Fiscal debates: Troubled waters ahead or perfect calm?

September 27, 2013

Key highlights

- The impact on markets during previous fiscal debates was short-lived.
- While the long-term stakes are high, the incentive for Congress to reach an agreement is strong.
- Clients should avoid timing investing decisions based on Washington’s actions and, instead, should focus on staying the course.


Roger Aliaga-Diaz


Sarah D. Hammer

Once again, deadlines loom over Capitol Hill as another round of fiscal debates takes place in Congress. An agreement to raise the debt ceiling will have to be reached by mid-October to avoid the risk of a government default. But even before that deadline arrives, government funding is scheduled to expire on September 30. Lawmakers have the task of passing a new spending bill by October's start in order to keep the federal government running.

Questions about the potential implications for investments and the financial markets may be appearing on clients' radar as the political rhetoric continues to heat up.

If yesteryear's episodes of fiscal debates are any indication, the impact on the markets could be relatively calm.

For example, the 2012 debt-ceiling debate side-stepped the risk of default, but ran to the last minute. Markets rallied when they reached an agreement.

The dramatic fiscal 2011 budget impasse that culminated in a near-shutdown of the government put pressure on the stock and bond markets. But by year-end, markets were virtually in the same places as they were before the debt-ceiling/government-funding fiasco took place.

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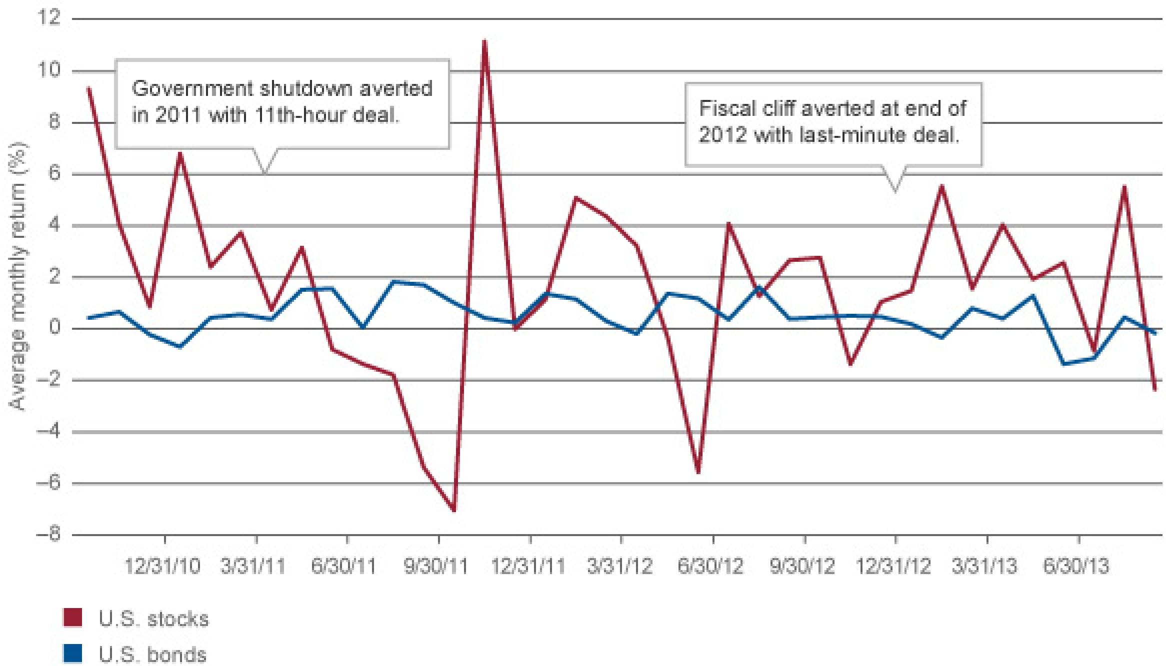
U.S. stock and bond returns during recent fiscal debates



Sources: For stock returns, MSCI US Broad Market Index through March 31, 2011, and CRSP US Total Market Index thereafter. For bond returns, Barclays U.S. Aggregate Bond Index.

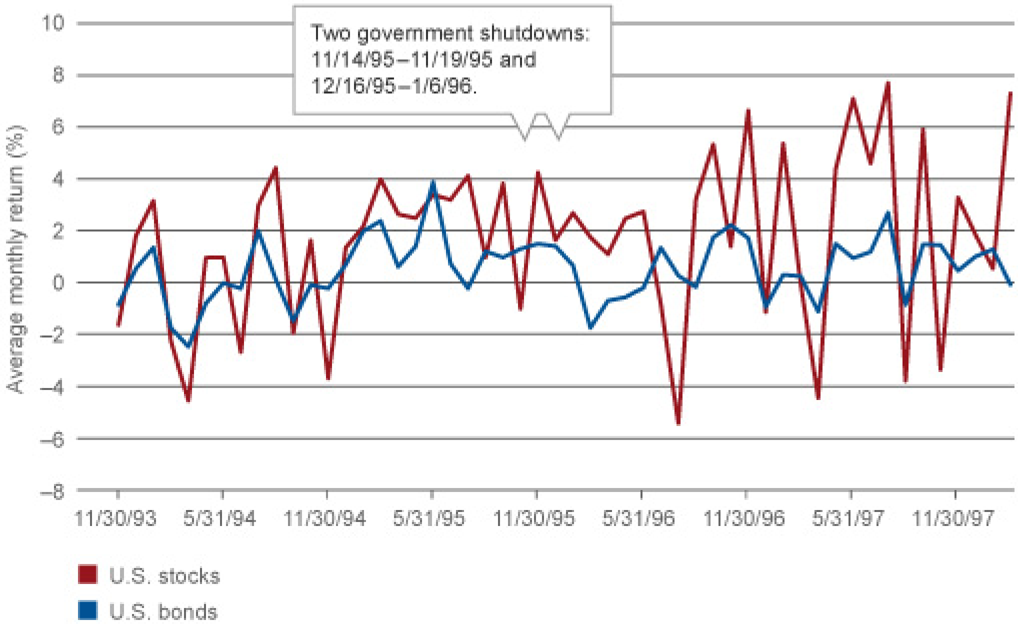
Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

An even better example might be the 1995–1996 fiscal stalemate that forced two government shutdowns.

What was the market's response?

"Resilience," according to Roger Aliaga-Díaz, a senior economist in Vanguard Investment Strategy Group. "In fact, markets were defiant, and broad equity and bond prices rose against the pessimism."

U.S. stock and bond returns before and after shutdowns of 1995–1996



Sources: For stock returns, Dow Jones Wilshire 5000 Index through April 22, 2005, and MSCI US Broad Market Index thereafter. For bond returns, Barclays U.S. Aggregate Bond Index.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

A word of caution

However, as the disclaimer following the above chart reads, "past performance is no guarantee of future returns." The same care should apply to today's government-funding and debt-ceiling debates.

"The debt-ceiling discussion has a big symbolic component. If Congress actually failed to increase the limit, it would mean a tremendous fiscal squeeze of the size of the budget gap and a significant challenge for the full faith and credit of the U.S. government. The impact on the economy from such a dysfunctional political outcome would be unthinkable," said Aliaga-Díaz.

For that reason, the stakes are high, and all parties involved should have a strong incentive to come up with an agreement.

"What we fear more this time around is that given the unexpected improvement in the federal budget year to date, there is now even less pressure to address the long-term structural deficit through necessary changes to entitlement programs and comprehensive tax reform," said Aliaga-Díaz.

What course does Vanguard suggest during the political uncertainty?

Sarah Hammer, a senior investment analyst in Vanguard Investment Strategy Group, encourages clients to maintain their commitment to long-term goals and avoid attempting to "time" investing activity around Washington's actions.

"Clients should stick to their long-term investment plans and avoid making short-term decisions based on the legislative outlook," said Hammer. "Instead, clients should practice tax-efficient investing and smart asset allocation, and maintain discipline and a long-term perspective."

Notes:

- All investments are subject to risk, including possible loss of principal.
- Investments in bonds are subject to the risk that an issuer will fail to make payments on time and that bond prices will

decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.

- Diversification does not ensure a profit or protect against a loss.

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