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Shutdown? Default? Consequences?

It's possible that you've heard a news report or two about the government shutdown that started October 1, and now a dispute over raising the U.S. debt ceiling and possibly defaulting on the government's debt obligations as soon as October 17. The question for an increasingly nervous investing public is: how will this affect the U.S. economy and (not to be too selfish here) my retirement portfolio?

Interestingly, it is starting to look like the government shutdown, if it runs for weeks instead of months, might have almost no effect on the economy at all. Why? The economic impact that had economists worried was the loss of income suffered by tens of thousands of federal employees. But the Defense Department has continued paying all of its civilian personnel, simply by declaring all of them "essential employees." Not only were the leaders of the House of Representatives not inclined to argue; they have quietly passed legislation that would give back-pay to all federal workers who have been furloughed, just as soon as the stalemate ends. The Senate and the President are likely to go along, giving the country the worst of all worlds: paying most government employees for staying home and not providing a wide variety of services to the public.

Ironically, the way the politics are working, one can almost guarantee that there will be some kind of a stock market selloff before the shutdown ends. For the Republican leaders in the House, there is little cost to holding their ground so long as there is not a public outcry and loss of voter confidence. One of the sources of that pain would be a big drop on Wall Street. Indeed, if you listen closely to the speeches by President Obama and the Democratic leadership, you hear dire warnings of a market drop as a result of the shutdown--which is their way of focusing the public's attention on who to blame when it happens.

What is interesting about that is that the markets often deliver corrections after long, accelerating uptrends like what we have experienced in the U.S. since March of 2009, and with the 20+% returns that Wall Street has delivered so far this year. It wouldn't have surprised anyone to see some kind of a quick downturn this Fall regardless of whether the government was operating at full capacity or at a standstill. A week of small leaks in stock prices could lead to something larger as some investors realize they may be sitting on nice gains and have no idea what Congress will or won't do next. The last time the government was shut down, stocks dropped 20%, the Republican leadership realized it wasn't winning any popularity contests and the stalemate ended. We've seen this script before. (The other part of this script, of course, is that once the stalemate ends, stocks tend to bounce back, and I don't recommend that anyone try to time this scenario.)

A more consequential issue is the debt ceiling. Congress must raise the total amount that the U.S. government can borrow (by selling Treasury bonds) to pay its various obligations, including, of course, interest on its current Treasury bonds. Contrary to popular belief, raising the debt ceiling does not increase the federal debt; that debt exists whether or not Congress authorizes additional borrowing.

Failure to authorize the government to pay its legal obligations would create a self-induced fiscal crisis--ironic for a country whose representatives claim that they never want to become another Greece, and then talk about voluntarily defaulting on the nation's debt obligations, which even Greece has avoided.

One recent article suggested that a default on Treasuries would ripple through the global economy, among other things, causing anxious investors to demand higher interest rates and dramatically raising U.S. borrowing costs. That, in turn, would raise rates on mortgages, credit cards and student loans, pushing the U.S. toward or into another recession and putting more pressure on the stock market. One report suggests that if the U.S. misses just one interest payment, the downward impact on stock prices would be greater than the Lehman Brothers bankruptcy. In THAT aftermath, the stock market lost half its value.

Bigger picture, a default would undermine the role of the U.S. in the world economy.

The irony of the debt ceiling debate is that the gap between government spending and tax revenues has been closing rapidly on its own. In July, the Congressional Budget Office (CBO) reported that the deficit had fallen by 37.6%, the result of tax increases and sequester-related cuts in spending. As a percentage of America's GDP, the deficit has fallen from more than 10% at the end of 2009 to somewhere around 4% currently. Last June, the government actually posted a surplus of $117 billion, paying down the overall deficit, and the CBO has projected that September will also bring government surpluses.

Most observers seem to think that all of this will get worked out. After all, what rational person--in Congress or elsewhere--wants to self-impose these problems when we have plenty of economic challenges already? The stock market's recent relatively calm trading days tell us that investors expect a compromise on the government shutdown in the near future. It may take a sharp day of selling to prod Congress off its behind. Foreign investors are still lending to the U.S. government at astonishingly low interest rates (despite modest increases over the past week), which tells us they aren't worried about a default.

The last time we went through this, the stock market plunges proved to be buying opportunities for investors. One of the great things about uncertainty and volatility is that it causes investments to periodically go on sale, and creates such anxiety that only disciplined investors are able to take advantage. There's no reason to think this isn't more of the same.

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