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What federal budget, regulatory, and trade decisions could mean for investors **March 19, 2024**

What's at stake for investors in the 2024 elections

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Congressional outlook: A potential for a split Congress and implications for policy reform and markets

This year, we anticipate a close race for control of both sides of Congress, yet party control is likely to flip in both chambers. Republicans currently have a 219-213 majority in the House (with three vacancies). Six to 12 of their seats are viewed as toss-ups,[1] with Democrats occupying 5 to 10 seats identified as toss-ups. Democrats need a net gain of four seats to clinch a majority. In the Senate, Democrats currently hold a narrow majority. Republicans must gain one seat to lead the Senate if they win the White House or two seats if they lose the presidential bid. A thin majority is the likely outcome.

House outlook for 2024

In the House, the focus will be on races considered "toss-ups" and "crossovers" — congressional seats that voted for one party in the 2020 presidential election and another one in the 2022 House elections. Of the 12 Republican toss-up seats, all are in congressional districts that voted for President Biden in 2020, while 4 of the 10 Democratic toss-ups are in districts that voted for former President Trump in 2020. Eight of the Republican toss-up seats in 2024 are in Democratic strongholds of California and New York — four in each state. Based on the data, we believe that Democrats have an early edge toward reclaiming the House this year.

Potential impact of the White House bid on congressional races

Historically, there has been no strong pattern of victorious presidential candidates with coattails in the House. Since 1992, the winner of the presidency has gained House seats exactly half the time: in 1996, 2004, 2008, and 2012. Presidential winners lost ground in the House in 1992, 2000, 2016, and 2020.

It is unclear how the 2024 presidential race will play out, of course, but President Biden and former President Donald Trump are the front-runners of their respective parties, and current polls suggest a close contest.

Senate outlook for 2024

Democrats currently hold a 51-49 majority in the Senate with one-third of the seats up for reelection this cycle. Of the 34 Senate races, Democrats and Democratic-aligned independents occupy 23 seats, while Republicans are defending 11 seats — all in states Trump carried in 2020. We expect that the combination of retirements and several toss-up seats is likely to flip Senate control to the Republicans, but again delivering only a very small working majority.

We see a few key takeaways for Senate and House elections:

- Democrats have a better map than Republicans to take the House, while Republicans should fare better in Senate races.

1. According to "Inside Elections" and "Cook Political," two nonpartisan publications that analyze congressional races

- Four Democrats in Trump districts and 12 Republicans in President Biden districts will likely determine the makeup of the new House.
- In the Senate, Republicans have as many as seven seats in play. Specifically, three states that Trump won are being defended by Democrats: Montana, Ohio, and West Virginia. Republicans are defending no Senate seats in states that Biden won in 2020.

A historical perspective

Amid narrow margins of control in each chamber and strong intraparty divisions, we do not expect major new legislation that might move financial markets. In fact, the past 20 years have produced more leadership changes than at any other time since the tumultuous period between 1877 and 1899. Then, as now, sharp regional differences polarized politics. Reconstruction, the Industrial Revolution, and westward expansion increased the demand for credit. The available gold supply could not support the demand for credit and sparked strong regional divisions over whether currency should be redeemable in silver, as well as gold, in order to expand credit.

Our expectation for continued polarization contrasts with periods during the past 20 years when, however briefly, a single party controlled the White House and both chambers of Congress. Those were periods of significant and market-moving legislation. Examples include: Bush 43, 2001 (Economic Growth and Tax Relief Reconciliation Act); Obama, 2009–2010 (American Recovery and Reinvestment Act, Affordable Care Act); Trump, 2017 (Tax Cuts and Jobs Act of 2017); and Biden, 2021–2022 (American Rescue Plan and Inflation Reduction Act).

We view 2023 as the counterpoint that only further underscores the dominant trend of inaction during the past 20 years. In fact, Congress passed just 27 bills that became laws in 2023, despite over 720 separate votes. It was the lowest point for governmental progress since the Great Depression.[2]

Investment implications

The upshot for investors is that we expect little in terms of significant legislation next term, but more executive action. Should Biden secure a second term, we may see executive orders to continue a strong focus on antitrust rules, which could pose constraints for the tech and financial sectors. Alternatively, we also believe that a Trump White House might impose additional tariffs that could benefit some industries (domestic steel) and hinder others (companies that import from China and the auto sector). Trump's deregulatory agenda could also expand exploration opportunities for the oil and gas industry. Ultimately, however, executive orders often face (often protracted) legal challenges that could postpone or even thwart the executive's intention. Thus, the investment implications are not yet clear. We consider these issues in greater depth in the next section.

Narrow voting margins in Congress, a likely flip in party leadership in both chambers, and a tight race for the White House collectively point us toward a strong preference not to adjust portfolios for prospective election results, at this time.

Close congressional races, coupled with a likely flip in party leadership in both chambers, underscore our preference to refrain from adjusting portfolios for prospective election results this far in advance.

2. Harri Leigh, "Congress Only Passed 27 Bills That Were Signed Into Law in 2023, the Least Since the Great Depression," Spectrum News 1, December 21, 2023

Presidential campaign platforms and market implications

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Setting priorities

With primary season well underway, the leading candidates are firming up their campaign platforms. Although the 2024 presidential race is shaping up to be a replay of 2020, Joe Biden versus Donald Trump, we see differences in the political and economic landscape. The post-COVID-19 U.S. economy continues to grow, albeit at an increasingly slower pace, alongside higher debt levels that may pose long-term structural issues. Fiscal policy reforms to address debt and deficit burdens cross party lines, while other campaign issues seem to diverge. Immigration reform continues to be a priority for President Trump, yet it is gathering steam for some Democrats. Still, for voters, a strong economy remains a top priority.

Based on the outcome, some prospective policy reforms may have implications for markets post-election. We do not recommend making major portfolio adjustments based on polls or potential outcomes this far in advance of the election. Rather, we prefer positioning portfolios for potential choppiness from headline risk as November approaches.

Key campaign issues for 2024

We expect several prominent issues to take center stage as the election season heats up. These include:

- **Debt and deficits** — U.S. debt has doubled in the past decade and now exceeds $34 trillion with net interest cost at $650 billion annually.[3] Investors will likely view the candidates' fiscal plans through the lens of this debt burden. Yet, there is a stark contrast between their proposals to tackle the problem. A Trump administration would likely focus on reducing regulations and legislating tax cuts to stimulate growth. Biden purports to raise taxes on the wealthy and corporations to offset spending.
- **Tariffs and trade (China policy)** — Both parties support reinvestment in U.S. manufacturing to varying degrees. Both candidates agree that China's economic policies have had deleterious consequences for the U.S. economy, fostering bipartisan consensus on a firm China policy (with differing degrees). Trump proposes raising tariffs on Chinese goods to 60% while imposing a 10% tax on all U.S. imports.[4] The Biden administration has retained the Trump-imposed China tariffs. The White House deals with China with a "managed competition" strategy that aims to keep U.S. technology out of Chinese hands through sanctions and export controls, limiting U.S. investment into China. This approach would likely continue in a Biden second term.
- **Federal Reserve (Fed) policy** — A two-year rate-hike campaign to slow inflation has raised interest payments, now projected to reach $1.6 trillion in 2034.[5] Inflation has cooled but remains elevated. The next president will select a new Fed chair (Powell's term ends in May 2026). Trump would likely commission new leadership.
- **Taxes** — In our view, Trump seeks to lower individual and corporate taxes but will likely need to offset outlays with spending cuts. Biden would allow some Trump tax cuts to expire while extending tax

3. "Trump Vs. Biden: Who Can Handle the Reins of a Hot Economy," Barron's, February 16, 2024
4. "Trump Could Reverse Decades of Trade Liberalization," Piper Sandler, January 30, 2024
5. Committee for a Responsible Federal Budget, February 7, 2024

reductions for household incomes under $400,000, paid for by levying taxes on higher-income earners, higher corporate tax rates, and higher taxes on stock buybacks.[6]

- **Energy, environmental, and antitrust regulations** — Trump aims to roll back Biden-supported environmental protections to accelerate permitting, open more federal lands to drilling, and bolster subsidies for fracking.[7] He would likely try to limit or reverse other regulatory efforts, including the current administration's stricter guidelines on corporate merger and acquisition activity in technology and other sectors, aiming to produce a more dynamic business environment.
- **Immigration policy** — Border security remains a signature issue for Trump and GOP leadership, which we believe would include increased funding for stronger oversight on the southern border. Democrats generally favor legal paths for resident immigrants, though in our view some Democratic lawmakers are taking a firmer stance on comprehensive immigration reform that would strengthen border security and prioritize enforcement of existing laws.

Economic and investment implications

Our analysis has found that presidential election years since 1960 historically have shown positive results for U.S. equity markets. The health of the U.S. economy can be a useful gauge of whether the incumbent party is likely to retain the White House. (See Sidebar 1 below). Based on the outcome, we see the following potential implications for investors and markets.

- **Democratic sweep** — Tax cuts for higher-income individuals likely would not be extended. Instead, lawmakers would likely push for corporate tax increases to cover middle-class tax cuts.
- **Republican sweep** — This outcome would likely extend the expiring tax cuts. Yet, many constituents worry about budget deficits. We would expect a GOP majority to target offsets on electric vehicles, Inflation Reduction Act restrictions, and discretionary spending to cover tax-cut extensions.
- **Split-party government** — In our view, Democrats retaking the House while Republicans take the Senate is the most likely scenario. A divided government presents a difficult scenario to garner majority support, limiting the legislative agenda. We believe a compromise is likely, whereby the two parties extend the tax cuts in return for middle-class tax relief and subsidies.

We believe the third scenario is the most likely. Thus, rather than dwelling on campaign promises and policy positions eight months ahead of the election, investors may be better suited to focus on issues with bipartisan support and likely staying power. These include infrastructure spending and reshoring of manufacturing, benefiting two of our favored equity sectors, Industrials and Materials. Both parties also favor domestic energy production, which aligns with our favorable view on Energy.

33% of Americans approve of President Biden's job performance and 28% rate economic conditions "excellent" or "good." Trump ended his term with 34% approval.

Sources: Pew Research Center, January 25, 2024, and Gallup, January 1, 2021

73% of Americans view a strengthening economy as the top policy priority for Washington, D.C. to address this year.

Source: Pew Research Center, February 29, 2024

6. "Trump Vs. Biden: Who Can Handle the Reins of a Hot Economy," Barron's, February 16, 2024
7. Ibid.

The economy, election campaigns, and portfolio strategy

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The economy and interest rates matter most for markets

Heading into the heart of the 2024 election season, we believe the best news on a "Goldilocks" economy is behind us. Slowing growth is coinciding with more grudging disinflation, risking more limited interest-rate cuts by the Fed to relieve the pressure on politically sensitive housing, small-business, and consumer credit.

Households and small businesses already are feeling the pinch of tight credit conditions as the Fed's swift rate-hiking cycle of 2022–2023 takes hold. And more recent data point to a weakening consumer: Consumer-led growth has lost momentum since the start of the year, centered more in nondiscretionary categories. Behind that loss of strength is a declining savings rate and credit-card debt accumulation adding to financial stress centered on lower-income households.

We expect a moderate economic slowdown through midyear capable of overshadowing campaign headlines and, perhaps, weighing on the election results themselves. But the economy should enjoy a modest recovery once the Fed initiates rate cuts. As we approach this pivot point, we anticipate increased market volatility tied more to the variability of economic data than to the ebb and flow of election headlines in the run-up to November.

It's still "the economy, stupid!"

Campaign issues noted earlier could have staying power after this election.[8] For now, however, we think investment strategy during this season largely boils down to a 1992 reminder from a Clinton political strategist who directed the phrase, "the economy, stupid" to his campaign workers as a reminder of what really matters to voters.

Fast-forward to 2024, and markets still appear focused more on the economy's performance than on the election-year policy debate. Complicating an assessment of the economy's impact on the election is a unique late-cycle environment distorted by the lingering impact of the initial COVID-19 outbreak and a more recent transition away from post-pandemic support to economic growth and disinflation. Key late-cycle distortions directly and indirectly tied to the pandemic include:

1. **Increasingly "sticky" inflation —** An unusually early and rapid break from peak 9.1% Consumer Price Index inflation in June 2022 boosted household purchasing power and accommodated lower interest rates. Normally, disinflation progress of this magnitude cannot occur without an economic contraction pressuring demand, but pandemic-era adjustments (weakening demand for goods and a swift unwind of supply-chain disruptions) made it possible this cycle.

   Importantly for 2024, however, we believe an unusually shallow economic slowdown will make the path back to the Fed's 2% target bumpier. "Sticky" inflation, centered on rents and medical-care costs, could complicate central-bank policy deliberations. Cut too early, and Fed officials risk a replay of the 1970s of reigniting inflation and restarting rate hikes; cut too late, and they risk facing a more damaging economic slowdown. This year's presidential election only complicates the matter, as the Fed historically prefers

8. "Campaign 2024: Political Issues With Staying Power," Wells Fargo Investment Institute, November 20, 2023

to act extra cautiously in the months leading up to a November presidential election, based on our view of changes to the federal funds rate late in election campaigns back through the late 1970s.

2. **A tight job market** — Overall, solid job growth has boosted consumer confidence and spending directly and indirectly, by buoying year-over-year wage inflation currently above 4%, according to Labor Department data. The tight labor market reflects a slow rebalance from post-pandemic distortions, whose timing and magnitude will affect highly visible job growth, the unemployment rate, and, perhaps, "on-the-fence" voters just ahead of the November election.

3. **Adequate, if not ample liquidity** — Lower interest rates from the early break in inflation have helped support unusually accommodative credit conditions this late in an economic growth cycle, cushioning a slowdown already benefiting from post-pandemic supports. However, liquidity can turn on a dime, making it difficult to determine how this factor will affect voting in November.

Weathering election-year and economic uncertainties

More than the usual uncertainty is attached to this year's election, leading us to reiterate our preference to avoid risking portfolio adjustments based on polling results and speculation over possible election outcomes — particularly with markets prone to additional headline risk in a close, polarized campaign. Our base case for a split government with narrow congressional majorities translates to limited scope for new legislation or other major policy changes. This suggests that election-year initiatives likely will be confined to regulatory changes and other executive actions.

For example (again) on the subject of executive orders, even beyond potential legal challenges, campaign rhetoric around the size of potential tariffs may not match an eventual policy decision, considering the political opposition that may build in some industries and the varying dependence on foreign inputs (raw materials sourced overseas). Moreover, reshoring of particular industries and supply-chain changes are already well along and may dilute the negative economic consequences of tariffs.

As for broad financial markets, the economy's slow growth, sticky inflation, and still-unsettled track of interest-rate declines support our preference for U.S. over international equities, more financially resilient large-cap over small- and mid-cap stocks, and higher-quality taxable and municipal bonds.

Signs of household financial stress weighing on future economic growth include a sub-4% personal savings rate[9]— more than 2 percentage points below its pre-pandemic norm — and a credit-card delinquency rate near a post-pandemic high in last year's fourth quarter.[10]

An unusually early and rapid break in consumer price inflation, from a peak of more than 9% to little more than 3% by late last year, accounts for much of the strength and resilience of the economy over the past 12 to 18 months.

9. As of January 2024, according to the Commerce Department
10. According to the Federal Reserve

Risk considerations

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. The prices of small and mid-cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Investing in foreign securities presents certain risks not associated with domestic investments, such as 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.

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. **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. 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.

Investments in fixed-income securities are subject to interest rate and credit 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. Credit risk is the risk that an issuer will default on payments of interest and principal. High yield fixed income securities are considered speculative, involve greater risk of default, and tend to be more volatile than investment grade fixed income securities. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Municipal bonds offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income.

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