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Election Post-Mortem

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Seat count by party:

House of Representatives*

- Democrat: 233
- Republican: 201

Senate*

- Democrat: 47
- Republican: 52

** As of November 26, 2018.*

Key takeaways

- A legislative stalemate should allow U.S. equity markets to focus on positive economic trends. We favor positioning portfolios for growth in equity markets. We hold a favorable view of the Health Care and Consumer Discretionary sectors and a most favorable view on the Industrials sector. The Consumer Discretionary and Industrials sectors should benefit from the solid pace of consumer spending, an improved rate of business spending, and steady economic growth overseas.

- We believe that divided government most likely will not result in significant market- or economy-moving legislation. Possible exceptions may involve bipartisan infrastructure, health care, or immigration proposals.

- Markets had a favorable initial response to the election outcome, yet this quickly turned to concern as attention returned to various economic and market uncertainties (e.g., growth, inflation, and trade).

Final thoughts on the midterms

Amid estimates of record turnout (49%) for a modern midterm election, Democrats picked up enough seats to retake control of the House of Representatives. The late-November tally in the House showed Democrats gaining enough seats to take a 233-201 seat advantage. Republicans picked up two Senate seats; the last uncalled race is in Mississippi, where a special runoff election will be held on November 27. Republicans had been a favorite to retain that seat, but recent developments have tightened the race.

The key question remains: will the Democrats, now controlling the House, focus on investigations and oversight of the president and his administration—or will they work with Republicans to pass legislation for the betterment of the U.S. economy and markets? The first approach may appeal to the Democrats' more progressive, liberal base. The second approach may make Democratic candidates more appealing to a wider audience, and enable them to make gains in the Senate and even the presidency in 2020. We initially heard cordial comments between President Trump and Democratic leadership. Yet, that quickly returned to bipartisan rhetoric. Whether politicians focus on the next election, or address the top issues which concern voters, remains to be seen.

Will politicians address key voter issues?

Exit polling listed health care and immigration as the top two issues for voters in the midterm elections. The Affordable Care Act (ACA) appears to be safe following the Democratic victory in the House. Yet, there is much that needs to be accomplished with regard to improving the state of health care in the United States. Health insurance premiums continue to rise, with silver-tier ACA plans having risen in cost by an average of 32% in 2018.[1] Further, concerns exist about coverage for those with preexisting conditions. These are issues that are of interest to voters of both parties, and they should be addressed. Differences usually occur with regard to funding (e.g., higher taxes versus cutting federal spending on other programs). Voters remain hopeful that elected officials will make health care the top priority.

Immigration could remain an unresolved issue. Republicans were unable to pass immigration reform or build the wall—even when they held the presidency and both chambers of Congress. Recent migrant activity on the Mexican border is heightening the importance and urgency of action.

[1] Bryan, Bob, Business Insider, "Obamacare premiums are still on the rise—here's how much they're increasing in every state"; accessed on November 13, 2018.

Trade

Current U.S. monthly trade deficits[2]:

Goods trade with all nations:
-$77.2 billion (a record)

Goods trade with China:
-$40.2 billion (a record)

Key takeaways

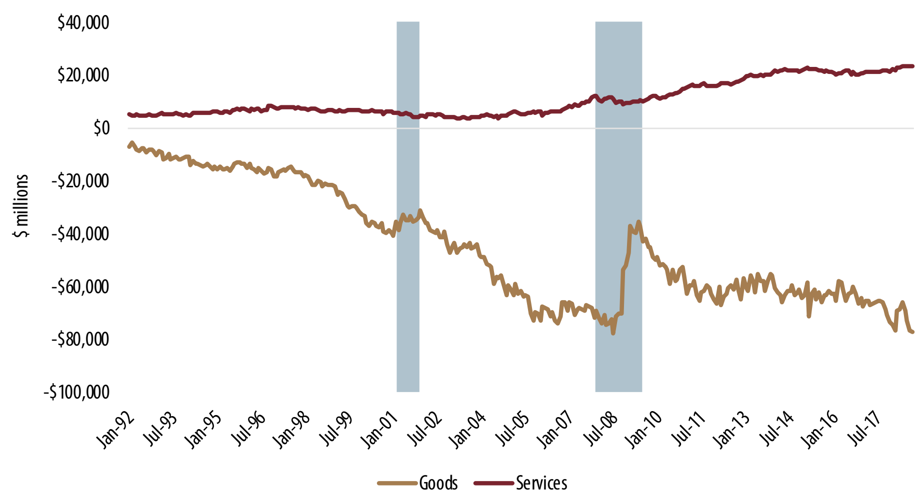
- Trade uncertainty may bring added volatility going forward. While we expect an eventual U.S./China trade deal, policymakers in emerging economies are likely to continue using fiscal stimulus to counter trade fears and credit growth. These trends are supportive of our favorable guidance on the emerging market equity class.
- Increased tariffs on trade with China continue to disrupt markets and threaten existing supply chains worldwide. A successful outcome of the meeting between President Trump and President Xi Jinping likely would be viewed positively by equity markets as it possibly would result in their forgoing the next round of tariffs.
- Greater market access at lower tariff rates likely would benefit large U.S. multinationals that conduct business in Europe and Asia.

Deficits should continue to drive trade negotiations forward

One area in which the election results likely will have little effect is trade negotiations. With significant trade authority granted to the executive branch, President Trump maintains the authority to renegotiate existing trade relationships in the manner that he deems to be most equitable, or "fair," for the U.S. Indeed, with the loss of Republican control of the House, President Trump may have his domestic agenda placed on hold and focus even more intently on foreign policy, including trade.

The U.S. runs a persistent trade deficit in goods and a surplus in services. The goods trend was in place well before China joined the World Trade Organization (WTO) in December 2001, but it accelerated to higher trade-deficit levels in the years that followed 2001. As Chart 1 shows, the goods trade deficit had stabilized prior to the Great Recession, and it sharply reversed as the global economy and trade contracted. It now has reached record levels, led by the large and rising goods trade deficit with China. This is partially offset by the steadily rising trade surplus the U.S. runs with other countries. The administration's trade goals remain to lower foreign tariffs and eliminate unfair trade practices. This could assist in reducing the trade deficit by enabling U.S. firms to be more competitive in foreign markets. Combined with the rising U.S. trade surplus in services, this would contribute to reducing the overall U.S. trade deficit.

Chart 1. U.S. goods trade deficit is partially offset by services



Sources: U.S. Census Bureau, Wells Fargo Investment Institute, November 14, 2018. Shaded areas depicts recessions, as defined by the National Bureau of Economic Research (NBER). The NBER defines a recession as a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.

[2] "Trade in Goods with China," U.S. Census Bureau; accessed on November 14, 2018.

President Trump and President Xi Jinping have agreed to meet following the G20 leaders' summit in Buenos Aires November 30-December 1. At the same time, trade discussions remain ongoing at lower levels. There are almost no expectations that a formal agreement will result from the meeting. Yet, signs of positive intentions and goodwill from both leaders may reduce the chances of the next round of tariffs on more than $250 billion of Chinese goods, along with the increase of the existing tariff rate from 10% to 25% planned for the beginning of 2019.

Other trade developments

Robert Lighthizer, the U.S. Trade Representative, alerted Congress of the intention to begin official trade negotiations with the EU, Japan, and the U.K. Following the required 90-day waiting period, formal negotiations likely would begin in January. The major issue revolves around potential tariffs on imported autos and auto parts. This would have a significant economic impact on the EU and Japan. Yet, again, the likely U.S. goal will be to use this tariff threat as a way to lower overall tariff rates on U.S. goods and enable U.S. firms to be more competitive in Europe and Japan.

Increase in debt to GDP ratio 2007-2017:

- China: 18%
- Germany: 0%
- France: 32%
- Italy: 32%
- Japan: 60%
- U.K.: 47%
- U.S.: 31%

Source: International Monetary Fund

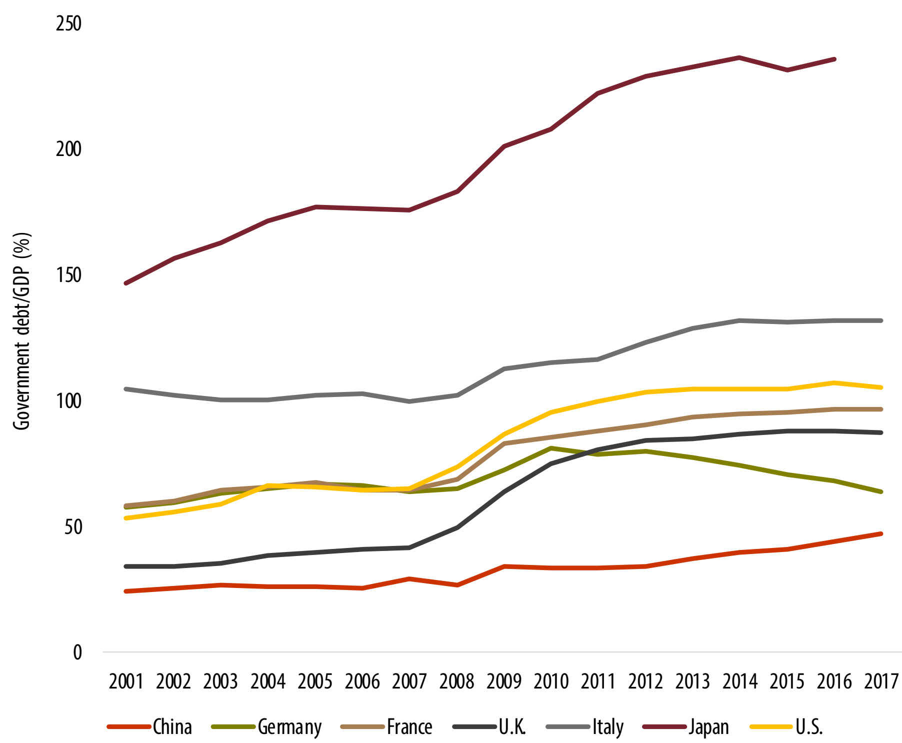
Key takeaways

- An expected rise in interest rates should make credit more expensive. We favor defensive positioning for fixed-income portfolios in the coming quarters. We also prefer short-term maturities and caution investors to consider raising average fixed-income credit quality.
- Rising levels of interest and principal payments typically consume a greater share of government spending. This results in less money available for spending on productivity enhancements (e.g., infrastructure or education) that are used to further economic growth or social welfare for citizens.
- Conceptually, rising levels of debt would require fixed-income investors to demand greater compensation in the form of a higher yield premium on government debt. This has been debated many times, yet it is unclear at which point the bond "vigilantes" will step in and demand a higher yield premium on U.S. federal debt.

How serious is the U.S. government debt problem on a relative basis?

Federal deficit projections by the Congressional Budget Office (CBO) have been revised lower since the passage of tax reform. This has been partially due to higher-than-expected U.S. economic growth. While we do not expect U.S. growth to slow significantly in 2019, it may not exceed 4%[3] again, either. As a result, higher U.S. deficits are projected in the future. While we may think about this in terms of absolute debt levels, it also is important to think about U.S. debt levels relative to those in other developed countries. We can evaluate this by comparing total government debt levels with the size of the economy, as measured by gross domestic product (GDP). It is important to use a measure of total government debt instead of just federal debt to account for the different structures of government in various countries. Chart 2 depicts this relationship for a select group of developed economies and China.

Chart 2. How does U.S. government debt compare with other countries' debt levels?



Sources: International Monetary Fund, Wells Fargo Investment Institute, November 13, 2018. Series represent the level of total government debt as a percent of GDP, or gross domestic product. Annual data is shown for 2001 through 2017. Japan's data is only through 2016 (latest data available). Generally, government debt as a percent of GDP is used by investors to measure a country ability to make future payments on its debt, which affects the country's borrowing costs and government bond yields. A debt-to-GDP ratio of 1.0 (100%) means that a country's debt is equal to its gross domestic product.

[3] Quarterly measure, annualized.

Most countries' ratios of government debt to GDP rose during the Great Recession as government spending increased and economic growth contracted, with a few notable exceptions. China's government debt continues to grow as its economy develops; yet its ratio of government debt to GDP remains at the lowest level of the countries shown in Chart 2. Germany's debt ratio actually declined as austerity measures curbed spending, and the country's export-driven economy continues to grow. Japan remains at the top end of the spectrum, with the highest government debt to GDP ratio, by far. As the U.S. economy recovered, the government debt to GDP ratio leveled off at a new, higher level. Rising levels of U.S. government deficits, expected to breach $1 trillion next year, and the rising federal debt levels are currently supported by continued economic growth. It would be beneficial for the U.S. government to cut spending while the economy is still growing, instead of waiting for the next recession; yet neither party currently seems to be interested in making those tough political choices.

RISK CONSIDERATIONS

All investing involve risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors some of which may be unpredictable. Each asset class has its own risk and return characteristics which should be evaluated carefully before making any investment decision. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

Stock markets, especially foreign markets, are volatile. A stock's value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. International investing has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets. Investments in fixed-income securities are subject to market, interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price.

When considering investing in the industries within equity sectors, it is important to consider the sector`s particular risks. Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy. This can increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. 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 impact consumer sentiment. *Health care industries* are subject to greater utilization rates, aging population, infrastructure risk pharmaceutical drug costs, government regulations and government approval of products and services, among other things. This can have a significant effect on investment in the industries within this sector. There is increased risk investing in the *industrial sector*. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation, government regulations, among other things, all of which can significantly affect a portfolio's performance.

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