



A note from Ashvin Chhabra, Chief Investment Officer, Merrill Lynch Wealth Management

A partial shutdown of the U.S. government has begun. What are the implications for investors?



Our View

There are two distinct events in play: the shutdown of the U.S. government and the potential breach of the U.S. debt limit.

The expiration of the budget continuing resolution, at midnight on September 30th, has now cut off funding for some U.S. government operations.

The long-term financial impact of a short shutdown is likely to be limited. We note that since 1981, there have been no less than 11 government shutdowns. Most have lasted fewer than three days and have not had a long-term impact on the equity markets.

Exhibit 1: Timeline of Debt Ceiling measures



Source: Congressional Budget Office, ML GWM Investment Management & Guidance. Data as of September 2013.

Are Not FDIC Insured	Are Not Bank Guaranteed	May Lose Value
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Exhibit 2: Recent U.S. government shutdowns and equity impact

S&P 500 performance prior, during and subsequent to historical government shutdowns						
Shutdown*	Duration (days)	1m prior	2wk prior	During	2wk after	1m after
Sep 30, 1976	10	3.1%	-0.1%	-3.4%	-1.5%	-2.0%
Sep 30, 1977	12	0.2%	0.1%	-3.2%	-1.2%	2.7%
Oct 31, 1977	8	-4.3%	-1.2%	0.7%	3.8%	0.7%
Nov 30, 1977	8	2.4%	-0.6%	-1.2%	1.1%	-3.2%
Sep 30, 1978	17	-0.9%	-1.5%	-2.0%	-3.6%	-6.0%
Sep 30, 1979	11	0.3%	0.5%	-4.4%	-3.8%	-0.9%
Nov 20, 1981	2	1.2%	-0.8%	-0.1%	3.0%	0.6%
Sep 30, 1982	1	2.3%	-2.7%	1.3%	9.5%	12.7%
Dec 17, 1982	3	-0.3%	-0.9%	0.8%	2.0%	3.8%
Nov 10, 1983	3	-4.8%	-0.3%	1.3%	0.0%	-2.0%
Sep 30, 1984	2	-0.3%	-1.6%	-2.2%	1.0%	3.1%
Oct 3, 1984	1	-2.5%	-2.7%	0.1%	3.2%	3.6%
Oct 16, 1986	1	3.4%	2.4%	-0.3%	2.2%	-0.9%
Dec 18, 1987	1	1.5%	11.3%	0.0%	-0.8%	-2.6%
Oct 5, 1990	3	-4.0%	0.1%	-2.1%	2.4%	2.8%
Nov 13, 1995	5	1.3%	1.6%	1.3%	1.2%	2.0%
Nov 15, 1995	21	3.8%	1.5%	0.1%	-0.8%	4.8%
Average	6.4	0.1%	0.3%	-0.8%	1.0%	1.1%
Median	3.0	0.3%	-0.3%	-0.1%	1.1%	0.7%
Average since 1981	3.9	0.1%	0.7%	0.0%	2.1%	2.5%
Median since 1981	2.0	1.2%	-0.3%	0.1%	2.0%	2.8%

Source: BofA ML US Equity & Quant Strategy, Strategy Snippet: The shutdown saga continues. Sept. 27, 2013.

* Since the congressional budgeting process was established in 1976, Congress has failed to pass a budget 17 times. In 1981, it was established that a failure to pass a budget should result in a government shutdown.

The cautionary note here is that a government shutdown lasting more than a few days will cause a further drag on an economy that is still in a fragile stage of recovery.

The larger issue is a potential breach of the U.S. debt limit. In essence, failure to raise the debt limit would lead the U.S. government to default on its debt payments.

The U.S. hit its borrowing limit in May and the various funding measures the Treasury has taken since then to manage the government's debt are expected to run out in mid-October. In the absence of congressional agreement, the actual default could take place in mid-to-late October or, with further extraordinary measures, later in the year.

The U.S. government has never failed to raise the debt limit. To fail to do so now risks creating unprecedented uncertainty in the global financial system. In the event of a default, even if U.S. Treasuries were still widely viewed as creditworthy, the unintended consequences of a credit downgrade by one or more credit rating agencies would be complicated and potentially long-lasting. In our view, the probability that Congress would allow this to happen is very low.

As events play out heading into mid-to-late October, however, we can expect political brinkmanship and this may result in a sharp increase in near-term market volatility.



Portfolio Implications

Investors should not panic and should stay the course, remaining focused on their strategic asset allocations.

We recognize that, as political brinkmanship plays out, the market may experience considerable short-term volatility. We urge investors to distinguish between political posturing that may lead to short-term market volatility and those decisions that may have implications for long-term returns. While market volatility remains at reasonable levels, investors who cannot bear increased short-term volatility may want to consider hedging their exposure or taking gains off the table as we head into the year-end. Investors can also use this opportunity to rebalance their portfolios to their strategic allocation targets.

While the debt ceiling will likely be raised, the sobering conclusion is that the large political divide is unlikely to yield a meaningful agreement on the longer-term fiscal challenges that face the nation and may create a systemic drag on future growth.

The CIO Office will continue to monitor developments in Washington and provide updates through publications and market calls.

For further reading please refer to:

[CIO View: U.S. Budget & Fiscal Outlook, Déjà Vu](#)

[CIO Monthly: Navigating Monetary and Fiscal Complexities](#)

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Asset allocation and diversification do not assure a profit or protect against a loss during declining markets.

This investments discussed have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

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Some or all alternative investment programs may not be suitable for certain investors. Many alternative investment products, specifically private equity and most hedge funds, require purchasers to be "qualified purchasers" within the meaning of the federal securities laws (generally, individuals who own at least \$5 million in "investments" and institutional investors who own at least \$25 million in "investments," as such term is defined in the federal securities laws). No assurance can be given that any alternative investment's investment objectives will be achieved. In addition to certain general risks, each product will be subject to its own specific risks, including strategy and market risk.