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Election Q&A: What if the Democrats Sweep in November?

Key takeaways

- Our base case now is that the Democrats will capture the White House and control both chambers of Congress in 2021.
- We believe some market-negative implications may be likely, but we also see potential counterbalancing implications. Most importantly, we believe that the most controversial campaign promises will not make it through Congress, due to economic and other constraints.

What it may mean for investors

- We favor planning for market turbulence into year-end and expect a probable recovery through 2021. Our preferred strategy includes a disciplined plan to de-emphasize U.S. small-cap equities, in preference for U.S. mid- and large-caps, as well as sectors that offer growth potential and strong balance sheets.

Why has our base case changed to a sweep by the Democrats?

In June, we projected a close race for the White House, but we now believe that former Vice President Biden has the better chance to be elected president in November. As part of this scenario, we also foresee that the Democrats may take a modest majority in the Senate and keep control of the House.

The odds could flip again to favor President Trump. Trump is an aggressive campaigner, and Biden is only partially tested as a presumptive nominee. It is not unusual to see polls tighten in the 100 days before an election.[1] Finally, voter turnout amid the pandemic remains an unpredictable factor that may change the odds.

Nevertheless, it is our view the incumbent has an increasingly uphill fight. President Trump no longer enjoys stronger poll numbers than former Vice President Biden on managing the economy. Meanwhile, as COVID-19 infections increased nationally in July, Trump has trailed Biden by double digits in polls.[2] We do not expect a reversal of these trends.

[1] "Big Polling Leads Tend to Erode. Is Biden's Edge Different?, Nate Cohn, New York Times, July 20, 2020.
[2] Cook Political Report, Charlie Cook, "Mining the Polls for Some Kernels of Hope for Trump", July 24, 2020.

What about Trump voters who have not declared themselves?

A majority of Pennsylvanians surveyed in a recent Monmouth University poll suggested that many Trump backers decline to reveal their support.[3] There are several caveats to this poll result. The first is that many such voters do not participate at all. Over 137 million voters went to the polls in 2016, but about 39% of eligible Americans did not vote. Many of these are working-class white voters, who have been Trump's most reliable supporters. It is not clear that they will participate in 2020.

The second caveat is that many of these voters may break for Biden, including younger voters who have not always participated in past elections. An important difference between 2016 and 2020 is that Biden is less unpopular than Hillary Clinton was (Table 1). Meanwhile, Biden's lead over Trump is not only wide but broadly so across polls. Even polls of likely voters, which tend to show a somewhat closer race, do not change the consistency of the story. In every swing state we have been watching, unemployment is rising, and Biden leads Trump.[4]

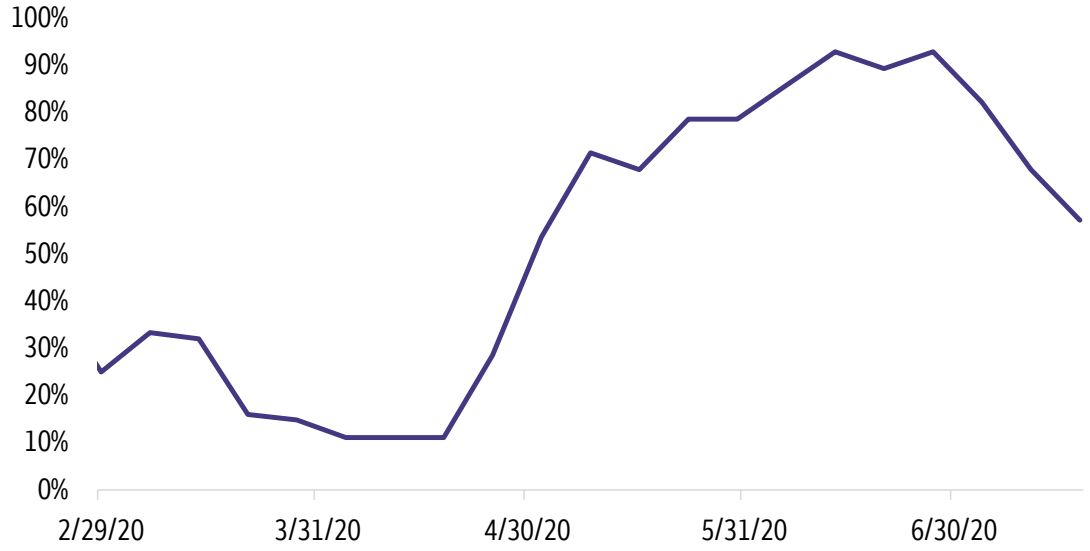
Table 1. Biden has better favorability ratings than Clinton at mid-summer 2016 versus 2020

	Favorable	Unfavorable
Biden (2020)	44.5%	46.0%
Clinton (2016)	38.3%	55.3%

Sources: RealClearPolitics, Wells Fargo Investment Institute, July 27, 2020. Biden favorability ratings are based on the averages of 11 polls between May 7, 2020 and June 16, 2020. Clinton favorability ratings are based on the averages of 7 polls between July 9, 2016 and July 24, 2016.

Third, the top issues remain the economy and the pandemic, and both are trending away from Trump. High-frequency data show further loss of economic momentum. The chart shows that economic activity through July 24 is still expanding, but the number of indicators showing expansion is narrowing, coinciding with new infections disrupting the economy's reopening.

Chart 1. High-frequency indicators show moderating U.S. economic activity



Sources: Bloomberg Financial News, Inc.; Federal Reserve Bank (FRB) of SF; FRB of NY; FRB of Philadelphia; Opportunity Insights; US TSA; Opentable.com; Mortgage Bankers Assn.; Apple, Inc.; Google; Assn. of American Railroads; Edison Electric Institute; American Iron & Steel Institute; Federal Reserve Board; U.S. Labor Department; U.S. Energy Department; Moovit App Global Ltd; U.S. Census Bureau. The line shows the percentage of 27 daily and weekly measures of economic activity that are improving, based on weekly changes in a four-week moving average.

[3] Trump Hunts for Hidden Voters-but Biden Does, Too, WSJ, July 24, 2020, Gerald Seib.
[4] RealClearPolitics, July 24-26, 2020 polls.

Finally, Trump also faces the incumbent's disadvantage that dissatisfied voters tend to blame the country's problems on those in office. In a WSJ/NBC news poll in early July, 72% of respondents said that the country is heading in the wrong direction, up from 56% in March 2020.[5] In sum, we expect that some people have not declared their voting intentions, but in our view, those plans will not make the difference for the incumbent.

Will a sweep by the Democrats change our investment approach?

It is difficult to predict the legislative priorities of the next Congress, but tax reform is likely near the top of the list. We anticipate the corporate tax rate is likely to rise from 21% to 28%, and the top individual rate to 39.6%. State and local tax (SALT) deduction caps are likely to be rescinded, but the income cap on Social Security liability could be raised. We believe the corporate tax increase could reduce 2021 S&P 500 Index earnings per share by up to 7% on our forecast for earnings per share, but the exact amount will depend on other provisions in any legislation. We expect the regulatory environment should return to what it was under the Obama administration.

Nevertheless, it will be important for investors to gauge the constraints on single-party government. First, if Congress only hikes taxes next year, the economic recovery will be at risk. We expect spending programs to potentially stimulate the economy and help to counterbalance tax hikes. Campaign promises until now indicate a wide variety of spending programs—health care, infrastructure, and income support programs just for starters.[6] We believe the Democrats will have a net stimulate policy.

Another constraint on the Democrats will be that single-party government does not eliminate ideological differences that should complicate the passage of controversial issues. It seems the Democrats have a deep split between moderates and progressives. And we still expect a large Republican minority. We cannot know at this time how power will distribute among the three groups, but we expect that old adage to hold—namely, across groups with very different ideologies, the moderates typically hold the deciding votes. An ideological split within the Republican party in 2017 blocked most of the legislative agenda for six months, and market expectations priced in during that time were disappointed. So, we believe the most controversial issues are unlikely to become law, including the Green New Deal and Medicare for All.

What investment opportunities do we expect?

We prefer not jumping to negative conclusions about market performance under a potential Biden administration. Re-regulation and higher taxes are negatives for financial markets, but we look for other policy changes potential positive for the economy and the markets during the coming one to two years. Even beyond spending programs, we believe a Biden administration is likely to eschew tariffs as a trade policy tool—another potential positive for the economy. On balance, taxes may reduce S&P 500 earnings, but the other initiatives mentioned here may substantially blunt the earnings reduction from higher tax rates.

We view as equally importantly, new government spending initiatives should potentially create targeted investment opportunities. Investors may have to change their approach to assessing opportunities, asking more often, "What is the government trying to do?" For example we expect, infrastructure spending is likely to favor the Materials and non-defense Industrial sectors; government involvement in the health care industry is likely to favor the Health Care sector; and even income support strategies are likely to generate additional earnings in the Consumer Staples sector.

[5] NBC/Wall Street Journal Survey of 900 registered voters between July 9-12, 2020.
[6] Source: Joebiden.com, July 27, 2020.

What do we favor doing in portfolios now?

1. **Stay focused on the economic recovery.**

   Chart 1 illustrates that the economy is still growing. We have strong conviction that even a gradual recovery will support higher equity prices into the end of 2021, although there may be some range-trading into year-end 2020.

2. **Remember that the U.S. system of government has many checks and balances.**

   It's a fact that many Republican voters worried about their investments when President Obama was elected. Many Democrats similarly worried when President Trump was elected. Our system has historically worked against extreme changes, and we believe that the system will work again this time. We do see potential changes after this election, but it's too early to alter investor portfolios.

   Remember what happened after the 2016 elections: markets rushed into sectors favored by Trump's campaign promises. Those expectations were dashed and those favored areas of the market sold off in mid-2017, because the expectations in November 2016 did not reckon with what would/could actually get done in Congress. That kind of clarity may not occur until after the election. We favor focusing on the economy and using our June elections report ("Weighing the Impacts of a Potential Watershed Election") as a guide to potential changes in the balance of congressional power. We also believe it will be useful to await a legislative agenda likely becoming clearer in January. Even if one party dominates Congress and takes the White House, there is a large risk to predicting whether that party can accomplish next year what it promises today.

3. **Our current recommendations for the next 12 to 18 months follow the trends that we think will continue irrespective of who sits in the White House.**

   While concerns about the pandemic remain with us, we expect continued strong consumer demand for those services that allow people to shop/consume from home. This trend should continue to favor U.S. mid- and especially large-cap equities. We have favored Information Technology, Communication Services, and Consumer Discretionary since the pandemic broke upon us. We recently added Health Care as well. These are sectors with generally good balance sheets, good cash flow, and (because of potential strong demand still to come) good earnings prospects. We favor raising cash for these sectors by reducing holdings of the Energy and Real Estate sectors. We also favor reducing international equity (and fixed income) positions overseas and prefer U.S. markets. With volatility expected, we don't foresee a need to push cash into the market all at once. Set up a plan with an investment professional to put money to work in a disciplined way on pullbacks.

Risks Considerations

Forecasts, targets and estimates are based on certain assumptions and on our current 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. **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.

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. **Consumer Staples** industries can be significantly affected by competitive pricing particularly with respect to the growth of low-cost emerging market production, government regulation, the performance of the overall economy, interest rates, and consumer confidence. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. 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. **Real estate** investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. 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.

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