Politics

In June, the 2020 election season will begin in earnest, with the first Democratic debate taking place. The debate will give voters the chance to hear the top candidates and assess their positions on key economic and market-impacting events.

Trade

U.S.-China trade negotiations suffered a setback during the first half of May. Non-trade areas of conflict between the two countries also may impact discussions.

Fiscal policy

Updated forecasts continue to project higher U.S. deficits and debt levels. President Trump and Congress have had preliminary discussions about an infrastructure plan. The funding of that plan is an open question.
### Key takeaways

- Campaign promises may or may not become policy. However, the cost of Medicare for All and the Green New Deal are concerning, even in a $20 trillion economy. Such large increases in government spending may result in a crowding-out effect, with the government borrowing more, driving up rates, and preventing private investment that may otherwise have occurred.

- Although it is unlikely to be passed while Republicans maintain control of the Senate, we believe that a Medicare for All system would be negative for the Health Care sector—due to elimination of the private insurance industry and likely lower negotiated product and service prices. Depending on implementation, the Green New Deal may be positive for Industrials and Materials. It would be negative for the Energy sector and could drive utility and transportation costs higher.

- Higher taxes likely would be insufficient to cover the costs of these programs, resulting in increased federal deficits and debt. Equity markets could suffer as revenue prospects decline.

## Meet the leading Democratic candidates

Believe it or not, the 2020 presidential election is about to kick into high gear. There are currently 24 Democrats that have either formally declared their candidacy or have formed exploratory committees to run. The first Democratic debate will take place in June. Politics always has been a rough game. A question for investors to consider is whether the Democrats can settle quickly on a likely nominee.

Former Vice President Joe Biden led polls even before he officially entered the race on April 25, 2019. Since that time, his lead has increased, and he now ranks first in the polls with roughly 40% of the vote. Most of this gain has come at the expense of Senator Bernie Sanders. The ranking has remained fairly steady, with Joe Biden leading, followed by Senator Bernie Sanders, Senator Elizabeth Warren, and Senator Kamala Harris. While platforms are not finalized, there are several policy areas that may have direct effects on the economy and investors’ portfolios. Table 1 lists the most consistently ranked top candidates and their positions on key policies.

### Table 1. Top Democratic candidates and their policies

<table>
<thead>
<tr>
<th>Candidate</th>
<th>Raising taxes</th>
<th>Abolishing the electoral college</th>
<th>Universal health care</th>
<th>Free college</th>
<th>Green New Deal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joe Biden</td>
<td>Reverse tax cuts</td>
<td>No explicit position</td>
<td>Supports Medicare for All but not the elimination of private insurance</td>
<td>Free community college</td>
<td>No explicit position</td>
</tr>
<tr>
<td>Bernie Sanders</td>
<td>Broad increase in taxes to support Medicare for All and other programs</td>
<td>Supports</td>
<td>Sponsor of Medicare for All bill in the Senate; would eliminate private insurance</td>
<td>Free public college</td>
<td>Supports</td>
</tr>
<tr>
<td>Elizabeth Warren</td>
<td>Higher corporate and individual taxes, including a wealth tax</td>
<td>Supports</td>
<td>Cosponsor of Medicare for All bill in the Senate; would eliminate private insurance</td>
<td>Free public college; plan to reduce outstanding student debt</td>
<td>Supports</td>
</tr>
<tr>
<td>Kamala Harris</td>
<td>Higher individual tax rates on the wealthy; financial institution tax</td>
<td>Open to discussion</td>
<td>Cosponsor of Medicare for All bill in the Senate; would eliminate private insurance</td>
<td>Free public college; supports universal pre-K</td>
<td>Supports</td>
</tr>
</tbody>
</table>

Sources: Politico, Wells Fargo Investment Institute, May 15, 2019.

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1 Data as of May 21, 2019.
2 RealClear Politics 2020 Democratic presidential nomination poll. This averages polls conducted by other entities. Poll average as of May 14, 2019.
3 Beatrice Jin and Caitlin Oprysko, “Here’s where the Democratic candidates stand on the biggest 2020 issues”, Politico, Updated May 9, 2019.
Let’s examine the costs of the economically and market-impacting plans in ascending order. Keep in mind, none of these “free” plans comes without cost. All of them likely would be funded through a combination of higher taxes and/or increased public debt.

- Senator Sanders proposed a College for All bill during the 2016 election cycle. His estimate at that time was a cost of $47 billion annually to provide money to states for the elimination of tuition.\(^4\) States still would be responsible for funding the additional $23 billion needed each year. This is not a significant amount as federal budgets go, but it is important to remember that the 2018 deficit already was $779 billion.

- As we mentioned in last month’s report, the estimated cost of the proposed Medicare for All plan is roughly $2.5-$3.5 trillion a year.\(^5\) That is roughly two to three times what the federal government currently spends on major health care programs ($1.2 trillion in 2018 for Medicare, Medicaid, etc.); four to six times what is spent annually on the entire U.S. military ($627 billion in 2018); and potentially larger than the $3.3 trillion in federal government revenues for 2018.

- The Green New Deal proposes to address climate change by having the U.S. economy switch to 100% renewable energy within 10 years. So far, the proposal is not specific about which energy sources would be phased out and on what timeline. However, some work has been done that would place the cost over the next 10 years at a level between $5 and 9 trillion per year.\(^6\) To put that into perspective, on an annual basis, that is higher than the entire federal government outlay of $4.1 trillion and roughly 25-45% of the 2018 economy’s total output of $20.8 trillion.

Campaigning is a tough job, and not all promises eventually turn into policy. Voters will decide the future of programs such as these by determining their candidate and eventually choosing the next president. Many thought that the U.S. would never have the federal government play such a large role in the health care system as it now does (until the Affordable Care Act was signed into law in 2010). While the price tags of some of these options do not seem to be feasible, a political sweep of the presidency and both chambers of Congress could leave the door open to these programs.

\(^5\) Craig Holke, “Higher Taxes After Tax Cuts?”, Wells Fargo Investment Institute, April 30, 2019.
Decline in China global exports for April 2019:
-2.7%

Key takeaways
- There is a chance that the next round of 25% tariffs on $325 billion in Chinese goods will be enacted. These would be heavily consumer-oriented goods. While the 10% tariffs were partially absorbed by producers, the increase to 25% tariffs, and the newly discussed tariffs, likely would be passed on. This may lead to increased U.S. inflation. Consumer and business spending may be negatively affected, impacting the Consumer Discretionary, Information Technology, and Industrials sectors.
- Chinese retaliation could negatively impact the agriculture component of the Consumer Staples, Energy, and Industrials sectors.
- The eventual trade deal that we expect is likely to cover Chinese purchases of U.S. goods and intellectual property protection (which China was already studying on its own). Such a deal would only partially address the issues, but it could arrest the cycle of escalation. The problem for investors is that those comparatively less complex issues might be fully priced into markets. If so, then this relatively simple deal might result in a reaction that is only modestly positive for equity and commodity markets. Conversely, a disappointing deal could mean market downside.

Other items complicating the U.S.-China trade negotiations

U.S.-China trade negotiations took a step backward in early May. China appeared to backtrack on commitments to have reforms enshrined into law (such as protection of intellectual property, elimination of forced technology transfer via joint ventures, and currency manipulation). Each side ended up applying new tariffs against the other’s goods, and the U.S. added a threat of further escalation. We discussed the specifics in a recently issued Institute Alert.7

The U.S.-China relationship is complicated. China has risen to be the main competitor to the U.S., in both economic and military terms, yet both countries have important economic ties that would be costly for each to break. Both countries are adjusting to this new dynamic. While trade negotiations are important for both economies, there are many other disputes that are related to trade—and unrelated—which complicate the issue. The U.S. is seeking to address the reform of many Chinese business practices (intellectual property theft, forced technology transfer via joint ventures, and currency manipulation) through the trade negotiations. Other outstanding issues deal with the hacking of the U.S. government and businesses by Chinese government-affiliated persons and private citizens. China also is buying oil from Iran, despite warnings that if this continues, the U.S. may be forced to take action, such as blocking Chinese banks’ access to the U.S. financial system. The militarization of the South China Sea via man-made islands and building installations on contested islands has led the U.S. Navy to send warships through the area that is vital to shipping. And the big outstanding issue remains—North Korea. The U.S. seeks China’s assistance in dealing with North Korea. As soon as the recent trade negotiations with China were set back, North Korea launched more missile tests. Coincidence? Maybe not.

We believe that a comprehensive U.S.-China trade deal may take longer than originally anticipated to complete, because each side has issues that are close to nonnegotiable. China views the tariffs on goods it sells to the U.S. as a violation of free trade principles, while the U.S. wants to keep at least some tariffs in place to enforce China’s compliance. The U.S. also wants to be able to re-impose tariffs if it believes that China is not following the rules—and wants to prevent China from countering with tariffs of its own. This will be a very difficult position for China to accept. The U.S. also has renewed a new $500 million arms deal with Taiwan. Considering China’s “One-China” policy, which states that there is only one China (despite two separate governments), this has the potential to disrupt relations even further.

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Finally, certain Chinese technology companies that may be linked to the government have been deemed a liability and banned from critical U.S. communication infrastructure. The U.S. also has lobbied for other countries to avoid using the technology. Without this access to leading-edge technology, China may not reach its goal to become a technology leader in the 21st century.

China generally has more flexibility to quickly respond to economic and financial-market challenges via direct intervention (and stimulus) than the U.S. does. As trade talks broke down, Chinese banks were instructed to offer additional liquidity and state-run investment funds were directed to buy local equities to support share prices. The Trump administration is looking to implement a second round of support for U.S. farmers, likely including direct purchases of agricultural products and assistance in finding new markets.

The trade negotiations probably will continue, especially since the two presidents could use the June 28-29 Group of 20 (G-20) meeting in Tokyo to announce progress (or even a deal). But our base case is that they will use that opportunity to reiterate their commitment to negotiating in good faith. A trade deal—even a simple one on purchases and intellectual property protection—is likely to take beyond June to achieve. More financial and commodity market volatility is likely while the uncertainty about the scope and timing of a deal continues.

Ultimately, we believe that U.S.-China negotiations will resume and that a trade deal will be reached. A resolution to this trade dispute is too important to the U.S., China, and the world for there to be no resolution reached. However, the depth of disagreement over many issues illustrates that a comprehensive deal over all items is unlikely, at least for now. The latest round of negotiations reveals that the two sides are prepared to escalate the punitive measures even while they are negotiating. Investors had not previously seen this behavior. In addition to direct trade negotiations, there are other geopolitical factors that need to be considered as part of the equation. Markets may have been too optimistic on achieving a quick, easy U.S.-China trade deal. Trade negotiations are complicated, take time, and may result in a more negotiated, and less positive, result than was originally anticipated.
Is there any money available for infrastructure spending?

The Congressional Budget Office (CBO) released its updated budget projections for the next 10 years. As in its original report from January, the CBO continues to project rising federal deficits and debt levels. In the CBO projections, federal spending will continue to rise at a faster rate than revenues, even though revenues will reach record levels. Increases in mandatory federal spending are expected to average 5.5% a year—largely driven by increases in Social Security and Medicare for an aging population—along with interest on ever-increasing debt levels. Interest on federal debt may come in below the official estimates in the near term. We believe that the Federal Reserve (Fed) will not raise rates again this year. If 2.25%-2.50% is the level at which the federal funds rate will peak for the cycle, it will be below previous expectations. Other fixed-income rates, such as Treasury yields, remain muted as well. These developments should, in turn, result in lower interest costs on federal debt than was previously anticipated.

While the impact of lower rates on federal interest payments would be a positive, this still leaves the question of what money the U.S. has left to spend on programs to help grow the economy. We have talked before about the possibility for a bipartisan infrastructure spending package. Speaker Nancy Pelosi and Senator Chuck Schumer met with President Trump at the end of April to discuss ways to work together on an infrastructure spending plan. The somewhat surprising result of the meeting was the announcement of a $2 trillion infrastructure deal. Yet Congress and the president have yet to agree on how they will pay for it.

President Trump released an infrastructure spending plan in early 2018 that would use a combination of federal and state spending for funding. The plan included $200 billion in federal spending to be matched on a four-to-one basis by states. President Trump’s plan consisted of the following items:

- $100 billion to state and local governments for use in infrastructure spending
- $20 billion to “projects of national significance”
- $50 billion in rural block grants to states for transportation, water, waste, etc.
- $30 billion in “other infrastructure-related projects”
A key provision would have consolidated and shortened the permit process for projects. Democrats were critical of this provision, fearing that it would weaken environmental protection. The plan would also have allowed the federal government to raise money by selling assets to states or private companies. Most people don’t think of the federal government as being in the utility business, but the federal government has owned the Tennessee Valley Authority since 1933. It also owns and operates the Reagan National and Dulles International airports.

The Democrats released their own plan at approximately the same time as the administration. Not to be outdone, Democrats planned on spending $1 trillion in federal funds on infrastructure. While it did not attach specific dollar figures to all items, the Democratic infrastructure plan included:

- Improving roads, bridges, and public transit
- Developing nationwide high-speed internet
- Improving the freight and passenger rail system
- Investing in physical and digital infrastructure for schools
- Investing in airports and aviation systems to improve efficiency and safety
- Developing safe drinking and wastewater systems
- Improving and modernizing energy infrastructure, including a focus on renewable energy.

Whether the fundamentals of either of these plans will be incorporated in a new bipartisan infrastructure agreement remains to be seen. With currently large federal deficits and larger ones projected in the future, plans for leveraging state and private spending may be more fiscally prudent. The aging infrastructure in the U.S. has a negative effect on productivity. Spending money wisely to improve the capability and safety of our country’s infrastructure likely will reap benefits down the road. Most members of Congress and President Trump agree that the U.S. needs significant spending on infrastructure. The disagreement on how to prioritize and pay for it remains challenging to resolve.
RISK CONSIDERATIONS

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