OF SHUTDOWNS AND CEILINGS

JANNEY FIXED INCOME STRATEGY

SEPTEMBER 30, 2013

We expect the imminent government shutdown to be brief, though a longer one carries economic risks, as does the impending debt ceiling debate.

CONTENTS

GOVERNMENT SHUTDOWN
DEBT CEILING
CONCLUSIONS
INFORMATION & DISCLAIMERS

GOVERNMENT SHUTDOWNS, DEBT CEILINGS, AND THE BOND MARKETS

- Without a continuing resolution, the federal government will go into shutdown mode at midnight on September 30, the 18th such event since 1976 and the first since 1996.
- There are serious economic implications if such a shutdown lasts more than several days, as we estimate as many as 1 million non-essential employees will be furloughed.
- In mid-October, the government will bump up against the debt ceiling, which is a much more significant concern for both the economy and the financial markets.

At the time of publication, the House and Senate had yet to agree on a so-called continuing resolution. These resolutions provide for funding appropriation spending in the absence of a formal budget—which, incidentally, hasn't happened since 2008. Without passage of a resolution by midnight on September 30, the federal government will go into shutdown mode. In practical terms, this means that all "non-essential" services will be put on hold, though "essential" services such as tax-collection, law enforcement, and the military will continue to operate.

Government shutdowns have been surprisingly common since 1976, when the current budget structure went into place. In fact, if the government does shut down in 2013, it would mark the 18th such occurrence, though it'd also be the first since the infamous Clinton/Gingrich 21-day standoff that ended in January 1996. Most of the 17 prior shutdowns have been over ideological issues and rarely have they lasted more than a few days, with the shortest actually taking less than 24 hours to resolve. Given, however, the unusually varied interests at play within today's legislature, it's not clear to us that a resolution will be quick this time around, but it does mean that the outcome is hard to predict.

GOVERNMENT SHUTDOWN

Problems related to the shutdown of the US government are generally economic and practical in nature. Although we don't have precise numbers, based on the latest contingency plans submitted to President Obama, this time around 1 million employees will be furloughed come midnight. That's a 25% increase over the 1995 – 1996 shutdown, which impacted 800,000 employees. According to the Congressional Budget Office (themselves furloughed, so perhaps there was a bone to pick), the impact of that shutdown cut would be about 0.5% off of economic growth during 4Q 1995. In that case, however, a number of appropriations bills had already been passed, so some non-mandatory spending continued, and the private sector was growing much more robustly at the time.

There Have Been 17 Prior Shutdowns

Date of Shutdown Start	Length
Sep 30, 1976	10 Days
Sep 30, 1977	12 Days
Oct 31, 1977	8 Days
Nov 30, 1977	8 Days
Sep 30, 1978	18 Days
Sep 30, 1979	11 Days
Nov 20, 1981	2 Days
Sep 30, 1982	1 Days
Dec 17, 1982	3 Days
Nov 10, 1983	3 Days
Sep 30, 1984	2 Days
Oct 03, 1984	1 Days
Oct 16, 1986	1 Days
Dec 18, 1987	1 Days
Oct 05, 1990	3 Days
Nov 13, 1995	5 Days
Dec 05, 1995	21 Days
Average	6 Days

Source: Janney Fixed Income Strategy; Congressional

GUY LEBAS
Chief Fixed Income Strategist
215 665 6034
glebas@janney.com

See page 4 for important information regarding certifications, our ratings system as well as other disclaimers.

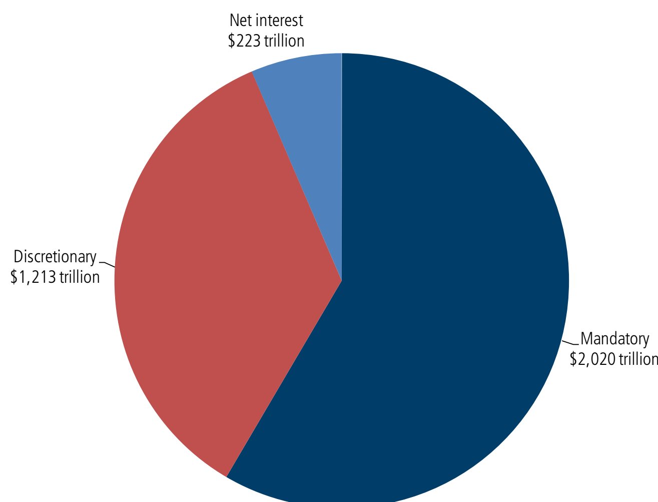
JANNEY MONTGOMERY SCOTT
www.janney.com
© 2013 Janney Montgomery Scott LLC
Member: NYSE, FINRA, SIPC

Janney CAPITAL MARKETS

CONTENTS

GOVERNMENT SHUTDOWN
DEBT CEILING
CONCLUSIONS
INFORMATION & DISCLAIMERS

Portion of Discretionary Spending Hit in Shutdown



Source: Janney Fixed Income Strategy; CBO

For a theoretical 2013 shutdown to last the same 21-days would have a negative impact on economic growth of 0.9% - 1.4%. If we assume that of the $1.2 trillion in annual discretionary spending, 60% is "essential," a 21-day pause would have immediate GDP impact of 0.7%, while lost income alone from the 1 million furloughs would represent another 0.1% headwind. But the real economic cost, which is extremely hard to measure, comes from heightened uncertainty. Greater uncertainty will create hesitancy on the part of businesses to embark on new projects, and encourage consumers (especially those who derive some income from government-related activities) to save rather than spend. In essence, an extended government shutdown has the potential to reverse a good portion of the Federal Reserve's low interest rate stimulus. All of that said, it seems most likely that any government shutdown will be short-lived, and really designed as a brief negotiating tool rather than a long-term "nuclear option" threat.

Our basecase expectation is that Congress shuts down the government for a matter of hours or a few days, but a longer shutdown risks significant economic damage.

In terms of bond market impact, we've already seen a significant trading shift related to the impending government shutdown. Equity markets have faced significant headwinds subsequent to mid-September, and interest rates have been falling, reflecting a demand on the part of investors for safe-haven assets. The outperformance of Treasuries, with ten year yields having dropped 10 basis points in the post-Fed markets comes with a certain irony: even though the government—and in part government debt—is the cause of uncertainty, investors are buying up government bonds to reduce their own portfolio uncertainty. Economic risk is also part of the mix, as weaker economic growth that could result from a protracted government shutdown should also support a move towards lower interest rates.

Debt Ceiling

Although the likely impact of a government shutdown is economic in nature, the potential for the US to reach the debt ceiling represents a far more significant threat, albeit one that's much less-likely to be realized. First, some background. The debt ceiling, currently set at $16.7 trillion is a statutory limit set by Congress and signed by the President on how much debt the US Treasury Dept. can issue to fund projects for which Congress has already appropriated funds. The problem comes from conflicting requirements: on one hand, Congress (or past Congresses) has made spending laws, but on the other hand, the current Congress has the ability to block spending by refusing to allow more indebtedness. This problem is far from trivial.

On or about October 17—many payments are variable, so it's impossible to know the exact date—the Treasury Dept. will run out of "emergency measures" it's been employing in recent weeks. At that point, the Treasury will either have to violate the debt ceiling and issue additional Treasury bills, notes, and bonds, or it will have to prioritize other payments. Such a prioritization might include not paying contractors, haircutting monthly Social Security checks, or other equally-unpalatable options. The US will not, however, necessarily default on its debt. Since a debt maturity reduces indebtedness, the Treasury Dept can issue new debt to pay off old debt without breaching the debt ceiling. The bigger issue is for interest payments. Come November 15, the Treasury Dept. owes $30 billion in interest, one of the government's four big quarterly interest payments. If the debt ceiling is not raised by that point, the consequences are admittedly hard to envision.

JANNEY MONTGOMERY SCOTT
www.janney.com
© 2013 Janney Montgomery Scott LLC
Member: NYSE, FINRA, SIPC

Janney
CAPITAL MARKETS

CONTENTS

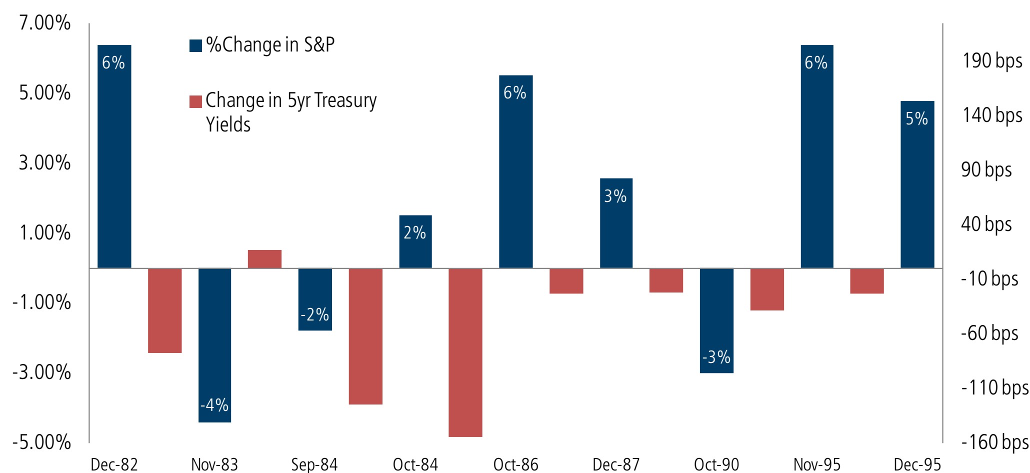
GOVERNMENT SHUTDOWN
DEBT CEILING
CONCLUSIONS
INFORMATION & DISCLAIMERS

There are some legal theories on how the Treasury Dept. could avoid problems with the debt ceiling, possibly without having to prioritize payments.

- One unlikely arrow in this quiver comes from the 14th Amendment, which, among other things, guaranteed equal protection under the law. The amendment was passed in the wake of the Civil War and includes a clause reading, "The validity of the public debt of the United States, authorized by law…shall not be questioned." While meant to force the South to pay for debts incurred during the Civil War, the clause could arguably be applied in this circumstance—the Treasury could issue debt authorized by prior spending law, and Congress couldn't question that issuance.
- A second and related arrow in the quiver could be an executive order from President Obama raising the debt ceiling independently of Congress. Limits on executive orders are quite fuzzy, and there's a good justification that national security could be at risk if the US can't fund its military and law enforcement needs.

The potential to reach the debt ceiling introduces a whole host of problems, though Congress' incentives are aligned so as to make a breach unlikely.

Market Performance from Month Prior to Month After Shutdowns Has Been Mixed



Source: Janney Fixed Income Strategy; S&P

CONCLUSIONS

Nowhere is the bond market response to Congressional wrangling more confusing than with respect to the debt ceiling. A debt ceiling breach which lasts long enough could force the US to default on its outstanding Treasury bills, notes, and bonds (even now, we view this as highly unlikely). Yet despite this risk, investors and traders are continuing to snap up Treasuries, as a way to express risk aversion. In reality, the risk asset markets are facing greater challenges than the Treasury markets, as reflected in softer equity prices and the underperformance of corporate bonds in recent days.

It's our expectation—and indeed, most share this expectation—that, while the government could be officially shutdown for a period of days or even weeks, that cost is economic and not catastrophic in nature. The debt ceiling, however, is another matter. It's nearly impossible to predict all of the potential problems from prioritizing payments, and even more challenging to contemplate a failure of the Treasury Dept. to pay on its debt. Even the approach of the debt ceiling could represent enough uncertainty to get the ratings agencies concerned once again. On a historical note, we should point out that the US has actually defaulted on its debt a number of times, though most were in the pre-twentieth century era. For now, however, the good news is, with all of the incentives aligned to raise the debt ceiling, we very much expect Congress will act before default is imminent, though it might take a substantial market event to trigger that action.

JANNEY MONTGOMERY SCOTT
www.janney.com
© 2013 Janney Montgomery Scott LLC
Member: NYSE, FINRA, SIPC

Janney CAPITAL MARKETS

CONTENTS

GOVERNMENT SHUTDOWN
DEBT CEILING
CONCLUSIONS
INFORMATION & DISCLAIMERS

Analyst Certification

I, Guy LeBas, the Primarily Responsible Analyst for this report, hereby certify that all of the views expressed in this report accurately reflect my personal views about any and all of the subject sectors, industries, securities, and issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

Definition of Outlooks

Positive: Janney FIS believes there are apparent factors which point towards improving issuer or sector credit quality which may result in potential credit ratings upgrades

Stable: Janney FIS believes there are factors which point towards stable issuer or sector credit quality which are unlikely to result in either potential credit ratings upgrades or downgrades.

Cautious: Janney FIS believes there are factors which introduce the potential for declines in issuer or sector credit quality that may result in potential credit ratings downgrades.

Negative: Janney FIS believes there are factors which point towards weakening in issuer credit quality that will likely result in credit ratings downgrades.

Definition of Ratings

Overweight: Janney FIS expects the target asset class or sector to outperform the comparable benchmark (below) in its asset class in terms of total return

Marketweight: Janney FIS expects the target asset class or sector to perform in line with the comparable benchmark (below) in its asset class in terms of total return

Underweight: Janney FIS expects the target asset class or sector to underperform the comparable benchmark (below) in its asset class in terms of total return

Benchmarks

Asset Classes: Janney FIS ratings for domestic fixed income asset classes including Treasuries, Agencies, Mortgages, Investment Grade Credit, High Yield Credit, and Municipals employ the "Barclay's U.S. Aggregate Bond Market Index" as a benchmark.

Treasuries: Janney FIS ratings employ the "Barclay's U.S. Treasury Index" as a benchmark.

Agencies: Janney FIS ratings employ the "Barclay's U.S. Agency Index" as a benchmark.

Mortgages: Janney FIS ratings employ the "Barclay's U.S. MBS Index" as a benchmark.

Investment Grade Credit: Janney FIS ratings employ the "Barclay's U.S. Credit Index" as a benchmark.

High Yield Credit: Janney FIS ratings for employ "Barclay's U.S. Corporate High Yield Index" as a benchmark.

Municipals: Janney FIS ratings employ the "Barclay's Municipal Bond Index" as a benchmark.

Disclaimer

Janney or its affiliates may from time to time have a proprietary position in the various debt obligations of the issuers mentioned in this publication.

Unless otherwise noted, market data is from Bloomberg, Barclays, and Janney Fixed Income Strategy & Research (Janney FIS).

This report is the intellectual property of Janney Montgomery Scott LLC (Janney) and may not be reproduced, distributed, or published by any person for any purpose without Janney's express prior written consent.

This report has been prepared by Janney and is to be used for informational purposes only. In no event should it be construed as a solicitation or offer to purchase or sell a security. The information presented herein is taken from sources believed to be reliable, but is not guaranteed by Janney as to accuracy or completeness. Any issue named or rates mentioned are used for illustrative purposes only, and may not represent the specific features or securities available at a given time. Preliminary Official Statements, Final Official Statements, or Prospectuses for any new issues mentioned herein are available upon request. The value of and income from investments may vary because of changes in interest rates, foreign exchange rates, securities prices, market indexes, as well as operational or financial conditions of issuers or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. We have no obligation to tell you when opinions or information contained in Janney FIS publications change.

Janney Fixed Income Strategy does not provide individually tailored investment advice and this document has been prepared without regard to the circumstances and objectives of those who receive it. The appropriateness of an investment or strategy will depend on an investor's circumstances and objectives. For investment advice specific to your individual situation, or for additional information on this or other topics, please contact your Janney Financial Consultant and/or your tax or legal advisor.

JANNEY MONTGOMERY SCOTT
www.janney.com
© 2013 Janney Montgomery Scott LLC
Member: NYSE, FINRA, SIPC