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Policy, Politics & Portfolios

What federal budget, regulatory, and trade decisions could mean for investors **October 31, 2023**

- On September 30, President Joe Biden signed continuing resolution legislation that funds federal programs for 45 days at the current year's funding levels.
- Lawmakers must pass 12 appropriations bills by November 17 or risk a federal government shutdown. To date, none of the appropriations bills have cleared Congress.
- Most federal spending would be unaffected, including Social Security, Medicare, and Medicaid. The U.S. economy would bear a modest impact from a shutdown, largely through suspended discretionary spending, which would have to wait for funding approval.

- The risk of an outright Moody's U.S. debt downgrade is low, in our view. However, a government shutdown or a lengthening of its duration[1] could add pressure for a negative credit watch and a subsequent downgrade.
- We do not anticipate significant forced selling of U.S. debt associated with a potential Moody's downgrade. We believe investors should continue to dollar cost average into long-term fixed-income assets to take advantage of higher yields.

- In our view, the latest budget deficit episode adds to the cyclical forces we see pressuring the U.S. dollar over the next year, though its long-term value — and status as the world's premier reserve currency — is unlikely at risk.
- The U.S. dollar's dominant role in global trade and finance has been a blessing and a curse — accommodating relatively large deficits at times but also adding a volatile component to U.S. deficit financing.
- Our forecasted window of dollar weakness next year complements our current guidance, favoring large-cap, high-quality multinational stocks and materials producers.

1. Duration is a measure of a bond's interest rate sensitivity.

Implications of a government shutdown showdown

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A temporary respite

After passing in Congress with overwhelmingly bipartisan support, on September 30, President Joe Biden signed continuing resolution legislation that funds federal programs for 45 days at the current year's funding levels. Now that lawmakers have a temporary reprieve to finalize the 2024 spending bill, financial markets are deliberating economic and policy implications of a potential government shutdown as the November 17 deadline approaches. Below we discuss where the budget negotiations stand at present and the potential economic and market implications of a shutdown.

Where budget negotiations stand today

On October 1 of each fiscal year, Congress must deliver 12 appropriations bills that establish discretionary funding for 12 matching subcommittees or risk a federal government shutdown. To date, the House has passed only four of the 12 bills, while the Senate has yet to pass one. Shutdowns in the past 30 years have ranged from a few days to over a month. If one occurs this year, we anticipate it could last weeks because of an increasingly polarized Congress. The bipartisan (and even intra-party) divide on issues such as border security and funding for Ukraine and the narrow House majority make a quick resolution tricky.

Perhaps details from the previous two government shutdowns may provide some perspective for the current situation. At year-end 2018, five of the 12 appropriations bills had passed at the start of the 35-day closure between December 2018 and January 2019, limiting the shutdown's length and economic impact. In October 2013, the government shut down over the Affordable Care Act, but the standoff was short-lived, as many pieces of the bill were already in place, including health care exchanges.

To be sure, a few guardrails should help limit the risk of open-ended confrontation, including election-season pressure to avoid a protracted shutdown. First, current political candidates would likely prefer to eschew a repeat performance of past shutdowns. Second, mandatory 1% across-the-board discretionary spending cuts from fiscal-year 2023 levels would be announced at the end of calendar-year 2023 if all 12 appropriations bills fail to pass or if a full-year continuing resolution for 2024 is not in place. The cuts must continue through 2024 if neither action on spending is passed by April 30, 2024.[2] And third, a prolonged government shutdown could generate financial market volatility that, in the past, has led to swift resolution of bipartisan disagreements. Finally, Congress adopted austerity measures in the past, when borrowing costs became significant.[3]

Our base case

We believe the risk of a government shutdown next month is rising. There are deep disagreements over spending on border security versus continued aid to Ukraine. Additionally, it is unclear how negotiations will be affected by a new House Speaker and new geopolitical risks.

2. "Two Government Funding Scenarios Under the Debt Limit Deal," Bipartisan Policy Center, June 20, 2023
3. See *Investment Strategy* report cover story "Economic Implications of the Dollar's Global Role," May 1, 2023

However, any shutdown would leave 65% of mandatory, or entitlement, spending that includes Social Security, Medicare, and Medicaid untouched. Only discretionary spending deemed nonessential would be affected by a government closure. Essential services would remain intact, including defense and border protection, in-hospital care, air traffic control, and power grid control — although there still may be some absenteeism that interferes with productivity.

Potential economic implications

The U.S. economy would bear most of the modest impact from a shutdown via a cut in discretionary spending (26% of the fiscal-year 2023 budget), which must wait for approval of appropriations bills. Economic setbacks of past shutdowns came from ripple effects of lost government and consumer spending but were typically modest. Government and private estimates of lost real gross domestic product (GDP) are typically minimal (around 0.2%) and are normally recouped after reopening.

Although financial markets historically responded favorably once federal shutdowns were resolved, a shutdown is one of several unrelated uncertainties that together could aggravate the economy's weakening trends. The more prominent of these uncertainties include renewed student-debt repayments, the United Auto Workers strike, rising fuel costs, and, of course, an expanding fiscal deficit.

The ballooning U.S. budget deficit is a particularly notable risk because it could trigger another credit rating downgrade of U.S. debt. For perspective, deficits do not only widen. In July, the U.S. debt-servicing cost hit 14% of tax revenue, which historically has been a threshold for lawmakers to either raise tax rates or cut spending levels. Such steps could help avert a rating downgrade in the near future, as we discuss in the next section. Our final section then considers the potential impact on the dollar's exchange value amid a widening deficit.

With less than three weeks until the November 17 deadline, none of the 12 appropriations bills have cleared Congress.

Navigating U.S. debt rating downgrade warnings

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U.S. Treasury yields pay the price for erosion of fiscal governance

Credit rating agency actions like an upgrade, a downgrade, or a “credit watch” label often serve as a compass for investors to evaluate credit risk. Historically, U.S. government debt has held the highest credit rating (triple-A), signifying exceptional quality and minimal credit risk. However, two of the three credit rating agencies in the U.S. (Standard & Poor's and Fitch) have already downgraded U.S. debt from its top-notch rating in 2011 and 2023, respectively. Only Moody’s still holds a triple-A rating on U.S. government debt.

The focus now has shifted toward Moody's near-term credit rating assessment of U.S. debt. Moody's has issued a warning that a government shutdown is a negative factor, because a shutdown signifies intensifying political constraints.[4] Moody’s views a government shutdown as proof that political polarization could hinder the government’s ability to provide effective fiscal response, while rising interest rates raise the U.S. Treasury's interest cost on the public debt. Moody’s also cited persistent fiscal deficits and deteriorating debt affordability as key factors the agency is watching.[5]

At this time, we believe the risk of an outright Moody's downgrade without a negative credit watch is unlikely; however, a potential government shutdown, especially a long one, could prompt Moody's to issue a negative credit watch that may precede an eventual downgrade. But if Congress can avoid a shutdown, the Treasury may avoid a Moody’s rating downgrade this year.

What does a debt downgrade mean?

A rising general government deficit, among other reasons, formed the basis for Fitch Ratings' downgrade of U.S. long-term debt in August 2023.[6] Other issues included the expectation of an increase in government debt, unaddressed medium-term fiscal challenges, erosion of governance, and Federal Reserve (Fed) tightening of interest rates. We believe that near-term solutions are difficult to achieve while a potential government shutdown could further underscore these challenges.

However, it is crucial to clarify that a credit downgrade implies neither an impending nor an eventual default. We do not believe that debtholders' principal investment is at risk. Neither do we anticipate significant forced selling of U.S. debt associated with a potential Moody’s downgrade.[7] We have not observed an exodus of U.S. long-term debt associated with the recent Fitch Ratings downgrade. Rating agencies utilize a credit rating scale corresponding to varying risk levels. For instance, Moody's triple-A (Aaa) represents the highest credit level associated with minimal credit risk. A downgrade leads to double-A (Aa), which is considered high quality and subject to very low credit risk. It would require further downgrades three notches lower for a debt obligation to reach speculative grade with substantial credit risk (Ba).[8] In our opinion, U.S. long-term debt remains far from this point.

4. “US Risks Its Top Credit Rating With Shutdown, Moody’s Warns,” Bloomberg, September 25, 2023
5. Ibid.
6. “Fitch Downgrades the United States’ Long-Term Ratings to ‘AA+’ from ‘AAA’; Outlook Stable,” Fitch Ratings, August 1, 2023
7. Dan Burrows, “Why Investors Needn’t Worry About U.S. Credit Downgrade,” Kiplinger, August 2, 2023
8. "What Is a Credit Rating?" Moody's Investors Service, accessed October 20, 2023

Investment implications

In our view, the more likely scenario is rising U.S. Treasury yields into year-end 2024, based on a combination of interwoven risks related to fiscal deficits, higher-for-longer policy rates, and the amount of U.S. Treasury issuance. The cost of large, new Treasury issuance over the next year may need to increase to meet investors' demand at a higher coupon rate, which will increase the cost of debt payment when debt-service pressure is already mounting. In the summer of 2023, the U.S. Department of the Treasury announced plans to issue over $1 trillion in new issuance.[9] At the time of writing, yields have risen above 5% for 2-year U.S. Treasuries and remain close to the 5% level for 10-year and 30-year U.S. Treasuries. A potential Moody's credit downgrade or negative credit watch could be viewed as another confirmation that a continuation of these risks likely will bring higher yields next year.

The prospect for rising yields, but with a potential peak in the first half of 2024 if a recession ensues, may create investment opportunities. For fixed-income investors with a long-term focus, we believe it may be beneficial to continue to hold long-term Treasuries and dollar cost average into new purchases to lock in any potential increases in yields. Investors have the option to hold bonds until maturity and not be deterred by short-term losses on statements as bond yields fluctuate. In the long term, bond performance should be viewed through a total-return lens — that is, income from the bonds plus price appreciation if interest rates start to decline. Meanwhile, holding bonds in the portfolio may add diversification benefit, potentially reducing the overall risk for investors.

Total outstanding debt of the U.S. government surpassed $33 trillion.

Source: "Debt to the Penny," Treasury Direct, as of October 16, 2023

During the fourth quarter of 2023, the Treasury expects to borrow $852 billion in privately held net marketable debt.[10]

Source: U.S. Department of the Treasury, Quarterly Refunding Statement, as of July 31, 2023

9. "Treasury Announces Marketable Borrowing Estimates," U.S. Department of the Treasury, July 31, 2023

10. Marketable debt includes Treasury bills, notes, bonds, floating-rate notes, and inflation-protected securities where ownership can be transferred from one person or entity to another. They can also be traded on the secondary market. Privately held net marketable debt refers to Treasury securities purchased by private individuals and entities. It excludes rollovers (the amount of securities that mature and the Federal Reserve does not redeem) that increase the amount of cash raised for a given privately held auction size by increasing the Federal Reserve System Open Market Account.

The global dimension to U.S. federal budget deficits

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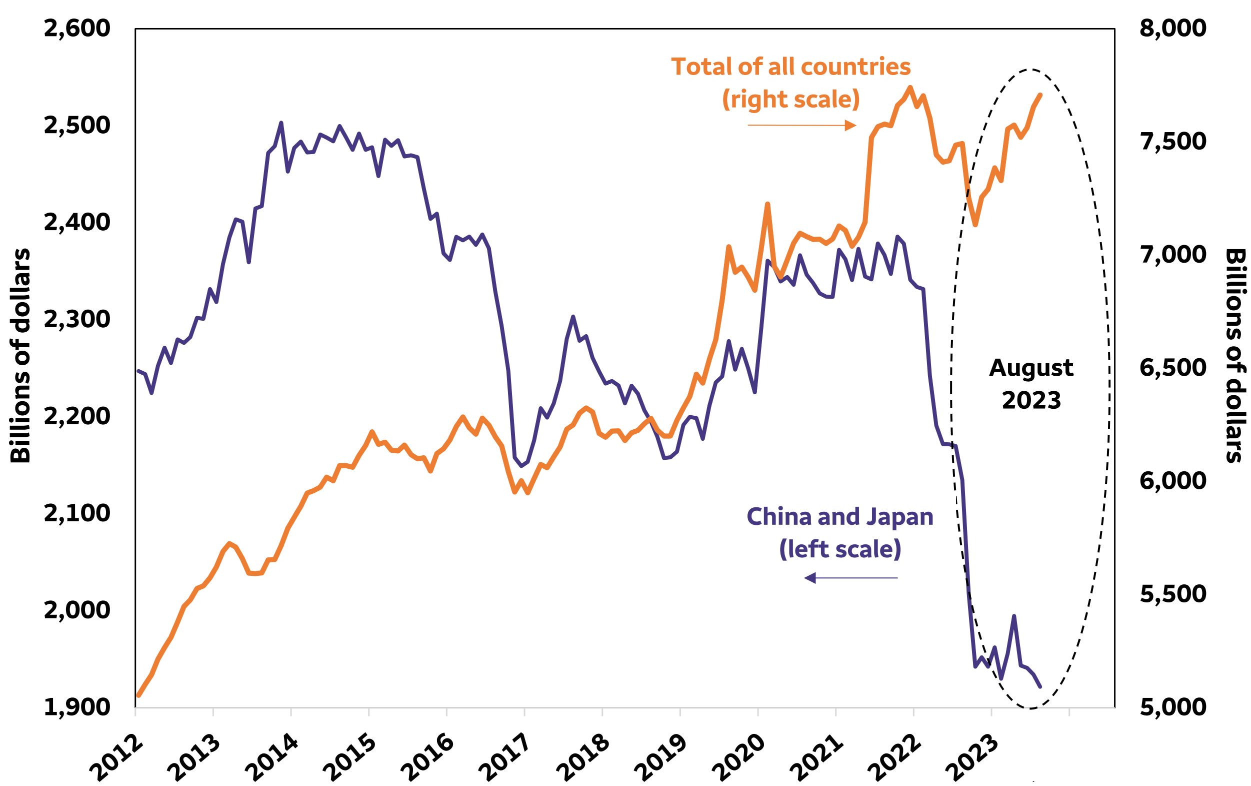
U.S. budget deficits, the U.S. dollar, and global market implications

The Congressional Budget Office (CBO) projects the U.S. budget deficit to remain historically high for the foreseeable future. This is due to distortions created by rising interest expenses and inflation-indexing increasing entitlements spending and restraining tax-revenue growth.

Linking the deficit and the U.S. dollar

The good news is that the U.S. dollar's role as the dominant international currency should, in our view, continue to attract the foreign investment allowing the U.S. to run wider fiscal deficits compared with other major advanced economies. From 2001 to 2022, the average U.S. budget deficit as a percentage of GDP was 4.7% — nearly twice that of other G7 nations (2.5%) over that same period.[11] The foreign share of U.S. Treasury debt is still high by international standards, at over 30% as of the second quarter of 2023. A secular decline in that share since the 2008 Global Financial Crisis has been part of a rotation by foreign investors into other parts of the U.S. bond market in search of yield, leaving the overseas share and dollar amount of all U.S. debt holdings largely unchanged despite an unwind by China and Japan in recent years.

Chart 1. Sell-off by two primary holders masks increased foreign investment in U.S. Treasuries



Sources: Wells Fargo Investment Institute and U.S. Treasury Department, data as of August 2023.

11. International Monetary Fund (IMF) data

Enlarged U.S. deficits do not alter our long-term conviction of the U.S. dollar as the world's main reserve currency.[12] We believe deep-seated, unique strengths — including the rule of law, transparency, and a highly liquid financial market — make a global shift away from the U.S. dollar difficult and highly unlikely, maintaining that financing cushion.

The dollar's blessing and curse

Still, international financing of U.S. budget deficits has been as much a curse as a blessing for the U.S. and the global economy. Overseas investment in U.S. government debt has been more volatile than domestic holdings when demand for the dollar and Treasuries is dampened by weak fiscal policy and poor economic performance, in part due to more attractive, global alternatives. Historically, a weakening U.S. dollar — triggered by a foreign pullback from U.S. investments (including Treasuries) — has been the principal conduit through which worries over economic policy and performance have been transmitted to the global economy.

The years 1978 and 1992 were among the more notable examples of a pullback by foreign investors responding to deteriorating U.S. economic conditions and to a loss of confidence in the ability of U.S. policymakers to rein in budget deficits. U.S. fiscal restraint was reactive and piecemeal rather than structural, leaving budget financing by U.S. and foreign investors vulnerable to recurring problems.

In the current cycle, the Fed's credit tightening and perceived safe-haven demand during the global economic slowdown have so far supported the U.S. dollar and foreign financing of the budget deficit. However, we expect dollar demand to weaken temporarily in response to falling U.S. interest rates and stronger global risk appetite if investors favor other currencies and the world economy recovers later in 2024 as we expected, perhaps aggravated by reduced foreign demand for U.S. debt. Diminished support may pose near-term headwinds to the U.S. dollar, but we believe its long-term value — and its status as the world's premier reserve currency — is unlikely at risk.

What it may mean for investors

Forecasted dollar weakness during the second half of 2024, tied to factors including falling interest rates and a large budget deficit, reinforces our tactical preference for U.S. Large Cap Equities. Specifically, currency-related gains would benefit U.S. multinational companies, lifting dollar-denominated returns on overseas income. A pullback in the dollar would also provide an added tailwind to commodity prices, bolstering our favorable view of commodities and the Materials sector of the S&P 500 Index tactically and over the longer term. Additionally, a lower dollar could present several potential buying opportunities within international market segments once the global economy recovers from our forecasted slowdown. These include a potential upgrade by us of Developed Market ex-U.S. Equities and Fixed Income (both currently rated neutral) and possibly a more constructive view of Emerging Market Equities and Fixed Income (currently rated unfavorable and neutral, respectively).

Barring major policy changes, the CBO projects gradually rising deficits to be the norm over the next decade, averaging 5.5% to 6.0% of GDP compared with about 3.5% in the pre-COVID, 2000 to 2019 period.

The foreign share of all U.S. debt holdings remains elevated despite declines in Treasury holdings by China and Japan in recent years.

Source: U.S. Treasury Department, data as of July 2023

12. See Wells Fargo Investment Institute's Special Report "The U.S. Dollar's Future As the World's Reserve Currency," September 7, 2023

Risk considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

A periodic investment plan such as dollar cost averaging does not assure a profit or protect against a loss in declining markets. Since such a strategy involves continuous investment, the investor should consider his or her ability to continue purchases through periods of low price levels.

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation, and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

U.S. government securities are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market risk. Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

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Definitions

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

Bond rating firms, such as Moody's, Standard & Poor's and Fitch, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as "junk bonds".

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