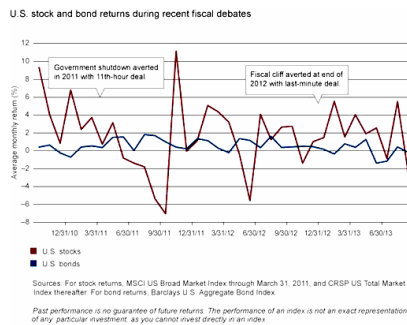


How to Take the Federal Budget Debate in Stride

By Kerry Pechter *Fri, Oct 4, 2013*

Don't let political disruptions in Washington disrupt your long-term investing strategy, say Vanguard's experts.



Once again, deadlines loom over Capitol Hill as another round of fiscal debates rages.

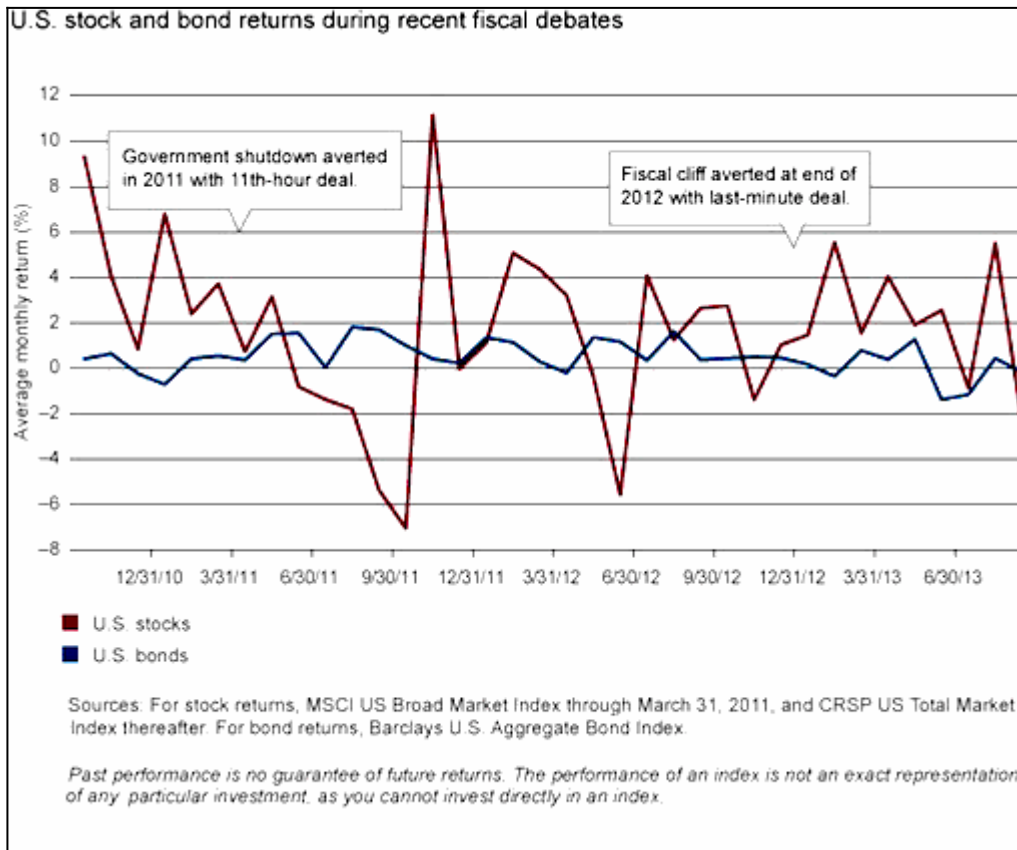
An agreement to raise the federal debt ceiling must be reached by mid-October to prevent a government default that could rock the global economy. Of more immediate concern: funding for federal programs expired on Monday, September 30, sending nearly 800,000 government employees into an unplanned (and, for most, unpaid) holiday.

As policymakers on both ends of Pennsylvania Avenue and both sides of the political divide wrangled over the budget, U.S. financial markets remained open, with the Securities and Exchange Commission still able to provide regulatory oversight—for now, at least.

The implications for Wall Street may be on your mind as the political rhetoric heats up. But if previous years' fiscal debates are any indication, the market impact could be relatively minor.

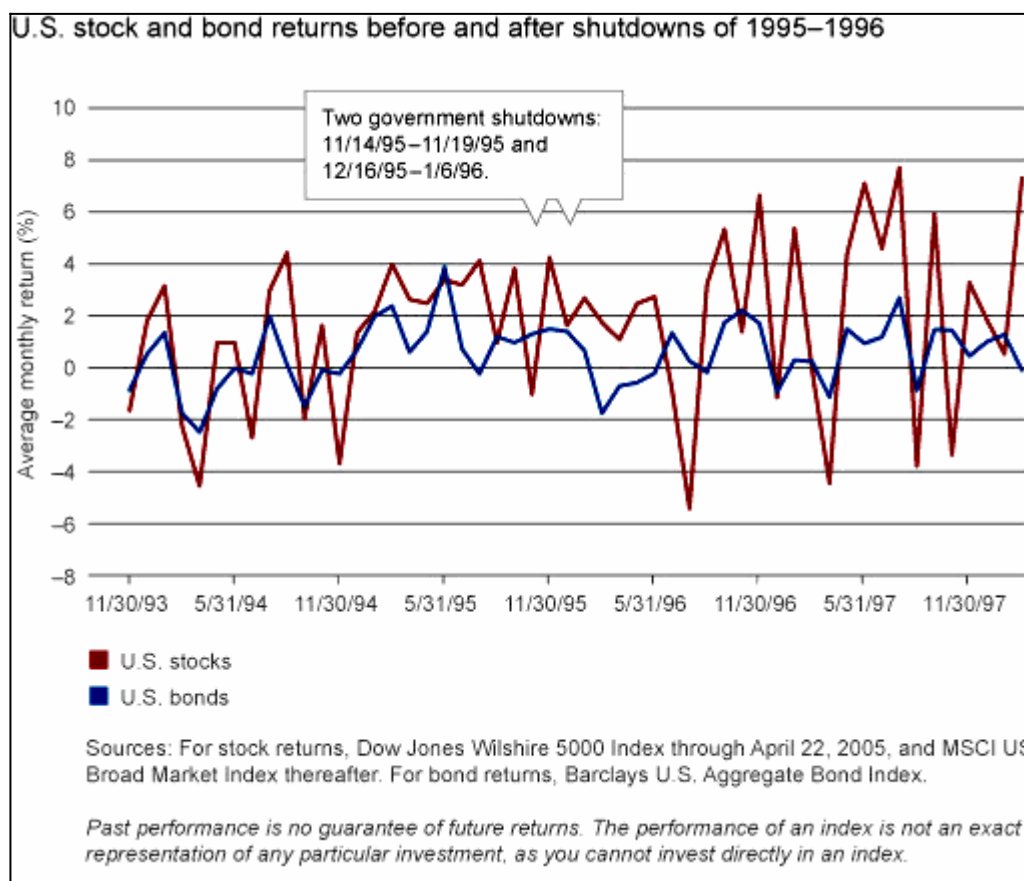
For example, the 2012 debt-ceiling debate ran to the last minute but sidestepped default. Markets rallied when lawmakers reached an agreement.

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 before the debt-ceiling/government-funding fiasco.



An even better example might be the 1995-1996 fiscal stalemate that forced two government shutdowns. What was the market’s response then?

“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.”



A word of caution

However, as the disclaimer following the above chart reads, “past performance is no guarantee of future returns.” The same caveat applies to today’s fiscal debates.

“The debt-ceiling discussion has a big symbolic component,” Mr. Aliaga-Díaz said. “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.”

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

“What we fear more this time around,” Mr. Aliaga-Díaz said, “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.”

How should you respond?

Sarah Hammer, a senior analyst in Vanguard Investment Strategy Group, encourages you to maintain your commitment to long-term goals and resist the temptation to “time” investing activity around events in

Washington.

Five years after the crisis, how healthy is the economy?

A conversation with Vanguard chief economist Joe Davis and Mark Zandi, chief economist for Moody's legislative outlook," Ms. Hammer said. "Instead, clients should practice tax-efficient investing and smart asset allocation, and maintain discipline and a long-term perspective."

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