

A Turning Point Before Midterms?

The recent passage of some Democratic legislation may boost their odds in midterms, but stubborn inflation and a recession could help Republican candidates up and down the ballot.

Recent Democratic wins may be a turning point, or at least a point at which the party and President Joe Biden have finally slowed their precipitous slide in their favorability ratings and polls. With the CHIPS and Science Act (a bipartisan deal aimed at boosting American innovation in opposition to growing Chinese technological dominance) in the rear-view, focus has turned to the newly minted Inflation Reduction Act of 2022.

The \$750 billion bill hashed out by centrist Sen. Joe Manchin (D-WV) and Sen. Majority Leader Chuck Schumer (D-NY), with the consent of Sen. Krysten Sinema (D-AZ), passed the Senate with the 50-vote threshold required under the reconciliation process. Schumer was able to keep his Democratic colleagues healthy (several Senators from both parties have been sidelined by COVID-19), present for the amendment process, and in line for the final tally. Vice President Kamala Harris was brought in to cast the tie-breaking vote in the 50-50 Senate, which, incidentally, was her 26th tie-breaking vote—the most in almost 200 years dating back to VP John Calhoun, who cast 31.

House Trained?

House Speaker Nancy Pelosi called the House back from their August break to vote on the Inflation Reduction Act. Different rules prevail in the House, and a simple majority is all that's required to pass the Senate-backed measure. The Democrats passed the climate, tax, and healthcare-focused package. While the progressive wing of the Democratic party previously fantasized about spending \$3–4 trillion in earlier iterations of the legislation (formerly known as Build Back Better 2.0), they're now coalescing around the Inflation Reduction Act, realizing that this may be their last shot at passing their legislative priorities for the next two years.

A Taxing Situation

Over the course of the past 18 months, the Democrats considered and discarded dozens of tax increases, as well as a carried interest provision that targeted the private equity industry. The end result was a 15% minimum corporate tax and a 1% excise tax on stock buybacks.

Here are the highlights of the 755-page Inflation Reduction Act of 2022, which includes \$430 billion to combat climate change and extend healthcare coverage, paid for with savings on prescription drugs and taxes on corporations. Additionally, it shifts hundreds of billions of dollars toward deficit reduction.

- **15% minimum corporate tax:** Raises revenue applying to large corporations with over \$1 billion in yearly profits; accelerated depreciation would be exempted
- **\$124 billion for enforcement increases at the IRS:** Designed to help narrow the tax gap between what is paid and what is owed to the federal government
- **Drug pricing:** Empowers Medicare to, for the first time in history, negotiate prices with drug companies with the aim of cutting prescription-drug prices for people 65 and older. The legislation also includes a cap on the price of insulin for Medicare recipients 65 and older.
- **1% buyback excise tax (takes effect January 1, 2023):** With Sinema removing a provision to close the carried-interest tax loophole (which benefits private equity and hedge fund managers), a 1% excise tax on stock buybacks was added to the bill with analyses showing that the excise tax generates more revenue than the carried-interest provision



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Key Points

- The \$750 Billion Inflation Reduction Act is likely to be the last major Democratic priority enacted for two years.
- Recent legislative wins by Democrats could stem downward political spiral and offset potential midterm losses.
- Primary wins by untested Republicans could help Democrats retain the Senate, but inflation and economy remain front and center on voters' minds; the House may turn Republican.

Taking Stock of Washington

- **Three-year Affordable Care Act subsidy extension:** Savings from the aforementioned drug-pricing provision would be earmarked to pay for a three-year extension of Affordable Care Act subsidies—heading off a predicted rise in insurance premiums expected to take effect in 2023
- **\$369 billion on climate and energy:** Covers investments designed to combat climate change and supercharge clean-energy initiatives. This includes incentives for farmers and ranchers to reduce methane emissions; an extension of the electric vehicle tax credit; and the launch of a National Climate Bank that would make investments in clean-energy technologies and energy efficiency. Specifically:
 - \$200 billion in clean-energy tax credits
 - \$80 billion in rebates for electric vehicles in addition to green energy at home
 - \$1.5 billion in rewards for cutting methane emissions
 - \$27 billion for a Clean Energy and Sustainability Accelerator (National Climate Bank)
 - \$29 billion to reduce emissions in agriculture, steel, and ports; support for fossil-fuel projects; support for miners with black lung

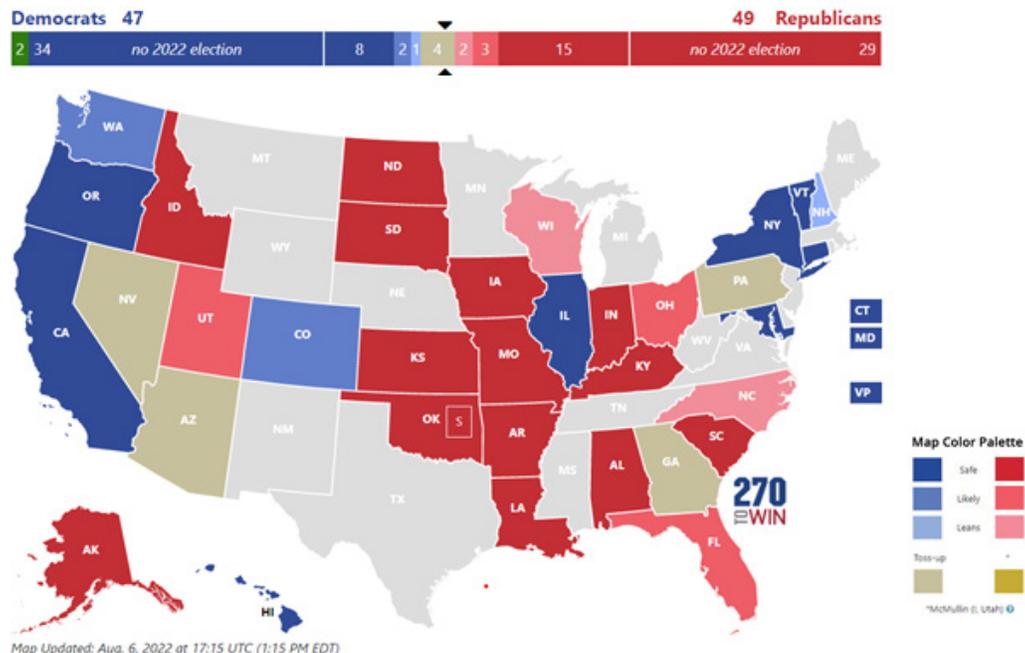
September’s Slim Pickings

When Congress returns in early September, the annual government spending bills will take center stage with big-tech antitrust, cannabis banking, and crypto-currency legislation all under consideration. Given the short timeframe before Congress recesses again for the midterms, our best-case scenario is that a government stopgap bill is passed through November when Congress will return with potentially different priorities given the election outcome. The appetite for bipartisanship is almost certain to quell the closer we get to November 8.

As we look again at the Senate midterm map (FIGURE 1), there are 34 Senate races this fall (one-third of the Senate is up every two years) and our attention is centered on the eight states that are toss-ups or lean either Republican or Democrat: Pennsylvania, New Hampshire, Georgia, Arizona, North Carolina, Nevada, Wisconsin, and Ohio. With the exception of NC and OH, Biden won each of these states in 2020.

The remaining 26 races are currently considered safe Republican or Democrat. We’re watching for significant shifts in polling and changes in voter sentiment in those states and will recalibrate accordingly. For example, incumbent Sen. Patty Murray (D-WA) is inching closer to being number 9 on our list of races to watch.

FIGURE 1
2022 Senate Election Map



Source: 270 To Win, as of 8/6/22.

Midterm Momentum

As the final passage of the Inflation Reduction Act is nearing, senators are wasting no time hightailing it back to their states to prepare for the opening stretch of campaign season 2022. Senate Democrats will be touting their recent victories, and some Republicans will be joining them given that most legislation passed over the summer was accomplished with bipartisan support (the major exception being the Inflation Recovery Act, which they will leverage to their advantage).

The CHIPS and Science Act, the Promise to Address Comprehensive Toxics (PACT) Act, the confirmation of Norway and Sweden into NATO, and the first gun-control measure to pass Congress in decades are giving the Democrats much-needed momentum to offset what's been a brutal year politically for Biden, Schumer, and Pelosi. As Republicans aim to change the narrative back to Democrat malaise, they're taking every opportunity to counter Democratic senators who supported the Inflation Reduction Act, with some already airing ads accusing Democrats of reckless spending and new tax increases.

Primary Pitfalls

Heading into the fall of 2022, the Senate map slightly favors the Democrats, since they have less seats to defend as well as recent trends in targeted states. Now that primary season is over in the eight swing states we're tracking closely, the die has been cast for the general election. Our biggest takeaway is that the best hope for Democrats retaining the Senate lies with several untested and unpredictable Republican candidates prevailing in the primaries over more mainstream candidates. In coming months, we'll touch on the specifics in each of these swing states (see the spotlight on Georgia to the right).

History Repeating

The first midterm election of a new president's tenure is historically met by losses for the party holding the White House; the exception being President Bill Clinton (+5 in 1998) and President George W. Bush (+8 in 2002). 2022 isn't looking to be any different in these regards, especially in the House.

Republicans have been chomping at the bit to make the midterms a referendum on Biden and inflation, gas prices, and economic malaise. To date, recession fears have worked in their favor. The recent wave of legislative victories in addition to the ripple effect from the Supreme Court's *Roe v. Wade* decision have given Democrats a life preserver for the time being. We're still assessing recent abortion ballot initiative outcomes in Kansas and recent primary turnout in toss-up states, but we maintain that Republicans will take the House and Democrats will hold the Senate. However, stubborn inflation and a potential recession may help Republican candidates up and down the ballot.

Georgia on My Mind (Again)

Incumbent Sen. Raphael Warnock (D-GA) will be facing off against Republican candidate Herschel Walker this November in what's shaping up to be one of the wildest and hottest races this fall. But even more, Libertarian Chase Oliver will likely siphon votes from both Warnock and Walker. And in case you've forgotten, candidates must get over 50% of the vote to win in Georgia elections. So, if Warnock and Walker are held to under 50%, then we're looking at a runoff on December 6.

Talk to your financial professional to make sure your portfolio is prepared for whatever happens in Washington D.C.

About the Author:

James R. (JT) Taylor serves as Senior Policy Analyst at Hedgeye Potomac Research. JT has extensive experience in both government and business in Washington, D.C., with a career spanning the legislative and executive branches as well as the financial-services industry. Prior to joining Potomac Research Group, he ran Pelorus Research, the US public-markets division of the Holdingham Group based in the United Kingdom. He previously led a policy research team as Managing Director at DeMatteo Monness. From 2002-2009, he was Managing Partner of Kemp Partners, a Washington, D.C.-based strategic consulting, business development, and marketing firm he founded with Secretary Jack Kemp in 2002. At Kemp Partners, he oversaw day-to-day operations and business development while managing client relationships in both the corporate arena and financial-service industries.

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