Brian Gardner
Chief Washington Policy Strategist
bgardner@stifel.com

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WASHINGTON POLICY STRATEGY

Potomac Perspective

Talks between U.S. President Joe Biden and Chinese President Xi Jinping could reestablish military communications between the two countries, which in turn could reduce geopolitical risks – a positive for the markets. Our base case, however, remains that the U.S. will extend most tariffs on Chinese imports and will impose new restrictions on chip exports.

Congress seems to be making progress towards averting a government shutdown. The pending Thanksgiving holiday could be a powerful motivator to pass a government funding bill.

Lastly, banking regulators will probably face questions on the Basel III endgame proposal when they testify before Congress this week. We explain why we believe the odds are good that the proposal will be modified.

US/CHINA TRADE

Investors should keep expectations in check for major breakthroughs following a meeting this week between President Biden and Chinese President Xi. The two leaders will meet in San Francisco at the Asia-Pacific Economic Cooperation forum. The talks are a continuation of a series of meetings between high level American and Chinese officials and are, generally, positive for maintaining relations between the two countries at a time of heightened tensions. We do not, however, expect that the meeting between Presidents Xi and Biden will produce significant changes in U.S. trade policy.

In the coming weeks, we expect the Biden administration will announce the extension of most of the 2018 tariffs on Chinese imports, which have been the subject of a statutory review. The administration is also expected to announce new restrictions on the exportation to China of chips used in artificial intelligence.

ANOTHER POSSIBLE SHUTDOWN

The current government funding bill expires on Friday night. House Speaker Mike Johnson has indicated that he will offer a novel approach to avert a government shutdown. According to the Johnson plan, the new Continuing Resolution (CR) would fund part of the government covered by four appropriations bills until January 19 while the rest of the government (eight appropriations bills) would be funded until February 2. The Johnson plan would fund the government at current spending levels and would not include any policy riders, nor would it include President Biden's request for supplemental funding for Israel, Ukraine, and other matters.

Some conservative Republicans are opposed to the Johnson plan and will vote against a procedural vote. This could kill the legislation because such procedural votes are typically cast along party lines, and all Democrats would probably vote "no." Instead, Speaker Johnson might bring the bill to the floor without the preliminary procedural vote, but this option requires a two-thirds majority to pass the House. This is the same tactic used by then-Speaker Kevin McCarthy in late September to pass the original CR. That move ultimately cost McCarthy the Speaker's gavel, as the CR passed with more Democratic votes than Republican votes – something that is anathema to conservative Republicans. Speaker Johnson is still on a political honeymoon, so it is unlikely he will be removed as Speaker, but it will cost him some political capital with conservatives. There is also no guarantee the Johnson plan will pass, but if it passes the House, it will also likely pass the Senate.

Congress will be eager to get out of Washington to return home ahead of the Thanksgiving holiday, so some lawmakers could be incentivized to vote for the bill even if they view it as flawed. Although odds of a shutdown seem to grow last week, **the lack of Democratic criticism seems to suggest that the Johnson plan might pass and the government will remain open. If, however, Congress drops the ball and the government shuts down, investors are not expected to panic. Markets tend to ignore government shutdowns. We have previously noted that the S&P 500 rose during the previous two shutdowns (10% during a 34-day shutdown that began in December 2018 and ended in January 2019; and gained about 3% during a 16-day shutdown in October 2013).**

BANKING REGULATORS TESTIFY: A LOOK AT THE POLITICS OF BASEL III

Banking regulators will testify before Congress this week, and lawmakers are likely to ask numerous questions about the Basel III Endgame proposal. The Senate Banking Committee will lead off on Tuesday, and the House Financial Services Committee will follow on Wednesday. Since the Basel III proposal's comment period is still open, it is unlikely regulators will say much about the proposal other than they "look forward to the public's input." This week's hearings might not shine much new light on the proposal, but **we think there is a good chance that it will be watered down and possibly scrapped. There are three reasons why the proposal could be changed (with some overlap among the three factors).**

- ***Congressional pressure*** – There is bipartisan pressure to change the Basle III proposal. In addition to Republican opposition, some Democrats have expressed concerns that the move to increase risk weights for some high loan-to-value residential mortgages could reduce access to credit for lower income borrowers. Lawmakers have also expressed concerns over a possible reduction in credit availability in agricultural and small business lending.
- ***Litigation threat*** – The bank trade associations have clearly signaled that they believe the proposal violates the administrative procedures act and will possibly litigate this issue. Litigation would slow down the process, and any delay in finalizing or implementing the proposal could increase the risk that a Republican administration (if a Republican candidate wins in 2024) would scrap the proposal. Therefore, banking regulators might decide that it is in their interests to modify the proposal in an attempt to avoid possible litigation.
- ***Election considerations*** – The banking regulators have already extended the comment period through January. Given that this is late in the presidential cycle and the possibility the White House could flip in the 2024 election, regulators are running short on time to finish the rule.
    - If a Republican wins the presidency, control of the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) could change on Inauguration Day. The president can fire the head of the OCC at will. A president can also fire the head of the Consumer Financial Protection Bureau (CFPB) at will. Since both agency heads are also members of the FDIC Board, control of the FDIC would change even if Chairman Martin Gruenberg remained as Chairman. The Federal Reserve could technically go it alone on Basel III since the Federal Reserve (Fed)'s leadership would not change immediately. However, we do not think the Fed acting alone would be Chairman Jerome Powell's preference. We think he would prefer a multi-agency rule to avoid possible

regulatory arbitrage. We also think Chairman Powell would be cognizant of any change in the political winds and might be reluctant to finalize a rule that is opposed by a possible new administration.

- If this view is correct, the Fed might decide to slow down work on Basel III (if it has yet to be completed) as soon as Election Day (or possibly earlier in the event that a GOP win became obvious at some point in the fall of 2024).
- **This scenario would leave supporters of the Basel III proposal within the Fed, the OCC, and the FDIC with the choice earlier in 2024 of either: 1. Watering down Basel III so they can make some adjustments to large bank capital rules and claim victory (and possibly avoid being sued by the industry); or 2. Holding out and taking their chances that President Biden is reelected and finalize a rule that is similar to the proposal.**
- **The regulators might view the first option as the safer course of action, and it is why we think chances are good that the Basel III proposal will ultimately be watered down.**

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