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Potomac Perspective

The whirlwind of a second Trump term continues. Tariffs, spending freezes, and decisions on tax policy are all being rolled out piecemeal, and key details remain elusive. In our weekly note, we look at the possible timing of announcements and the implementation of tariffs. We also revisit the fiscal debate as the administration pauses some federal spending and congressional Republicans search for a strategy on how to extend the expiring Trump tax cuts. Finally, we are fielding occasional questions about which Trump nominees might be blocked by the Senate. Our note discusses the prospects for the three most "at risk" nominees.

The start of every new administration brings a flurry of activity that can impact the economy and the markets, but with the Trump administration, it feels like we are drinking from a fire hose every day. That is neither good nor bad, but the pace of change seems greater than usual. Few, if any, of President Trump's initial actions are surprising, as they were all telegraphed during the election campaign. Still, many details have yet to be revealed, which leaves investors and the markets unsure of the impact of the Trump agenda. With that said, we offer some quick thoughts on recent events and developments we expect to occur in the coming days and weeks.

- Tariffs –
  - Canada and Mexico – Recently, President Trump said tariffs on Canada and Mexico could be announced on February 1 (Saturday). We would not be surprised to see that date slip as he might want to have his trade team in place. Confirmation hearings have yet to be held for the nominees for the U.S. Trade Representative (Jameson Greer) and Secretary of Commerce (Howard Lutnick). Their confirmation by the full Senate is likely days or even weeks away. Even if Mr. Trump announces tariffs on Canada and Mexico as scheduled, critical details about the scope and size of the tariffs could initially be omitted and announced at a later date. We expect certain goods and services from Mexico and Canada will be ultimately exempt from tariffs levied, but the administration might not announce which ones immediately. It seems probable they will start the regulatory process of imposing tariffs and leave the details for later. This pattern will probably follow with other countries also. We expect tariffs on Canada and Mexico will be implemented in mid-2025, unless agreements between the countries to avert the tariffs are reached first. Mr. Trump is, in our view, a transactional politician and a deal maker, so a compromise is possible. Our base case, however, is that tariffs will be implemented within the next few months.
  - China – Among Mr. Trump's first Executive Orders was to direct federal agencies to review U.S.-China trade relations. Subsequently, the U.S. Trade Representative has announced it is investigating whether China has engaged in unfair trade practices. It is also examining whether China has complied with the trade deal it entered with the U.S. during the first Trump administration. These reviews, which are expected to be completed in the spring, could set the stage for additional tariffs on China. This does not preclude Mr. Trump from announcing these tariffs whenever he announces tariffs on the North American countries. Treasury Secretary Scott Bessent (who was confirmed by the Senate on Monday night) has suggested imposing an initial tariff of 2.5% that would be increased over time to let impacted companies adapt. Mr. Trump has apparently rejected that level, but we think he has rejected Bessent's proposal as the finish line rather than the starting point.

- **Global** – President Trump has said less about tariffs on the rest of the world than he has about China, Canada, and Mexico, but we think global tariffs remain an option. The challenge for the administration, however, is what trade laws to use if it pursues these tariffs, as each law has certain flexibility but also certain limits. Mr. Trump could use Section 122 of the Trade Act of 1974, which allows the President to impose tariffs on countries that have persistent trade surpluses with the U.S. (i.e., those with whom America has a trade deficit). This option, however, could exclude some South American countries with whom the U.S. has a trade surplus. Also, this option is only temporary (150 days) and can only be extended by Congress. The administration might also consider using the International Emergency Economic Powers Act (IEEPA), which gives the President broad powers to declare a national emergency and take actions such as tariffs. We note, however, that IEEPA has historically been targeted at specific countries and not previously been used against broad regions or groups of countries.

- <u>Fiscal and Tax</u>
  - **Spending Freeze** – On Monday, the Trump administration announced a temporary pause of federal grants and assistance programs. A federal judge has blocked the pause until February 3 (a pause on the pause). The scope of the memo issued by the Office of Management and Budget (OMB) was vague and has generated a lot of confusion. OMB explicitly exempted Social Security and Medicare and subsequently issued another memo stating the pause was not "across the board," and does not apply to programs, such as student loans, which provide direct aid to individuals. Today's injunction probably sets up litigation on the legality of OMB's actions. The administration did not use the Impoundment Control Act of 1974, which establishes a framework for rescinding funds previously appropriated by Congress, because, in its view this is merely a pause, and the administration has not completely refused to spend these funds. This does signal a looming fight about a president's ability to refuse to spend funds appropriated by Congress. Members of the Trump administration think the Impoundment Act is unconstitutional and the President has broad powers not to spend approved funds. Recently, however, the Supreme Court has issued several decisions that restrict the executive branch's discretion in enforcing statutes passed by Congress and signed into law. We think the underlying rational of these decisions could apply to this situation, and the administration might lose in court if the pause continues for a considerable length of time.
  - **Tax Legislation** – House Republicans are meeting this week in Florida to strategize how they will proceed with reconciliation legislation to extend the Tax Cuts and Jobs Act of 2017. It seems unlikely, however, that the GOP will return to Washington, D.C. with an agreement on either the process or the substance of the legislation. Senate Republicans prefer two reconciliation bills, while the House GOP wants one bill. No agreement on this issue is possible without Senators present. On the substance of the bill, we are still in the early stages of negotiations, so handicapping what might be in or out of reconciliation legislation is difficult at this point. The first step in the process is for the House and Senate to pass a budget resolution, which is a prerequisite to a reconciliation bill. No budget resolution; no reconciliation bill. House Speaker Mike Johnson has said he would like to finish the budget resolution by February 24, which we think is a highly ambitious goal. The House and Senate still need to get on the same page about whether to pass one or two reconciliation bills. Then Republicans will need to agree on what the parameters of the budget resolution will be – What budget baseline will they use? How much will they allow the debt to increase during the 10-year budget window of a reconciliation bill? The answer to that question then leads to the debate over how much spending will Congress cut while also cutting taxes. The debate over these issues will pit budget hawks, who want deep spending cuts, and moderates, who will resist such cuts while also angling for relief from the cap on the State and Local Tax deduction, which adds to the cost of the tax bill. All

of this will take place in a House where Republicans cannot afford to lose a single vote from their members until April, after which they will probably have a two-vote cushion. Until these debates are settled (along with passing a spending bill before the current Continuing Resolution expires in March and deciding how to address the debt ceiling), it is nearly impossible to forecast which programs might be cut, but investors should expect headline risk from this debate, especially as it relates to health care, student loans, and municipal finance, to highlight just a few key areas.

- <u>Nominations and Personnel</u>
    - **Financials** – Two key financial regulators, the Office of the Comptroller of the Currency and the Consumer Financial Protection Bureau (CFPB), are still led by Biden administration holdovers, but we expect that to change soon. With Treasury Secretary Scott Bessent confirmed by the Senate, we think Acting Comptroller Michael Hsu could be replaced in the coming days. The controversial spending freeze (discussed above) might slow down the confirmation of Russ Vought to be Director of OMB, but once he is confirmed, we think he could be appointed as Acting Director of the CFPB. The precedent for this occurred in Trump's first term, when Mick Mulvaney simultaneously led OMB and CFPB.
    - **Trump Cabinet** – Many of President Trump's cabinet nominees have been confirmed, or are likely to be confirmed, by the Senate with bipartisan support. However, there are a few pending nominations that face enough opposition to possibly block them. In particular, Robert F. Kennedy, Jr.'s nomination to be Secretary of Health and Human Services, Lori Chavez-DeRemer to be Secretary of Labor, and Tulsi Gabbard's nomination to be Director of National Intelligence could all face Republican opposition. At the same time, they could also attract some Democratic support that could save their nominations. Some Senate Republicans disagree with Mr. Kennedy's views on vaccines and public health, and he also faces opposition from pro-life groups, which could be a pretext for broader opposition from conservatives. At the same time, Democrats who support his past work on environmental issues could offset Republican defections. As a Member of Congress, Ms. Chavez-DeRemer supported the PRO Act which would override state right-to-work laws. She will likely be opposed by several Republicans, but Democrats might decide she is the best nominee for the Department of Labor they could expect from the Trump administration and make the strategic decision to support her. Ms. Gabbard has been criticized for her position on Section 702 of the Foreign Intelligence Surveillance Act, as well for holding a meeting with former Syrian dictator Bashar al-Assad. Unlike Kennedy and Chavez-DeRemer, it is unlikely any Democrats will support Ms. Gabbard. If confirmed, it will probably only be with Republican votes, and there currently seems to be some opposition within the GOP to her nomination. Of these three nominees, we think Gabbard is most at risk, followed by Kennedy. Chavez-DeRemer appears to be the most likely of this group to be confirmed, but she will probably need Democratic support.

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