Weekly Market Commentary

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Markets May Hit the Ceiling

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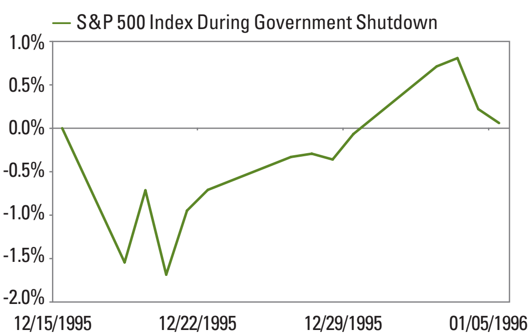
Highlights

The markets could face a government shutdown at the end of this week if Congress does not agree to a continuing resolution to extend funding for this fiscal year on or by March 4.

During the last government shutdown the Federal Reserve cut interest rates helping to halt the stock market's slide.

The range of potential outcomes could include default on U.S. government debt at the extreme; however, the most likely outcome is that the impasse is resolved with modest cuts and is probably neutral for the markets. But that may not come until a market volatility inducing showdown in Congress over funding takes place starting this week.

1 Fed Helped Halt Stock Market Slide During Last Shutdown



Source: LPL Financial, Bloomberg Data 02/25/11

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Much attention has been focused on the federal debt approaching the $14.294 trillion debt ceiling and the showdown over spending in Congress as the ceiling is hit sometime in May. However, the markets have a more pressing fiscal concern. The government could face a shutdown this week if Congress does not agree to a continuing resolution to extend funding for this fiscal year on or by March 4. The desire by the Republicans to link the government funding and the debt ceiling votes have led to the increasing likelihood of a government shutdown. The potentially negative impact of a government shutdown is likely to add to the macroeconomic and geopolitical pressures on the markets this week.

For a historical perspective on what the shutdown may mean for the markets, we have to look back 15 years to the last time a government shutdown occurred. At that time, the shutdown lasted three weeks from the failure of negotiations on December 15, 1995 through January 6, 1996. As the shutdown began, the S&P 500 started to slide, dropping nearly 2% over four days. However, the Federal Reserve cut interest rates on December 19, 1995 to promote economic growth, helping to halt the market's slide [Chart 1]. By the time the shutdown ended on January 6, 1996, the S&P 500 had recovered all of its losses.

The Fed is unlikely to take any stimulative actions in the coming weeks beyond their planned bond purchase program whether there is a government shutdown or not. In addition, the debt is much larger and credit concerns remain foremost in the minds of investors after the financial crisis of 2008. This may leave the market more vulnerable than fifteen years ago.

Another concern for investors may be over the earnings of those companies that do business with the government. During a shutdown, government agencies cannot enter into contracts with businesses and may be forced to delay payments. This may lead to temporary quarterly earnings misses for some companies with a high percentage of government business. During the last government shutdown, companies cautioned investors that quarterly earnings would be reduced as a result. The defense-oriented companies within the Industrials sector are potentially the most affected.

The likelihood of a government shutdown is heightened by several factors. The outcome of the November 2010 elections was driven in no small part by concerns over runaway spending. The resulting split-party Congress has led to a bitter feud over proposed spending cuts. In addition, the Republicans appear to have a diversity of views and a large number of freshmen members of Congress that vote differently than the party leadership making negotiating a time-consuming process.

While another temporary continuing resolution may fund the government and avoid a shutdown beginning this week, the debt ceiling issue lingers and is likely to garner increasing attention as Republicans seek spending cuts. The range of potential outcomes for the debt ceiling issue is wide. Of course, an extreme outcome could be default on U.S. government debt, as the Treasury Secretary has warned. This would be a disaster for the markets. Alternatively, one potential outcome that could be welcomed by the markets is the passage of a bill currently in the House with bi-partisan sponsorship (Corker-McCaskill CAP Act) that caps federal government spending at 20-25% of GDP with no allowance for raising taxes and automatically forces cuts to discretionary and entitlement programs if Congress failed to meet the cap. This outcome could be good news for bonds and stocks and strengthen the dollar. However, the most likely outcome is that the impasse is resolved with modest cuts ($40 billion or so — a rounding error compared to trillions in annual federal spending). This most likely eventual outcome is probably neutral for the markets, but may not come until a market volatility-inducing showdown in Congress over funding takes place starting this week.

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