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2018 WASHINGTON POLICY — BROADLY MARKET POSITIVE BUT NO MAJOR LEGISLATION

TRADE POLICY CREATES MARKET VOLATILITY; INFRASTRUCTURE BEARISH

Market calls. Washington's 2018 policy actions generally will continue to be broadly market positive. But more major legislative successes are unlikely, and trade policy remains a major wildcard over the next few months. We here summarize the market positives, negatives, and unknowns, as well as our initial thoughts on the 2018 midterms. The full note provides more details.

Market positives.

- Continued fiscal **stability.** A spending deal is 90 per cent likely between mid-January and mid-March; a debt limit deal is 95 per cent likely by late 1Q 2018;
- **Legislative progress** that will produce positive market activity on many fronts, including infrastructure — **but more legislative success is unlikely**, as discussed below;
- **The tax law boost** starts to become real in fiscal and economic terms as early as February, a market positive for many sectors including retail;
- **The pace of deregulatory changes** begins to quicken, a market positive for the financial and energy sectors;
- **M&A friendly**. The Trump Justice Department proves itself friendly to increased M&A activity; and,
- **Health care policy risk decreases** with the only major legislative action an ACA short-term patch, but we remain alert for drug pricing actions.

Market negatives.

- **No major legislation.** The likelihood of more major legislative successes à la tax is very low, including on infrastructure, which we peg as 20 per cent likely today. No major legislative priority today has the needed combination of policy consensus, a clear process path, and some bipartisanship, and it is very unlikely that this will change; and,
- **No structural deregulation.** Regulators will continue to work on deregulation within the boundaries set by law. But Congress is very unlikely to broadly dismantle industry or sector regulatory structures — anything major requires some bipartisanship — but some incremental changes for financials are possible.

Market unknowns.

Trade policy is one of three unknowns that could increase market volatility. The three significant Washington unknowns entering 2018 that could be major causes of market volatility or market negatives are trade policy, the Mueller investigation, and the effects of potential geopolitical turmoil, North Korea and Iran particularly. We will focus closely in the first weeks and months of 2018 on evolving Trump trade policy priorities and actions.

In summary: we expect the Trump Administration to keep pursuing its "aggressive but between the lines" trade strategy that was first detailed in spring 2017. As first announced, it includes more focus on bilaterals instead of tri- or multilaterals; increased enforcement; more tariff increase decisions; and pressuring WTO to reinterpret existing agreements to favor transparent, market-based economies. There is likely to be significant market reaction to the execution of this strategy for many reasons, not least because it has been decades since markets have seen anything like the Trump shift to more aggressive trade policy.

Specific Trump trade actions could cause significant market volatility. These include:

- **NAFTA renegotiations**, which conclude in March or later: there are four rounds left to go and the next round begins in late January. We remain cautiously positive that pragmatic Trump takes some NAFTA successes and concludes a successful renegotiation, but investors should expect market volatility in 1Q and beyond in NAFTA-sensitive sectors and industries because negotiating tactics and brinksmanship on all sides will increase short-term uncertainty about ultimate success;
- **Tariff decisions.** Individual antidumping and countervailing duty tariff decisions have been increasing since Obama days and would continue to regardless of who was elected in 2016, but they likely will be viewed with greater market interest and concern against the backdrop of the more aggressive Trump trade strategy; and,
- **Early 2018 potential decisions on steel, aluminum**, and other industries where imports may be "undermining" them to the detriment of national security. Recommendations for action are likely as early as mid- to late January, and Trump would have up to 90 days to act, although he is expected to reach a final decision within days or weeks afterward.

Midterm elections overhang. The November 2018 midterm elections also contribute to the likely lack of legislative success as the parties sharpen policy differences as part of the fight over today's small Republican majorities. Today we think Republicans are more likely than not to keep or expand somewhat their congressional majorities, but that assessment is preliminary: it is very early days and the political landscape is in flux. We do not dismiss the possibility of a Democratic "wave" election, but think there is less evidence of it so far than political pundits tout today. The next signs of whether a 2018 Democratic wave might materialize will come in the spring in two congressional special elections with Republican open seats.

The full note also includes a list of 2018 dates to watch.

2018 POLICY CALLS

Overview. Washington's 2017 ended with significant market-positive policy successes, most prominently on tax legislation, on which we alone were strongly nonconsensus positive all year. The Trump White House and congressional Republicans tout a 2017 list of market positive accomplishments, including not just tax reform, Alaska drilling, and ending the ACA mandate tax, but also the beginning of the reordering of government priorities through deregulation and reshaping the judicial branch by making more conservative, free market oriented appointments.

Most 2018 Washington policy actions are likely to be market positive. Investors will see some progress on infrastructure, trade, housing finance, and deregulation, among other policy areas, but more major legislative successes *à la* tax today are unlikely. In some instances policy volatility is likely to cause market volatility, particularly on trade: more about that below. The collaborative coalition developed between Trump and congressional Republicans on tax reform and judicial nominations likely holds together on these new policy priorities, but the lack of needed bipartisanship from Democrats makes more significant legislative accomplishments very unlikely (bipartisanship was not needed on tax because the unique simple majority budget process was used).

But we do not dismiss entirely prospects for legislative success on any front for a number of reasons.

- Candidate Trump presented pragmatic solutions as part of his crossover appeal. The Trump White House has shown itself capable of pragmatism in policy negotiations, particularly on tax legislation, where Trump focused on an aggressively low corporate rate and was flexible on other details. They may be able to show more policy flexibility and attract some Democratic support on some of these new issues.
- Congressional Republicans continue to identify issues upon which they can work with Trump and ways of doing so, even while they continue to keep their own brand separate from Trump. This combination of policy agreement and political separation worked for congressional Republicans in 2016 when they kept their majorities against the odds (in many cases doing better than Trump). They hope it will help them hold and increase Republican seats in 2018, although President Trump may prove harder to keep at arm's length than candidate Trump.
- Congressional Democrats see the possibility to overturn the small Republican congressional majorities and thus are unlikely to work in a bipartisan manner on many Trump / Republican priorities. But there will be areas where they think their constituencies and political brand may clearly benefit from bipartisanship — government spending and housing finance are two of these. And, depending on the political winds throughout the year, some Senate Democrats could decide to work across the aisle on particular issues.

We briefly summarize below our initial views on 2018 policy priorities, and then provide brief 2018 midterm elections thoughts.

SPENDING / DEBT LIMIT: FY 2018 spending deal 90 per cent likely in 1Q 2018; debt limit deal 95 per cent likely end 1Q 2018.

Perceptions of the Washington policy and political environment as hyperpartisan are not inaccurate, but they also are cartoonish and distracting from reality on the ground. There is more consensus in Washington today than is commonly thought, and bipartisanship on fiscal stability, specifically government spending, is at its core. For the last five years there has been what we long have called a fiscal stability "broad bipartisan consensus" that helps underpin market confidence and that we think is very likely to continue. There has been, and we think continues to be, bipartisan agreement that the government should continue to be funded in a stable manner and that the obligations of the US government should continue to be met. This Washington fiscal stability consensus now is assumed by markets, but, as was seen in 2011 and 2013, when fiscal instability risks rise in Washington negative market impacts follow. Political leaders in Washington are united in keeping this bipartisan fiscal consensus going because it helps the economy and markets and because it maintains policy stasis in a closely politically divided Washington.

As 2018 begins we think that bipartisan consensus continues and produces both positive policy results and positive market impacts. The full-year FY 2018 spending deal is 90 per cent likely to be reached between mid-January at the earliest (the current spending bill expires January 19) and mid-March at the latest. (Today we lean towards March because that is the Trump deadline for "dreamers" (DACA) resolution, but this easily could change.) This is consistent with our long-held views that short-term spending deals would see Washington through the holidays until both parties were ready to address longer-term solutions. The bipartisan spending deal that has been in the works since November will provide stable government funding with small increases of between $100 to $200 billion over two years divided between defense and domestic spending. We continue to think the "dreamers" (DACA) issue gets worked out sooner or later in a bipartisan manner (there is great bipartisan support for a solution) and will not be something that torpedoes a full-year spending bill. We also think another debt limit deal (either suspension or increase) is 95 per cent likely to be made in the spring: no one in either party wants to engage in the sort of 2011 brinksmanship that resulted in a US government downgrade. CBO's latest estimates have the government with enough cash until late March / early April. If there is even somewhat of an upside fiscal surprise in early 2018, this could easily extend into the summer since Treasury gets an influx of income tax revenue in mid-April. But with tax cuts now on the books, we suspect the risks actually lean in the other direction to an earlier deadline.

INFRASTRUCTURE: Legislative success is only 20 per cent likely today, but the sector occasionally will jump on short-term positive policy news.

As 2018 begins we are bearish on the prospects for increased infrastructure spending legislation, which today we think has a 20 per cent chance of becoming law. Today infrastructure lacks both a bipartisan policy approach and available federal spending, and thus is most likely to become a political football in the 2018 midterms. Trump and congressional Republicans' not yet released $1 trillion plan probably becomes a centerpiece of the first formal Trump State of the Union address in late January and supposedly will rely heavily on private sector initiatives and incentives. Trump officials say that $200 billion in direct federal spending will be available by cutting other federal programs. The rollout of the infrastructure plan in late January — probably in the State of the Union address — will be market positive. After that, other events in the first half of 2018 — particularly a potential House passage of the plan — also will be short-term market positives for infrastructure.

But underneath any momentary bullishness is a more fundamental reality: today there is no policy and political consensus to get the Trump plan through Congress.

- As discussed above, Congress' spending deal will provide small increases in federal spending, and so neither party will agree to spending cuts.
- Repatriation monies are not available to help pay for infrastructure — something on which there had been bipartisan agreement in concept since 2015 — since repatriation proceeds

now are used to help pay for tax legislation. So there is no direct federal spending money available.

- Any Trump / Republican plan is very unlikely to be supported by Senate Democrats in sufficient numbers: at least 9 would be needed to make the Trump / Republican plan happen. The Trump plan already is being criticized by Democrats as yet another corporate giveaway, a major 2018 Democratic campaign theme. Democrats instead will say they wanted $1 trillion in direct federal spending, which Republicans have made impossible due to the tax law.

Even if our bearish view changes to a positive one if facts change, infrastructure spending would have little immediate direct economic impact because projects usually take years to be awarded and completed.

TRADE: The Trump trade strategy likely causes 1Q market volatility due to policy uncertainty stemming from NAFTA negotiations and tariffing decisions. We will spend much time in 1Q 2018 helping markets anticipate and understand potential Trump trade actions. We summarize briefly our current views below, which are likely to develop and change as events do.

The overall Trump trade strategy is well known. Trump told Congress in spring 2017 his Administration would pursue an “aggressive but between the lines” trade strategy that was a compromise between establishment pragmatists and populist barnburners in the Administration. Its main pillars: pursuing trade bilaterals (none so far); renegotiating existing trade agreements including NAFTA (underway); increasing trade enforcement including more individual tariff decisions (we said in 2016 this would be happening regardless of who became president); and pressuring WTO to interpret trade agreements to favor market-based, transparent economies.

There will be a number of trade policy hotspots that have market-moving consequences in the next weeks and months, including:

- **NAFTA.** Today we think that the NAFTA renegotiation is likely to conclude in March or later with some marginal improvements: there are several rounds left to go and Trump informed Congress that negotiations would not finish before March. But markets should expect political volatility on trade throughout the next few months because NAFTA negotiating tactics will include on all sides threats to walk away and / or announced intransigence on specific issues: both will increase short-term uncertainty about success and have the potential to be market negative. Today we think all sides want to conclude a deal, but, as the parties’ negotiating positions are classified, investors should understand that markets will get skewed and mostly negative information about negotiations from third party pressure groups. We also maintain our long-held view that only Congress — not Trump — can walk away from NAFTA as a constitutional matter (Congress ratifies trade agreements and makes their provisions US law): Congress will not want to walk away from NAFTA even in the unlikely event that Trump does.
- **Antidumping / countervailing duty tariffs.** Expect 1Q 2018 tariffing decisions at least on solar products and washing machines. Increased tariffing decisions have been happening since the last years of the Obama Administration and would be continuing regardless of who was elected president in 2016. These decisions will continue to be a feature of trade policy. They will usually have only specific market impacts on a particular industry or sector, but will be more scrutinized by markets today against the backdrop of the new Trump trade strategy.

- **Steel, aluminum, and the trade / national security nexus.** Finally, markets also should expect in January 2018 Commerce Department recommendations on whether steel and aluminum imports are harming national security. These inquiries were directed by Trump in April 2017 as two of six potentially harmed "core" industries: the other four are vehicles, aircraft, shipbuilding, and semiconductors. As we observed in April, "[s]teel stock prices increased after [Trump directed the steel inquiry to begin], and similar market moves could result with the other "core" industries in the event of similar Trump…actions."

A few other trade policy thoughts:

- We continue to think that Trump is unlikely to unilaterally try to abrogate treaties (including NAFTA), which we long have thought Congress would not permit on constitutional grounds. Congress, not the president, ratifies trade agreements and turns them into US law: presidents only negotiate trade agreements, and thus we think cannot abrogate them without affirmative congressional action which Congress would not take.
- The eclipse of arch-populist Bannon within the Trump orbit may have put the establishment pragmatists (Cohn, Mnuchin) in the ascendant on trade: they do not want the economic pluses of the new tax law to be limited by protectionist trade policy. But Commerce Secretary Ross and USTR Lighthizer remain in charge of the details of trade policy development and execution, and the struggle for policy supremacy is likely to continue for some time.
- Tariff changes mostly are up to Congress, and updated tariff schedules will be considered on a bipartisan basis: they were introduced in the Senate in November 2017.
- We continue to think skilled workers are unlikely to be negatively affected because large-scale immigration legislation will not happen in 2018. But more background vetting will take place that effectively will slow the programs relied upon by tech.
- China-related decisions (IP, steel tariffs) remain wildcards and resolutions depend in part on the North Korean situation.
- CFIUS reviews are being more expansively used as a policy tool, as the Ant-Moneygram rejection showed.
- One additional political uncertainty is whether Trump uses trade as a means to rally his political base should the Mueller investigation start to threaten his presidency. Today the likelihood of this seems low, but of course it could change quickly if the investigation gathers speed and political lethality.

HEALTH CARE: Decreased market risk due to less policy volatility; drug pricing remains a focus. After two ACA reform failures, Congress is in triage mode, likely to make its only 2018 action approving short-term ACA fixes as part of the "Alexander-Murray" legislation agreed to in concept by Senate leaders and Trump during tax law negotiations. Today the Alexander-Murray timetable is very uncertain, but we think it probably gets resolved in late 1Q or early 2Q, perhaps around the same time as full-year spending legislation. The new tax law repealed the individual mandate tax, which may increase somewhat market instability and increase the need for early year action.

Serious legislative threats to drug pricing under Medicare Part D have lessened thanks to this relative lack of legislative action, but we continue to think the Trump White House is a wildcard because it could insist on drug pricing action either as part of Alexander-Murray or in the FY 2018 spending bill. As we write there are no indications that either will happen, but we remain alert for any possibility that Trump might use either of these legislative levers.

BANK REGULATION: No Dodd-Frank repeal; incremental regulatory changes possible from Congress; deregulation picks up pace. Attempts to repeal or change Dodd-Frank cause market buzz and will be a small market positive for financials, but real changes are largely illusory. Major DFA change is almost impossible since it would take some Senate Democrats to agree, who will not: even the Senate "regulatory relief" bill is unlikely to see the Senate floor due to Democratic-progressive opposition. The Trump Treasury will continue to deemphasize FSOC and focus even more on revising financial regulations in 2018. The market buzz around this will continue to be market positive for financials, but changing regulations is a years-long process that will not have immediate bottom line impacts.

MERGERS / ACQUISITIONS: Trump Justice likely friendly even while M&A will continue to be scrutinized. We continue to think that the Trump Justice Department — with antitrust leadership only for the last few months — is likely to be friendlier to merger / acquisition activity than the Obama "red light" *ad hoc* DoJ: this means more M&A activity across sectors and industries. New leadership at FCC and FTC also help this change in environment. Uncertainty on Trump M&A policy likely is resolved in first half of 2018: we continue to think that the Trump DoJ in individual cases will prefer positive resolutions through conditions to saying no to M&A activity.

HOUSING FINANCE REFORM: Investors should anticipate action, but legislative success is unlikely today. Housing finance reform has been sidetracked for 10 years, a market negative for the US housing sector. GSE reform may become a 2018 priority: the Senate Banking Committee will attempt to advance consensus legislation and Treasury Secretary Mnuchin continues to make positive noises about GSE reform. Democrats want to retain a government role for affordable housing, while some Republicans want to gradually privatize housing finance. There is a compromise available between those positions, but without a strong Trump / Mnuchin compromise position and willingness to expend political capital little will happen. The only thing certain to stimulate compromise will be if GSEs' dividends are no longer contributors to the Treasury: this is uncertain today but could happen more quickly under the terms of the December 21 Treasury / FHFA deal to permit a $3 billion capital buffer for each GSE. Federal Reserve support for housing finance privatization would be needed through the CCAR process. FHFA head Watt favors keeping GSEs in conservatorship until Congress acts, but also continues to warn of potential capital crisis.

2018 MIDTERMS

Today congressional Republicans are likely to keep their majorities, but the political environment is in flux. As 2018 opens we favor Republicans to keep their congressional majorities, but there are over 10 months before the midterms and the political environment is very much in flux. As always, the midterm elections feature all 435 House seats and one-third of the 100 seat Senate.

Republican congressional majorities are small: 20 in the House, 2 in the Senate. Opposing party gains tend to be the midterms norm. So Democrats gaining seats or even majorities in one or both houses is very possible. But congressional Democrats have a more uphill climb to win congressional majorities than is widely recognized. The 2018 midterms feature 25 Senate Democrats up for reelection (10 in Trump-won states) compared to 8 Republicans, and today only

3 of those seats can be considered competitive. The Republican House majority has substantial advantages in incumbency, favorably drawn districts, and funding. Today House Republicans have more competitive races (64) than Democrats (20), but Democrats will have to defend all their competitive House seats and pick up around another 20 to gain a majority — certainly possible but far from a given. Also, the Republican Party is strong nationally. Today 34 of the 50 state governors are Republican; 28 of the 50 state legislatures are wholly Republican, and another 3 have Republican majorities in one house; and 56 per cent of state legislators are Republican.

There are two unknowns today as the midterms approach.

- The first unknown is whether the few early signs of a potential Democratic voting surge in late 2017 will turn out to be real and an effective counter to the pro-Republican voting pattern in the last few midterms. We are more skeptical of the current evidence for a Democratic wave than are many political pundits: Virginia state legislative races and the outlier Democratic Alabama Senate victory are not much to go on. But there will be two early opportunities in 1Q 2018 to assess the relative state of political enthusiasm for the political parties, first a March 13 special House election in the Pittsburgh suburbs / exurbs (PA 18, a Republican seat for 20 years) and then an April 24 special House election for the Arizona 8th district seat (now a pro-Republican seat). These results of course will not be perfect indicators of a national trend, but a Democratic win in either or both districts would shake up the midterms political calculus going into spring.
- The second unknown is whether there will be continued economic improvement (whether as a result of the new tax law or not), and, if so, whether it will translate into increased voter enthusiasm for Republicans. Both parties have placed big bets on how the tax law plays with the 2018 electorate. Republicans will point to it as the beginning of fulfilling a promise to improve the economy, while Democrats already have signaled they will use the tax bill “scam” and “deception” as a major part of their midterm rhetoric. All this will play out for many months and will not clarify until around a month or two before the midterms.

We will explore the developing and uncertain 2018 US political landscape frequently this year, with an eye specifically on potential market impacts as we did in the 2014 and 2016 elections.

Dates of Interest 2018

January 11: President Trump Must Certify (Or Not) Iranian Compliance With JCPOA

January 12-17: Deadlines for USG’s Extension of Temporary Waivers of Sanctions Against Iran Under Terms of JCPOA

January 19: Current CR Expires

January 26: Solar Tariff Case

January 23-28: NAFTA Renegotiations Round 6

January 30: State of the Union Address

February 5: President Trump Submits FY 2019 Budget Request

February 15: CBO Submits Report to Budget Committees on FY 2019 Budget

March TBD: CHIP Reauthorization

March TBD: Raising the Debt Limit

March 5: DACA Visas Expire (But Could Be Extended)

March 13: House Pennsylvania 18th Special Election

March 31: FAA Funding and Reauthorization

April 1: Senate Budget Committee to Report FY 2019 Budget Resolution

April 24: House Arizona 8th Special Election

May 15: House Appropriations Committee Starts Considering Annual Bills

June 10: House Appropriations Committee Target for Reporting Last Annual Spending Bill

June 30: House Target for Completing Action on Annual Spending Bills

August 7: House Michigan 13th Special Election

October 1: FY 2019 Begins

November 6: 2018 Midterm Elections

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