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Lessons from the Lame Duck

The midterm results have given way to a busy Lame Duck session. Lawmakers are rushing to pass legislation ahead of the new Congress. Early signs of division within the Republican Party, as well as the negotiating positions of both parties on government funding, indicate a likely crisis over the debt ceiling in mid-2023 as well as increasing politicisation of ESG.

Key takeaways

- Republicans are divided, with members in the House and Senate publicly disagreeing over strategy and policy. A lack of internal cohesion will create further obstacles to any legislative progress.
- The right of the Republican House is using aggressive tactics to gain influence over the House Speaker race. The narrow majority in the House means any Speaker will need to gain the support of this wing of the party to win election.
- A House Speaker who requires support from the right of the party to remain in post increases the likelihood of a crisis over the debt ceiling. House Republicans will put forward measures that will be rejected by Senate Democrats and vice versa.
- The most likely outcome is a debt ceiling crisis resolution close to the so called X-date, after market consequences have become apparent. As in 2011 and 2013, market volatility is likely to galvanise policymakers into reaching a solution.
- A split Congress will prevent any partisan legislation passing into law. Despite this, House Republicans will use control of committees to launch investigations into ESG investing and the regulatory actions of the SEC. It is likely that ESG will become increasingly politicised ahead of the 2024 election.

Government budget likely to pass

Underperformance against historical norms in the midterms, as well as ongoing disagreement over the political direction of the party, is driving divisions within the Republican Party. Republican Senate Minority Leader Mitch McConnell and House Minority leader Kevin McCarthy have publicly disagreed on how to approach budget negotiations with Democrats.

Despite this, it appears that, with the support of some Senate Republicans, a budget bill will pass in December 2022. Although a framework for the budget has been agreed, Republican negotiators have indicated that any tax changes, including child tax credit expansion and corporation tax cuts, are unlikely to be included due to ongoing disagreement between the two parties.

Although Congress remains focused on Budget negotiations, other activity in the Lame Duck, particularly within the House, provides useful indications for what can be expected in US politics over the next two years.

House Republicans fracture

An extremely narrow majority in the House, combined with tactical disagreements within the Republican Party will disrupt Congress.

The right of the Party, loosely aligned to the Freedom Caucus, strongly advocates for a confrontational approach to bipartisan negotiations. These Republicans are seeking to influence the race for Speaker of the House. Four

Republicans are publicly withholding votes from frontrunner Kevin McCarthy, seeking to win policy concessions.

In exchange for their support, the group is seeking a commitment not to raise the debt ceiling without also cutting spending and reinstating the motion to vacate the chair—a procedural measure that allows members to call for the removal of the Speaker. A very small number advocate for not raising the debt ceiling in any circumstance.

McCarthy likely has around a 50% chance of being elected Speaker, but to do so would need to make significant policy concessions to the Republican right. The determination of this group to receive these concessions, is a key indicator of their likely behaviour in the next Congress. Brinkmanship over the Speakers vote would likely indicate a willingness to continue to challenge the authority of the Republican leadership, resulting in a more chaotic Congress.

Key to this is the coming debate over raising the debt ceiling. If the Freedom Caucus can successfully influence the House Republican leadership at this stage, the likelihood of compromise well ahead of the X-date narrows significantly.

Debt ceiling negotiations represent a significant risk in 2023

A large policy gap between both parties, narrow majorities in Congress and growing internal party divisions all combine to increase the risk of brinkmanship around the debt ceiling.

A key part of Republican strategy in the House will be to utilise the debt ceiling to extract policy concessions from President Biden. However, Republicans are divided on exactly what these policy concessions should be.

The right of the Republican party advocates for cuts to discretionary and mandatory spending, including entitlement programs such as Social Security and Medicare. This is likely to principally focus on tightening future entitlement to these programmes as well as reducing discretionary spending in federal agencies. This would be strongly resisted by Democrats.

More centrist Republicans seek cuts to remaining Covid-19 funding and a refocus on addressing border security, which is likely to have a greater chance of attracting support from moderate Democrats.

The absence of an agreed strategy on policy priorities will contribute further to the risk of a debt ceiling crisis in 2023. The failure of Republicans to coalesce around a set of policy goals, will add a further layer of complexity to negotiations, increasing the likelihood of legislative proposals being held up by small groups of legislators.

The debt ceiling is likely to be breached in late Q1-early Q2, though this date is highly uncertain and dependent on government spending in the coming months.

Once the ceiling has been breached the US Treasury will use “extraordinary measures” to find additional funding. The point at which the Treasury can no longer implement these measures, leading to a technical default, is known as the X-date.

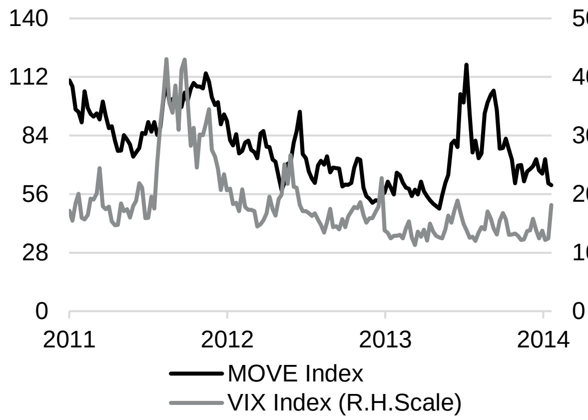
The Bipartisan Policy Centre currently predicts the X-date will fall in early Q3 2023. A recession in the US, higher interest rates, and any extension of the federal student loan repayment freeze would all be likely to move the X-date closer, though still not likely to be before mid-Q2.

It is possible that Congress will choose to raise the debt ceiling well in advance of the X-date to avoid the risk of disruption to markets. However, the current behaviour of House Representatives indicates this is unlikely. Any solution acceptable to the Democrat Controlled Senate is unlikely to have majority support in the House.

Republicans on the right of the Party have explicitly advocated for using the debt ceiling as leverage to achieve federal spending cuts. With the Biden administration likely to resist, this makes a last-minute deal to raise the debt ceiling the most likely scenario. While this avoids the most serious fiscal consequences, the closer legislators get to the X-date without a deal, the more likely there are to be material consequences for markets.

Previous debt ceiling crises in 2011 and 2013, demonstrate there can be market consequences even where a default is avoided. In 2011, the S&P 500 dropped by 18 percent between July and October, though recovered once the crisis was resolved. Markets were also responding to the ongoing European debt crisis at the same time. In 2013 however, a clear market response to the debt ceiling negotiations can be seen.

Figure 1: Increased volatility seen around debt ceiling crises in Summer 2011 and Autumn 2013



Source: Bloomberg as of December 2022

A US Government Accountability Office Report found that the 2013 debt limit crisis resulted in disruption to the Treasury debt market, particularly a sell off of securities due to mature around the X-date. Secondary market yields on Treasury Bills maturing in late October 2013, though to mid-November also rose from 1 basis point in mid-September to over 50 basis points by the time a solution was agreed on October 17, 2013.

House committees will make ESG a focus of investigations

Beyond utilising the debt ceiling to gain concessions on federal funding cuts, Republicans will use control of House Committees to launch investigations into the Biden administration, the actions of regulators, and ESG investing**.** These investigations are intended to be disruptive**,** particularly for regulators, but will not result in policy change.

Scrutiny of ESG investing has been growing at a state level. Most recently Florida Governor Ron DeSantis has announced the state government will withdraw $2bn from Blackrock managed funds due to its ESG commitments.

With Republicans retaking the House, this criticism is now likely to enter federal politics. Republicans have indicated that congressional inquiries would focus on whether ESG considerations harm shareholders and violate fiduciary duty and whether companies may be violating antitrust laws by participating in voluntary, industrywide ESG initiatives.

However, beyond committee inquiries, Republicans will be unable to enact change on ESG regulation at a federal level while Democrats control the Senate. The 2024 elections would therefore be the next point in which material change on ESG regulation and legislation could begin again.

Implications for investors

- Split Congressional control between the Republicans and the Democrat will result in few legislative achievements over the next two years. Any new large spending proposals will be blocked.
- Republicans are fractured, with the leadership in the House and Senate publicly disagreeing on strategy and House Republicans engaging in aggressive negotiating strategies over the House Speakers race. This increases the likelihood of brinkmanship over must-pass legislation in 2023.
- The risk of a crisis over the debt ceiling is high. The most likely scenario is a last-minute deal to increase the ceiling once market consequences have started to become apparent.
- ESG investing is likely to become increasingly politicised, with House Republicans likely to launch a series of investigations into its use. While these will not have material consequences on policy, the outcome of the 2024 elections will have a significant impact on future legislation and regulation.

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