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Fiscal Policy: Once More, With Ceiling

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In October, as the new fiscal year begins, Washington will face two critical deadlines: It will need to pass a new continuing resolution to keep the government running in the absence of a budget, and it will need to raise the debt ceiling to allow the required borrowing. Since failure on either could shut down the government, the attendant debates will inevitably roil markets, causing some investors to make periodic flights to safety. But since Washington will almost certainly avoid a shut down and instead will likely postpone the ultimate decision on fiscal policy, such flights will also be short lived and quickly reverse.

This is far from the first time Washington and markets have faced such issues. The government's inability to agree on a budget for years now has forced periodic needs to pass continuing resolutions. For this coming fiscal year, Congress has sent 12 annual spending bills to the president's desk, but still no budget. A continuation of government services, then, will require a majority to vote a stopgap resolution for at least part of the new fiscal year. Such stopgaps in the past have simply extended the spending channels of the previous fiscal year, sometimes for longer periods, sometimes for shorter. Washington has managed this way since President Obama took office. It will be more difficult this coming fiscal year, as a continuing resolution of this kind would effectively invite the next round of sequestration, something in excess of $100 billion.[1]

The need to vote for a new debt ceiling has a similar pedigree. Washington actually came up against the debt ceiling last December. To keep the government running, the Treasury at that time took extraordinary measures, ending the issue of state and local government series securities, for instance; relying on debt issued by the Federal Financing Bank, which is not subject to the ceiling; and delaying contributions to the government employees' retirement savings program. These measures bought time until February, when Congress, still unable to raise the ceiling, simply voted to allow the government to keep on borrowing until May. As that month approached, Washington acknowledged reality by raising the ceiling, from $16.4 trillion to $16.7 trillion. When that room ran out, the Treasury returned to extraordinary measures. It now says that these have gone as far as they can go and that it will need new borrowing authority in October.[2]

Anticipating these impending deadlines, the sides in Congress and the White House have begun to marshal their demands. The president and the Democratic leadership, not surprisingly, want as few constraints as possible. In the absence of a budget, they would like easy continuing resolutions, avoiding the next step in the sequester if possible, and a simple, unconditional, but substantial rise in the debt ceiling, "clean," in the president's words. Republicans in both houses of Congress have put forward two negotiating positions. The more extreme would seek to defund the Affordable Care Act in return for either continuing resolution legislation or an increase in the debt ceiling. Alternatively and less pointedly, House Majority Leader Eric Cantor (R-VA), speaking for the Republican leadership, has indicated that the party would look for fiscal reforms and pro-growth policies before agreeing to a continuing resolution or a rise in the debt ceiling. Without offering any detail to speak of, Cantor would look for changes significant enough to put the federal budget on the path to balance in 10 years.

Though the distance between these positions would seem at first to create an impossible impasse, the pattern of past years points to a different, less dramatic situation. Since neither side can win its positions nor will a compromise likely emerge, Washington can continue to operate, as it has, with the ad hoc measures used to date. Certainly, this would be a more politically attractive alternative than either yielding to the other side or a government shutdown. The desire not to yield is obvious enough in today's highly partisan environment. The need to avoid a government shutdown was made plain to the political class after the difficult impasse on the debt ceiling in August 2011. Then, the voters, whatever their other preferences, told members of both parties that they would hold them to account if a shutdown occurred. Since then, the sides in this debate have never come close to an interruption in government services. They have instead agreed to differ and simply postponed a decision. Washington will most likely go down this same avenue this fall.[3]

Until this by now common pattern becomes clear, markets will respond to each turn in the coming debate and worry over every partisan gesture. Fears of an impasse and, consequently, a government shutdown will drive investors, from time to time, out of riskier assets, such as credit-sensitive bonds and equities, and into what they believe are safer asset categories, such as (ironically) Treasuries and agencies. Such fears have done this in the past. Asset prices will swing with such movements. Then, as some softening in the situation develops, especially when Washington, as in the past, simply postpones its decision, that flight will reverse and asset prices will move back accordingly.

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[1] For more detail, see, Michael Townsend, "2013 Debt Ceiling Debate: What Investors Need to Know," Charles Schwab, August 28, 3013, and Peter Schroeder, "House GOP Says It Will Raise Debt Ceiling by Mid-October," The Hill, September 6, 2013.
[2] Ibid.
[3] For more detail, see, "How to Play This Fall's Debt Ceiling Fight in Washington," *The Tell*, August 7, 2013, and Schroeder, *op. cit.*

CRITICAL RELEASES IN THE WEEK AHEAD
by Milton Ezrati

Of all the releases and announcements scheduled for the week, the most forecasting information will arrive on Friday, September 27, at 8:30 a.m. ET with the release of:

	Previous	Prospective
Personal Income for August *	+0.1%	+0.2%
Personal Outlays for August*	+0.1%	+0.3%

There is every reason to expect the income growth figures to return to trend and for the consumer to reflect both slightly faster income growth and improved confidence, though without undue enthusiasm.
*Source: Department of Commerce.

OTHER IMPORTANT RELEASES
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Wednesday, September 25, at 8:30 a.m. ET, will see the release of:

	Previous	Prospective
Durable Goods Orders for August*	-7.3%	0

The sharp drop recorded in July reflected a downward adjustment from an unsustainable surge in aircraft orders. Some lingering effects of that adjustment will keep the growth reported for August slower than it otherwise might be.
*Source: Department of Commerce.

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Wednesday, September 25, at 10:00 a.m. ET, will see the release of:

	Previous	Prospective
New Home Sales for August*	-13.4%	-0.8%

The sudden drop recorded for July reflected both the effects of rising mortgage rates and an adjustment for a previously unsustainable surge. Some of these effects should carry over to August.
*Source: Department of Commerce.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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