Weighing the Impacts of a Potential Watershed Election

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Key takeaways

• We expect that the presidential and Senate races will be closely contested and decided, by voter reaction to the president’s handling of nationwide protests in May and June, and by how well the U.S. economy’s reopening is managed.

• Based on current polls, we view the most likely outcome as a divided federal government, which should moderate, or even block, the most ambitious policy initiatives of any president. We believe that the main alternative scenario is single-party government leadership, led by the Democrats.

• Fast-changing economic dynamics and the unusual nature of this economic cycle lead us to conclude that it is premature for investors to change portfolio allocations based only on projected election outcomes. We prefer to maintain our current tactical allocations.

Election outlook: Close races for the White House and Senate are likely

The challenge facing the challenger: Various polls show former Vice President Joe Biden with a moderate, but not insurmountable, lead five months before the election.¹ His success could depend on how well he unites progressives and moderates in his party—and then attracts less ideological, undecided moderates among independent voters.

¹ See, for example, the average of polls at RealClearPolitics.com. As of June 2, 2020.
During the primaries, progressive Democrats sought voter support for an ideological revolution within the party to unseat President Trump. Moderates have believed that the bigger issue is the president’s character and leadership style, and they have favored incremental changes to the existing system. The view of most independent and other swing voters probably leans toward the latter.

So far, Biden has had only lukewarm popularity among progressives, many of whom are Millennials (ages 20 to 35 years). The campaigns of Senators Elizabeth Warren and Bernie Sanders exploited this support, recruiting progressive, young voters for the grassroots work of canvassing neighborhoods and activating voters through social media and web-based advertising. Their turnout on Election Day is just as important. Millennials are the second largest voter bloc, with 27% of eligible voters, but they posted only a 51% turnout in the 2016 election (10 percentage points below the overall average turnout), according to the Pew Research Center.² The priority on recruiting progressives came through clearly when Biden announced unity policy committees. His economic policy task force, for example, includes a member of Congress, labor leaders, and academic economists—but none of the former vice president’s Wall Street supporters.

The incumbent faces a test of his own: History tells us that just 10 standing presidents have failed to win re-election in the 58 contests dating back to President George Washington. The key issue may well be the management of the economy’s reopening. Here, President Trump faces two risks. The first is the fact that economic weakness and the loss of more than 40 million jobs may have become entrenched enough to restrain growth after an initial, summer bounce. Second, a rising coronavirus infection rate could trigger another lockdown. Table 1 suggests some apprehension as the U.S. economy prepared to reopen in late April, notably among independent voters.

Table 1. Changes in President Trump’s approval rating for handling the coronavirus situation, just prior to the states’ reopening

<table>
<thead>
<tr>
<th></th>
<th>March 13-22, 2020</th>
<th>April 14-28, 2020</th>
<th>Change (Percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. adults</td>
<td>60%</td>
<td>50%</td>
<td>-10</td>
</tr>
<tr>
<td>Republicans</td>
<td>94%</td>
<td>91%</td>
<td>-3</td>
</tr>
<tr>
<td>Independents</td>
<td>60%</td>
<td>50%</td>
<td>-10</td>
</tr>
<tr>
<td>Democrats</td>
<td>27%</td>
<td>11%</td>
<td>-16</td>
</tr>
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On balance, the president has managed to keep his overall approval rating in line with President Obama’s, in the months before his successful 2012 re-election bid. Chart 1 illustrates that the incumbent’s approval ratings need not exceed 50% during the last 14 months of the re-election campaign. Yet, the unsuccessful campaigns of President Jimmy Carter and President George H. W. Bush remind us that presidents who suffer deteriorating economic conditions during their first terms tend to see their approval ratings collapse at some point. The crucial uncertainty to be resolved is whether reopening the economy succeeds in generating new growth, without a new surge in COVID-19 infection rates.

The fact that the U.S. economy wasn’t as strong heading into the pandemic crisis as it appeared a year ago underscores the importance of a successful economic reopening. Since the Johnson presidency in the mid-1960s, only President Carter faced voters who were squeezed by declining household income growth. We recall from Chart 1 that President Carter was one of only two incumbents to lose the presidency in his re-election bid. Although Chart 1 indicates presidential approval tracking favorably for Trump so far, Chart 2 suggests that his approval rating may be vulnerable if U.S. household incomes fail to improve. At the onset of the pandemic’s economic fallout in March, inflation-adjusted household income growth already was down 2%, slightly more than the reading during the Carter and Reagan campaigns.

**Slim Senate majority possible for either party.** We see a high probability that the winner of the presidential race will see his party control the Senate—but only by a thin majority. The Republicans currently have a four-seat Senate majority, but they are defending 23 of the 35 seats up for re-election. The crucial closest races are in Alabama, Arizona, Colorado, North Carolina, and Maine. We foresee no more than a one- or two-seat majority for either party in the Senate, and we doubt that either one will command a majority large enough to force through controversial issues in the upcoming Congress.

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1 The Democrats only need to pick up three currently Republican seats if they win the White House and the vice president’s Senate president vote goes Democratic.
Chart 2. Electoral-vote share has been well-correlated with household income growth

Sources: U.S. Census Bureau, Wells Fargo Investment Institute, April 30, 2020. Income growth is represented by the growth of inflation-adjusted disposable income per household.

**Advantage to Democrats in the House.** The odds favor a Democratic majority in the House of Representatives. As of early May, Democrats were favored in 222 of the 435 seats up for re-election, including 183 solidly, and 34 likely leaning in toss-up races. In addition, the latest (June 1, 2020) Cook Report shows Republicans favored in just 192 of the November contests, a 25-seat gap, and the Democrats with more than 22 seats viewed as up for grabs.

**Our base case and the main risk.** Neither presidential candidate has emerged as a clear front-runner; and each one faces significant challenges. The pandemic’s progression likely holds the key. If the economic reopening stabilizes the economy and begins to create jobs, Trump may earn a second term and the Republicans may keep a thin Senate majority. If the reopening fails to stabilize the economy or to create jobs, the outcomes should favor Biden, with the Democrats controlling Congress—albeit also with a thin Senate majority. In either case, we do not believe that the congressional elections will be decisive enough to push the most controversial ideas into law.

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5 Ibid.
Five factors to watch ahead of the November elections

1. **Campaigning tools:** Another implication of the pandemic is that social distancing rules force both candidates to find new ways to energize supporters, gain visibility with undecided voters, and raise money. Biden had a small field organization during the primaries and was disadvantaged when the shelter-in-place rules canceled large campaign rallies. Non-traditional venues remain important for the Democrats, because of their popularity in high-density urban areas.

   Trump has the advantage of the presidential podium and of daily national media attention. Also, Republicans have had four years to work on personal canvassing—a ground game. However, his greater exposure sometimes may work against him, judging from the president’s slippage in the polls behind Biden since mid-April.

2. **Voter turnout:** Voter participation during a presidential election historically has been key to shaping policy after the election. As Chart 3 shows, voter turnout of 56% or more during presidential elections from 1960 through 2016 has been associated with “one-party control” of the White House and both houses of Congress. Strong turnout in the 2020 Democratic primaries strengthens the view that passions on both sides are sufficient to boost voter turnout above that threshold, provided that progressive voters feel motivated to vote for Biden. Turnout below that 56% threshold tends to produce split control of the government, often associated with policy gridlock.

**Chart 3. Voter turnout of 56% or more has been associated with a one-party government since 1960**

Sources: Dr. Michael McDonald, “United States Election Project,” University of Florida; Wells Fargo Investment Institute. Data are through the 2016 national elections, as of June 1, 2020.
Voter turnout may be the most difficult variable to predict, particularly if a new surge in COVID-19 infections occurs in the autumn. Some congressional leaders have suggested voting by mail, but we doubt that all 50 states have the time and money needed to implement universal vote-by-mail by November. Colorado, Hawaii, Oregon, Utah, and Washington already have vote-by-mail in place, but these procedures were introduced over multiple election cycles. However, the key swing states of Florida, North Carolina, Wisconsin, Michigan, and Arizona allow voters to request mail-in ballots without having to provide a reason for the request.

3. **Swing states and the Electoral College**: If the recent past is any guide, this election may hinge more on the Electoral College vote than the popular vote—meaning that the geographic distribution of votes may matter more than the size of that lead in recent polls. For context, in 2016, Trump won the election despite losing New York and California, because he captured enough support in Southern and Midwestern states with midsize electoral vote totals (e.g., Florida, Michigan, Ohio, and Wisconsin). We expect Midwestern and Southern swing states to be among the most closely watched.

Some averages of statewide polls taken in late May showed Biden with a small (1% or 2%) lead over Trump in four of six swing states, accounting for 101 of the 270 electoral votes needed to win the election. Biden also faces a significant electoral challenge. California and the Northeast are strongholds for the Democratic party, but battleground states in the upper Midwest could again go for Trump, if the Democrats fail to motivate the progressive voters—or if Biden’s campaign veers too far left and alienates moderates in these states.

4. **Getting tough with China**: How does each candidate propose to manage the increasingly fraught U.S.-China relationship? A crescendo of tensions has arisen over freedom in Hong Kong’s and Taiwan’s independence, China’s territorial claims in the South China Sea and, of course, trade with the U.S. and other countries. Allegations that China’s government mishandled the emerging coronavirus have popularized getting tough with China as a rare bipartisan issue. Investors likely will be looking for some balance, however, because U.S. corporate ties with China would be expensive to sever abruptly. As the campaign advances, investors should watch how each candidate would increase or decrease the stress on the relationship.

5. **Nationwide demonstrations**: The demonstrations in May and June put new pressure on Trump. The protests and riots follow months of lockdowns and tens of millions of newly unemployed potential voters. Many previously undecided voters may decide not to wait for the gradual recovery to see Trump more favorably. By contrast, Biden may gain new interest from progressives, who generally have been lukewarm about his campaign. He already appealed largely to the moderate base, but the demonstrations may galvanize progressive energy against Trump, to the advantage of Biden.

**Issues and implications**

**The issues—what’s changed**: During the past four years, China’s growing economic challenge and, now, the COVID-19 pandemic have introduced policy proposals that are outside the policy mainstream of the previous three decades (and longer). Regarding China, Republicans and Democrats broadly agree on the need to respond, but the parties differ on the question of how. Meanwhile, aggressive government response to the pandemic has allowed more activist federal economic policy to move toward the mainstream. Although many ideas have been proposed during the campaign, our convictions are that:

- The most extreme proposals are politically unlikely, whether the elections produce a divided government or a unified government, but with only a narrow majority in the Senate.

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6 See a collection of presidential general polls at FiveThirtyEight.com, between May 21, 2020 and May 28, 2020. The swing states include (with electoral votes): Arizona (11), Florida (29), Michigan (16), North Carolina (15), Pennsylvania (20), and Wisconsin (10).
Financial-market participants likely would be encouraged if the new Congress focuses first on issues of bipartisan consensus (e.g. on repairing infrastructure and supporting the economic recovery), instead of controversial measures.

Here are the issues that we believe will be the most relevant for investable markets:

**Issue—Tax and regulatory policy**: In the event of divided government, we expect insufficient congressional support for extreme changes. By contrast, single-party government leadership under the Democrats likely will advocate—but may not win—more progressive income tax rates and higher corporate tax rates (proposed to rise from 21% to 28%), along with repeal of the favorable treatment of business investment. The ideological divide among the Democrats (and with Republicans) may make a difficult hurdle for many of the tax proposals from the campaign trail. Among the more contentious proposals are wealth and financial transaction taxes, repeal of real estate like-kind exchanges, and small-business tax credits to develop retirement plans.\(^7\)

The regulatory environment bears close attention. Executive orders under a Biden administration likely would reverse business deregulation to restore something akin to the regulatory scope during the Obama years. In addition, the president will have a chance to fill positions among key regulatory agencies: a new Federal Reserve (Fed) chair in February 2022 and a Fed vice chair of banking supervision, as well as directors for other bank regulators, the Consumer Finance Protection Bureau, and the Federal Housing Authority. We expect bipartisan support to return supply chains to the U.S. (i.e., reshoring of prescription drugs, medical goods, and other goods that directly affect national security).

**Issue—Fiscal and monetary policy**: Income inequality was already a sensitive political issue before 2020, but the pandemic worsened the problem by eliminating many low-paying service industry jobs (such as those in travel, leisure, and hospitality). We expect additional federal spending and large deficits, although the fiscal approaches will differ depending upon whether government is divided or led by a single party. Under our base case, a Republican Senate majority—or even as a Republican minority in a closely divided chamber—may block or limit large, additional fiscal outlays for income supports, infrastructure, and reshoring, instead preferring to deliver support for small businesses and public-private infrastructure partnerships. Infrastructure improvement and supply-chain reshoring of health care goods and other items deemed critical to national security likely will be pushed either by a split government or one led by the Democrats.

Even if Biden wins the White House and Democrats lead Congress, the combined opposition from the party’s moderate wing and from Republicans should make it difficult to push through transformational fiscal programs, such as the Green New Deal and Medicare for All. However, we would expect more fiscal spending programs with targeted goals (unemployment or state and local government funding support). This could take the form of direct payments to households similar to those in recent stimulus programs and even more aggressive guaranteed income support.

In either case, we expect Fed policy to be proactive in supporting the economy, so much so that monetary policy could become subordinate to fiscal stimulus and the historically high budget deficits associated with it. This implies a multi-year period of low rates and exceptionally large Fed liquidity support for credit markets, the banking system and, ultimately, businesses.

**Issue—Foreign economic policy**: We see a broad recognition across Japan and the Western democracies that China poses a growing economic and geopolitical challenge. In the U.S., public opinion recently turned negative on China’s government—and Democrats and Republicans have different approaches to China’s challenge.\(^8\) Both parties criticize China’s commercial

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\(^7\) The repeal on like-kind exchanges in real estate refers to ending the provision under which properties with increased value can be exchanged without a tax event.

policies and would like to see many companies resshore their supply chains. Republican leadership is likely to focus more on commercial leverage, through tariffs and limiting Chinese business in the United States. Democrats likely will prefer to apply diplomatic and political pressure via international coalitions and also will likely sanction China for its treatment of democracy protesters and minorities.

Both approaches create uncertainties and costs for U.S. businesses. U.S. multinationals’ supply chains from China are mostly too expensive to move now. However, the two countries are accelerating their punitive measures against each other, which may raise business operating costs by enough to compel relocating those supply chains in the coming years. Multilateralism under a Democratic administration may improve U.S. trade relations with Europe and Japan, but it may introduce other risks. First, it could dilute pressure on China to correct the core grievances of trading partners, including subsidies, forced technology transfers, and access to its market. Second, multilateralism risks papering over legitimate complaints between the U.S. and its trading partners—distorting and raising the cost of world trade.

**Issue—Health Care**: The pandemic is likely to spark growth in the Health Care sector regardless of the election outcomes. Among the most visible needs are more seamless coordination between in-person and virtual care, better global coordination of public health organizations, the buildup of strategic reserves for critical medical supplies, and ongoing research and development of anti-viral treatments.

COVID-19 also has raised awareness around broadening health care access, but neither of our election scenarios foresees enough political support for a single-payer system, such as Medicare for All. Whether the elections yield a “single-party” government or a divided government, we believe that Congress and the president will focus on expanding the existing health care system, with greater government assistance to reduce the number of uninsured and others with inadequate or financially burdensome coverage. Perhaps more sensitive to election results is the debate over price controls on prescription drugs, likely to gain momentum if the Democrats control Congress and the presidency in November.

**Issue—Energy and climate change policy**: We expect a second Trump administration to look for ways to further deregulate or otherwise encourage fossil fuel production. Fundamentally different policies from a Biden White House would push for higher carbon controls, strict limits on coal mining, and reduced fracking. More broadly, there may be an analogy between the pandemic and energy policy. Plans for a lockdown were developed only partially during the 2006 avian flu by policymakers not anticipating a pandemic anytime soon. Now, the wakeup call around the pandemic may prompt analogies to climate change, intensifying the policy debate over fossil fuels. Such a change in energy policy probably would accelerate investment in Environmental, Social and Governance (ESG) and sustainable investing.

**Investment implications**

In our view, the most likely election outcomes in November maintain divided government. Split control between the two parties should block or moderate the most ambitious policy initiatives of any president. Nevertheless, the U.S. economy’s dynamics are fast-changing and unique in many respects. We’re still early in a campaign that is likely to be shaped by the success or failure of the economic reopening. The results of the reopening are not possible to predict now but will go a long way toward determining the likely election outcome. We expect to revisit these issues and developments in the election campaigns with an updated report this fall.

Investor patience is critical, because market opportunities may not evolve until after the elections. Investors may remember how markets rushed to drive prices higher in particular sectors in early 2017, following President Trump’s election and single-party control of Congress. Yet, many of those expectations were disappointed when policy proposals either fell short of investor expectations or failed to become law. In sum, our greatest conviction lies in remaining patient and implementing our current tactical guidance and asset allocation preferences.
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