A Dramatic Shift in Washington

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Just a few months ago, President Joe Biden was enjoying solid public support and a brief surge of inflation seemed to be temporary. But the mood in Washington has shifted as Republicans seem likely to recapture the House—and perhaps the Senate as well—in the 2022 fall elections.

After passing a $900-billion COVID aid bill at the end of 2020, Congress passed a $1.9-trillion COVID aid bill in the spring of 2021, then approved a massive infrastructure measure. It apparently didn’t dawn on the lawmakers that they were giving an ailing patient too much medicine, with side effects—primarily inflation—coming from so much spending.

Biden’s solid approval ratings never recovered after the inept U.S. withdrawal from Afghanistan in the summer of 2021 and the public’s increasing discontent over urban crime, a flood of illegal immigrants, and the sharp rise of inflation.

Inflation quickly became the dominant economic issue of 2021, as fiscal and monetary policy seemingly veered off course. Members of Congress reported that their constituents were angry over the soaring prices of food, gasoline, and other goods, and policy makers appeared to have no solution for supply chain backlogs and a clear shortage of labor.

We thought that inflation eventually would subside—or level off—but there’s no easy solution for the wage surge.

Thousands of businesses, especially in the service sector, had to offer higher salaries or bonuses to attract (or retain) labor. Commodities such as oil or lumber can go up or down; wages and benefits seemingly only go up.

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Part of the labor-induced inflation can be attributed to Washington policies. Benefits passed by Congress were so generous that they precluded people from aggressively seeking jobs. Many simply quit and lived off the benefits—which include an increase in food stamp funding, a temporary increase in the child tax credit, and a 5.9-percent increase in Social Security benefits in 2022.

The extreme shortage of workers in much of America could be alleviated by immigration reform, which would bring new workers into the economy. But immigration reform is too hot to handle for Congress, with both parties gridlocked on this issue, as well as gun reform, abortion, voting rights, etc.—all topics that seemingly defy compromises.

The Federal Reserve, meanwhile, was slow to react to the inflation surge, and by the fall of 2021 the central bankers were way, way behind the curve. The Fed is about to finish its tapering of asset purchases, but the damage has been done. Rate increases in the first half of 2022 seem inevitable.

To be fair to Biden and Powell, there’s no template for dealing with a once-in-a-century pandemic. The policy makers decided to crank up the stimulus, not realizing that they were doing too much. Now they are left with a legacy of inflation that will alter the political climate.

As Americans emerged from hibernation in 2021, demand for goods spiked—which clogged U.S. ports. The gridlock could persist well into 2022, along with continued tight supplies of semiconductor chips. Someone must get blamed for this, and the Democrats appear to be the likely scapegoat.

In talking with contacts on Capitol Hill, it appears to me that the issue for the 2022 elections won’t be whether the Republicans take the House, but by how many seats. A GOP pickup of 25 to 30 seats is possible; the Republicans need only a net gain of five seats to take the House. The Senate is a closer call, but with a 50-50 tie now, the GOP could take control there as well.

Republicans we talk with are astonished to see Biden’s job approval rating plunge below 40 percent positive in some polls, and they think several issues—illegal immigration, urban crime, and inflation—will work to their advantage in the upcoming election. History would suggest a loss of at least 20 seats for the Democrats.

Thus, it looks inevitable that President Biden will have to deal with Republicans
who should control at least one of the houses of Congress in the final two years of his term. Biden’s veto power should be good, which means gridlock is likely—not necessarily a bad story for the financial markets, which often prefer to see no major policy changes.

Biden could still wield power on regulatory policy, which doesn’t depend on Congressional legislation. He has installed activist progressives in many agencies; the regulators will aggressively regulate the financial services industry, energy firms, prescription drug companies, and the tech sector. And antitrust policy will seek to aggressively resist corporate takeovers.

Biden also would have power to fill vacant Supreme Court seats. He already has one to fill and there could be more.

A major theme will be tough regulations on fossil fuels—oil, coal, and natural gas—but ironically supplies of all three may stay very tight. Fossil fuels have been demonized, but the country’s energy needs cannot be met by renewables such as wind and solar power. In any event, the pending regulatory climate will be more aggressive in 2022 than any year in recent memory.

Biden also will have the power to shape foreign policy, but his standing in this arena may never recover from the Afghanistan debacle, which stunned allies and adversaries alike. I think there will be three geopolitical hot spots.

First, relations with China are unlikely to improve significantly, because the mood in Washington is still very leery toward Beijing over China’s treatment of dissidents, its development of sophisticated new weapons, its hacking into U.S. companies, and its unwillingness to be forthcoming on the origins of COVID-19.

Second, we don’t expect any improvement in relations with Russia as Vladimir Putin attempts to intimidate the government of Ukraine and uses his supplies of natural gas to pressure Western Europe into easing sanctions on Moscow. Putin also has generated intense suspicion within U.S. intelligence agencies over his role in Havana Syndrome, which has inflicted brain trauma on U.S. embassy employees.

Third, there are no signs that the new leadership in Iran will be any more reasonable than the last regime, so we anticipate more provocations from Tehran in the Persian Gulf. Negotiations on a nuclear treaty may resume, but we don’t expect quick or meaningful results.

The good news for investors in 2022 is that there’s plenty of monetary and fiscal stimulus in the pipeline, at least for the first two quarters of the year. The markets probably can tolerate one or two Fed rate hikes in the first half of 2022, but if there are more increases—with the threat of additional monetary tightening in 2023—the markets may worry about slowing economic growth by the end of 2022.

Once the 2022 Congressional elections are finished, the campaign for 2024 will begin, because that’s how Washington works. We’re not sure Biden, 79, will run again, and Donald Trump, 75, also isn’t certain to run. He faces numerous legal challenges, and a growing number of Republicans we talk with are eager—in private—to move on.

There’s a palpable need for fresh blood as Nancy Pelosi, 81, and Mitch McConnell, 79, also near the end of their careers. I would expect to see at least a dozen Republicans running for president if Trump doesn’t; the early frontrunners would include Florida Governor Ron DeSantis and former United Nations Ambassador Nikki Haley.

If, as we expect, Biden doesn’t run for re-election, there also would be a dozen Democrats in the mix. Kamala Harris would have a chance but would face Amy Klobuchar, Cory Booker, Gavin Newsom, and many other candidates in a likely free-for-all.

There’s a long way to go before the next presidential election, but one theme seems clear: Progressives have been soundly rejected by the electorate. There’s little appetite for a wealth tax, Medicare for all, packing the Supreme Court, killing the filibuster, etc. The only area where progressives have support is spending money; everyone, it seems, likes to spend money.

U.S. budget deficits will continue to be enormous—more than $2 trillion a year—although receipt growth has been a pleasant surprise, primarily because the strong stock market has produced huge profits. States such as California are enjoying an enormous surplus.

At some point, Washington will have to realistically approach the budget deficit, but the options are limited. There’s no support for major tax hikes, but there is support for modest tax increases for the rich and highly profitable corporations.

There’s not much support for deep spending cuts, and defense spending still appears to be off limits. As for the giant entitlement programs—Social Security and Medicare—most politicians are terrified to even suggest reforms.

In the final analysis, “It’s the economy, stupid,” as political advisor James Carville proclaimed two decades ago. The economy can still grow decently for the next few quarters, but inflation and labor shortages are likely to persist. It’s difficult to envision a return to stable prices by the 2022 fall elections, which promise to shake up the status quo in Washington—once again.

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