The Markets Prepare For Crunch Time in Washington

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As summer ends – eight months through their first year in power – the Republicans are working to pass their first piece of major legislation. With the markets watching, crunch time is coming in Washington.

When President Trump took office, the Republicans designated two pieces of must-pass legislation: a substitute for the Affordable Care Act and rewrite of the tax code. It appears that the former is dead, torn between conservative Republicans who wanted greater cuts in government's role in the health care system and moderates concerned about the deleterious effects those cuts could have on lower-income families. (Although efforts at full-scale reform are likely over, Congress may consider bipartisan changes to stabilize the current system, adding to its already crowded calendar.)

But tax changes are very much alive, and it is those changes that the markets are craving.

Before it can turn to taxes, though, Congress must address two deadlines this fall.

- By last March, the federal government had borrowed the total amount – close to $20 trillion -- authorized by Congress. Since then, the government, unable to borrow, has limped along using tax receipts and money in accounts it does not immediately need. The non-partisan Congressional Budget Office estimates that the government will need to borrow again by the end of September. If Congress fails to raise the debt limit by that time, then at some point the government's ability to pay interest on U.S. debt outstanding will be called into question, severely roiling the financial markets. Treasury Secretary Mnuchin has asked Congress to pass a "clean" bill raising the debt ceiling without condition. But fiscal conservatives want that bill to include riders curbing future spending and the permissible uses of borrowed funds.

- Congress has funded the federal government through September 30, the end of the current fiscal year. To avoid a government shutdown on October 1, Congress must appropriate additional funds before that date. Republicans are calling for increases in military spending and deep cuts in domestic spending. Fiscal conservatives also are calling for cuts to entitlement programs, such as Social Security, Medicare, and

Medicaid. President Trump also is demanding funds to build a wall on the U.S.-Mexican border, and has threatened to shut down the government to get them.

Under the Senate filibuster rules, 60 votes are required to pass legislation raising the debt limit and funding the government. Because the Republicans hold 52 Senate seats, Democratic support is needed. Democrats insist on a "clean" bill that raises the ceiling without condition. They also oppose proposed cuts to social and entitlement programs, and vehemently object to providing funds to build the President's wall. Reaching a compromise will require serious effort. Ultimately, Congress must raise the debt ceiling to avoid the risk of a national default, but getting there could be messy. We also see a short-term government shutdown in early October as a distinct possibility.

These matters preview what businesses and the markets view as the most important legislative effort this year: tax reform. There is broad consensus among Republicans at both ends of Pennsylvania Avenue that U.S. tax rates must be reduced to grow the economy and foster U.S. business competitiveness. But tax reform is not straightforward: most legislators insist that tax changes not significantly reduce the revenue the government derives from the tax system. To achieve this "revenue neutrality," tax reform, in addition to lowering rates, must curtail existing deductions and exemptions. But each deduction and exemption provides a benefit to a particular group or economic sector. Once a tax bill identifies a deduction or exemption as a candidate for change, those industries adversely affected push back strenuously, threatening Congress' will to enact reform.

We see increased market volatility this fall, as Congress struggles to meet its fiscal deadlines and starts to consider wholesale changes to the tax code. Each development will prompt the markets to recalibrate the likelihood of tax reform, with a consequent positive or negative effect on stock values.

Readers at this point might conclude that we are pessimistic about Congress taking actions this fall that will please the markets. In fact the opposite is true. Yes, we see the prospect of increased volatility: as Congress struggles to pass legislation to raise the debt ceiling and fund the government in September, the markets could pull back. But, at some point, Congress will authorize additional borrowing to avoid a U.S. default, and the government will be open. We believe a pullback based on Washington actions (or inactions) is likely to be temporary.

More important, we do not believe Congress' failure to deal swiftly and smoothly with the debt ceiling and government funding bears on the likelihood of tax relief this year. Extrapolation from the debt ceiling and government funding legislation to tax legislation is misplaced. The former requires 60 Senate votes (and thus Democratic support). But procedural rules permit Senate Republicans to pass tax measures with a simple majority. Thus, Republicans are free to fashion a tax bill without concern about garnering Democratic support.

And, finally, we do not think that the impediments to reaching agreement on a revenue-neutral rewrite of the tax code mean Congress will fail to pass tax relief. As we've noted, if market movers get anxious that the debates this fall are not moving toward tax cuts, market volatility could spike. But if Republicans are unable to agree on full-scale tax reform, we believe that Congress will abandon the sweeping goal of simplification to pass streamlined legislation that simply reduces tax rates (more akin to the 2000 Bush tax cuts than the 1986 Reagan overhaul). It would be too embarrassing for the Republicans, having assumed control of Congress and the White House with the promise of lowering taxes, to fail to pass any tax relief legislation at all this year. (There is a risk that tax cut legislation standing alone will not be revenue neutral and thus could lead to higher deficits down the road, retarding future economic growth. Our guess is that consideration is too long term to affect market approval of business tax relief.)

Thus, we see increased volatility in the coming months as Congress struggles to meet its fiscal deadlines and dives into the morass of wholesale changes to the tax code. But we remain optimistic that, in the final analysis, the markets will get what they most crave: a reduction in tax rates, suggesting that market pullbacks could be a buying opportunity.

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