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WASHINGTON POLICY STRATEGY
Potomac Perspective

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Happy New Year to all clients, colleagues, and friends – wishing everyone a happy, healthy, and prosperous 2023!

The New Year ushers in a new Congress, which could start in chaos as House Republicans struggle to elect a Speaker. This could lead to some market volatility if investors lose confidence in the government's ability to conduct business. The chaotic start to 2023 also sets up the narrative for the rest of the year – gridlock. Later in the year, Congress could struggle to keep the government open and pass an increase in the debt ceiling. Despite gridlock, there will be a handful of issues on which Congress might be able to agree, and even though the legislative process may be bogged down, the regulatory agencies will be active in 2023.

2023 OUTLOOK

Political Chaos and Market Volatility to Start the Year – The 118th Congress will convene on Tuesday, January 3, and while the majority in each congressional chamber is known, it is still unclear who the next Speaker of the House will be. Voting for a Speaker could potentially take several days, during which time the House will be unable to conduct business. **The political chaos caused by this vacuum could lead to some market volatility as investors might lose confidence in the U.S. government's ability to function properly.**

The entire House elects its Speaker, and the winner must gain a majority of members who vote for a specific candidate. So, even though House Republicans nominated Representative Kevin McCarthy (R-California) to be Speaker, Mr. McCarthy must be elected by the whole House. Republicans will have a 222-212 (1 vacancy) majority, so assuming that all Democrats vote for their party's nominee, Representative Hakeem Jeffries (D-New York) or someone other than McCarthy, McCarthy can only afford to lose four Republican votes. House Republicans nominated McCarthy 188-31, but five of the 31 "noes" have publicly indicated they will not vote for McCarthy on the House floor. It is possible that McCarthy and his Republican opponents will reach a compromise that will give McCarthy the votes he needs. If McCarthy fails to win a majority of votes on the first ballot (this would be the first time since 1923 that the House failed to elect a Speaker on the first ballot), he could see if enough pressure could be brought to bear on the holdouts during a second or subsequent ballot to move enough votes to win the speakership. If the Republican holdouts persist, then House Republicans would have to consider nominating someone other than McCarthy. That could take some time, during which the House would still be unable to conduct business. Also, it is possible that some Republicans, unhappy with the tactics used by McCarthy's opponents, could vote against a new nominee which could mean that the process lasts several days.

Any political chaos accompanying the opening week of Congress could contribute to a risk-off sentiment in the markets.

Gridlock in Washington: What to watch for from Congress and the Regulators – Gridlock in Congress will limit what legislation can pass, which could mean that most policy action is at the regulatory agencies. Still, there are some key areas on which Congress will need to act and some areas where there could be bipartisan cooperation.

Budget and Debt Ceiling – At some point in mid- or late-2023, the federal government will need to increase the debt limit in order to avoid a default on federal debt and to allow the government to continue to borrow. The Bipartisan Policy Center (BPC), a Washington D.C.-based think tank that tracks the debt limit, estimates that the debt ceiling will be reached in first quarter 2023 at which point the Treasury will rely on “extraordinary measures” to avoid a default. At some point, Treasury will exhaust these extraordinary measures (these include steps such as delaying payments for government retirement funds), and Congress will need to raise the debt ceiling. The BPC estimates this “X date” as sometime in third quarter 2023.

Republicans see the debt ceiling debate as providing leverage to pass some of their domestic priorities which they could not pass otherwise. However, advocates of leveraging the debt ceiling debate to pass other legislation typically overestimate its efficacy, so chances of major structural changes are low. Frustrated by their inability to pass their agenda, some Republicans could refuse to raise the debt limit which would cause political headaches for the GOP leadership (especially in the House) as they seek enough votes to raise the debt ceiling and avoid a default. There could be a standoff similar to the summer of 2011 when during a debate over the debt ceiling, the S&P 500 fell from roughly 1350 in early July to approximately 1100 in the second week of August, at which point President Barack Obama reached an agreement with House Speaker John Boehner. The S&P then traded in a range and broke below 1100 in early October 2011 before beginning a recovery that saw the index rally back to 1350 in February 2012.

The prospects of a default are remote -- Congress will eventually raise the debt ceiling, but there is headline risk associated with the debt limit debate.

Congressional Republicans, especially in the House, have recently expressed frustration with the annual appropriations process. While Republicans might try to pass appropriations bills via regular order instead of in an omnibus appropriations bill as happened recently, **Congress could struggle to meet this goal which could result in a government shutdown in the fall of 2023.**

Antitrust and M&A – The Department of Justice (DOJ) could make significant changes to its merger guidelines in an anticipated proposal to amend the DOJ’s horizontal and vertical merger guidelines. A release is expected in early 2023.

Similarly, banking regulators could propose changes to **bank merger review guidelines**. Such changes could impose new rules on market concentration, access to bank services, community lending rules, and the possible impact of mergers on banks’ financial stability. Banks with more than \$100 billion in assets will likely bear the brunt of any changes to bank merger rules.

Technology and Social Media –With Republicans taking over the House, it is likely that **Congress will look at social media companies and their protection under Section 230 of the Communications Decency Act**. Both parties are interested in policy changes related to the technology sector. Republicans will look at allegations of the suppression of speech. Democrats will focus on how platforms have been used to spread disinformation. Both parties have varying degrees of interest in changes to antitrust laws as they apply to the technology sector. Although **Congress was unable to pass tech-related antitrust legislation in 2022, it is expected that Congress will give this issue a second look in 2023.**

Banking Regulation – In addition to revising bank merger rules, **banking regulators could propose higher bank capital rules. Any changes in the merger rules would probably impact the largest banks the most.** As regulators consider changes in capital rules, regulators could ease the rules under the Supplementary Leverage Ratio while also increasing other bank capital requirements.

Cryptocurrency Legislation – **The recent collapse of FTX could bolster bipartisan efforts to pass cryptocurrency legislation in 2023.** A pair of bipartisan bills have been introduced in the Senate that would clarify how different types of digital assets are regulated. These bills are likely to be reintroduced in 2023. Jurisdictional debates over which agency regulates which assets could doom a broader bill. If Congress is unable to pass sweeping digital asset legislation next year, it might opt to pass narrower legislation that addresses the regulation of stablecoins but not other digital assets.

Healthcare – Following the passing of the Inflation Reduction Act (IRA) which imposed price controls on drug prices via Medicare, Democrats might try to push to cap prices on insulin provided via private health insurance plans. Democrats passed the IRA in 2022 under reconciliation rules which blocked them from regulating prices on drugs provided under private insurance plans. Given the political appeal of drug price controls, **Democrats could revisit capping the price of insulin in 2023 but will probably struggle to pass legislation through a Republican House.**

Trade – The Biden administration has been reviewing tariffs placed on Chinese imports during the Trump administration. While there are some voices within the administration that would like to ease the tariffs in order to reduce inflation, many of the tariffs remain popular among Democrats, especially organized labor, so there is considerable pressure within President Biden's party to retain the tariffs. Furthermore, there is an interparty competition to see which party can be toughest on China. With the 2024 elections in view, Democrats will be reluctant to be seen as being soft on China. For these reasons, **the most likely outcome is that most tariffs will remain in place. Some tariffs on finished goods may be dropped or reduced in order to make a statement on inflation, but any elimination or reduction in tariffs are likely to be the exception to the broader policy of retaining most tariffs.**

2024 – Despite just finishing the midterm elections, attention is already turning to the 2024 elections.

It appears likely that President Joe Biden will run for reelection. If he does, it is unlikely that any credible Democrat will oppose him. If Mr. Biden decides not to run, he might still wait to announce his decision lest he become a lame duck president. In this scenario, numerous Democrats would probably seek the nomination, including Vice President Kamala Harris, several U.S. senators, and a group of Democratic governors.

On the Republican side, former President Donald Trump has already announced his intent to run. He is likely to be challenged by any number of governors, including Florida Governor Ron DeSantis, several Republican senators, and possibly former members of his administration. Polling suggests that former President Trump's standing among Republicans is diminished. This sets up a paradox in which the seemingly weakened position of the former president lures numerous Republican candidates into the race which, in turn, splinters the non-Trump vote within the GOP. While Mr. Trump appears vulnerable, there are scenarios in which he could win the 2024 GOP nomination.

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