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FIRST ANALYSIS

News or events that may affect your investments **January 4, 2024**

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Round three in the fiscal 2024 budget debate

Key takeaways

- Congress sidestepped a government shutdown in November, only to be faced with another, staggered deadline early this year.
- If negotiations are still deadlocked at the end of April, the Fiscal Responsibility Act of 2023 (which lifted the debt ceiling in June 2023) requires automatic budget cuts. In our view, automatic budget cuts would further pressure an already weakened economy and likely weigh on risk markets, particularly equities.

What it may mean for investors

- Our defensive guidance positions portfolios for a developing economic slowdown and political uncertainty in an election year, and we believe that the increased threat of a budget impasse makes this guidance even more relevant.

Back-door bipartisanship averted a government shutdown in mid-November, as House Democrats stepped in to move the latest continuing resolution (CR) across the finish line on November 16. Since then, little real progress has been achieved toward passing specific spending bills making up the fiscal 2024 budget. An agreement to hold fire in November left the two parties — and their factions — with an even greater threat of at least a partial government shutdown on January 20. Attention now shifts to more complex negotiations over 12 appropriations bills. Both the House and Senate are back in session by January 9.

High stakes in round three of the budget debate

Congress effectively is working without the safety net of another CR to extend spending, which Speaker Mike Johnson is on record as opposing. Even as the calendar turned to 2024, the appropriations process remains far from complete. The House has passed 7 of 12 spending bills as of this writing. The Senate has approved just 3 of 12 appropriations bills but is even better positioned than a divided House because all 12 bills have cleared the Senate Appropriations Committee in bipartisan votes.[1] However, none have cleared both chambers, leaving open the possibility of a full government shutdown if the CR runs out for all agencies by February 2.

1. New York Times, "These are the fights that many House Republicans really want," November 16, 2023.

Additionally, there is now more at stake than a government shutdown triggered by temporary funding disruptions. The clock is also ticking toward permanent, 1% across-the-board cuts in discretionary spending from fiscal 2023 levels if all 12 appropriations bills are not approved by April 30. Any comfort to House leaders from reduced spending would be outweighed by the mix of those cuts: defense outlays would be $36 billion less than the proposed $886 billion for fiscal 2024 if the automatic spending cuts are triggered, while the $704 billion in planned non-defense discretionary outlays would increase $32 billion from expenditures planned for fiscal 2024.

Gauging progress toward a budget agreement

Signs of progress toward a budget accord will hinge on a broader array of potential complications. Among them:

- **A discretionary spending cap.** Senate Democrats have largely hewed to the $1.59 trillion target enshrined in last spring's debt-ceiling accord, but conservative House Republicans are determined to cut the top-line figure to $1.41 trillion.[2] The difference is complicating efforts in the Senate and the House to complete work on the 12 appropriations bills comprising the budget.

- **Funding for Ukraine and Israel.** Though not part of the actual budget, House Republicans are levering the administration's more than $100 billion supplemental foreign-aid request for Ukraine and Israel against increased border-security funding. Budget negotiations remain stalled by an impasse here despite a compromise defense authorization bill that allowed for a fractional $300 million in Ukraine aid.[3]

- **Appropriations bills or bust.** Speaker Johnson is on record as opposing additional CRs after expending political capital negotiating the last one with disgruntled conservative Republicans. That puts the pressure on the Senate and House to pass and reconcile four appropriations bills before the January 19 deadline and eight more before the February 2 deadline.

- **Tier 1 appropriations bills.** Compromise on the four appropriations bills tied to the January 19 deadline will be an early bellwether of success in completing the remaining eight bills by February 2. Agencies funded by the departments of Energy, Veterans Affairs, Transportation, and Housing and Urban Development are at greater risk of a shutdown after January 19 because the political consequences seem less dire.[4]

- **Support from moderates.** The few House moderates in borderline districts will be closely watched for signs of compromise with Democrats on tempering politically sensitive spending cuts demanded by House conservatives less than a year before the next elections.

- **Hot-button issues.** We will gauge negotiating flexibility by progress on such hot-button issues as abortion (figuring in the debate over the Farm Bill through a provision to ban mail delivery of an abortion pill) and immigration, threatening agreement on Agriculture, Homeland Security, and other appropriations bills.

- **Saving Speaker Johnson.** The House Speaker will be walking a fine line between the interests of competing House factions (including within his own party) and the Senate leadership, particularly with the threat of an even narrower Republican majority after special elections. Talk of his ouster could be taken as a sign that no further compromise is likely.

2. The Washington Post, Congress averted a government shutdown, but the real fight is ahead, November 18, 2023.

3. Bloomberg, "U.S. Congress Sends $886 Billion Defense Policy Bill to Biden," December 14, 2023.

4. New York Times, "These are the fights that many House Republicans really want," November 16, 2023.

What it means for investors

The investment implications of a government shutdown have been the one constant through successive rounds of budget talks in 2023. Added wrinkles in this latest round of talks are the risk of a more extended government shutdown now that CRs appear off the table, along with potential changes in the size and mix of government spending in a compromise 2024 budget.

We believe this raises the stakes for an increasingly fragile economy facing late-cycle weaknesses and the usual election-year uncertainties. Given the combination of headwinds, we reiterate our defensive portfolio guidance, preferring investors prioritize quality and liquidity in equities and fixed-income securities.

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