

# Watch for the Signals on Policy Direction Out of Washington

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- As expected, the deal that passed Congress on October 16 is another short-term, kick-the-can package. The big question is whether we will have to endure yet another saga next year, when Congress is once again forced to address the debt ceiling and fund the government.
- We are skeptical on the outlook for the bipartisan budget conference committee: The main obstacles to a grand bargain that have existed for the past two years continue today.

With the federal government reopened and the debt ceiling extended, it is not surprising that markets have experienced a “relief rally” as investors cheer that the unthinkable – a default on U.S. debt – has been averted. Exhausted, if not disillusioned, by this most recent episode of political dysfunction, market participants are eagerly hoping for a reprieve from the uncertainty and brinksmanship that has characterized Washington recently.

Sadly, we do not anticipate getting much of a respite: Policy uncertainty is likely to increase once again near the end of the year as Congress yet again has to tackle important fiscal issues – and in an increasingly hyper-partisan context.

What should investors look for? One bellwether will be how the Congressional budget conference committee interacts and what, if anything, the committee produces.

## What did the deal include?

As expected, the deal that passed Congress is another short-term, kick-the-can package that simply delays difficult decisions without meaningfully taking the threat of shutdown or default off the table. Also as expected, the bill (despite its bipartisan support in the Senate) only passed the House by Speaker John Boehner defying the so-called Hastert rule: securing votes from all Democrats but only a minority of Republicans.

What does the deal do? 1) It requires a bicameral bipartisan budget conference committee to create a budget blueprint for fiscal year 2014 by 13 December 2013 – though importantly, it does not include a “trigger,” an enforcement mechanism to ensure that a committee agreement gets signed into law; 2) it funds the government through 15 January 2014 at 2013 sequester levels; and 3) it extends the debt ceiling to 7 February 2014, with potential for the Treasury to continue to use “extraordinary measures” that will likely push the actual debt ceiling deadline into March. The deal also requires income verification for beneficiaries of “Obamacare” as well as provides back pay to all furloughed government employees.

## Don't expect a grand bargain from the budget conference

If the bicameral bipartisan budget committee that this deal sets up sounds familiar, it should: This is the eighth bipartisan budget commission since 2010. Optimistic observers think the budget conference could revive the prospects for a “grand bargain” – a comprehensive debt deal that substantively addresses our long-term entitlement challenges coupled with wide-ranging tax reform.

We are more skeptical, however: Without a trigger to align both parties' incentives, we think that at best we may get some tweaks at the margin – reconfiguring some of the sequester cuts in exchange for some moderate modifications to entitlements (such as the way Social Security benefits are indexed for inflation – something President Obama has already endorsed). At worst, we think we could get a lot of rhetoric and name-calling without any real policy proposals. Why? The main obstacles to a grand bargain that have existed for the past two years continue today: Democrats won't agree to substantive entitlement reform without material revenue increases (i.e., tax hikes), and Republicans, feeling they already have conceded too much on the revenue side in the fiscal cliff compromise, refuse to agree to any tax increases.

## Will we have to live through this all over again?

The big question, of course, is whether we will have to endure yet another saga of brinkmanship and eleventh hour deal-making next year, when Congress is once again forced to address the debt ceiling and fund the government. Time will tell on this question, but it won't be a long wait.

Right now, there's tremendous hostility on both sides of the aisle, not to mention considerable tension within the Republican party. Some congressional Republicans – feeling they lost big in this fight – are readying for another. However, other Republicans have conceded that this was a losing strategy (Senator Lindsey Graham called the package “a joke compared to what we could have gotten if we had a more reasonable approach”), and it is hard to conceive that Republican leadership in either chamber would want a repeat of this saga heading into the 2014 election cycle given the blow the recent episode has given to their already lackluster polling numbers.

If the budget conference committee approaches negotiations with a spirit of compromise, if concessions are made on either side – however small – and if a bipartisan framework for fiscal year 2014 is agreed upon, then the outlook is somewhat brighter. We could expect a much less contentious resolution to the 15 January 2014 government funding deadline, which could have positive spillover effects for the debt ceiling debate. If, however, the budget conference resembles what we have seen over the last three weeks – partisan bickering and a refusal to move from ideological positions – we should expect more turbulence in the beginning of the year.

Either way, expect the focus – despite possibly everyone's wishes – to remain on policymakers in D.C. for the foreseeable future.

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