First Trust
Monday Morning OUTLOOK

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Higher Rates & A Shutdown On The Menu

The University of Colorado Buffaloes are undefeated and suck up a lot of oxygen in the college football world. After just three games as the new head coach, Deion Sanders was interviewed by 60 Minutes. For now, the Buffs have gone from irrelevant to essential in the college football world. In the competitive arena of sports or business you need to stand out to be noticed. But, when you're the government, standing out isn't hard to do.

This week, the Federal Reserve is set to release a new statement on monetary policy. And, by the end of this month, Congress is supposed to either pass a new budget or possibly shutdown non-essential government services. Investors will be watching intently.

We don't think the Fed will provide many surprises. As of the Friday close, the futures market was putting the odds of a rate hike at this week's meeting at less than 1%. That may be too low, but the Fed won't surprise on this front. It will release a new batch of economic forecasts as well as "dot plots" that show where policymakers see short-term interest rates heading.

This could be the surprise: The futures market's odds of a rate hike by the December meeting are roughly 45% and we think that's too low. Oil prices are lifting inflation once again, and rising health insurance rates will keep inflation elevated later this year. Meanwhile, real GDP growth looks solid in Q3. Mixing stubbornly high inflation with solid economic growth is not a recipe for a prolonged pause by the Fed, at least not yet.

We think the Powell presser and the dot plots will make it clear the Fed is leaning toward one more rate hike before the year is through. Our greatest hope is that someone asks Powell about the money supply and he acknowledges its importance for conducting monetary policy, but if that happens we'd be (happily) surprised.

Instead, we expect to hear at least one question for Powell about the looming possibility of a government shutdown at the end of September. The media and investors are starting to focus on this issue. We don't think this is time well spent. History shows no relationship between federal shutdowns and the performance of the economy.

We had two shutdowns in late 1995 and early 1996, and saw no recession either time. There was a shutdown in 2013, no recession. There was a brief shutdown early in 2018, no recession. The most recent shutdown was the longest, thirty-five days from December 2018 through January 2019. You guessed it, no recession. The last time a shutdown coincided with a recession was in October 1990. That was only a four-day shutdown, but money was already tight and a recession was inevitable either way.

Here's another way to think about it: In the last forty years, the government has been shut for 91 days. Among those days, the US was in recession for four days and not in recession for eighty-seven. By contrast in the past forty years the US has been in recession about 8% of the time. That means the economy was more likely to be growing when the federal government was shut than when it was open!

This doesn't mean a recession can't start in the fourth quarter. But if we do get a recession it'll be a coincidence, due to the lagged effects of the tighter monetary policy of the last year, not a shutdown itself.

Note that unlike some other budget confrontations in the past, this one does not involve paying the federal debt. For better or worse the debt limit has been suspended until January 2025. This means that even if the government is shut all the debt will get paid on time; there will be no default.

Social Security checks and other benefit payments will still go out. The mail still gets delivered. Essential government workers keep working, including those needed for national defense. The government is not the economy, even though many in DC (and many voters) think it is. But, those that produce wealth are the ones who have to pay for it. And that cost keeps going up. In 1930, the federal government (without defense) was about 2% of GDP. Today that percentage is 22%. The government has grown about 10 times more than the economy as a whole. Debt is at a record high and, with higher interest rates and rapidly rising entitlement costs, we are on an unsustainable path.

As we said two weeks ago, the federal government is running the most reckless and irresponsible budget in US history. Even John Maynard Keynes' would not support such massive deficits with the unemployment rate so low. This can't go on now that interest rates have returned to more normal levels. If a shutdown is the price we pay to start moving in the direction of less government spending, investors should be eager to see that happen. The shutdowns in the mid-1990s caused the government to become more fiscally responsible and led to Clinton era surpluses. And that was good for everyone.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-19 / 7:30 am	Housing Starts – Aug	1.437 Mil	**1.436 Mil**		1.452 Mil
9-21 / 7:30 am	Initial Claims – Sep16	225K	**223K**		220K
7:30 am	Philly Fed Survey – Sep	-1.0	**-0.7**		12.0
9:00 am	Existing Home Sales – Aug	4.100 Mil	**4.180 Mil**		4.070 Mil