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ELECTIONS | 2020
INSIGHTS & IMPACTS

Policy, Politics & Portfolios

POLICY EXPECTATIONS AND MARKETS, AFTER THE ELECTIONS

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Linking party control of government and investment performance should be handled with care, owing to, among other things, narrow differences in returns during split and unified governments, changes in party ideology, return volatility over past congressional sessions, and the distorting effect of outlier gains and losses.

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Partisan disagreements in Washington have shifted focus to the scope and timing of economic stimulus at the beginning of the year. The strong possibility of a new divided government makes a modest stimulus package likely in January.

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This year, investors have questions about how potential changes to the tax code under a Biden administration might affect investment and planning decisions. This is a legitimate concern because President-elect Biden has proposed to raise taxes by $3.5 trillion over the next decade. In this section, we consider the likelihood of securing tax reforms over the next two years and highlight potential tax implications for investors and small business owners.

Is asset-market performance hostage to the election cycle?

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Looking back…

Investors are scrutinizing the results of the November 3 election for policy and investment implications in what has become a postelection ritual. The election-cycle approach to gauging future investment returns typically divides results between one-party and split governments. A split government means one party controlling the White House and the other controlling one or both houses of Congress. What do the numbers tell us? Chart 1 shows asset performance during two-year congressional sessions under split and unified governments since the mid-1970s. The results? A virtual dead heat for stock returns in a period of near-double-digit returns both for split and unified governments. That may be due to the ambivalent policy impact of both over the past 45 years. Bold policy action under a one-party government, at times, may work to the benefit or to the detriment of the stock market. Congressional stalemate cuts both ways for markets. Gridlock may support market risk appetite by avoiding higher business costs. Yet, a stalemate historically undermines risk sentiment when Congress fails to deliver economic support that markets expect.

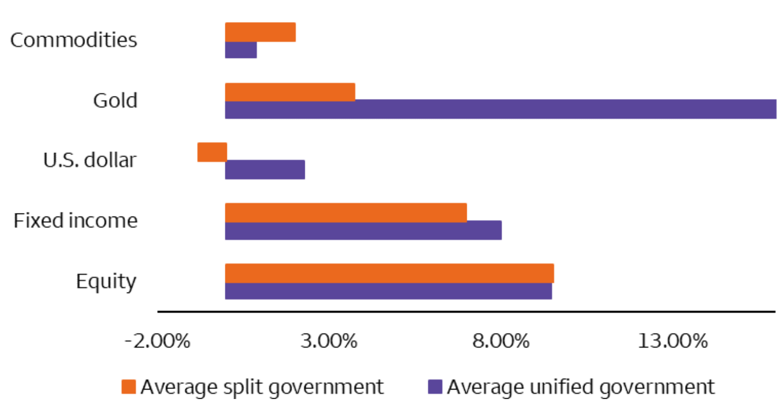
Stock-market returns have differed little under split and unified governments during congressional sessions back to the mid-1970s.

We've taken the exercise a step further by reviewing performance of other assets under those same postelection scenarios in the past 45 years. Bonds have done better under a unified government, a nice counterweight to slight underperformance by stocks. The dollar has done noticeably better under one-party government, which helps explain the weaker performance of commodities typically priced in dollars. The performance gap between government types has been greatest for gold, a perceived safe-haven, inflation-sensitive asset whose averages were distorted by sky-high inflation and market turbulence during single-party, Democratic control in 1977 and 1978.

Gold has had the widest performance gap between one-party and split-government alignments in the past 45 years, due less to policy differences than to sky-high inflation and market turbulence during single-party, Democratic control in 1978 and 1979.

Promising election-cycle performance in past decades still must contend with high return volatility in some asset markets and, in some instances, with competitive results simply using buy-and-hold strategies.

Chart 1. Average returns two years after each national election, 1976-2020



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of November 15, 2020. Gold represented by gold spot price. Indexes used to measure asset classes are as follows: equity (S&P 500 Index), fixed income (Bloomberg Barclays U.S. Aggregate Bond Index), U.S. dollar (U.S. Dollar Index), commodities (Bloomberg Commodity Index). **Past performance is no guarantee of future result.**

…is not quite like looking ahead

What does all this say about market performance during the next two-year Congress? Handle election-cycle history with care.

Why? First, there's the issue of ideological change. We see changes in the two parties' points of emphasis over time. Populism seems to be eroding the perception of Republicans as the party of big business and deficit control. Worsening income inequality has seemingly tilted Democratic priorities from growth-oriented to redistributive policies. Both can distort the traditional link between parties, policies, and investment returns.

Second, there is the data. Historical stock returns under split and unified governments are too evenly matched to make a compelling decision based on the numbers. However, history may not be much of a guide for investors in the next Congress: This will be the first time since 1884 that an incoming Democratic president and House is paired with a Republican Senate if Republicans retain their majority by prevailing in at least one of the two January 5 runoff elections in Georgia.

Average returns by government alignment have varied more for other asset classes. However, outlier gains or losses in a single year have affected bonds as well as gold, and other assets are vulnerable to those distortions too. Return volatility has been high enough between congressional sessions of the past 45 years to make past averages less than reliable in anticipating future returns. There's also the question of whether actively managing stock portfolios against historical performance is worth the effort. A look at stocks going back to 1933 shows returns under a split government lower, and volatility slightly higher, than a buy-and-hold strategy.[1]

What's the lesson from all this? If election-cycle history is used at all in developing investment strategy, it should only be in conjunction with other well-grounded tools. Ultimately, there's no substitute for fundamental analysis of economic, market, and company conditions. Election cycles may yield a pattern. However, behind every pattern lies a close correlation with economic growth, inflation, interest rates, and, yes, even specific policy decisions often removed from election results and their impact on party alignments in government.

Key takeaways

- There's less than meets the eye to assessing split-party and unified-government alignments with investment returns in decades past. Narrow performance differences and, in some instances, the distorting effect of outlier results are partly to blame.
- Other reasons to handle election-cycle history with care as a market-forecasting tool include recent changes in party ideologies, return volatility over past congressional sessions, and election-cycle performance against average returns for a buy-and-hold strategy.
- If it is used as a portfolio-strategy tool at all, election-cycle history should be combined with other well-grounded tools, centered on economic, market, and company fundamentals.

[1] Dan Clifton. Policy Outlook report. Strategas, October 13, 2020.

Evaluating a second COVID stimulus

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What could the new stimulus look like?

The U.S. passed the most expansive economic stimulus in modern history in March 2020 with bipartisan support. However, concerns linger as the world economy continues its attempt to restart. A potentially divided Congress next year may reduce the size of the spending program and intensify those concerns.

The Democratic-led House of Representatives has the more ambitious target, aiming for an additional $2 trillion in stimulus, including funds for a new round of $1,200 personal payments, additional COVID-19 contact tracing, and even payments and assistance to state and local governments.[2] Senate Republicans, on the other hand, have introduced a smaller stimulus weighing in at around $500 billion, which targets small business funding, slightly expanded unemployment benefits, and funding for schools.[3]

We believe that this gridlock has largely been the result of political posturing since before Election Day. Partisan differences remain at the forefront. The Democrats will have to come from behind in early January to achieve control of the Senate — and even then with only a 50-50 tie. In such a close balance, it may be difficult for the Democrats to achieve everything in their stimulus plan. If the Republicans win at least one seat in the Georgia runoff, a Republican Senate majority will likely force the Democrats to accept an initial stimulus in the $1 trillion range, in keeping with what the Trump White House had initially requested.

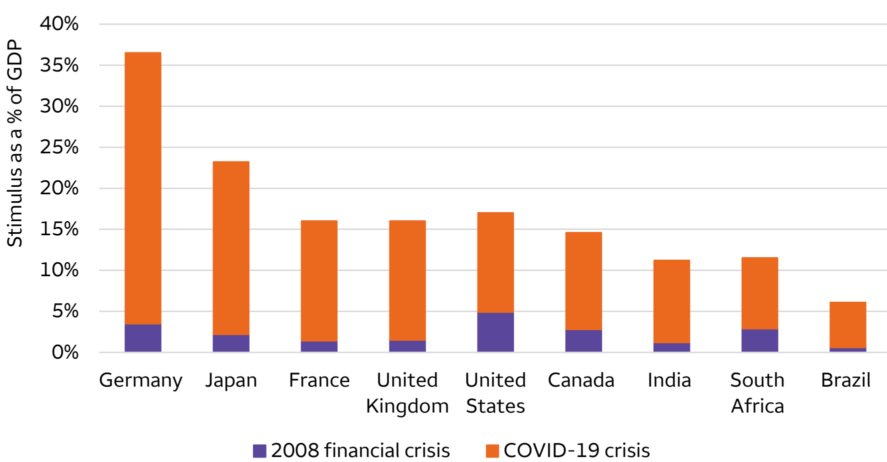
New senators and representatives take office on January 3.

Source: Schneider, Judy. "The First Day of a New Congress: A Guide to Proceedings on the Senate Floor." Congressional Research Service, December 19, 2018.

As a percent of GDP, U.S. economic stimulus was smaller than Germany, Japan, France, or the U.K.

Source: Ziyad Cassim, Borko Handjiski, Jorg Schubert, and Yassir Zouaoui. "The $10 Trillion Rescue: How Governments Can Deliver Impact." McKinsey & Company, June 2020.

Chart 2. Stimulus response during COVID-19 and the 2008 financial crisis



Source: Ziyad Cassim, Borko Handjiski, Jorg Schubert, and Yassir Zouaoui "The $10 Trillion Rescue: How Governments Can Deliver Impact." McKinsey & Company, June 2020. 2019 GDP is used for values related to the COVID-19 crisis. 2008 financial crisis values include discretionary measures for 2008 – 2010. GDP = gross domestic product.

[2] "Summary of H.R. 6800 – The Heroes Act", Congressional Research Service, introduced into the House on May 12, 2020.
[3] Emma Newburger. "Senate to Vote on $500 Billion GOP Coronavirus Stimulus Bill Wednesday." CNBC, October 17, 2020.

Since Election Day, the Democrats have requested additional stimulus as soon as possible, with Senate majority leader Mitch McConnell agreeing that more stimulus is needed before year-end.[4] However, McConnell has continually pointed to quickly recovering employment and gross domestic product (GDP) numbers as supporting a more targeted stimulus plan. Chart 2 demonstrates that the stimulus response to COVID-19 in both the U.S. as well as globally has already far outweighed stimulus implemented in response to the 2008 financial crisis. It is important to note that even if both parties agree that stimulus is needed as soon as possible, key disagreements are likely to delay action until the first quarter of 2021. We believe only a continued surge in infections into December and some perceptible economic slowing are likely to soften the resolve of Senate Republicans.

The outlook

The U.S. economy has already started the fourth quarter with solid momentum. The prospect of a limited and delayed stimulus package underscores how important the economic data will be over the coming weeks. Significantly weaker data may keep U.S. equity market leadership among those quality sectors that have led the market during much of the pandemic — namely, Information Technology, Communication Services, and Consumer Discretionary. Additionally, if a plan includes funding for state and local governments, we would expect municipal bonds to benefit. Municipal bonds saw a rotation out of favor as the COVID-19 crisis worsened, so stimulus supporting local governments may represent an attractive opportunity to rotate back into them. We still expect the economy to grow faster after the first quarter, and such a scenario ultimately may benefit more cyclically oriented sectors. We are watching for this possibility, but it is too early to know the exact timing.

Key takeaways

- Continued partisan disputes in Congress make a stimulus package unlikely until the first quarter of 2021.
- Split control of Congress, if it becomes reality, may force a compromise between Republicans and Democrats, with our expectations for stimulus ranging from $500 billion to $1 trillion.
- We believe that slowing economic growth over the coming months and a small stimulus combine to favor higher-quality, technology-related sectors and Health Care — the sectors that have outperformed during most of the pandemic. A rotation to more cyclically oriented sectors (for example, Materials, Industrials, or Financials) may arise once the stimulus takes hold and COVID-19 infections subside.

[4] Jacob Pramuk. "McConnell and Pelosi Are Once Again at Odds Over the Size of a Coronavirus Stimulus Package." CNBC, November 6, 2020.

Tax policy priorities of a Biden White House

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Change of course or status quo?

As the dust from election season settles and with a new year in sight, investors are reviewing their portfolios ahead of year-end deadlines. This year, questions about how potential changes to the tax code under a Biden administration might affect investment and planning decisions are weighing on investors' minds. We believe this is a legitimate concern because President-elect Biden has proposed to raise taxes by $3.5 trillion over the next decade on corporations and on individuals who earn more than $400,000 per year.[5] Yet, it may be a bit premature. Below, we consider the likelihood of securing tax reforms over the next two years. We also highlight potential tax implications for investors and small business owners.

In an April 2020 survey, Gallup found that the vast majority of respondents feel that the federal taxes they pay are either "about right" (48%) or "too high" (46%).

Source: Gallup, April 28, 2020.

The outcome of this year's election points to divided government and not the Democratic sweep the pundits were expecting. Runoff elections for two Georgia Senate seats on January 5 will clarify the final Senate seat count. Democrats retain control of the House by a slim majority. A narrowly divided Congress means the president will need bipartisan support to advance ambitious policy initiatives and likely will require compromise to see any movement on tax or other policies. The main takeaway here is that investors should not expect big changes to tax policy in the near term.

President-elect Biden has proposed to raise taxes by $3.5 trillion over the next decade on corporations and on individuals who earn more than $400,000 per year.

We think bipartisan support for large-scale individual and corporate tax increases in Biden's economic program will be difficult to achieve with split government and most likely are off the table for now. This may be a positive development, particularly for high-income earners and for the corporate earnings of multinational corporations. More broadly, this may align with the sentiment of American voters. In an April 2020 survey, Gallup found that the vast majority of respondents feel that the federal taxes they pay are either "about right" (48%) or "too high" (46%).[6]

Tax-loss harvesting involves selling assets at a loss and using capital losses to offset taxes due for the year. We recommend discussing tax-loss harvesting with your financial or tax advisor.

History teaches us that legislating tax reform is no easy feat. Even with a Republican-led House and Senate, President Trump's Tax Cuts and Jobs Act of 2017 (TCJA) took a year to pass. Although some provisions of the TCJA are permanent, the lower personal income tax rates and greater estate tax exemption are set to expire at year-end 2025. For Biden to repeal any portion of the TCJA would likely prove challenging. Existing statutes grant the president and the Treasury Department broad authority to effect tax changes unilaterally through executive orders. Yet, historically, the president rarely has exercised the power to raise tax revenue and has instead relied on Congress to do so. That said, President Trump and President Obama were amenable to pursuing more tax-friendly executive orders to enact payroll-tax holidays.

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[5] "What Does a Biden Presidency Mean for Your Tax Bill?" Forbes, November 7, 2020.
[6] Gallup, April 28, 2020.

Table 1. Highlights of Biden's proposed tax policy reforms

Restore the top individual income tax rate to pre-2017 level of 39.6%
Raise the corporate tax rate from 21% to 28%
Eliminate the 15% rate on minimum book value and double the rate on foreign income to 21%
New payroll taxes such as an added Social Security tax at 12.4% split between workers and employers for all wages above $400,000
Individuals making more than $1 million annually to pay the same rate on investment income (39.6%) as they do on their wages

Source: www.joebiden.com

Key takeaways

- As investors review portfolios ahead of year-end deadlines, questions about potential tax changes under a newly elected Biden administration are being raised.
- With razor-thin margins in the House and Senate, individual and corporate tax increases may have difficulty garnering bipartisan support and most likely are off the table for now.
- Although Biden's proposed tax reforms most likely will not affect tax bills for 2020, two legislative actions (the SECURE Act and the CARES Act) may have tax implications.

Investor implications for 2021 and beyond

Once the new administration is situated, we may get a better sense of policy priorities for 2021. If Biden's proposed tax reforms do not materialize this year:

- We believe demand for municipals should remain strong given the continued state and local deduction cap. We remain favorable. Yet, municipal bonds, tax-favored investments, and the value of exemptions all could find additional support if tax rates were higher.
- Consumer spending could get a boost because discretionary spending is skewed toward high-income earners. If these individuals do not see income taxes rise, we believe equity sectors like Consumer Discretionary and the overall economy are likely to benefit.

Two legislative changes in 2020, the SECURE (Setting Every Community up for Retirement Enhancement) Act and the CARES (Coronavirus Aid, Relief, and Economic Security) Act, may have tax implications for individual investors and small businesses.[7] It is important to talk with a financial, tax, or legal advisor for any tax-related questions.

SECURE Act: Provisions from the SECURE Act may affect retirement accounts, including limitations of stretch IRA provisions that may adversely affect beneficiaries, required mandatory distribution age raised from 70 ½ to 72, and no age limits on traditional IRA contributions.[8]

CARES Act: Measures from the CARES Act that provided relief for individuals and small businesses during the pandemic-related lockdowns may have tax-related implications. We encourage investors and business proprietors to speak with their tax or legal advisor or accountant regarding questions or concerns.

We encourage investors who are interested in learning about tax-advantaged strategies to talk with their investment professional.

[7] See the Wells Fargo Private Bank *2020 Year-End Planning Guide* for more details about the acts.
[8] See Wells Fargo Investment Institute "The SECURE Act—A New Year's Gift?" January 28, 2020.

Risk considerations

Wells Fargo and its affiliates are not legal or tax advisors. Be sure to consult your own legal or tax advisor before taking any action that may involve tax consequences. Tax laws or regulations are subject to change at any time and can have a substantial impact on individual situations.

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

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. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. Income from **municipal securities** is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).

Investments in gold and gold-related investments tend to be more volatile than investments in traditional equity or debt securities. Such investments increase their vulnerability to international economic, monetary and political developments. They are also exposed to the risk of severe price fluctuations in the price of gold bullion.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. **Communication** services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. 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 affect consumer sentiment. Investing in the **Financial** services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. **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. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index definitions

S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

U.S. Dollar Index (USDX, DXY) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies.

Gold: The gold spot price is quoted as U.S. dollars per troy ounce.

Bloomberg Commodity Index is comprised of 23 exchange-traded futures on physical commodities weighted to account for economic significance and market liquidity.

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