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# Institute Alert

FIRST ANALYSIS

**News or events that may affect your investments** **July 15, 2024**

**Paul Christopher, CFA**
Head of Global Investment Strategy

## Investing amid shifting political tides

### Key takeaways

- Political news in Europe and the U.S. has captured media and investor attention.
- But market action shows the myriad cross currents at work across capital markets, not just political factors.

### What it may mean for investors

- We illustrate some of the pitfalls of making investment decisions based on summertime presidential polls.
- Our investment guidance continues a focus on quality. A quality focus implies a preference for the U.S. markets, and for U.S. companies with strong balance sheets, good revenue prospects, and attractive valuations.

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A confluence of election surprises recently has attracted media and financial market attention on both sides of the Atlantic Ocean. The results of the European elections are known, while U.S. voters wait for November. Our view is that financial markets have taken notice but remain focused on economic performance while political conditions remain fluid on both sides of the Atlantic. More surprises seem likely during the coming months, and we believe patience will be the investor's most important tool.

To help with the waiting, this report considers what investors might watch for amid the shifting tides of leadership in the U.K. and France and explains what might happen with the U.S. presidential race, depending on President Biden's participation in the race.

### Q&A on options available to President Biden

**Question: Could President Joseph Biden choose to stay in the race?**

**Answer: If Biden wants to remain his party's presidential candidate, it will be difficult for challengers to replace him.**

President Biden accumulated 3,894 of his party's 3,933 delegates during the primaries. Only seven are pledged to other candidates.[1] The party rules indicate that "[a]ll delegates to the National Convention pledged to a presidential



1. The Green Papers - Presidential Primaries 2024, Democratic Delegate Vote Allocation, July 8, 2024. As of July 8, 2024, there were 3,894 delegates pledged to President Biden.

candidate shall in all good conscience reflect the sentiments of those who elected them."[2] Some or all of these delegates could vote for someone else, but historical challenges to the presumptive nominee all have failed. Biden also could resist moves to replace him by substituting for a delegate who is reluctant to support him. Finally, time is short for any challenger. The party plans a virtual convention to renominate Biden in late July, before the convention in Chicago, beginning August 19.[3]

**Question: What if Biden chooses to withdraw from the race before the convention?**

**Answer: An open or brokered convention becomes likely. Vice President Kamala Harris would have a financial advantage as a potential nominee.**

If Biden chooses to withdraw, his delegates would be free to support other candidates. If he endorses a candidate who attracts a majority of the available delegates, the replacement process should be straightforward. But if no candidate attracts a majority, then the delegates, candidates, and 739 superdelegates from party leadership broker a nominee.[4] There would be an added efficiency if Biden and the leadership endorse Harris to replace Biden.[5] However, an open convention probably would be contentious, and we believe it would be difficult for investors to price an outcome in advance.

**Question: How would the party replace Biden if he withdraws after the convention?**

**Answer: The Democratic National Committee would select a replacement nominee.[6]**

To avoid the uncertainty of an open convention, or if Biden were to withdraw after the convention, the Democratic National Committee could choose presidential and vice-presidential nominees. However, such a nomination would fall after the ballot access deadlines in many states, and replacing the team on the ballot could require time-consuming legal challenges on a state-by-state basis. Also, allowing a 100-person leadership committee to choose the nominees could alienate party members and voters who might feel that the democratic process was short-circuited.

## Reading capital market movements while political conditions remain fluid

The campaign has seen changeable poll results, but market reactions have been muted. In our view, a key factor is that both candidates have the lowest approval ratings of any president since Harry Truman.[7] In the latest event, the apparent assassination attempt on former President Donald Trump should boost his supporters, but it's unclear how many independent voters will rally to him on November 5. Our view is that events so far have ratcheted up the media's energy, but have not produced sustained market reaction, which we illustrate below:

a. **Natural gas:** U.S. natural gas prices have been rising gradually since April. More improvement in July is consistent with Trump's favorable proposals to develop hydrocarbon production but also with rapidly

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2. "Call for the 2024 Democratic National Convention," Democratic Party of the United States, September 10, 2022.
3. The virtual vote allows the party to nominate a candidate before Ohio's August 7 filing deadline. See: Ed Kilgore, "The Window to Replace Biden is Rapidly Closing," Intelligencer, July 3, 2024.
4. The last brokered Democratic convention occurred with the nomination of Adlai Stevenson in 1952. See Jeff Mason, How Democrats could replace Biden as presidential candidate before November, Reuters, June 29, 2024.
5. According to federal campaign finance laws, she is the only potential replacement who, as Bidens' ticket mate, would have automatic access to the funds raised by the main Biden campaign committee. For more, see David Dayen, "Campaign Finance Laws Give Harris Big Boost in Biden Dropout Scenario", *The American Prospect*, July 2, 2024.
6. Op. Cit., Reuters, June 29, 2024.
7. Source: Gallup. Biden's average rating is based on his first 13 quarters in office, through March 2024.

 

developing power generation needs for artificial intelligence (AI) data centers, a trend that predates the debate.

b. **Crude oil:** The benchmark U.S. West Texas Intermediate crude oil price also rose after the debate. The day after the debate, the Supreme Court issued a ruling that narrows the scope for regulators to interpret legislation, particularly in energy and financials. But we do not believe that these events necessarily make deregulation more likely. Rising demand for gasoline likely powered June's oil price gain. Also, the Court's decision applies limits to both parties' regulators, whether their president favors more or less regulation.

c. **The U.S. dollar's value:** Tariffs under a Trump administration would likely reduce U.S. imports and thereby raise the dollar's value, in our view. Yet, the dollar's modest depreciation so far in July probably has had more to do with the euro's bounce higher. Since the French legislative elections concluded, the euro has strengthened, and the dollar has reversed its recent gains.

d. **Bond yields:** Whether Biden, Trump, or someone else wins the presidency, we are expecting wider budget deficits to result. The 10-year U.S. Treasury security yield rose immediately after the debate but quickly returned to its pre-debate level. What's more, a proxy for the market's premium to cover uncertainty over the next 10 years (called the term premium) remains close to its 2024 average. If yields initially moved higher because of the debate, that impulse quickly reversed.

e. **Small-cap equities:** The Russell 2000 Index of small-cap companies did not perceptibly respond to the debate. This makes sense to us. Small businesses may be anticipating extra tax benefits, if a Trump presidency can extend the 2017 tax cuts. But small business owners also are likely pricing in tariffs that raise prices and may complicate supply chains for these businesses. When we consider a presidential candidate's policies, we don't apply them singly to markets but weigh them collectively for potentially offsetting investment implications.

f. **Large cap equities:** According to Bloomberg data for the first six months of 2024, the total return of the largest 10 constituents of the S&P 500 Index outperformed the index by 26.1%, while the largest 100 and smallest 100 underperformed (-2.9% and -19.0%, respectively). That pattern was unchanged in June Looking ahead, the dominant market themes still appear to be the technology-driven performance from the top 10 stocks and a more pedestrian return from many of the rest, whose main driver is the slowing economy.

## Lessons from the shifting political tides in Europe

European legislative elections this summer offer other relevant points for U.S. investors and about U.S. elections. The first point is that strong partisan divisions in countries may produce gridlock, but not necessarily stalemate where national budgets are concerned. Notably, the French legislative elections gave a plurality to a coalition of left-wing parties, but a majority to none. Gridlock could block their extensive spending plans — or not, if they forge an agreement with the far-right parties, which want larger pensions and lower taxes. Bottom line: Gridlock in France could favor French government bond holders, but much depends on compromises yet to be arranged. The elections by themselves are less conclusive than the negotiations that will follow.

A second lesson seems to us that even a strong majority requires a wait-and-see regarding policy. The U.K. parliamentary elections delivered a very strong majority to the Labour party, but, as in the U.S., tax and spending decisions of the past are likely to constrain the government's budget in the future. We foresee very difficult fiscal policy choices for the new British government.

We see parallels for the U.S. in these European lessons. First, it's worth remembering that the presidential winner may have to work with congressional leadership by the opposing party. In such a scenario, we doubt that a Democrat in the White House would have enough congressional support to raise taxes significantly, or a Republican to cut taxes. However, there may be compromises that widen the deficit further. For example, we could foresee a bipartisan deal to extend some of the Trump business tax cuts, in exchange for a child tax credit. But the deficit likely would grow.

In addition, it's possible that the already wide deficit and growing interest cost of the debt could constrain Congress and force spending cuts or selected higher taxes, even for a party that sweeps to power. Clearly, many of the decisions most relevant for markets are likely to depend on compromises to be hammered out next year — including a likely debate over raising the public debt ceiling in 2025. The bottom line for the U.S. is that pre-election guessing about which scenario could occur requires making many more assumptions than just who is leading in the presidential polls today.

## Summary and investment implications

As the above Q&A demonstrates, any successor to Biden (if he decides to exit) may potentially struggle for name recognition with voters, or he or she may surge to a lead in the race. What seems clear is that the significant logistical and procedural challenges imply no clear favorite yet, and low approval ratings leave the polls susceptible to unusually wide swings in response to surprise events.

Our discussion above also illustrates some of the pitfalls of making investment decisions based on summertime polls on the presidential race. We showed that current market action reflects the myriad cross currents at work across capital markets, and that favoring a candidate for one policy may miss that another of his policy proposals may offset or undo the benefit of the first policy. Finally, the European elections illustrate that markets may be most sensitive to the elections after the winners take their seats in January. Against this still-fluid backdrop, security selection based on the latest tide in the election polls can easily mistake the risk and reward in a particular asset class.

Moreover, market volatility is especially likely over the next two quarters. September could be an especially volatile month for equity and fixed income markets. Liquidity is likely to tick lower as the federal government collects quarterly taxes due; the Federal Reserve policy meeting on September 18 could bring a first interest rate cut, or not; and the judge in Trump's New York trial has scheduled sentencing for September 18. More market volatility potential is likely to follow in early 2025, once the new government leaders set their priorities. Meanwhile, we still anticipate a shallow economic slowdown and lower inflation, and then a transition to firmer growth and inflation as 2025 progresses.

While election and economic uncertainties bunch up to produce possibly rough seas in the coming months, our investment guidance continues a focus on quality. A quality focus implies a preference for the U.S. markets, and for U.S. companies with strong balance sheets, good revenue prospects, and attractive valuations. At a high level, these include U.S. Large Cap Equities over Mid Cap and Small Cap Equities; investment-grade fixed income (including corporates and municipals) over high-yield fixed income; a broad-based commodity exposure; and alternative investments that historically have low correlations with equity and fixed income markets.

**Risk considerations**

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. **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. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. 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. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds.

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S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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