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Institute Alert

FIRST ANALYSIS

News or events that may affect your investments **November 13, 2023**

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A déjà vu moment for the federal budget

Key takeaways

- Averting a government shutdown by the November 17 deadline with a continuing resolution (CR) — that is, funding the government at current spending levels — is being slowed by inter- and intra-party differences.
- Avoiding a government shutdown in the coming days is tied to progress toward a so-called clean CR — one with a single expiration date and absent accompanying riders such as spending or border security.

What it may mean for investors

- As with this past September's budget impasse, we prefer investors look beyond market volatility related to a potential government shutdown and stay aligned with our more defensive portfolio guidance, positioning for a developing economic slowdown.

Policy déjà vu

Congress faces another Cinderella moment as the clock ticks toward a budget deadline at midnight on November 17. We believe a shutdown is likely beginning November 18, but we see reasons why any shutdown could be short and thereby limit material impacts for the economy and capital markets.

There has been hope that a conservative GOP Speaker of the House would have the political capital to thread the needle on a compromise CR lasting into January. However, the partisan differences that prevented a long-term budget agreement in September remain. Moderates on both sides of the aisle and in both chambers favor a clean CR, one without additional riders for partisan projects. Some House GOP members have countered with a proposal for a clean CR in exchange for trade-offs — for example, tougher border-security provisions in exchange for Ukraine aid — or through staggered deadlines on appropriations bills between early December 2023 and mid-January 2024.

The split challenges new House Speaker Mike Johnson to negotiate this divide to keep his gavel, a situation not unlike the one Kevin McCarthy faced earlier this year. Stiff opposition from the Senate leadership to permanent side deals on military aid and border security threatens to stall progress toward averting a shutdown. Meanwhile, the Senate is in the early stages of crafting a simple CR to fund the government through the end of fiscal 2024. Considering the wide differences in positions, a shutdown seems likely. But what kind of shutdown?

One issue is the type of shutdown that may occur, full or partial. A House-Senate compromise is required on each appropriations bill to keep relevant departments funded beyond November 17. Fortunately, the House had passed 7 of 12 appropriations bills as of November 8, while the Senate had approved 3. Any agreement by midnight on November 17 on at least some bills might mean a partial shutdown that affects only spending not passed by both chambers. However, the two chambers remain far apart on the final form of most bills. Whether any shutdown is full or partial, essential government services elsewhere — ranging from Social Security and Medicare benefits to the U.S. mail and air-traffic control — would continue, but without federal pay for government workers providing them.

A second issue is the duration of any shutdown, which we think would be short. That some appropriations bills have passed already indicates that compromise is possible and is a sign we continue to watch. Moreover, incumbents likely will want to avoid the political liability of a shutdown that worsens the current economic slowdown during election season. Even a full government shutdown could look more like the 17-day closure in October 2013, rather than the longer, albeit partial, shutdown in late-December 2018 through late-January 2019.

Reading the tea leaves

Avoiding a government shutdown is, by nature, a two-track process that involves efforts to push through compromise appropriations bills in both chambers and separately negotiate for a CR. Below are a few signposts we believe are likely to shape the odds of a government shutdown, the type (full or partial), and the possible length:

- **Progress on appropriations bills:** Thus far, progress has been slow in passing any of the remaining appropriations bills, but the agreements accumulated so far provide a good gauge of intra-party cohesion in reaching a CR compromise.

- **A straight versus laddered CR:** A simple CR proposal emerging from the GOP-led House seemingly is a precondition for a compromise bill with the Senate. One rider that could help spur a compromise: creation of a commission to control federal debt, favored by some in the House.

- **Extraneous budget demands:** Progress toward a CR agreement excluding steep, permanent spending cuts or stricter border-security provisions is viewed as a prerequisite for agreement on the bill with Senate leadership.

- **Another House-speaker crisis:** A worst-case scenario is budget gridlock in the House that removes Speaker Johnson — in other words, a replay of the three-week "freeze" on House business following the removal of former Speaker McCarthy. This is not our base case but would become more likely if progress breaks down.

What it means for investors

In our view, the investment implications of a potential government shutdown are unchanged from September's budget impasse. The impact of past government shutdowns on the economy, stocks, bonds, and other investments has been quickly reversed after the reopening, particularly if the shutdown is short. Weighed against the economy's late-cycle weakness, we anticipate any shutdown would likely be brief, given the political stakes and potential channels for an early compromise on a CR.

For those reasons, we prefer to look beyond any shutdown-related market volatility and, instead, to emphasize the weakening economy. This focus drives our defensive portfolio guidance that prioritizes quality and liquidity in equities and fixed-income securities, with bond exposure balanced between short- and long-term securities.

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