings agency assigning the highest rating (Aaa) to US sovereign debt. This could increase the pressure on Moody's to follow the other two, but it may prefer a good reason and wait for a specific incident, similar to S&P in 2011. There is still the possibility of a government shutdown in October, so that could be an event for Moody's to watch with special interest."

The government shutdown could also affect the **release of economic data** by government agencies. For example, in the first week of October, the PMIs and ADP employment growth are published by private organizations, but jobless claims and the official Employment Report (nonfarm payrolls, unemployment) are published by the government. With its poor track record, we would not like to rely on ADP for a recent snapshot of the labor market. While not all government agencies will shut down in the first week of October, table 1 gives a list of the economic releases that could be at risk of delayed publication and those that are not published by the government. If the shutdown lasts long enough, even the collection of data could be impeded.

Table 3: Key economic data in first week of October at risk or not

Date	*Government (= at risk)*	*Private (= not at risk)*
Oct 2		S&P Global US manufacturing PMI (Sep F) ISM manufacturing (Sep)
Oct 3	JOLTS (Aug)	
Oct 4	Durable goods (Aug F)	ADP employment (Sep) S&P Global US services PMI (Sep F) ISM services (Sep)
Oct 5	Initial jobless claims (Sep 30) Trade balance (Aug)	
Oct 6	Employment Report: nonfarm payrolls, unemployment, average hourly earnings (Sep)	

Source: Bloomberg, Rabobank

With the next **FOMC** meeting on October 31-November 1, a four week shutdown could leave the FOMC without recent data. This would make a rate hike difficult to explain. Therefore the FOMC may prefer to wait until December before taking an informed decision on rates, if the shutdown lasts long enough to halt the release of crucial economic data.

A government shutdown is expected to slow down GDP growth, but should have limited impact on financial markets compared to a government default. In **financial markets**, government shutdowns tend to be a accompanied by lower longer-term interest rates. This could be attributed to weaker GDP growth and increased risk perception. However, whether we are really going to see lower rates this time obviously also depends on other factors driving rates.

Conclusion

From a game-theoretical perspective, the fact that the impact of a government shutdown is less severe than the impact of a government default, makes a shutdown more likely than a default. History has confirmed this proposition empirically. What's more, the Freedom Caucus has the leverage within the House of Representatives and the apparent willingness to play hardball. Consequently, there is a high probability of a government shutdown this weekend, which would last until a bipartisan continuing resolution is adopted. Meanwhile, House Speaker McCarthy is trying to appease the House Freedom Caucus and find the optimal point at which he can switch to a bipartisan solution without being removed from his speakership. The more time it will take him to convince the hardliners that he has done everything in his power, the longer this government shutdown will last.

RaboResearch
Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts
+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Global

Michael Every
Senior Macro Strategist
Michael.Every@Rabobank.com

Europe

Elwin de Groot
Head Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Bas van Geffen
Senior Macro Strategist
ECB, Eurozone
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Stefan Koopman
Senior Macro Strategist
UK, Eurozone
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Erik-Jan van Harn
Macro Strategist
Germany, France
+31 6 300 20 936
Erik-Jan.van.Harn@Rabobank.nl

Maartje Wijffelaars
Senior Economist
Italy, Spain, Portugal, Greece
+31 88 721 8329
Maartje.Wijffelaars@Rabobank.nl

Americas

Philip Marey
Senior Macro Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Christian Lawrence
Senior Cross-Asset Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Une
Senior Macro Strategist
Brazil, Chile, Peru
+55 11 5503 7347
Mauricio.Une@Rabobank.com

Renan Alves
Macro Strategist
Brazil
+55 11 5503 7288
Renan.Alves@Rabobank.com

Molly Schwartz
Cross-Asset Strategist
+1 516 640 7372
Molly.Schwartz@Rabobank.com

Asia, Australia & New Zealand

Teeuwe Mevissen
Senior Macro Strategist
China
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Benjamin Picton
Senior Macro Strategist
Australia, New Zealand
+61 2 8115 3123
Benjamin.Picton@Rabobank.com

FX Strategy

Jane Foley
Head FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Rates Strategy

Richard McGuire
Head Rates Strategy
+44 20 7664 9730
Richard.McGuire@Rabobank.com

Lyn Graham-Taylor
Senior Rates Strategist
+44 20 7664 9732
Lyn.Graham-Taylor@Rabobank.com

Credit Strategy & Regulation

Matt Cairns
Head Credit Strategy & Regulation
Covered Bonds, SSAs
+44 20 7664 9502
Matt.Cairns@Rabobank.com

Bas van Zanden
Senior Analyst
Pension funds, Regulation
+31 30 712 1869
Bas.van.Zanden@Rabobank.com

Paul van der Westhuizen
Senior Analyst
Financials
+31 88 721 7374
Paul.van.der.Westhuizen@Rabobank.com

Cas Bonsema
Senior Analyst
ABS, Covered Bonds
+31 6 127 66 642
Cas.Bonsema@Rabobank.com

Agri Commodity Markets

Carlos Mera
Head of ACMR
+44 20 7664 9512
Carlos.Mera@Rabobank.com

Michael Magdovitz
Senior Commodity Analyst
+44 20 7664 9969
Michael.Magdovitz@Rabobank.com

Paul Joules
Commodity Analyst
+44 20 7887 824436
Paul.Joules@Rabobank.com

Energy Markets

Joe DeLaura
Senior Energy Strategist
+1 212 916 7874
Joe.DeLaura@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Europe	+31 30 216 9045	Hans.Deusing@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
Adam Vanderstelt	Australia, New Zealand	+61 2 8115 3102	Adam.Vanderstelt@rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Short-term Interest Rates

Marcel de Bever	Global Head	+31 30 216 9740	Marcel.de.Bever@Rabobank.com

Bonds & Interest Rate Derivatives

Henk Rozendaal	Global Head Fixed Income	+31 30 216 9423	Henk.Rozendaal@Rabobank.com

Solutions

Sjoerd van Peer	Global Head	+31 30 216 9072	Sjoerd.van.Peer@Rabobank.com

Relationship Management

Rogier Everwijn	Global Head	+31 30 712 2440	Rogier.Everwijn@Rabobank.com
Rob Eilering	Banks	+31 30 712 2162	Rob.Eilering@Rabobank.com
Petra Schuchard	Insurers		Petra.Schuchard@Rabobank.com
Frank Dekkers	Asset Managers		Frank.Dekkers@Rabobank.com
Javier Alvarez de Eerens	MDB	+31 30 712 1015	Javier.Alvarez@Rabobank.com
Christel Kleinhaarhuis	Fintech		Christel.Klein.Haarhuis@Rabobank.com

Capital Markets

Laura Bijl	Global Head	+31 88 726 3254	Laura.Bijl@Rabobank.com
Christopher Hartofilis	Capital Markets USA	+1 212 808 6890	Christopher.Hartofilis@Rabobank.com
Ian Baggott	Capital Markets Asia	+852 2103 2629	Ian.Baggott@Rabobank.com
Willem Kröner	Global Head ECM	+31 30 712 4783	Willem.Kroner@Rabobank.com
Harman Dhami	DCM Syndicate	+44 20 7664 9738	Harman.Dhami@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

Disclaimer

Non Independent Research

This document is issued by Coöperatieve Rabobank U.A. incorporated in the Netherlands, trading as "Rabobank" ("Rabobank") a cooperative with excluded liability. The liability of its members is limited. Authorised by De Nederlandsche Bank in the Netherlands and regulated by the Authoriteit Financiële Markten. Rabobank London Branch (RL) is authorised by De Nederlandsche Bank, the Netherlands and the Prudential Regulation Authority, and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Further details are available on request. RL is registered in England and Wales under Company no. FC 11780 and under Branch No. BR002630. This document is directed exclusively to Eligible Counterparties and Professional Clients. It is not directed at Retail Clients.

This document does not purport to be impartial research and has not been prepared in accordance with legal requirements designed to promote the independence of Investment Research and is not subject to any prohibition on dealing ahead of the dissemination of Investment Research. This document does NOT purport to be an impartial assessment of the value or prospects of its subject matter and it must not be relied upon by any recipient as an impartial assessment of the value or prospects of its subject matter. No reliance may be placed by a recipient on any representations or statements made outside this document (oral or written) by any person which state or imply (or may be reasonably viewed as stating or implying) any such impartiality.

This document is for information purposes only and is not, and should not be construed as, an offer or a commitment by RL or any of its affiliates to enter into a transaction. This document does not constitute investment advice and nor is any information provided intended to offer sufficient information such that is should be relied upon for the purposes of making a decision in relation to whether to acquire any financial products. The information and opinions contained in this document have been compiled or arrived at from sources believed to be reliable, but no representation or warranty, express or implied, is made as to their accuracy, completeness or correctness.

The information contained in this document is not to be relied upon by the recipient as authoritative or taken in substitution for the exercise of judgement by any recipient. Any opinions, forecasts or estimates herein constitute a judgement of RL as at the date of this document, and there can be no assurance that future results or events will be consistent with any such opinions, forecasts or estimates. All opinions expressed in this document are subject to change without notice.

To the extent permitted by law, neither RL, nor other legal entities in the group to which it belongs accept any liability whatsoever for any direct or consequential loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

Insofar as permitted by applicable laws and regulations, RL or other legal entities in the group to which it belongs, their directors, officers and/or employees may have had or have a long or short position or act as a market maker and may have traded or acted as principal in the securities described within this document (or related investments) or may otherwise have conflicting interests. This may include hedging transactions carried out by RL or other legal entities in the group, and such hedging transactions may affect the value and/or liquidity of the securities described in this document. Further it may have or have had a relationship with or may provide or have provided corporate finance or other services to companies whose securities (or related investments) are described in this document. Further, internal and external publications may have been issued prior to this publication where strategies may conflict according to market conditions at the time of each publication.

A summary of the methodology can be found on our website