

Episode 78

# FireSide: What's happening in Washington?

Head of Public Policy Jason Cole joins Chief U.S. Economist Lara Rhame to discuss what the latest policy decisions could mean for investors.

Lara Rhame:

Welcome back to FireSide, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist here at FS Investments, and I'm joined for our first episode of the New Year with Jason Cole. And these are episodes that we call "What's Happening in Washington." Jason, welcome.

Jason Cole:

Thanks Lara. Good to see you.

Lara Rhame:

Jason is our Head of Public Policy and Corporate Social Responsibility, and I will brag for you because you've just had this exceptional two-and-a-half-decade career on and off Capitol Hill, and we've been lucky to have you here both on prior podcasts and we've presented together and I always learn so much from your insights. So always feel really excited when we get to sit down and dig apart some interesting aspects of policy and it's going to be an interesting year.

Jason Cole:

Yeah, absolutely. And I love doing these, so thanks for having me.

Lara Rhame:

Definitely. I talk more generally about the election. Who's going to win?

Jason Cole:

I have absolutely no idea.

Lara Rhame:

Dang it. I was hoping that we would get here on the FS FireSide podcast, we would get the answer.

Jason Cole:

No. That's going to be up to the voters. But what I can tell you is, give you a sense of where things are heading. Right now, if you look at national polling, and by the way, I'm going to assume that we have a rematch between former President Trump and President Biden. That just sort of seems to be where this is...

Lara Rhame:

Let's make that today. But I did want to talk about some of the other primaries that are kicking up.

Jason Cole:

Yeah, absolutely.

Lara Rhame:  
Fair enough.

Jason Cole:  
But for purposes of this, I want to assume that there's a rematch of the 2020 election. Former President Trump is polling nationally on the average about one percentage point of ahead of President Biden.

Lara Rhame:  
Okay.

Jason Cole:  
Now, we don't elect presidents in this country based on a national vote. There's really 50 state by state elections where you're not even voting for president. You're voting for somebody to, as an elector, to vote for the president. And they're bound by however your state goes. There are 538 electoral votes across all of the states. It takes 270 to win. Right now, I would argue that there are 44 states where we already know the outcome.

Lara Rhame:  
Sure.

Jason Cole:  
Just the way folks are locked into their sort of partisan lanes. President Biden begins with 226 of electoral votes and former President Trump begins with 235. That leaves 77 electoral votes up for grabs across just six states: Arizona, Georgia, Michigan, Nevada, Pennsylvania, and Wisconsin. The New York Times did a poll back in November, mid-November, of just those six battleground states and showed President Trump winning in five of them. Every state, but Wisconsin. Now, if those polls hold out and there's been subsequent polling that suggests that they are, President Trump would win with 302 electoral votes to Biden's 236.

Lara Rhame:  
Alright.

Jason Cole:  
And so, if the election were held today, to answer your question, and you believe the polling, former President Trump would get reelected.

Lara Rhame:  
Okay. And I think I'm eager to hear because, and maybe this is a topic for a future podcast too, there's so much to discuss whenever we sit down together, which is so exciting and I know it's going to be a year of us doing these podcasts. So I'm really looking forward to digging apart many aspects of this. One of the things that you mentioned to me back in November was that this still is not a certainty, it's not a done deal. And that I think we have a history of elections where, and I'm no dog in the fight here, but where things change, and I think one of the comments you made, which is interesting to me back in November was this basically gives the Biden team a roadmap for what they now need to correct.

Jason Cole:  
Yeah, that's right.

Lara Rhame:  
Which is tough. I mean it's not good news for them, but it's going to be interesting.

Jason Cole:  
That New York Times poll was bad news across the board for Team Biden. It showed independent voters running away from him. It showed his base black voters, youth voters braiding. But that effectively, again, gives that campaign a roadmap to who do we need to target? What do our messages need to be? And that's why close to \$5 billion is going to be

spent over the next 10 months on a campaign between both sides trying to send messages to, again, a very small handful of voters in six states. And

Lara Rhame:

That's not only the only piece of the election. Right? That's right. I think something that we talk about that's so important for policy is you've also got the Senate, you've got the House. How do those turn out?

Jason Cole:

So the Senate right now is very narrow majority, just like the House Democrats hold a one seat majority in the Senate. And so if Republicans don't take back the White House, they need to pick up two seats. They do take back the White House, they need to pick up just one. There are contests where there are Democrats sitting in states. Trump won from anywhere between eight and 40 some percent back in 2020. West Virginia, Ohio, and Montana, where there are incumbent democratic senators and West Virginia, Senator Manchin has announced his retirement. West Virginia is going to go Republican. Right? That's the state where President Trump won by 46% of the vote. Ohio and Montana are less certain, but they're going to be very difficult races for the incumbent Democrat to win. And remember, Republicans just need one of those seats in order to take back the majority. There's a number of other Senate contests in Arizona, Nevada, Pennsylvania, Michigan, Wisconsin, that all have democratic incumbents.

You'll recall I just named those states', office Presidential Battlegrounds. And so it'd be interesting to watch what tickets do voters vote for Trump for president, which they're signaling that they're going to do now and then to hedge their bet, vote for Democrat, or do they just vote straight party line. Interesting. And so right now, if you made me bet, I would wager that Republicans take back control of the Senate in the House. Again, there's technically a five seat majority. Once everything gets sorted out, probably when it's all said and done, a four seat majority, I think Democrats are likely to win a special election in New York. I think it's in February. And so four seat margin in the house heading to the election, redistricting has benefited both parties to a point where it's kind of a wash. And so it's going to come down to campaigns. Right now you have 18 Republicans sitting in districts that President Biden won, and five Democrats sitting in districts that President Trump won.

Lara Rhame:

Okay. So if you just do that math, that

Jason Cole:

If you do that math 13, yeah. If you do that math Democrats take back control of the house. That's way too simplistic to manage this. Campaigns need to be waged. And by the way, I find it difficult to swear in my mind a Trump presidential victory and a House of Representatives flipping from Republican to Democrat that would be highly unusual, hasn't happened since 1952. And so right now I think the House of Representatives is a total toss out.

Lara Rhame:

Okay. Okay. Okay

Lara Rhame:

I want to move us now to the deficit, which my role as chief economist, I think about the economy, the business cycle, and I think a lot about what I call macro markets and obviously Fed policy is deeply intertwined with both markets and the economy, but leads us to a discussion of interest rates, which, and when I think about macro markets, I think of equities, I think of core fixed income, I think of broadly credit markets, these sort of big asset classes. And I've also spent now decades in the field talking to advisors, talking to people, and it's been interesting to me that the deficit and government debt comes up a lot, but because of decades of falling interest rates, there's just developed this complacency that we know it's not a good thing to have a deficit.

And we know that we're carrying a lot of government debt, but it just isn't really going to matter. And I personally feel like this year, the next five years could be the years where finally that starts to really matter. And I know something you've said that's interesting to me is that it's really fallen on the list of voter concerns. I look at the fact that for really the last 12 out of the last 15 years, interest rates were for all intents and purposes zero, and we were sort of issuing debt with our eyes closed. And from here we're now in what I think you could describe as the start of a troubling cycle where, and I just put out my 10 for 24. One of the charts that to me I think is really important is the amount of government debt that matures in the next 12 months is 9.5 trillion.

Three years ago that was only \$5 trillion. And three years ago that was maturing at very different interest rates than it is today. And we've had long-term interest rates move down. I hear a lot from my colleagues out in the world that interest rates have peaked and I think maybe what they're talking about is the Fed funds rate because it's extraordinary to me that they would say that about long-term interest rates when if we're not going to have a recession or there's less likelihood of a recession, it's no longer my base case outlook. There's so much now government debt that needs to be cycled and needs to be issued. I gave you this backdrop, Jason, because you and I have talked about this before and I think you talk about the problem that this massive deficit causes for the government trying to stimulate the economy, trying to address its programs. From your perspective, do you feel like this is a, am I crazy? Am I the crazy one? This is really hitting an issue.

Jason Cole:

I don't think so. I think you're right to hit on this as a big problem, a looming problem. You're also correct in the fact that at least again, if you believe the polls, this isn't registering for voters right there. Number one concern right now is inflation cost of living the economy followed I think closely by immigration, debt and deficit barely registers. When you look at most polling, particularly when voters are asked to offer up their answer, if it's a choice in the poll, then that's a little different. But when voters are asked to offer up their answers, it barely registers. And I think some of that you're right, has to do with the fact for the last 12 or 15 years, policy makers have had this sort of fiscal free lunch where

Lara Rhame:

The way to put it, I love

Jason Cole:

That because interest rates have been so low and they can continue to spend without abandon and frankly without a lot of consequence This year. However, at the end of the fiscal year on September 30th, the deficit came in at \$1.7 trillion, which ratcheted up the debt ultimately to around 34 trillion. But that fiscal, but

Lara Rhame:

That's 125% of US GDP. Exactly,

Jason Cole:

Exactly. And that's where folks like you, economists begin getting worried about debt loss where you get up over a hundred percent and economists start reaming their hands. But that deficit, \$1.7 trillion is 6.3% of GDP. It was driven really by three things. One revenues, which were down last year with the soft economy, two mandatory spending such as social security and Medicare, and third interest on the debt, which last year rose to 659 billion or 2.5% of

Lara Rhame:

PDP. We have deficits because we're having to pay now so much more.

Jason Cole:

We're now having to pay so much

Lara Rhame:  
Interest on the

Jason Cole:  
Debt. Exactly.

Lara Rhame:  
That's the cycle, that's the,

Jason Cole:  
And that debt load right now, if you look across government programs, ranks fourth, if you want to call it debt or deficit service or debt service, a program, it ranks fourth in spending behind social security, Medicare and defense and accounts for almost 80% of all other non-defense discretionary spending. I mean, it's a super high burden. And if rates stay higher for longer, which I personally believe they will, the CBO or the Congressional Budget Office estimates that in 10 years that debt service is going to exceed federal spending on things like Medicaid or Medicare and defense. And in 30 years it's going to be the single largest program in the federal budget. And that's without funding a troop. That's without paving a road that's just

Lara Rhame:  
Money out the door.

Jason Cole:  
That's money out the door

Lara Rhame:  
Often to non-US,

Jason Cole:  
Non to US bond holders.

Lara Rhame:  
Absolutely.

Jason Cole:  
And so I think this is a huge problem and what frankly concerns me is that you only have one presidential candidate talking about probably the biggest driver of this problem, and that's entitlement spending around Social security and Medicare. All other candidates are saying, we're not going to raise the retirement age, we're not going to cut spending, we're not going to increase revenues into Social security and Medicare. We're not touching it.

Lara Rhame:  
Well, I think we've always said those, these are the hard choices and these are

Jason Cole:  
Extremely hard choices for politicians to make. But those two programs are absolutely going to consume the federal government's budget over the next two decades and then ultimately drive that interest expense into a place where it's just unsustainable

Lara Rhame:  
Over the next year. I think this idea that somehow there's going to be an immediate crisis that nobody's going to want to absorb US debt, I see it as more of a slow burn that US treasuries remain the global reserve asset of choice. The problem is that at the margin there are just fewer buyers, or let me put it this way, the Fed is quantitative tightening now. They're letting that balance sheet roll off. So they're stepping away as one of the largest buyers and then a lot of global countries that use treasuries or US government denominated bonds as a store of value for their central banks. I would argue that a lot of them have diversified away from that as much as they can already. There just aren't that many hangers to park a trillion dollar plane. I always

say if you're China, if you're Korea, if you're Taiwan, if you're Japan, you are going to have to hold some of those reserves.

And a lot of it has to be in dollars because there just aren't that many German bonds. There aren't that many Swiss government bonds. All that said, they're not adding to their reserves as a strategy today. So I think they're more in maintenance mode of rolling this debt. And I think that's where you could potentially, I think, see this slow squeeze. I think as we get these auctions that are bigger and bigger, the treasury will get it done. I just supply dynamics may matter for the first time. And I think that's a story that a lot of people are missing.

Jason Cole:

Yeah, I think that's right. I'll tell you what, I'm a little heartened about the fact that the new speaker has called for a deficit debt commission. Okay.

Lara Rhame:

Is that a bipartisan commission or

Jason Cole:

It would be a bipartisan commission. It would be a lot like the back in the day. They called it the super committee back in 2011 under the Budget Control Act. And that would ultimately look at those drivers of deficits and debt including social security and Medicare. And if you could produce a bipartisan product out of that where members of Congress, politicians collectively have to leap off the proverbial cliff and do an unpopular thing, I think that's our way out of this. And so I'm hopeful that as we get into these spending discussions around shutdowns, that debt and deficit and commission can gain some traction and some legs to maybe begin having the conversation around this, which is still needed. Yeah.

Lara Rhame:

All right. Okay. That's not the only policy that I think this focuses on and want to just briefly touch on something that I find so fascinating. I remember the first Trump, the first election when Trump was elected in 2016, and his really, I think very aggressive language around China and trade and moving towards a decoupling from China, which at the time felt radical and now feels more bipartisan. And I think one of the observations you made, I don't mean to steal your thunder, but I thought it fascinating when you said when Biden was elected, he did not change a single China trade tariff. He didn't make any change to that. I think there's, I Deglobalization was the big buzzword of 2023. I think this has somewhat fallen off the radar. Are there policies that are really top of mind? And again, it's early days. I think we'll get more specific later in the year as we see how the election's developing, but are there policies that you feel like are on the chopping block or are there policies that now, I mean I think if Trump gets reelected, do we lean into more deglobalization? Tell me how you're thinking about these two outcomes.

Jason Cole:

Yeah, it's an important question and you're absolutely right. President Biden didn't cut a single tariff on China when he came in. The China policy hasn't just stayed the same, but it's probably gotten even more stringent. Sure. And it's probably the only bipartisan issue in Washington right now is getting tough on China. When house Republicans took over, they stood up a brand new committee to, and these are their words, to build consensus on the threat posed by the Chinese Communist Party and develop a plan of action to defend the American people, our economy and our values. That committee has been entirely bipartisan. And right before the holidays released a bipartisan report calling for import and export controls, particularly around technologies and dual use technologies, calling for increased tariffs and stopping just short of revoking permanent normal trade relations from China, which would set off a trade war, no doubt about it. President Trump on the campaign trail with respect to other entities, and this question of yours about deglobalization broadly, not just with China, has proposed a 10% tariff on all goods from all countries coming into the United States. And

Lara Rhame:

This is a place where the president does have a lot of unilateral authority, right? In trade, correct.

Jason Cole:

Correct. And so this is a trend that I think is going to continue and it reverberates around if you're an investor in areas of opportunity as well. I mean, there's a lot of risk in tariffs in my view. They're effectively attacks, but I think there

Lara Rhame:

We just have made progress on inflation that would Yeah,

Jason Cole:

Exactly.

Lara Rhame:

Not be helpful.

Jason Cole:

Exactly. But there are some areas where these tensions are rising that could create opportunities for investors. And that is in this, and people will disagree about the propriety of it, but there is this new industrial policy that is entering into the vernacular of both parties in Washington. Last year, they passed a 280 billion bill to inject money into semiconductors and the resource semiconductor production of the United States. A big part of the President's Inflation reduction Act was doing things on green energy and to have that produced in the United States and where there's content requirements on electric vehicles. Now, if you want the tax credit for an ev, it's got to be that EV has to be substantially produced in the United States,

Lara Rhame:

By the way, probably only a fraction of what the Chinese have dedicated towards spending on developing chips. Correct,

Jason Cole:

Correct. But in terms of federal government dollars flowing to specific industries, I think that's something investors need to take a look at. Yeah,

Lara Rhame:

A hundred percent.

Jason Cole:

And can see that there's going to be substantial support for certain industries, particularly in the technology sector.

Lara Rhame:

What about financial regulation? I know that one of the things that we saw was a really significant swing when Biden was elected. What is it currently there are 61 rules proposed at the SEC when Trump was elected. A lot of these were rolled back. Tell me where you think the direction or the how. This seems like an area where the election outcome is very important, what's at stake? No,

Jason Cole:

Absolutely. And so there's a couple of things at stake. You're absolutely right. Right now they're at the SEC. So for our primary regulator, 61 rules either passed or proposed or going to be proposed.

Lara Rhame:

My humble bride F You were literally meeting with the SEC right before we

Jason Cole:

Correct? Yeah, we had a commissioner here in the offices and talking about some of those potential regulations. There's going to be a rush to propose a number of regulations in the first half of this year because of some quirks in the law with respect to Congress being able to override executive branch regulations in a new Congress if there's a new president and a Republican trifecta. And so you're going to see the Biden administration really try to get things out the door before probably June, July, to take that review process off the table. Okay. It's super technical, so I won't get it into it here, but if there's a Republican trifecta, you could see a number of these regulations, particularly if they're not timed correctly, go away.

And from a financial markets perspective, that wouldn't necessarily be a bad thing. Okay. If there's not a trifecta, the regulations are likely to stand. There's going to be a lot of compliance burdens, particularly on financial services firms to comply with these things. And so the elections do matter with respect to regulation. And you see it particularly when there's gridlock and dysfunction in Congress where the executive branch agencies, regardless of their Democrat or Republican, use their phone and their pen to do things that Congress won't otherwise do. And we're seeing that now. We'll probably see the reverse of it if Trump is reelected.

Lara Rhame:

Okay. So final question I'm going to take us home with is tax cuts and the possibility of further tax cuts in the upcoming election. I think Trump 1.0 big corporate tax cuts today, the

Jason Cole:

Big individual tax

Lara Rhame:

Cuts, big individual tax cuts. Of course expectation is that those will be extended. And if Trump 2.0, would we get more tax cuts on top of that or given the budget dynamics that we just finished discussing? Pardon me, hopes not, but my, of course, personal wallet hopes we do. So this is always the conflict, but what are your thoughts on the appetite of from the American people and from the sort of publicly stated policy wonks on the appetite for a 2.0 fresh round of deeper cuts?

Jason Cole:

That's going to depend on the election outcome.

Lara Rhame:

Okay. Right. Too soon to tell

Jason Cole:

Yeah, no, and if you have a trifecta, it's more likely than not that there's a deeper round, but let's take a step back on taxes. There's an interesting development happening on the Hill as we speak, where there is a limited tax deal being discussed that would extend expiring or expired provisions of the Trump tax cuts, namely the R&D tax credit for businesses, the interest expensing for businesses and the deductibility of capital purchases for businesses. Those all expired a year, and in the case of the research development tax credit two years ago, that would be coupled with about \$35 to \$40 billion in tax cuts to extend those through the end of 2025, which would really marry the expiration up of the rest of the Trump tax cuts. That would be paired with an extension of the child tax credit, which expired again, \$35 to \$40 billion.

And that deal is close on the hill. And so I think you could see some tax policy move in the next couple of months that does some tweaking of the two 2017 tax cuts and at least in the provisions that have already expired. When we get around to the new Congress, there will be a lot of pressure to extend the 2017 tax cuts. No politician wants to see taxes go up on their watch and by doing nothing, taxes will go up on corporations and individuals. And so there's going to be a lot of pressure to extend those regardless of who's in office. Whether you go further, I think depends on the election outcome.



Lara Rhame:

Okay. Well, I know that this is just the first of many conversations we'll have in 2024. So thank you for your time. Again, we are just so lucky to have you as a resource, and I know you do a lot with our Thrive programs. You are on the road constantly talking to our clients. You're in Washington, I don't know how you do it all and find the time. So I'm really appreciative that you were able to come into our studio today and talk with us. No,

Jason Cole:

No, this has been great. I am always happy to do it. These are a lot of fun. So, thanks so much.

Lara Rhame:

Thank you so much, Jason. Take care. This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard. It was produced by the investment research team. It was edited and engineered by Aaron Sherman. Special thanks to show coordinator Ellie Zhang. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcast. Thanks for listening.