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NEW LEADERS, NEW POLICIES — POTENTIAL IMPACT ON MARKETS?

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Priorities for a Democratic coalition

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Road map for a Biden administration

Front and center for Congress in 2021 is likely to be a continued response to COVID-19 through attempts to contain the pandemic and improve vaccine distribution. We view these efforts as being universally popular among the public, which could increase pressure on Congress to reach a compromise on another economic support program. Two potential areas for compromise to watch for are additional state and local funding and small-business protection for liability from the pandemic.

Moving on from there, federal spending proposals on infrastructure, health care, and green energy are likely targets and may secure some bipartisan support, considering their interest from both parties during the election. Spending initiatives already appear to be the top priority, as President Biden has proposed a nearly $2 trillion spending package. Other proposals are likely to occur before the midterm elections, which historically often have narrowed or eliminated a congressional majority for the president's party. Presidents Obama and Trump both experienced this. A congressional loss for the Democrats in 2022 could return the Republicans to leadership and likely block President Biden's initiatives. Also, Biden will be almost 82 at the end of his firm term, suggesting to us that he may choose not to take a second chance at legislative efforts after 2022.

Some tax-hike proposals could gain traction, including corporate taxes (from 21% to possibly 25% as a compromise on the 28% proposed last year) and taxes on corporate income earned overseas (which could affect multinationals in the S&P 500 Index, such as pharmaceuticals, financials, and technology companies). More controversial are proposals for higher levies on capital gains and top-tier income, as well as the restoration of some deductions lost in 2017.

More broadly, however, our view on taxes is that the timing and sensitivity about the economy may permit only limited and much-diluted tax increases. Historically, complex negotiations have required most of a year. What's more, by midyear 2021, Congress again must decide by how much to raise the federal debt ceiling — never an easy debate but likely even more protracted in a sharply divided Congress. Tax reform easily could take most or all of 2021. By then, Congress could be facing a vote on raising taxes with the next congressional election cycle looming. Consequently, the time-intensive negotiations and sensitivity in Congress about preserving the economic recovery may limit and dilute tax increases.

A majority in the House of Representatives of only three seats is the narrowest for either party in 60 years.

Source: "Party Divisions of the House of Representatives, 1789 to Present," History, Art & Archives, U.S. House of Representatives, accessed January 4, 2021.

Friendly Senate majorities matter: A Republican Senate confirmed fewer than 28% of President Obama's court nominees, compared with 88% under a Democratic Senate.

Source: "Judicial Nomination Statistics and Analysis: U.S. District and Circuit Courts, 1977-2018," Congressional Research Service, March 21, 2019

Investment implications

As the Democrats return to control in both chambers of Congress for the first time since 2011, their margin in each chamber is razor thin. Moreover, the split between moderates and progressives within each party has grown sharper. The need for compromise argues for a light touch on last year's campaign proposals. The area for greatest compromise appears to be on spending, which should reinforce private spending to produce strong economic growth after March. Our current preferences align with this view for a stronger economy and modestly higher interest rates in 2021. In particular, we have established and now reiterate our preferences as follows:

- A preference for equities most oriented to the U.S. and broader global economic recovery, including U.S. large- and small-cap equities and emerging market equities.

- Among the equity sectors, we retain favorable views on Information Technology, Consumer Discretionary, and Communication Services, which we look to continue to enjoy accelerated adoption among households and businesses in 2021. We also favor Health Care, which we believe should benefit from the potential for expanded federal spending on health coverage. Finally, we favor Materials, Industrials, and Financials, which we anticipate may benefit from our expectations for economic growth and modestly higher longer-term interest rates. There may be additional opportunities to add to these as policy priorities become clearer in the coming weeks and months.

- In fixed-income markets, we favor high yield, preferred securities, and investment-grade credit as ways to add yield over U.S. Treasuries. In addition, we expect the prices of municipals, including high-yield municipals, to appreciate from the potential for additional state and local government financing.

- In real asset markets, we continue to favor commodities and real estate investment trusts that may benefit from our expectations for information technology and trends toward online buying.

Key takeaways

- Historically narrow margins for congressional control, and splits within the two main political parties, are likely to narrow the legislative agenda to eliminate the more controversial campaign proposals.
- Congressional leaders may want to prioritize tax increases, but we believe the stronger prospects for congressional action will be around spending. Investors also should watch appointments for potential market impact.
- Our current portfolio guidance balances short-term and pandemic-related economic weakness against early signs for a stronger economy and modestly higher interest rates in the final three quarters of 2021. We reiterate our gradual rotation of preferences into markets and sectors that benefit from stronger growth.

The Biden team on Wall Street: A first look

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A team of moderates

Diverse, experienced, moderate, and left-of-center ideology are the terms we believe best describe the Biden economic team overall, many of whom are veterans of the Obama administration. News of Janet Yellen's nomination as Treasury Secretary at the end of November set a positive tone on Wall Street for most other personnel announcements that followed. Two exceptions are nominations of progressives Neera Tanden to head the Office of Management and Budget and Katherine Tai as the highly visible U.S. Trade Representative, who we believe is likely to increase the focus on labor standards and the environment in future trade negotiations. Yellen and Brian Deese, the appointee to head the National Economic Council, we view as likely to be the two most influential decision-makers in a group that also includes nominations of Cecilia Rouse at the Council of Economic Advisers and moderate Rhode Island Governor Gina Raimondo as Commerce Secretary.

We anticipate that Yellen and Brian Deese, the appointee to head the National Economic Council, will be the two most influential decision-makers in a group.

A Democratic majority in the Senate should clear the way for a smooth confirmation process extending beyond top-level nominees to heads of regulatory agencies, mid-level cabinet posts, and even federal judgeships often crucial in legal rulings on economic issues. Regulatory heads can be instrumental in interpreting existing legislation, in following through on executive mandates, or in lobbying for new laws. Even the hundreds of less visible subcabinet nominations are a critical conduit for presidential influence over executive-branch departments and government agencies.

The president's economic team encompasses nominations to the Federal Reserve Board, through the president's nominating authority for governors shaping monetary policy critical to economic and presidential policy performance.

The president's economic team encompasses nominations to the Federal Reserve Board, through the president's nominating authority for governors shaping monetary policy critical to economic and presidential policy performance. Biden will have an immediate opportunity to fill a Board seat and will be able to appoint a new leader to chair the Federal Reserve Board in February 2022. A history of high turnover on the Board suggests other vacancies over the next four years are likely as well.

The policy implications…

Nominations of moderates fit with the party's razor-thin majority in both houses of Congress, leaving the president beholden to Democratic centrists for required votes. We believe that helps explain the moderate cast to the Green New Deal and why there's been little mention of such progressive policy favorites as Medicare for All and Modern Monetary Theory.

Nominations also have provided clues to policy priorities, in our opinion. Labor reform likely ranks high on the list given the history of labor advocacy by Yellen, Tanden, Rouse, and CEA colleagues Jared Bernstein and Heather Boushey. Labor Secretary Nominee Marty Walsh, a Boston mayor with close ties to unions, could facilitate reform implementation. Brian Deese's background in climate change likely puts the environment high on the list too. We believe any doubts about the importance of pandemic relief as the top administration priority can be swept aside by the strong support for aggressive action by all in the group.

To a point, Democratic control of the Senate may give the president greater leeway in nominating left-of-center candidates to the Federal Reserve (Fed). At issue is the extent to which that facilitates the Fed's move toward such nontraditional policy goals as dealing with the environment, income inequality, and a more direct role by the central bank in deficit financing.

…and what it can mean for investors

The Biden economic team signals a new set of trade-offs for investors. More aggressive growth-supporting spending likely means a larger, more direct government role in the economy. We anticipate the potential for increased regulatory and labor costs, redistributive tax, and other policies weighing on margins likely are the price to be paid for greater policy transparency in domestic and foreign economic policy.

Our upgraded growth forecasts based on our expectations for more aggressive stimulus in the coming year strengthen the case for portfolio strategy more inclusive of small-cap stocks and other economically sensitive sectors of the stock market. Likewise, we view faster economic growth, low inflation, and modestly higher interest rates as consistent with the potential for opportunities for yield in fixed-income markets. Increased government participation and intervention in the economy ultimately could rekindle interest in growth stocks and bonds if they create headwinds for economic and earnings growth.

Key takeaways

- Moderates dominating the Biden economic team point toward left-of-center policies — focusing early on pandemic relief, health care, the climate, and labor reform — largely devoid of the more far-reaching proposals from the Democratic Party's progressive wing.
- Democratic control of the Senate will facilitate confirmation not only of top-level nominations within the administration but also of regulatory and mid-level positions vital to policy execution.
- Upgraded growth forecasts from more aggressive stimulus in the coming year strengthen the case for portfolio strategy more inclusive of small-cap stocks and other economically sensitive sectors of the stock market.

Stroke of a pen — a primer on presidential executive orders

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What are executive orders, and how have they been used?

An executive order is a written directive from the U.S. president that manages operations of the federal government. (See side bar 1 for other forms of executive action.) Article II of the Constitution grants the president broad authority to determine how to enforce the law to manage the resources and staff of the executive branch. Because the president's power to issue executive orders comes from the Constitution or federal statute, such orders require no approval from Congress, and Congress cannot simply overturn them. However, for presidential authority that comes from statute, Congress may pass legislation that makes it difficult or even impossible to carry out an order, such as removing funding. The courts may review and overturn an executive order if it lacks support by statute or the Constitution or if it exceeds the president's constitutional authority. Only a sitting U.S. president has the authority to overturn an executive order, whether it was issued by the current president or a predecessor.

Executive action comes in three forms: orders, memoranda, and proclamations. Memoranda are similar to orders except they are not listed in the Federal Register. Proclamations are largely ceremonial and do not carry the force of law.

Source: "Executive Orders: A Beginner's Guide," Library of Congress, August 5, 2020

Every sitting U.S. president has issued some form of executive order, now totaling more than 13,731.[1] Since 1789, a number of consequential executive actions have been issued, including the Emancipation Proclamation in 1862, the desegregation of public schools in 1957, and the establishment of the Peace Corps in 1961.

President Trump issued 30 executive orders during in his first 100 days in office, while Obama issued 19.

Source: www.whitehouse.gov, April 25, 2017

How do executive orders affect the economy and markets?

Although broad economic policy changes typically require congressional action, unilateral executive actions may have direct or indirect impacts on the economy and markets. Recent examples include:

Economic relief: In the wake of the pandemic, as debate on stimulus dragged in Congress, Trump passed a series of executive orders to provide economic relief for workers and taxpayers. These included extended unemployment supplements, a payroll-tax holiday, and student loan deferments.

Franklin D. Roosevelt holds the record for the most executive orders issued — 3,721 — with 5 overturned by the Supreme Court.

Source: Heritage Foundation, 2021

Tax policy: Existing statutes grant the president broad authority to effect tax changes unilaterally through executive orders. Yet, historically, the president rarely has exercised the power to raise tax revenue and has instead relied on Congress to do so. That said, Trump and Obama both were amenable to pursuing tax-friendly orders by enacting payroll-tax holidays.

[1]Source: "What is an Executive Order?" American Bar Association, www.americanbar.org, October 9, 2020

Investments: In December 2020, Trump issued an executive order banning investment in Chinese military-affiliated companies. This order bars investors from establishing new positions and requires liquidation of existing positions in about 30 impacted companies.[3]

The first 100 days and beyond

Executive orders are a potent source of presidential power. During his single term in office, President Trump issued more than 200 executive orders. This number is high compared with Obama and George W. Bush and about the same as Clinton during their first terms, and all issued fewer in their second terms.

Table 1. Number of executive orders issued by president

President	Executive orders	Executive orders
	1st term	**2nd term**
Trump	205	***
Obama	147	129
G.W. Bush Jr.	173	118
Clinton	200	164
H.W. Bush	166	***
Reagan	213	168

Sources: The American Presidency Project, 2021, Wells Fargo Investment Institute

Typically, an incoming president reviews standing executive orders, and we expect President Biden to do the same. In health care, we expect Biden to use the Defense Production Act to increase the manufacture of critical health care equipment. We already favor an overweight to the Health Care sector, in part to benefit from the potential for additional spending. Even broader use of executive orders we view as likely in the energy industries. In general, we expect the new administration to use orders to promote clean energy actively while discouraging hydrocarbon production. The new administration is likely to block drilling for oil and gas on federal lands and to increase the cost of hydrocarbon extraction. Measures to promote the latter may include ending subsidies and restricting access by hydrocarbon firms to low-cost financing.

Key takeaways

- An executive order is a written directive from the U.S. president that manages operations of the federal government.
- Since 1789, every sitting U.S. president has issued some form of executive order, now totaling more than 13,731.[2]
- We expect President Biden's executive orders to have the most potential positive impact on the Health Care sector and the most negative impact on the Energy sector.

[2] Source: "What is an Executive Order?" American Bar Association, www.americanbar.org, October 9, 2020

[3] See "Executive Order Bans Investment in Chinese Military-Affiliated Companies: Uncertainty Remains," WFII, December 22, 2020

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Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. **Communication** services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. Investing in the **Financial** services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

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