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SEPTEMBER ANGST: BUDGET BATTLE BLUES

Analysts are warning that September may see yet another bitter budget showdown between the President and Congress. The temporary agreements cobbled out earlier this year on the debt ceiling and spending are nearing expiration, and the two sides are farther apart than ever (and possibly even spoiling for a fight). Many are beginning to worry that a government shutdown or debt default are real possibilities that could send markets and the economy reeling (the Dow fell over 2,000 points in response to the 2011 debt ceiling battle).

I think these concerns are overwrought, at least for now. To begin with, many commentators seem to be conflating the prospect of a government shutdown with the prospect of a debt ceiling-induced default. These are two very distinct things.

In the wake of the 2011 budget battle, when a narrowly-averted debt ceiling-induced default led to a downgrading of the U.S.'s triple-A sovereign credit rating, the use of the debt ceiling as a "nuclear option" was widely seen as a loser for Republicans, both with the public and with a deeply worried business community. Except for a fringe of the Tea Party which sees default as a kind of righteous judgment to be accepted, there is little appetite among congressional Republicans to use the debt ceiling as a negotiating tool – the potential economic damage, and the blame associated with it, is simply too great. This was reflected in the 2013 "fiscal cliff" negotiations when, despite much speculation to the contrary, the debt ceiling was quietly extended with only token strings attached. I doubt that we will see Republicans support any long-term extension of the debt ceiling without significant concessions from the Obama Administration, but I also think it will be difficult for them to resist a short-term extension when needed, given the potentially catastrophic impact of even appearing unwilling to do so.

A government shutdown, however, is another matter. Sequestration has been seen as a major backdoor budget victory for Republicans, and the Obama Administration is determined to undo it. This sets the stage for a major battle over the Continuing Resolution (CR) that must pass to continue funding the government past September. Failure to agree on a CR could result in a government shutdown, at least for non-essential services. While dramatic, the economic impact of a temporary shutdown would be minimal and short-term (unlike the potentially devastating long-term consequences of a sovereign debt default). Moreover, while the accepted myth has it that the government shutdowns (there were actually two) in 1995-96 were a disaster for Republicans, in fact they were instrumental in winning a more favorable budget deal with President Clinton, and Republicans retained their House and Senate majorities afterwards. For congressional Republicans, a government shutdown is not without risks, but is a far more attractive tool than a debt ceiling-induced default for wringing concessions out of President Obama.

So a debt default (or near-default) would be devastating, but I suspect most Republicans would rather cave on this issue than even flirt with such an outcome, whereas a temporary government shutdown would have far less serious consequences but is also far more likely. However, it is unclear that either matter will necessarily come to a head in September. Better-than-expected revenues, combined with sequestration cuts, may allow Treasury to hold off any debt ceiling request until November. With little time to do battle after it returns from August recess, Congress may opt to pass one or more 30-day CRs that would give both sides time to marshal their forces for the real showdown in October, November, or even December. In other words, don't hold your breath, there's still some room to kick the can down the road.

Of course, I wish I could use my contacts on the Hill and with the Administration to predict exactly what will happen, and when. But the truth is, even they don't know how things will play out. As someone who had a front-row seat during the budget battles and government shutdowns of 1995-96, I can tell you that, despite what both sides say, there is no "grand strategy" at work. The old adage of a plan never surviving contact with the enemy holds true for budget battles. A reading of Bob Woodward's book "The Price of Politics" (about the 2011 debt ceiling confrontation) confirms what my 1995-96 experience taught me: that these kind of budget standoffs are fluid, multi-tracked, often contradictory (with negotiators often talking past each other), and confused (with a myriad of moving pieces), and remain so until the last possible moment. The "winner" is not the side with the best "grand strategy" from the start, but the side that is able to identify and seize a momentary opening or slight change in momentum amid the shifting sands of public sentiment and closed-door negotiation. The reason both sides hold out to the last possible moment is that, in such a fluid environment, there is no reason to commit to a concession when every day, every hour may bring some new development that may work to one's advantage.

This process is nerve-wracking for markets, which crave certainty. So we may well see increased volatility in markets as it unfolds. This is especially true if market commentators continue to conflate the prospect of a government shutdown with the prospect of a debt default. Longer-term investors need to keep the distinction, and its implications, clear in their minds, even – or perhaps especially – if markets fail to.

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