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Unsettled—What Voter Discontent May Mean for Markets

March 26, 2019

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Number of times the chambers of Congress have changed control since 2001:

- **House:** 3
- **Senate:** 3

Sources: U.S. Senate and U.S. House of Representatives.

Key takeaways

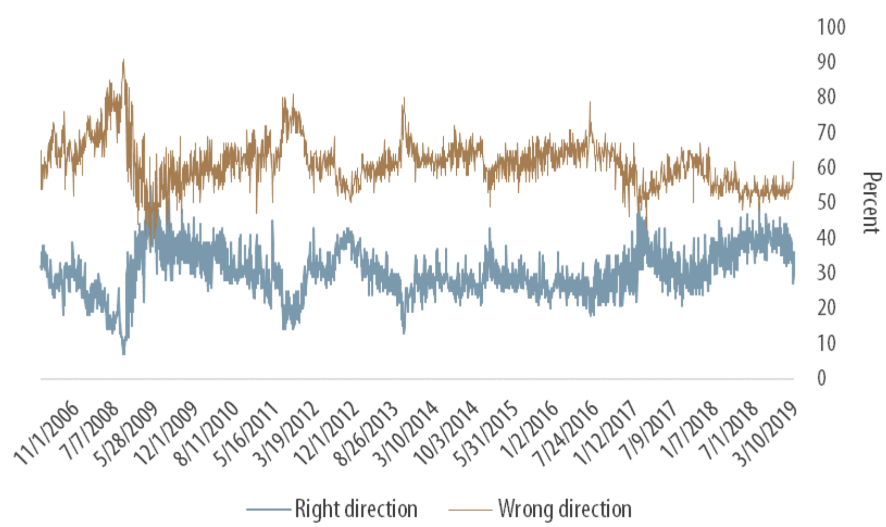
- Political uncertainty may lead to increased market uncertainty. Frequent change in congressional and presidential leadership could lead to increased market volatility, as individuals and businesses may be unsure of future policies.
- Well-diversified portfolios may help to insulate against politically-driven volatility. We encourage investors to conduct a portfolio review and rebalance more frequently, while considering moving funds into assets or markets that may look more attractive.

What do we really think of the people that we elect?

We have federal elections every two years that help to determine the future course of our country. We elect leaders to represent us in the Senate, the House of Representatives, and the presidency. The electorate is fairly divided by party these days. This tends to result in close elections. When combined with the constant presence of social media and political news media, it also can lead to voter dissatisfaction with those in charge. Recent elections have resulted in the current party in power losing control more frequently than in the past.

Even with an economy that has posted solid growth in recent quarters and continues to grow above trend, voter dissatisfaction remains high. Chart 1 reflects the view of whether voters believe that the country is headed in the right direction—or the wrong direction. The two times in recent history that the "wrong direction" has been in the minority was in 2009 and 2017, following the election of Presidents Obama and Trump. Unfortunately, after electing new leaders, this optimism has been short-lived.

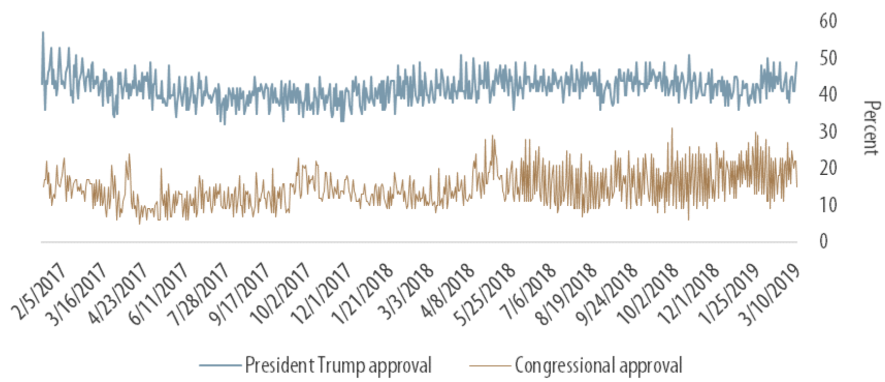
Chart 1. Do voters think the country is headed in the right (or wrong) direction?



Sources: RealClear Politics, Wells Fargo Investment Institute; March 14, 2019. Chart shows a composite of polling data identifying voters' perceived direction of the country ("right direction" or "wrong direction"). Data is from January 2006 to March 2019.

If many voters do not like the direction in which the country is headed, one would expect them to elect officials that they believe will make things better. As Chart 2 shows, that is not necessarily the case. With regard to presidents, overall approval ratings have been trending down. President Trump's voter approval consistently ranges between 40% and 50%. While this range seems low, neither President George W. Bush (49.4%) nor President Obama (47.9%) could break the 50% approval level. President Clinton came in at 55% voter approval, and President George H.W. Bush held an average of 61%. To top that, we would need to go all the way back to President Kennedy (at 70%).[1]

Chart 2. What do voters think of the president—compared to Congress?



Sources: RealClear Politics, Wells Fargo Investment Institute; March 14, 2019. Composite of polling data identifying voter approval levels. Data is from January 2017 to March 2019.

Overall, congressional approval ranks far below even President Trump's approval rating. Although Chart 2 only goes back to the beginning of the current administration, this trend has persisted over time. We elect our representatives to Congress, but a significant number of voters do not seem to approve of the current political environment or the accomplishments in Congress.

[1] Presidential approval ratings: Gallup Historical Statistics and Trends, Gallup, accessed on March 14, 2019.

2018 U.S. goods trade deficit:

Total: $891.3 billion
Year-over-year: +10.4%

Source: U.S. Census Bureau.

Key takeaways

- Market participants likely would respond positively to a U.S. agreement with China that sufficiently addresses key structural changes and results in increased purchases. Likely areas of increased Chinese purchases from the U.S. include agriculture, energy, and industrial equipment. This may benefit the Industrials sector—on which we maintain favorable guidance—and the Energy sector. A reduction in trade-related tensions could improve business sentiment and reduce capital-investment headwinds. An agreement to limit Chinese yuan devaluation may restrain upward pressure on the U.S. dollar. Further, potential removal of increased tariffs on $250 billion in Chinese goods may provide a positive spark for equity markets.

The U.S. has many irons in the fire

Let's briefly revisit where the U.S. stands on renegotiating global trade policies. Discussions are ongoing with China. Chinese goods valued at $250 billion are currently subject to increased U.S. tariffs. The tariff rate on the majority of those goods ($200 billion) may go even higher (from 10% to 25%) if a new trade deal is not completed soon. Signs are pointing to a deal involving some structural reforms (e.g., intellectual property protection, elimination of forced joint ventures, and a currency valuation agreement), along with an increase in China's purchase of U.S. goods and services. This could reduce the U.S.-China record trade deficit in goods ($419 billion in 2018, up 11.6% year-over-year).

President Trump has signaled that he is generally happy with current progress in the negotiations. However, if the final trade deal does not meet expectations, the president may walk away from negotiations (as he did following the recent U.S. summit with North Korea). Capital market participants likely will view a failure to reach a trade agreement, or an agreement that does not address key structural reforms, as negative for economic growth.

As we wrote in our Policy, Politics, and Portfolios report last month, the U.S. could potentially introduce higher tariffs on autos imported from other countries under the pretext of a "national security" concern.[2] (President Trump has mentioned auto tariff levels of up to 25%.) This sweeping action likely would have the largest effect on the European Union (EU) and Japan. The U.S. Department of Commerce report that may recommend higher auto tariffs still has not been released by President Trump.[3] The administration may be waiting for an upcoming announcement of a U.S.-China trade deal before opening this new avenue of negotiation. Higher auto tariffs likely would result in increased prices paid by U.S. consumers. The effect on an already slowing European economy (especially in Germany), along with the Japanese economic impact, may result in further downside risk for developed markets.

[2] Policy, Politics & Portfolios: "Debt and Chickens", February 26, 2019.
[3] Ibid.

Key takeaways

- Increased tariffs on imported autos likely would benefit the U.S. auto industry. With less competition and higher prices, U.S. manufacturers may be able to increase prices and operating margins. This also could benefit the Industrials sector. Foreign automakers could suffer a significant decline in U.S. demand from tariffs of up to 25% on U.S. auto imports. Currently slow European and Japanese economic growth could face additional downward pressure in the face of higher auto tariffs. Slower economic growth prospects could dent European and Japanese investor sentiment; earnings growth; and equity markets. It also could be negative for U.S. firms with operations in these countries.

- The changes to the U.S. auto sector contained within the USMCA could be positive for the Industrials sector, but the risks are asymmetrical to the downside. Any sign that the agreement will not be passed and that the U.S. would withdraw from NAFTA likely would have significant implications for equity and fixed income markets.

The new U.S.-Mexico-Canada Agreement (USMCA) is one important development that has been missing from much of the recent trade headlines—and it is an agreement that may potentially have the greatest impact on the U.S. economy. This agreement was signed on November 30, 2018; yet it still awaits ratification by Congress. The U.S. economic impact from this agreement could be significant. While China is the United States' largest trading partner in total volume of goods traded (due to the United States' imports of Chinese goods), the U.S. exported $298.7 billion worth of goods to Canada and $265 billion in goods to Mexico. Collectively, this is more than four times the $120.3 billion that the U.S. exported to China last year.

With the upcoming change in the makeup of Congress, there is a risk that the USMCA may not be ratified. Democrats may seek greater changes in labor and environmental protections that may force renegotiations. Congressional Democrats also may not want to give President Trump a political victory. If this agreement is not ratified, the president may pull out of NAFTA (North American Free Trade Agreement) entirely to try and force USMCA ratification. If this potential gamesmanship is unsuccessful, it likely would have a significantly negative effect on the U.S. economy. While such a sequence of events is possible, and slight changes to the final agreement may be made, we do not believe that either party will want to accept responsibility for the economic fallout from a disruption in trade with the United States' two largest export markets.

Estimated foreign cash repatriated in 2018:
$730 billion

Estimated 2018 increase in corporate share buybacks due to repatriation:
$315 billion

Source: Strategas Research Partners.

Key takeaways

- Were the White House budget to be implemented, increased defense spending likely would be positive for the Industrials sector. If an agreement can be reached for infrastructure spending, both the Industrials and Materials sectors could benefit.
- Rising federal deficits and debt can reduce investment and spending on other, more productive items. They also can limit the congressional ability to respond to unforeseen future circumstances (e.g., recessions or conflicts overseas) through tax and spending policies.

Let the 2020 budget battle begin

The 2020 budget battle has begun, with the White House unveiling its proposed budget for the fiscal year beginning in October 2019. The "presidential" budget tends to be mostly symbolic in nature. It lays out the president's policy priorities. Congress is not bound by any policies or amounts included in the presidential budget. In fact, even when Republicans controlled both chambers of Congress for the first two years of President Trump's term, the final congressional budget failed to significantly resemble the original White House submission. Now, in a divided Congress, there is even less likelihood for the majority of presidential budget priorities to be implemented.

Key highlights of the White House budget reflect fairly traditional Republican priorities: an increase in defense spending; a cut in domestic spending; and money to fund border security. As Table 1 shows, if the president's budget were enacted, defense spending would increase by approximately 4.7% year-over-year. Offsetting this increase is a proposed 5% cut in nondefense spending. After receiving only a fraction of the funds requested for border security during resolution of the federal shutdown, the White House is asking for a budget increase of 33% for border security and immigration enforcement. This includes an additional $5 billion for new border walls.

Table 1. Focus of White House spending priorities

	2020 budget proposal	Percent change from 2019 budget proposal
Defense	$750 billion	+4.7%
Nondefense	$597 billion	-5.0%
Border security	$32.6 billion	+33.0%

Sources: Office of Management and Budget, Wells Fargo Investment Institute; March 15, 2019.

Key takeaways

- Without a reduction in federal spending, taxes likely will need to be raised. Although it is not a likely prospect before 2021, higher federal tax rates eventually would result in less household and business income to drive U.S. economic growth. Equity markets likely would suffer as revenue prospects decline, with sectors such as Consumer Discretionary and Industrials potentially being most adversely affected.

- High debt levels have a disinflationary effect that is likely to lead to lower inflation expectations, lower bond yields, and lower equity return assumptions over time. Our longer-term capital market assumptions take these factors into account.[4]

The president's budget proposal includes a 5% cut, on average, across all government agencies, excluding defense. Larger budget cuts are proposed for the Environmental Protection Agency, the State Department, and the Department of Transportation, while the Departments of Homeland Security and Veterans' Affairs would receive increases. Historically, White House budgets have attempted to balance the budget in 10 years (which has not happened since the Clinton administration and the Republican Congress in the late 1990s). This budget proposal only balances the budget over a 15-year window, and it assumes an optimistic growth rate for the economy.

The White House did say that funds made available by domestic spending cuts would be able to be used for additional investment in areas such as infrastructure. This is a signal that the president would like to arrive at an infrastructure deal prior to seeking reelection. Democrats also would like to fund infrastructure. The fundamental disagreement is with regard to funding—Democrats almost certainly will not accept a cut in nondefense spending.

The budget battle for fiscal year 2020 (beginning on October 1, 2019) has the potential to be more volatile than normal. In addition to the battle over spending priorities, spending limits from the Budget Control Act of 2011 (sequestration) are set to resume, and the government is expected to reach the debt ceiling—all potentially occurring by the end of September.

[4] CMA forecasts are not promises of actual returns or performance that may be realized. They are based on estimates and assumptions that may not occur.

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. 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. Diversification does not guarantee investment returns or eliminate risk of loss.

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.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy. **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. The **energy sector** may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources and risks that arise from extreme weather conditions. Risks associated with investing in **Industrials** include the possibility of a worsening in the global economy, acquisition integration risk, operational issues, failure to introduce to market new and innovative products, further weakening in the oil market, potential price wars due to any excesses industry capacity, and a sustained rise in the dollar relative to other currencies. **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.

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