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Policy, Politics & Portfolios

CAN POLICY HELP COUNTER LOW GROWTH, HIGH INFLATION?

May 31, 2022

Ian Mikkelsen, CFA
Wells Fargo Advisors
Equity Sector Analyst, Energy

Gary Schlossberg
Global Strategist

Michael Taylor, CFA
Investment Strategy Analyst

Michelle Wan, CFA
Investment Strategy Analyst

Scott Wren
Senior Global Market Strategist

Windfall economics at the state and local level

Michelle Wan, CFA
Investment Strategy Analyst

Gary Schlossberg
Global Strategist

Bountiful budgets

Federal largesse and a powerful post-pandemic recovery have left state and local governments flush with cash. The group's surpluses more than tripled between 2020 and 2021, to $272 billion, according to Commerce Department data.[1] That was equivalent to 8.2% of total spending in 2021, the largest such share in at least the past 75 years. The good news continued into 2022, lifting rolling 12-month growth in April to nearly 29% (against an 8.3% inflation rate) from the same period a year ago.

The collective state and local surplus exceeded 8% of budget spending last year, the largest in over 75 years.

Varied strategies are being used by the majority of states to reduce or eliminate windfall surpluses. The Tax Foundation has identified 40 states with actual and proposed tax changes largely in response to the windfall surpluses,[2] including 14 states considering permanent tax cuts.[3] Measures passed and proposed include cuts in personal income and corporate tax rates, a shift to a flat-tax system, temporary or permanent reductions in sales tax rates, proposed tax rebates, debt paydowns, and increased pension contributions. The table below summarizes measures in eight of the largest states, accounting for half the country's economic output.

Over 40 states are considering tax changes, including 14 considering permanent tax cuts.

Sources: Tax Foundation and Center on Budget and Policy Priorities

Recapping state tax proposals to reduce historically high budget surpluses

State	GDP contribution	Credit rating	Proposed and discussed deployment of excess tax revenue
California	14.6%	AA-	A proposed $18.1 billion inflation relief package of direct income payments
Texas	8.8%	AAA	Approved two property tax relief ballot measures
New York	8.0%	AA+	Suspension of the state gas tax from June through December, tax relief for COVID-19-related investments, small business and property-tax relief
Florida	5.4%	AAA	Proposed $1.2 billion tax relief focused on sales-tax holidays and gasoline-tax relief in October 2022
Illinois	4.1%	BBB+	One-year suspension of the 1% grocery sales tax
Pennsylvania	3.6%	A+	House approved a bill to cut the corporate income tax rate from 10% to 8% by 2025
Georgia	3.0%	AAA	Cut the 29 cents per gallon gas tax from March to May and sends tax refunds; transitioning to a flat tax that eventually will reach 4.99%
Michigan	2.5%	AA	Proposed an increase in the Earned Income Tax Credit

Sources: U.S. Bureau of Economic Analysis, Strategas, and Moody's data as of the most recently available. Credit rating = general obligation bond rating. GDP contribution is as of the fourth quarter of 2021.

Fiscal changes in California, New York, and Texas, accounting for nearly a third of the U.S. economy, will have the greatest impact on business activity.

More than just a local impact

Where tax and spending changes are adopted is as important as the kind of measures themselves. Depending on the fiscal relief chosen, decisions by California, New York, and Texas — collectively making up nearly one-third of U.S. gross domestic product (GDP) — could rival the economic impact of policy changes in the next 12 states ranked by economic size. How states deal

1. Bureau of Economic Analysis, U.S Commerce Department, March 29, 2022
2. "State Legislatures Take Up Tax Reform and Relief in 2022," Tax Foundation, March 29, 2022
3. "States With Temporary Budget Surpluses Should Invest in People, Not Enact Permanent Tax Cuts," Center on Budget and Policy Priorities, March 11, 2022

with budget windfalls also can have ramifications for the national economy. State and local inflation-adjusted spending, at about 11% of U.S. real GDP, historically has been a stabilizing economic force. Outlays have been less than half as volatile as overall GDP in the past 20 years, and the sector's late-cycle strength cushions activity from slowing growth in other, more economically sensitive sectors.

State fiscal measures tied to budget windfalls may seem small at just $100 billion or less than 0.5% of U.S. GDP this year, according to one estimate.[4] That's just a fraction of the expected drag on the economy from a narrowing federal deficit. For some states, however, the measures are providing an important "echo effect" of federal stimulus programs in 2020 – 2021, coming at a critical time for households squeezed by soaring inflation.

"How" as important as "how much"

Just how state and local windfalls are disbursed can be as important as their size. One-time tax rebates, temporary tax cuts, pension contributions, and debt paydowns give states greater flexibility to tailor budgets to changing economic conditions, lessening the impact on credit quality. At issue is if the economic impact of rebates and temporary tax cuts is limited, in the view of critics, by a tendency to save more of a temporary tax windfall.[5] Cuts in gasoline taxes have been criticized for encouraging consumption at a time of limited supply responsible for the price increases encouraging the tax cuts in the first place. (Other, more complicated plans propose to skew gasoline-tax relief toward lower-income families, whose purchases are less discretionary.)

What it means for investors

Potential economic support from state and local fiscal relief extends beyond the $100 billion in estimated targeted changes for this year. By our estimate, nearly $335 billion would be freed up by bringing last year's surplus back in line with its long-term average relative to spending, equivalent to a not inconsiderable 1.4% of GDP. Among the biggest beneficiaries would be retailing, construction, and engineering firms potentially benefiting from increased state spending on federal and local infrastructure upgrades.

The stakes are potentially greater for credit quality and for the pattern of issuance in the market for municipal securities. For example, issuer credit ratings could be affected by heavy reliance on permanent tax cuts or spending increases, leaving state finances exposed to the risk of deteriorating economic conditions. That includes lower capital gains revenues and widening funding gaps at state and local pension funds because of recent stock and bond market declines. Instances of market-wide changes in credit quality are rare but possible in the event of a major economic shock. For example, a doubling in the share of BBB-rated credits in the municipal bond market accompanied the deep economic recession in 2008 – 2009.

Key takeaways

- An economic "echo effect" from federal stimulus in 2020 – 2021 is on the way from state tax and spending measures to trim or eliminate resulting windfalls, although only partially cushioning a looming economic growth slowdown later this year.
- How and where these state and local fiscal measures are enacted could have a measurable effect on state and local finances and on U.S. economic growth.
- Retailing, construction, and materials industries are among the most exposed in the stock market to disbursement of windfall revenues by state and local governments. For bond investors, the size and means of distributing fiscal surpluses can have a measurable impact on credit quality in the market for municipal bonds.

4. Strategas, Policy Outlook, May 17, 2022

5. "Temporary Vs. Permanent Tax Cuts and Marginal Propensity to Consume," Chron., accessed on May 18, 2022

Will summertime policy shifts satisfy consumers?

Michael Taylor, CFA
Investment Strategy Analyst

Ian Mikkelsen, CFA
Wells Fargo Advisors
Equity Sector Analyst,
Energy

Discouraged consumers

Western sanctions against Russia are aggravating energy supply shortages that have already driven prices higher. Rising oil, diesel, and gasoline prices in the U.S. are contributing to elevated inflation. High energy prices affect households directly through higher prices at the pump and indirectly through higher prices for food and consumer goods, leaving consumers with less purchasing power.

In April, the Biden administration announced a temporary suspension of a federal mandate that limits the level of ethanol in gasoline. The White House has also announced plans to release 1 million barrels of oil per day from its Strategic Petroleum Reserve (SPR) over the next six months. These moves aim to increase supply and reduce fuel prices ahead of the summer travel season, although their effectiveness may be limited. More broadly, it remains unclear how much of an impact these provisional policy shifts will have on containing inflation and spurring economic growth.

Gasoline as a share of disposable income for U.S. consumers was 2.3% in January but could exceed 3.0% as we approach summer.

Source: Wells Fargo Securities, March 24, 2022

Suspending the E15 mandate

The E15 mandate came about because of concerns that E15 elevates smog levels in warmer temperatures. Most gasoline sold in the U.S. contains 10% ethanol (E10). E15 typically sells for a dime cheaper than E10.

We believe the impact of the mandate suspension on gasoline prices and consumer wallets will be minimal, as 98% of retail gas stations cannot sell E15 — only 2,300 stations nationwide sell it, with most situated in Midwestern and Southern states. The absolute benefit to consumers is also limited by the reduced fuel efficiency of E15. Moreover, increased ethanol demand could drive up corn and other crop prices, which, in turn, could further inflate food prices.

The average household will spend $2,945 on gasoline in 2022, which in real terms is $455 (18%) more than in 2021.

Source: U.S. Energy Information Administration, April 12, 2022

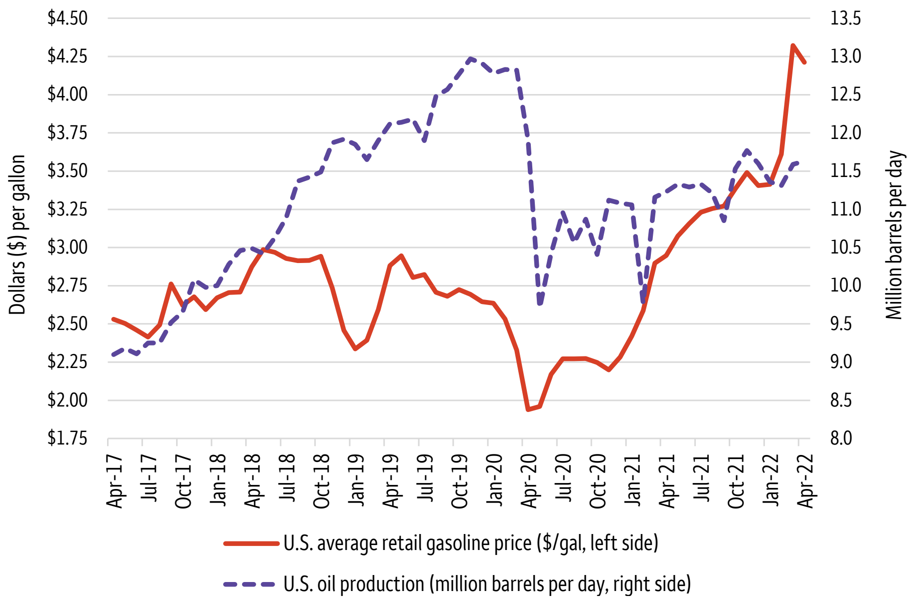
Increasing domestic supply

The administration will release 180 million barrels of oil from the SPR over six months to increase domestic oil supply; the proceeds from these sales will be used to restock the SPR in the future. This is intended to have a dual effect of lowering near-term domestic oil prices while providing a signal of future demand to encourage domestic production. Yet, in our view, domestic producers face several constraints to growing production — shareholder preferences, labor and materials shortages, and economic uncertainty dissuade production growth despite the high commodity price environment.

Increasing the oil supply does not necessarily lower fuel prices (see Chart 1), especially in the near term, as the market for refined products is separate from the global oil market. Russia is a major supplier of refined products, particularly diesel, to Europe. With restrictions on Russian energy, exports of

U.S. refined products to Europe have increased. This has led to counter-seasonal reductions in U.S. refined-product inventories, driving prices higher for diesel and gasoline. The U.S. refining complex is not configured to run entirely on domestic crude oil; refiners must import certain grades of crude oil that are blended in the refining process to produce a full range of refined products. In our view, this may limit the impact of greater domestic oil supply on refined-product prices.

Chart 1. U.S. oil supply and gasoline prices



Sources: Energy Information Administration and Wells Fargo Advisors, May 12, 2022

Economic and investment implications

The impact of suspending the E15 mandate and increasing domestic oil supply on gasoline prices will likely be nominal. Although gasoline is a modest portion of household budgets, it is a high-frequency purchase that often has an outsized psychological impact on consumer spending. Diesel fuel, however, is a key input cost for consumer goods; higher fuel prices could keep prices inflated, including food prices. This confluence of factors may cause consumers to draw down savings or trim spending. The combination of persistent inflation and aggressive interest rate increases weighs on household spending and economic growth, to the point that our base case is that a mild recession will develop beginning late in 2022 and extending into early 2023.

We expect near-term demand for crude oil to remain strong, supporting continued strength in energy commodity prices, albeit with relatively high levels of volatility. The Energy sector is likely to benefit from sustained higher energy prices, the continued rise in earnings growth estimates through 2022, and positive operational changes. We recently upgraded our guidance on Energy to favorable. Within the Energy sector, we are unfavorable on refiners over other Energy sub-industries. Despite favorable near-term conditions, we believe that the current geopolitical and macroeconomic backdrop has increased uncertainty for refiners over the longer term.

Key takeaways

- The White House has proposed waiving the current mandate that generally prohibits the sale of 15% ethanol blend (E15) gasoline in the U.S. between June 1 and September 15.
- The Biden administration also has ordered a daily release of 1 million barrels of oil for a six-month period, to increase crude oil supply.
- We believe temporarily suspending the E15 mandate and increasing domestic oil supply will have minimal impact on summertime fuel prices and consumer wallets.

Small business's bumpy road

Scott Wren
Senior Global Market Strategist

The near- to intermediate-term outlook for small business is cloudy

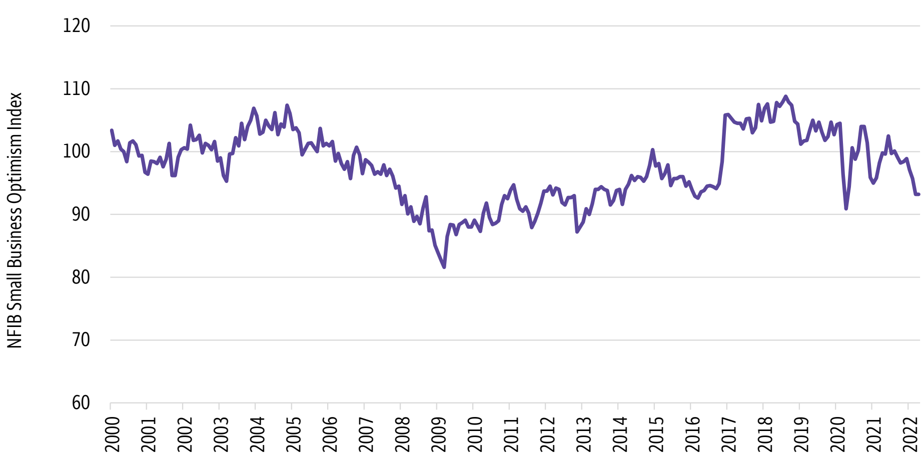
As is often stated, small business in America is a large job creator on a year-to-year basis historically. Prior to the pandemic, small business creation was strong and helped usher in an environment where the domestic unemployment rate in January and February 2020 fell to 3.5%, a 50-year low. Small business creation, as measured by the number of business applications compiled by the U.S. Census Bureau, was steady or modestly increased in the few years prior to the pandemic.

The survey revealed that the highest percentage of small business owners were most concerned about the effects of inflation on their operations since the fourth quarter of 1980.

But after an initial dip in the early months of the pandemic in 2020, applications surged as many unemployed workers attempted to become business entrepreneurs in an effort to buffer a loss of or meaningful reduction in income. This was in response to government attempts to stem the spread of COVID-19. Many small businesses, especially those in service-oriented industries, found their operations shuttered and their customers hunkered down at home trying to stay healthy. Over the past year, business applications have waned as the economy opened up and more jobs became available.

Supply chain disruptions were noted by 70% of respondents as having a significant or moderate impact on their operations.

Chart 2. NFIB Small Business Optimism Index



Sources: Bloomberg and Wells Fargo Investment Institute, as of May 12, 2022

Over the past year or more, as the intensity of the pandemic has meaningfully eased, many small businesses have seen a large percentage of their customers return, but all has not been smooth sailing. In fact, the NFIB's (National Federation of Independent Business's) monthly Small Business Optimism Index notched its fourth consecutive reading (93.2) below the 48-year average (98) and the lowest since the depths of the pandemic-induced recession in April 2020. So why are small business owners participating in the NFIB survey so gloomy?

The latest survey also revealed other angles on the small-business pessimism:

Inflation and related supply disruptions: The survey revealed that the highest percentage of small business owners were most concerned about the effects of inflation on their operations since the fourth quarter of 1980. Supply chain disruptions were noted by 70% of respondents as having a significant or moderate impact on their operations.

Difficulty in hiring qualified workers: In addition, small businesses are having a tough time finding workers. Both skilled and unskilled workers remain in short supply.

Limited opportunities to improve productivity: Capital spending by small businesses looking ahead will likely be focused on replacing equipment only when necessary and investing to improve automation and productivity given the tight labor supply and high costs of worker retention.

Another angle on the small business story is related to government policy, especially taxation and regulation. The NFIB has issued comments in recent months on the potential negative effects of some administration proposals in its 2023 budget surrounding the treatment of small businesses.[6] In particular, NFIB members are concerned about a potential increase in the corporate tax rate to the 28% level without lower rates for smaller businesses, increases in capital gains tax rates, eliminating stepped-up basis, and taxing unrealized gains above $100 million.

The Biden administration, on the other hand, has been highlighting efforts it is making to help small businesses and increase small business creation. The administration has put forth a four-pillar strategy to support small businesses.[7] Those pillars are: 1. Expanding access to capital by offering more than $300 billion in loans and equity investments through the end of the decade; 2. Making historic investments in programs that help entrepreneurs find the resources they need; 3. Leveraging federal procurement, infrastructure spending, and research and development to direct hundreds of billions in government contracts to small businesses; and 4. Leveling the playing field for small business owners by reforming the tax code.

Essentially, the Biden administration is pointing to micro policies to lower barriers to small business entry and to improve access to credit. These are always top of mind in small business surveys. However, policy evaluation and political support for an administration typically are skewed more toward the macro issues, like tax changes, inflation, and the policy impact on borrowing costs. It is no surprise to us, then, that the tone of the NFIB assessment of the administration's policies is largely negative.

In closing, recent U.S. small business optimism readings are well below average, largely based on the negative effects of inflation, supply chain disruptions, and a shortage of skilled and unskilled labor. The White House is making efforts to help small businesses, but business owners are also concerned about the ramifications of potentially higher corporate taxes and regulatory changes, now or in the future.

Key takeaways

- The NFIB's monthly Small Business Optimism Index notched its lowest reading since the depths of the pandemic-induced recession in April.
- Our current economic outlook is consistent with this theme and our portfolio recommendations suggest a more defensive stance is warranted by investors.

6. NFIB Press Release, April 6, 2022
7. As published in the April 2022 White House report "The Small Business Boom Under the Biden-Harris Administration."

Risk considerations

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

Different investments offer different levels of potential return and market risk. 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. **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.

Concentration in the energy sector and in industries may present more risks than if a portfolio were broadly diversified over numerous sectors of the economy. A downturn in the energy sector of the economy, adverse political, legislative or regulatory developments or other events could have a larger impact on a portfolio that concentrates in the sector.

Definitions

NFIB Small Business Optimism Index is the small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of ten seasonally adjusted components based on questions on the following: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job opening, expected credit conditions, now a good time to expand, and earnings trend.

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