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WELLS FARGO SECURITIES

Economics Group

Special Commentary

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Key Issues to Watch in the Second Session of the 115th Congress

Executive Summary

As Congress returns to begin the second session of the 115th Congress, the overarching question in the wake of the tax package vote is what comes next? In our congressional outlook for this year, we summarize some of the key policy debates that we see unfolding in 2018 and discuss what sectors of the economy could be impacted the most should policy change. Among the key issues we will be tracking are a potential infrastructure package, immigration reforms, financial regulation/Government-Sponsored Enterprise (GSE) reform, changes to entitlement programs and another possible attempt to repeal the Affordable Care Act (ACA). All of these issues are in addition to the need to come to a budget agreement for FY 2018, which is now more than a quarter complete, and the need to increase the debt ceiling by late March and pass a budget for FY 2019, which begins on October 1.

Among these key issues that are likely to be discussed in the second session of Congress, we see some immigration and financial regulation reform, along with a one- or two-year budget agreement, as the major policy changes most likely to occur this year. We remain skeptical that a large infrastructure package, entitlement reform, GSE reform or another attempted repeal of the ACA are likely given the challenges we outline below. Given the political dynamics of this mid-term election year, we see most major policy changes occurring early this year before members shift their focus toward primaries and the November elections.

In our congressional outlook for this year, we summarize some of the key policy debates that we see unfolding in 2018.

Infrastructure Spending

In our congressional outlook report released this time last year, we predicted that Congress would not have much of an appetite for a big boost in infrastructure spending in 2017.[1] This prediction turned out to be correct, as lawmakers directed their attention instead to ACA repeal and an overhaul of the nation's tax system. While the passage of the tax bill was a major check off the 2017 congressional to-do list, infrastructure remains a top priority for 2018. Several members of Congress have indicated that they would like to focus on making the president's infrastructure package a reality, dovetailing on the successful passage of tax reform in December. That said, we still remain skeptical that any large infrastructure package will be passed this year.

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The last time Congress passed a transportation bill, which occurred at the end of 2015 and amounted to $305 billion over five years, the biggest challenge was how to pay for the package. In the end, Congress found the funding through a variety of one-off items, such as capping the Federal Reserve's capital surplus at $10 billion and lowering the dividends paid to banks by the Federal Reserve.[2] The challenge of finding a funding source remains the biggest obstacle to enacting infrastructure reforms this year on the scale proposed by the administration. The Highway Trust Fund is primarily funded through the gasoline tax, which is based on the volume of gasoline consumed rather than the price (Figure 1). Given the increases in fuel efficiency over the past several years, and given that the gas tax was last adjusted in 1993 and is not indexed to

[1] Silvia, J.E., Brown, M.A. & Pugliese, M. (2017). Key Issues to Watch in the 115th Congress. Wells Fargo Economics. Available upon request.
[2] Fixing America's Surface Transportation Act of 2015, Pub. L. 114-94, 129 Stat. 1312, codified as amended at 23 U.S.C. §§1001-89003.

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

inflation, there has been a persistent structural decline in the revenues into the fund, which has resulted in less revenue available for highway projects (Figure 2). The solutions for solving this structural issue are not politically popular, including increasing the existing gasoline tax rate, switching the gasoline tax to a mileage-based measure or cutting other federal programs to pay for a replenishment of the Highway Trust Fund.

It is far from clear that there is universal agreement among the Republican caucus to borrow money for more government spending.

Given the complications in finding a new source of funds for infrastructure spending, we remain skeptical that any major package will be passed this session of Congress. While there is always the option of borrowing the money, it is far from clear that there is universal agreement among the Republican caucus to borrow money for more government spending like there was on the tax cuts. Put differently, if policymakers had hundreds of billions of dollars of low-hanging fruit sitting around, they likely would have already used it elsewhere.

Potential Sectors Impacted: Public and private sector stakeholders would likely be affected should Congress pass an infrastructure bill. On the public side, state and local governments could see an increase in government expenditures and employment to support new projects, boosting overall government spending. On the private side, industrial manufacturers and the construction sector could see positive gains as demand ramps up for building materials and related supplies for new projects. Should Congress decide to alter the structure of the gas tax or cut spending on other programs to fund the bill, higher taxes and lower program funding could weigh on consumers as well.

Figure 1

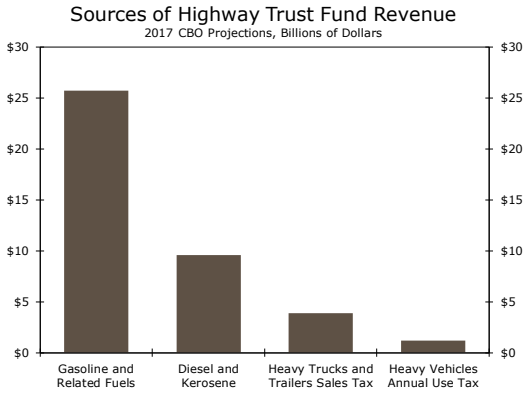
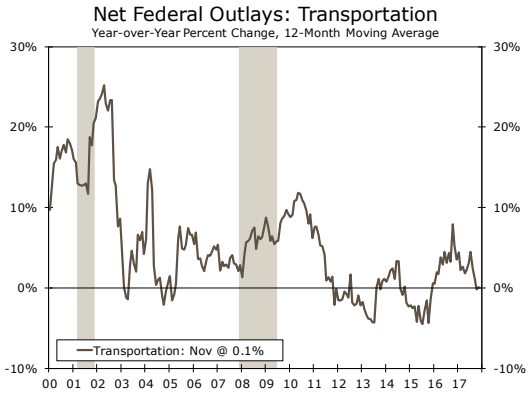


Figure 2



Source: U.S. Department of the Treasury, Congressional Budget Office and Wells Fargo Securities

Immigration Reform

Immigration reform was a hot topic last year as the administration attempted to make true on campaign promises to curb immigration and build a border wall. Of particular note was the Deferred Action for Childhood Arrivals (DACA) program instated under the Obama administration. The DACA program grants individuals brought to the United States illegally by their parents temporary legal status and protection from deportation as they attend school or work and attempt to gain permanent residence or citizenship. Many Democratic lawmakers pressed for a permanent fix to the DACA program, which is set to expire in March after the Trump administration announced in September 2017 that it would discontinue the program.

Several senators have recently stated that they hope to see a bipartisan DACA agreement this year.

As budget deadlines loomed at the end of 2017, Democrats campaigned for a permanent DACA fix to be included in several continuing resolutions (CR) that temporarily extended government funding. However, these efforts were unsuccessful, and the most recent CR passed on December 21 did not include any DACA provisions, effectively kicking the DACA debate to 2018. Several senators have recently stated that they hope to see a bipartisan DACA agreement this year, but whether this agreement will be part of the January 19 funding package remains to be seen. The administration has said it wants full immigration reform separate from the funding package, while Democrats are pushing for DACA provisions to be included in the funding

package. Beyond the DACA debate, the administration aims to solidify funding for a border wall as part of the 2018 budget process. The House Appropriations Committee's 2018 Homeland Security Bill includes $1.6 billion in funding for a border wall, and specific appropriations for new border patrol agents, technology and related equipment.[3]

In our congressional outlook report released this time last year, we viewed changes to immigration policy as likely coming from executive actions or agency rule revisions instead of Congressional intervention. This year, however, the push to find a permanent DACA fix and approve border security/wall funding makes it more likely for immigration policy changes to occur through legislative actions, in our view. Lawmakers have already positioned key immigration issues to potentially be a part of the budget package that must be passed before January 19 to avert a government shutdown. This deadline makes it more likely that lawmakers will need to come to some sort of agreement on immigration issues, or risk a government shutdown in the midst of a rapidly approaching midterm election season.

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Potential Sectors Impacted: Restricted immigration could weigh on employment and production in multiple sectors such as administrative services, agriculture, and construction that depend more heavily on immigrant workers (Figure 3).[4] The construction of a border wall could boost federal expenditures as well as have a positive effect on employment from both the construction of the wall itself and new border patrol agents hired. Labor shortages from lower immigration could also put upward pressure on wages, especially as foreign-born individuals have continued to make up a larger share of the labor force over the past several years (Figure 4).

Figure 3

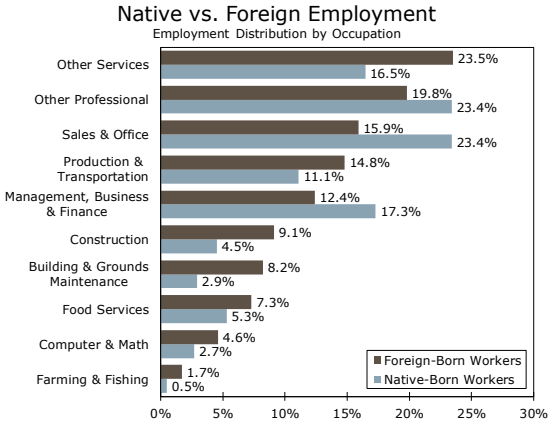
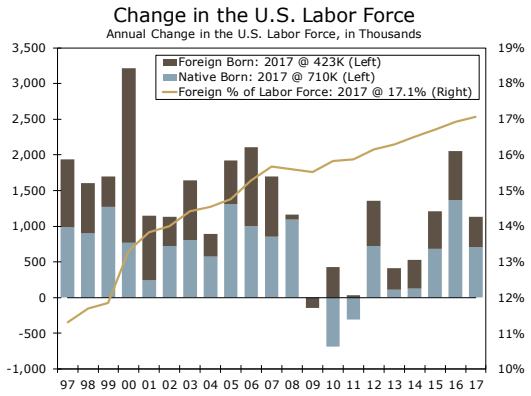


Figure 4



Source: U.S. Department of Labor and Wells Fargo Securities

Financial and GSE Reforms

One of the legislative issues that started to see some progress while the tax reform debate was unfolding was financial industry regulatory changes. The "Economic Growth, Regulatory Relief, and Consumer Protection Act" was approved on a bipartisan basis by the Senate Banking Committee on December 5. The bill would raise the systemically important financial institutions (SIFIs) threshold from $50 billion in assets to $250 billion, removes bank funds deposited at a central bank from supplementary leverage ratio (SLR) calculations and allows community banks with less than $10 billion in assets to qualify for exemptions from the Volcker Rule, capital requirements, mortgage lending liability and escrow requirements. One of the aspects of the bill that could have implications for demand for U.S. Treasury securities is allowing large banks to use

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[3] **FY 2018 Subcommittee Draft Homeland Security Appropriations bill. 115th Congress. (2017). https://appropriations.house.gov/news/documentsingle.aspx?DocumentID=394983**
[4] **The Pew Charitable Trusts. (2015). Immigrant Employment by State and Industry. Immigration and the States Project. http://www.pewtrusts.org/en/multimedia/data-visualizations/2015/immigrant-employment-by-state-and-industry**

municipal bonds to satisfy liquidity requirements.[5] The Senate bill is expected to see a full floor vote sometime early this year.

The Senate bill comes on the heels of a House-passed measure, the Financial CHOICE Act, that passed the House last June and contains more far-reaching rollbacks to financial regulations, which we believe is unlikely to pass the Senate in its current form. The most likely path forward is for the House to take up and pass the Senate bill, though a conference committee could take place down the road depending on how things develop. Given that the Senate bill does not make as many sweeping changes to financial regulations, it is unclear if there are enough votes in the House to support the Senate-passed reforms.

Another issue that will likely emerge is the possibility for reforms to the GSEs of Fannie Mae and Freddie Mac.

Besides the targeted financial reforms, another issue that will likely emerge is the possibility for reforms to the GSEs of Fannie Mae and Freddie Mac. In December, Representative Jeb Hensarling conceded that his proposal could not clear Congress in the current political environment. While there have been ongoing discussions in the Senate between Senators Bob Corker and Mark Warner, a bill has yet to materialize. While we suspect there may be ongoing discussions related to GSE reform, we are doubtful that major changes will occur this year given the number of other issues facing Congress.

Potential Sectors Impacted: The sectors impacted, should any financial regulations change, would be concentrated in financial services industries, although some spillovers to other sectors could occur as lending channels are reopened. Should GSE reform occur, residential investment would be impacted, and the direction and magnitude would depend on a final legislative package.

Entitled to Entitlement Reform?

Entitlement reform has been among the Republican Congressional leadership's top priorities for the past few years and House Speaker Paul Ryan has indicated that one of the top priorities for the second session of Congress will be to enact reforms to federal entitlement programs. The need for reform is clear as can be seen in Figure 5 below. According to the Congressional Budget Office, 63 percent of federal spending in 2017 was on mandatory spending, which includes Social Security and the federal healthcare programs Medicare and Medicaid.[6] As a share of the federal budget, mandatory spending is expected to be roughly unchanged by 2047, but as a share of nominal GDP mandatory spending is expected to rise to 16.5 percent of GDP from this fiscal year's 12.4 percent. The challenge for policy makers is how to "solve" the problem. With an aging workforce, the tax base over which to spread out increases in taxes for Social Security and the healthcare programs remains low relative to historical averages (Figure 6). Conversely, cutting benefits for a large retiree population is not only politically unpopular but also would likely have adverse effects on aggregate consumer spending given the large and growing number of individuals receiving these benefits.

In our view, we see a very low probability of significant reforms to Social Security and the Medicare programs.

Beyond Social Security and the federal healthcare programs, there have been a number of other entitlement programs that have been targeted for reforms, such as the federal food stamp program, known as the Supplemental Nutrition Assistance Program (SNAP) and the Temporary Assistance for Needy Families (TANF) program. Both of these programs saw proposed cuts within the president's fiscal year 2018 budget and are expected to be targeted in next fiscal year's budget.

In our view, we see a very low probability of significant reforms to Social Security and the Medicare programs, especially in an election year. Social Security in particular would be challenging to change, as the reconciliation process does not allow changes to this program, meaning any reforms would likely need to be bipartisan. The Medicaid program, which includes parts of the ACA, along with SNAP and TANF, are the entitlement programs most likely to see benefit cuts in the second session of Congress.

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[5] **Economic Growth, Regulatory Relief, and Consumer Protection Act. 115th Congress. S. 2155. (2017). https://www.congress.gov/115/bills/s2155/BILLS-115s2155rs.pdf**
[6] **Congressional Budget Office. (2017). The 2017 Long-Term Budget Outlook. https://www.cbo.gov/publication/52480**

Potential Sectors Impacted: Should entitlement reform be enacted, the details of which programs are affected will determine the sectors impacted. Possible sector impacts include consumer spending on healthcare, consumer spending on food for off-premise consumption and business investment in the healthcare sector. Should changes to taxes and/or benefits occur to Social Security, the net result would likely reduce overall growth in consumer spending due to reduced growth in income. In addition, given how large of a role entitlement programs play in the deficit forecast, any reductions to these programs would present some downside risk to our deficit and net Treasury issuance forecasts.

Figure 5

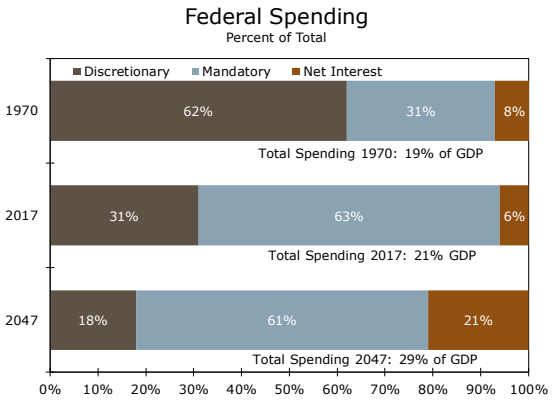
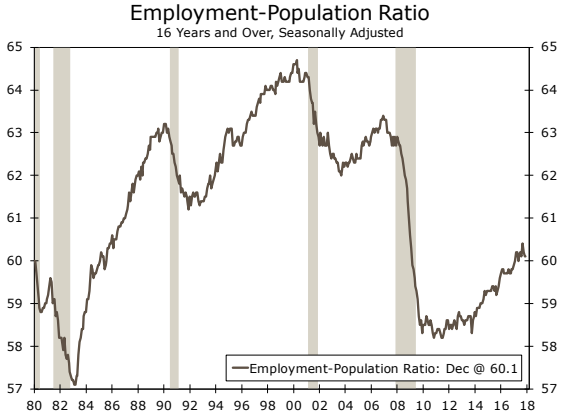


Figure 6



Source: Congressional Budget Office, U.S. Department of Labor and Wells Fargo Securities

Leaving the Door Open to Repealing the Affordable Care Act (Again)

When the history books are written, tax reform will likely steal the spotlight of the first year of the 115th Congress. Yet, it was not until September 30th when the reconciliation instructions for the ACA repeal expired that the tax overhaul process truly began to ramp up. Health care remains the thorn in the side of the GOP, and as a result we believe there is a chance Congress may return to this issue in the months ahead.

When Congress last left health care, Senators Lamar Alexander (R-TN) and Patty Murray (D-WA) had crafted a proposal that would attempt far less ambitious changes to the health care system, such as funding cost-sharing reduction payments to insurers, expanding eligibility for catastrophic coverage, streamlining the waiver process for certain ACA provisions and boosting funding for ACA enrollment outreach. At the time of this writing, that bill appears stalled in the Senate and is a non-starter in the House, despite strong support from some key Senators such as Susan Collins (R-ME).

With the tax bill cleared and a possible FY 2018 budget deal approaching (more on that below), Republicans will once again have the option of turning to a budget resolution (for FY 2019) to initiate the reconciliation process that they used to tackle health care and taxes last year. The key challenge for Republicans will be what to include in those reconciliation instructions. Republicans intentionally avoided tying an ACA repeal to tax reform reconciliation instructions to avoid bogging down the process, and that strategy largely seems to have paid off. At the moment, it does not appear the House and Senate have enough votes for either an ACA repeal or an ACA repair-job, perhaps making the status quo the most likely outcome this year.

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Potential Sectors Impacted: The health care sector as a whole would be impacted by any possible changes, with the devil to be in the details for more specific health care sectors. Any sweeping changes would likely include Medicaid cuts, which would challenge states that have expanded Medicaid. If Congress gets bogged down in another repeal-and-replace effort, it could put the brakes on other possible initiatives such as infrastructure spending and financial industry reform.

Figure 7

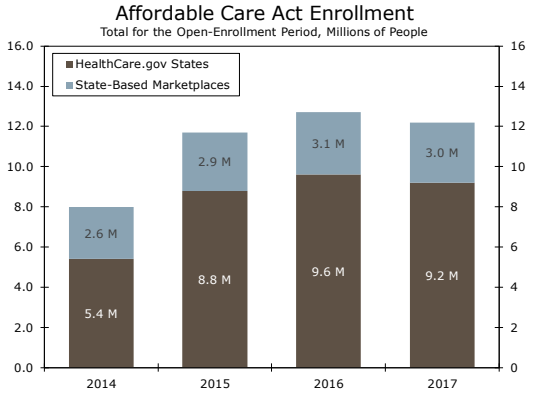
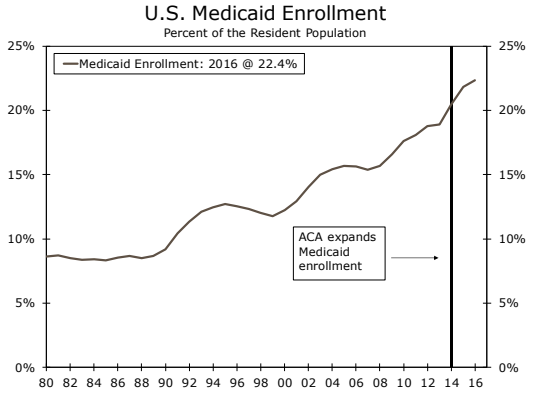


Figure 8



Source: Center for Medicare and Medicaid Services, Office of the Actuary, MACPAC, U.S. Department of Commerce and Wells Fargo Securities

The Budget, Debt Ceiling and Treasury Issuance: A Fiscal Potpourri

Last September, as fiscal year 2017 came to a close, Congress failed to come to a full-year spending agreement and passed a CR to fund the government at FY 2017 levels through December 8. This stop-gap measure helped buy policymakers time to work through tax reform, and with the finish line in sight Congress once again passed a CR to fund the government for two more weeks through December 22. Then, with the holidays approaching and taxes still consuming the bulk of the time and resources, Congress passed a third CR to keep the lights on through January 19.

The challenge on the budget front has been two-fold.

What gives? The challenge on the budget front has been two-fold. First, taxes and health care were all-consuming in 2017, leaving little time, fiscal resources or political capital for tough spending decisions. Second, unlike taxes, the annual appropriations process cannot be done through reconciliation, meaning it takes 60 votes in the Senate to advance legislation, giving Democrats some leverage. Not only that, but under current law the process has become a de facto two-step process. First, Congress must decide by how much they want to lift the spending caps put in place by the Budget Control Act of 2011 (Figure 9), then policymakers must go through the actual process of divvying up those top-line spending figures between all the various government agencies and programs.

Figure 9

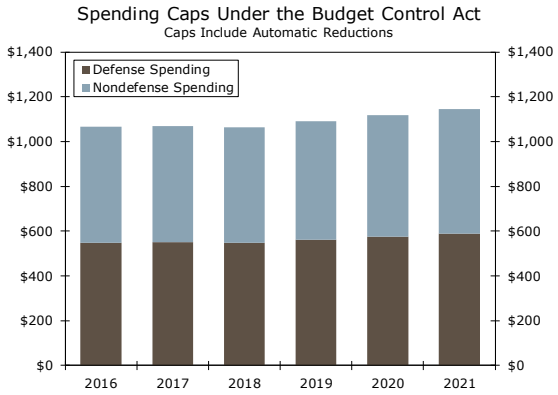
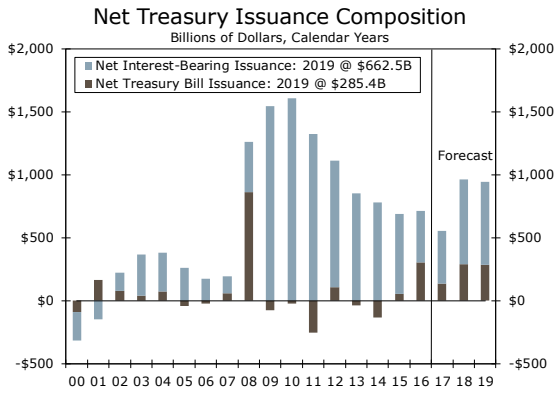


Figure 10



Source: Congressional Budget Office, U.S. Department of the Treasury and Wells Fargo Securities

At the moment, there is a sharp disagreement between Republicans and Democrats on the spending caps. Republicans want a large increase in defense spending with no change to the non-defense discretionary spending caps, while Democrats are demanding equal treatment between defense and non-defense spending. In addition, a slew of other factors have also been tied in to the budget debate: the debt ceiling will likely need to be lifted by late March, the Trump administration still wants funding for border security/a border wall and Democrats are demanding action on DACA. Finding a policy mix on spending, the debt ceiling and immigration that has majority support among House Republicans, garners at least 9 Democratic votes in the Senate and is supported by President Trump has proved a daunting task, which explains why yet another CR through mid-February may be necessary to buy more time for an agreement.

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A final point: we have gotten questions since the middle of last year about our relatively large deficit numbers and correspondingly large forecast for jump in net Treasury issuance in 2018 (Figure 10). For example, since September we have been nearly $200 billion above the Congressional Budget Office's FY 2018 budget deficit forecast. This surge in net Treasury issuance next year can be attributed to three main factors 1) bigger deficits from the tax cuts 2) greater spending across the board (our expectation that there will be higher budget caps for defense/non-defense spending in addition to the multiple bills for disaster aid related to the hurricanes and California fires) and 3) a backlog of debt to be issued as a result of the Treasury being up against the debt ceiling for much of 2017.

There are downside risks to our issuance forecast, such as Congress making meaningful cuts to mandatory spending programs that are effective immediately, but for now we remain committed to our baseline deficit forecast of $750 billion in FY 2018 and $950 billion in FY 2019, up from $439 billion as recently as FY 2015.

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Potential Sectors Impacted: U.S. Treasury markets will be impacted by the eventual budget deal and its impact on net issuance, and financial markets more generally could see disruption in the event of a government shutdown and/or debt ceiling dispute. Both defense and nondefense contractors will be impacted by the eventual decision on the budget caps. A budget agreement this late in the fiscal year that meaningfully lifts the spending caps may lead to a surge in federal government spending from the late spring through the summer as agencies rush to squeeze a year's worth of new spending authority into roughly a six month period. To get 3 percent real economic growth in 2018, it will likely take an acceleration in government consumption and investment compared to 2017. With the outlook for state and local governments uncertain, this puts the onus on the federal government to carry the burden.

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