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Debt, Democrats, and Dollars

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Increases in debt limit since 1993:

24

Source: Congressional Research Service, "The Debt Limit Since 2011", July 1, 2019.

Expected budget deficit in 2020:

Over $1 trillion

Sources: Congressional Budget Office, Wells Fargo Investment Institute (WFII), July 22, 2019. Projections based on the terms of the budget deal.

Key takeaways

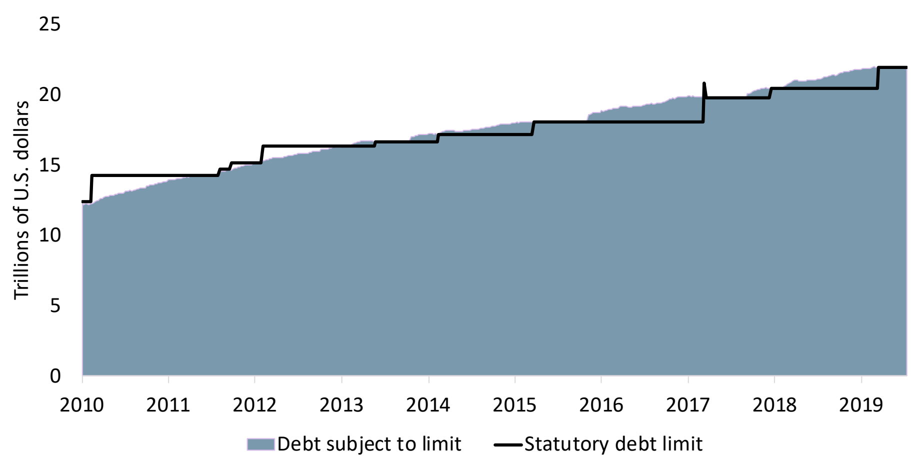
- A deal to raise the debt limit and increase spending caps has been reached. We expect the bill to be signed into law over the next few weeks.
- While budget appropriations will still need to be passed to remove the threat of a government shutdown this fall, we believe that this deal smooths the political path and removes an uncertainty from the market.
- We favor retaining exposure to equities and fixed income as part of a diversified portfolio (and in alignment with strategic objectives). If volatility rises in coming weeks due to congressional inaction, it may present a compelling opportunity to rebalance and purchase quality holdings.

A deal is reached—federal debt limit extended until July 2021

The U.S. government has been running a fiscal deficit for some time (spending more money than it collects). Issuing debt to fund federal spending obligations is a routine Treasury Department task. The U.S. debt limit set by Congress limits the amount of debt that the Treasury Department can issue. The federal debt limit does not authorize new spending commitments. It simply allows the government to finance existing obligations that Congress and the president have agreed to fund in the past.[1]

In February 2018, the *Bipartisan Budget Act of 2018* suspended the federal debt limit through March 1, 2019. At the time, Treasury Secretary Steven Mnuchin sent a letter informing Congress that the Treasury Department would begin taking "extraordinary measures" to continue funding the government and to prevent the U.S. from defaulting on its obligations.

Chart 1. The federal debt limit and debt outstanding



Sources: Bloomberg, Wells Fargo Investment Institute, July 12, 2019. Daily data from January 1, 2010 to July 11, 2019. Total public debt outstanding in excess of the statutory debt limit represents the dollar impact of the debt ceiling suspension.

The available funding from these extraordinary measures was projected to expire in September 2019. If congressional leaders and the president follow through on their commitment to approve the new budget and debt deal, the debt limit will be suspended until July 2021. The deal also removes the threat of sequestration by raising spending by $320 billion over existing spending caps. The increased spending would likely push the annual budget deficit above $1 trillion per year. The spending increases will be offset by only $77.4 billion in spending cuts. Budget hawks seem to have lost their voice in the current political climate.

[1] U.S. Department of Treasury, "Debt Limit: Myth versus Fact", May 2011.

While spending levels have been agreed upon, the actual appropriations that direct and allow the government to spend money still need to be passed once lawmakers return from their summer recess to keep the government open. In agreeing to the new spending, lawmakers have committed to keep any poison-pill language out of the appropriations bills, which reduces the threat of a government shutdown this fall.

In our opinion, the markets are not discounting a federal government shutdown or further budget-talk gridlock. If hints unexpectedly appear that a shutdown or budget gridlock may occur, we could potentially see a sell-off in U.S. risk assets (such as equities and high-yield debt), along with increased Treasury yield volatility. Yet, we believe that investors have learned from previous government shutdown episodes, and they may be more reluctant to sell risk assets as they seek to avoid missing out on any upside from a post-deal rally.

We expect U.S. economic growth to slow somewhat in 2019 (compared to last year), mostly influenced by new risks from a global slowdown and trade disputes. We also anticipate that the Federal Reserve (Fed) will take appropriate steps to mitigate U.S. economic risks. We believe that investors should retain exposure to equities and fixed-income assets in alignment with their strategic objectives. If market volatility rises in coming weeks due to congressional inaction, that may present a compelling opportunity to rebalance and to capitalize upon any price dislocations.

Democratic presidential candidate with the most words spoken in the first debate:

Joe Biden (2,475 words)

Source: FiveThirtyEight, June 28, 2019.

Democratic presidential candidate attracting the most second-quarter donations:

Senator Bernie Sanders (More than $25.7 million)

(Ahead of Mayor Pete Buttiegieg, at $24.9 million)

Source: Julia Wolfe and Chris Zubak-Skees, "What Second-Quarter Fundraising Can Tell Us about 2020", FiveThirtyEight, July 16, 2019.

Key takeaways

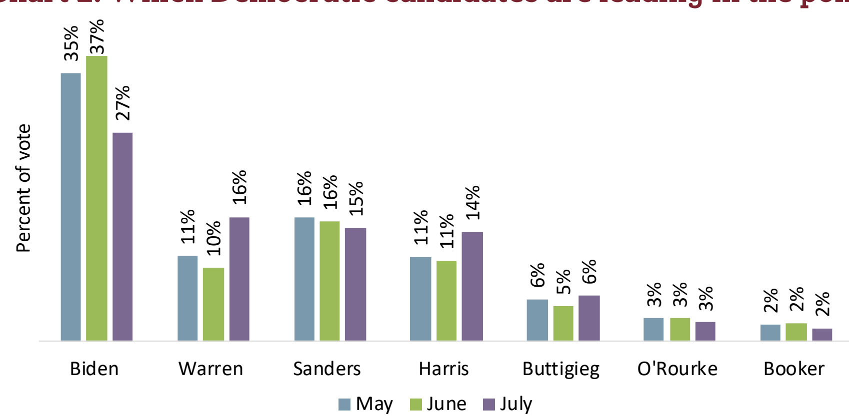
- The first Democratic debates underscored a new generational dynamic in the presidential race. Vice President Biden entered the June debate night as the clear frontrunner. While he remains the frontrunner, a weaker-than-expected June debate performance showed some vulnerabilities. A field of younger and vibrant candidates is attracting attention from Democrats.
- The Democratic field is composed of 24 presidential candidates after Representative Eric Swalwell dropped out of the race on July 8, while billionaire Tom Steyer has since joined.[2] The second Democratic debates will take place on July 30 and 31.

State of the Democratic presidential race

The Democratic presidential debates are now underway. These debates underscore how sharply Democrats have shifted in a liberal direction since Mr. Trump's election in 2016. From immigration to health care, tax reform, and gun control, most candidates demonstrated that they did not want to be perceived as insufficiently progressive on important issues. Yet, several voiced hesitation and called for pragmatism on some of the party's most progressive policy plans. With a crowded field, it is unlikely that the Democrats will settle quickly on a party nominee.

Seven candidates have stood out and currently lead the packed Democratic field. The leading group of seven candidates represents views that generally span the left side of the spectrum, but there is a lot of ground to cover before we know where the Democratic platform will land on issues most important to investors. In early July, former Vice President Joe Biden continued to lead in the polls, at roughly 27%.[3] Behind former Vice President Biden, the rankings shifted slightly, with Senator Elizabeth Warren, Senator Bernie Sanders, and Senator Kamala Harris grouped in a second tier. In early July, Senator Warren and Senator Harris commanded roughly 16% and 14% of poll votes, respectively, with most of their gain coming at the expense of former Vice President Biden. Mayor Pete Buttigieg ranked fifth in the polls, at 6%, while former Representative Beto O'Rourke (3%) and Senator Corey Booker (2%) followed. Senator Sanders and Senator Warren are the farthest left and most progressive candidates of the group. They are followed by Senator Harris and Senator Booker, who are running on broad, progressive platforms. Vice President Biden and Mayor Buttigieg have taken more moderate positions on key issues, while former Representative O'Rourke is counted as the most conservative in the group.

Chart 2. Which Democratic candidates are leading in the polls?



Sources: RealClear Politics 2020 Democratic presidential nomination poll, Wells Fargo Investment Institute, July 12, 2019. This RealClear Politics poll averages polls conducted by other entities. Poll averages are as of July 9, 2019.

[2] Data as of July 17, 2019.
[3] RealClear Politics 2020 Democratic presidential nomination poll. This averages polls conducted by other entities. Poll averages as of July 9, 2019.

The first Democratic debate emphasized an ideological divide within the field between the staunchly progressive candidates and more moderate ones. A majority of the Democratic candidates support liberal policies such as universal health care and the Green New Deal. The most progressive candidates, such as Senator Sanders and Senator Warren, welcome these policy proposals and take them further. They propose broad increases in taxes for wealthy individuals and corporations, while they call for large technology companies to be broken up. Moderate candidates, such as former Vice President Biden, propose more incremental policies instead, such as increased action to address climate change, improvement in the Affordable Care Act (also known as Obamacare), and moderate tax increases.

President Trump's advantage remains the economy, as the U.S. economic expansion is now the longest on record.[4] Economic growth persists, while consumer confidence remains generally solid and unemployment is near 50-year lows (at 3.7% in June).[5] The Democratic field has yet to demonstrate that it can communicate effectively to voters on economic policy. The party must convey how its economic proposals could benefit the average voter. To address income inequality, many of the Democratic candidates have voiced support for raising the minimum wage and building in a higher, marginal income tax rate for wealthy individuals. Several also would like to raise the estate tax. Most candidates also have discussed their stance on policy proposals that would provide health care for all, eliminate some or all student debt, and protect Social Security and Medicare.

Campaigning is a tough job, and not all promises turn into policy. However, the topics and policy proposals that Democratic candidates discuss in the debates offer insight into where they may focus their attention if they are elected. Going forward, candidates will want to make an impression on voters with their key policy proposals—and gather further support as the Democratic National Committee's (DNC) thresholds increasingly limit participation in future debates.[6] The DNC's criteria for the third presidential debate in September will require candidates to tally 2% or above in at least 4 national polls recognized by the DNC—and receive at least 130,000 unique donations, with 400 unique donors in 20 different states.[7] This threshold will likely limit participation in debates going forward, and we may start to see candidates drop out of the race if they cannot gain traction.

[4] According to the National Bureau of Economic Research, July 2019 marks the 121st consecutive month of positive gross domestic product (GDP) growth for the U.S. economy.
[5] Data from Bloomberg, accessed on July 12, 2019.
[6] The DNC's criteria for the June and July presidential debates required hopeful candidates to meet either a polling or a fundraising benchmark. The candidates were required to register greater than 1% in 3 public polls recognized by the DNC or garner at least 65,000 donors, with at least 200 donors in 20 states. Fourteen candidates met both criteria for the second debate in July, while a further 6 candidates met only the polling requirement and thus took the remaining debate seats.
[7] Montellaro, Zach, "Here are the qualifications for the first 2020 Democratic debates," Politico; updated on June 10, 2019.

Key statistics

Start of strong dollar policy (January 1995):

U.S. dollar Broad Real Effective Exchange Rate (REER) Index: 100.0

U.S. trade deficit as % of GDP: 1.3%

Latest reading (May 2019):

U.S. dollar Broad REER Index: ↑ 112.7

U.S. trade deficit as % of GDP: ↑ 3.1%

Source: Bureau of Economic Analysis, U.S. Census Bureau, Bank for International Settlements, Wells Fargo Investment Institute, July 2019.
GDP = gross domestic product. REER = real effective exchange rate.

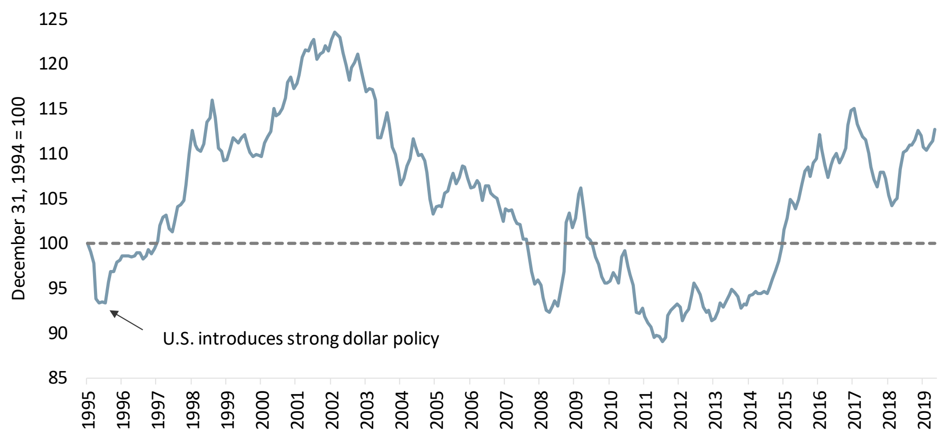
Key takeaways

- For more than two decades, U.S. administrations have favored a "strong dollar" policy. This policy has been viewed as a way to keep U.S. inflation, import prices, and borrowing costs low, while generally supporting economic growth.
- Lately, politicians on both sides of the aisle have called for a reevaluation of today's strong dollar policies, while the Trump administration has taken steps toward identifying and potentially punishing currency manipulators.
- A currency war is not inevitable. Rather, recent bipartisan support for a dollar-policy shift suggests that trade-related uncertainty and its influence on U.S. economic and market sentiment are likely to persist into the foreseeable future.

Forget tariffs—think currencies

President Donald Trump and Senator Elizabeth Warren typically don't agree on much, but lately they are seeing "eye to eye" on one thing—a weaker U.S. dollar. The merits of strong versus weak dollar policies are certainly debatable. But what's important for investors to note is that recent bipartisan support for a dollar-policy shift suggests that trade-related uncertainty and its impact on economic and market sentiment are likely to persist for the foreseeable future.

Chart 3. U.S. dollar is strong nearly 25 years after a policy was initiated to support its strength



Sources: Bank for International Settlements, Wells Fargo Investment Institute, July 12, 2019. Chart shows U.S. dollar Broad Real Effective Exchange Rate Index monthly data from December 1994 through May 2019. Data was rebased to December 31, 1994. Dashed line represents the start of U.S. "strong-dollar" policy. Real effective exchange rates are calculated as weighted averages of bilateral exchange rates (adjusted by relative consumer prices).

Is a weaker U.S. dollar coming soon?

At the time of the "strong dollar" policy's introduction in the 1990s, it was viewed as a way to keep U.S. inflation, import prices, and borrowing costs low, while supporting economic growth. Backing a strong dollar policy also signaled to the world that U.S. administrations would refrain from intervening in currency markets as a tool to influence trade and foreign policy. Lately, however, the appetite for dollar weakness and its use as a policy tool appear to be on the rise.

One point cited by President Trump and Senator Warren is that a strong U.S. dollar has contributed to a growing trade deficit, which they believe has made U.S.-produced goods less competitive internationally and resulted in lost American jobs. A shift toward a weak dollar policy could potentially reverse such imbalances. While it is possible that the weak dollar views espoused by President Trump and Senator Warren are only campaign themes, certain policy developments suggest that potential near-term changes are afoot for U.S. currency policy.

For example, in its recent semiannual report to Congress, the U.S. Treasury Department increased the number of trading partners that it evaluates for currency manipulation—while lowering the threshold used to determine that mark. This suggests that the Fed may be directed to intervene in foreign-exchange markets sooner, rather than later. The U.S. Commerce Department is also exploring changes to policies that it could use to deter (and even punish) currency manipulators.

A currency war is not inevitable

The support of President Trump and Senator Warren for a weak dollar mirrors policy tools intended to level the economic playing field for U.S. firms and workers. While the administration's tariffs have been a central instrument to this end, we anticipate that currency market intervention may be one more tool to achieve foreign-policy objectives that may be considered by this (and future) U.S. administrations. Such developments are increasingly likely to add "currency war" to the trade dispute narrative in the months ahead.

Unilateral foreign-exchange intervention and the unexpected shifts in U.S. dollar policy could lead to higher reported U.S. multinational earnings, particularly in the Information Technology, Materials, and Energy sectors (for which foreign sales represent a large share of total revenue). This assumes that foreign governments do not respond in kind and that foreign demand for U.S. exports remains constant.

A weaker U.S. dollar also has the potential to raise inflationary pressures and to lower living standards for U.S. households. This would, in turn, exacerbate economic weakness and generally weigh on investor risk sentiment. For now, we would expect that any changes in U.S. dollar policy would be measured, and we do not view a currency war as inevitable. Yet, we do expect that trade-related uncertainties will persist for the foreseeable future, adding to economic and market volatility in the months ahead.

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