

Global Investment Strategy

## Global Macro Strategy Report: Special Election Report

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### *Analysis and outlook for the global economy*

- » *Donald Trump's surprising presidential election win triggered selling in most global equity, currency, and commodity markets, but emerging economies seem most vulnerable.*
- » *The Republicans maintained control of both the House and Senate, but we do not believe that a Republican-run Congress necessarily helps President-elect Trump to implement all of his campaign promises.*

### *What it may mean for investors*

- » *We expect the new administration to push for lower taxes and higher spending, especially on infrastructure investment and defense. However, achieving many of the new administration's priorities could be politically difficult.*
- » *We advise investors to use this report to prepare for potential opportunities but to await legislative compromises before actually adjusting portfolio positions. We encourage investors to stay the course, continue their strategic investment plans and wait to see how policy evolves.*

## America Has Decided

The U.S. dollar and major U.S. stock index futures sold off sharply with global markets in response to Donald Trump's November 8 election victory. The immediate winners included those markets that historically outperform in times of sudden risk aversion, including gold, global bonds and low-yielding currencies (the Swiss franc, Japanese yen and the euro).<sup>1</sup>

The sharp selling occurred as traders reversed their bets on a Clinton victory and repositioned for President-elect Trump's campaign promises. His thinly described foreign-policy ideas and threats of new U.S. trade protectionism create geopolitical uncertainty and threaten to undercut global trade. Emerging markets and Japan depend heavily on trade and were among the worst performers on election night. In particular, the Mexican peso (a proxy for emerging markets) lost 10 percent against the U.S. dollar in just three hours, on its way to a record low.

The selling may increase further as some investors—notably the undiversified—are forced to sell into falling markets. Risk aversion and lower values in equity, commodity, and most currency markets are likely to be the focus in the days and weeks immediately following the election. Fixed income, gold and low-yielding currencies may benefit. If President-elect Trump aggravates global concerns about his policies, the selling could persist.

However, we believe that these market patterns will be short-lived for two reasons. The positive economic fundamentals are unlikely to change in the coming two or three quarters. And, in a healthy

<sup>1</sup> Low-yielding currencies tend to benefit during risk aversion as portfolio managers in those currencies bring assets home when they sense global risk. In repurchasing their local-currency assets, they boost demand for those currencies.

economy, sharp and sentiment-driven sell-offs historically are temporary and should present opportunities to buy value in beaten-down markets. We believe that the U.S. economy is still the healthiest and that the most vulnerable economies will remain those that depend the most on global trade, notably Japan and emerging economies.

### **Potential Policies and Investment Implications**

Markets may reflect nervousness with one party leading from the White House and Capitol Hill, but stark philosophical disagreements between these new leaders should block or delay some key administration goals, as we describe next and summarize in Table 1. In the more controversial policy areas, it is worth remembering that presidents since George H.W. Bush have been unable to enact most of their campaign promises.<sup>2</sup>

Tax Reform and Budget Policy: Corporate tax reform probably will be the top Republican priority. We expect lower tax rates and the end of double taxation on overseas earnings. To preserve revenue, Congress may target eliminating corporate deductions, which is politically divisive. Also, Congress will be pressed to include small-business tax breaks, which likely means dealing with the politically complex individual tax rules.

In addition, disputes over federal spending and the deficit also seem inevitable. President-elect Trump has proposed at least \$500 billion in infrastructure spending over five years and to increase the defense budget by 15 percent. Yet, congressional leaders have been battling for years to restrain deficits.

Trade: We believe that the White House will seek to tax imports and to renegotiate proposed and existing trade deals. The administration has a variety of executive powers to impose tariffs on other countries' goods, but extensive tariffs could quickly generate opposition from the many U.S. firms whose supply chains stretch overseas. Moreover, renegotiating trade deals may require collaboration from Congress, whose leaders have opposed trade restrictions.

Immigration: Some consensus exists for reforming and better enforcing immigration law, but the president-elect's promised wall along the Mexican border and threat to deport many immigrants remain controversial. Republicans in Congress likely will support improved border security and law enforcement but reject the more contentious issues of a wall and large-scale deportation.

Economic Policy: The administration and the Congress may reach consensus to support fossil fuels and approve the energy pipeline projects that have stalled on environmental concerns. With regard to regulations, candidate Trump proposed a temporary moratorium on new financial and environmental regulations.

Health Care: Republicans in Congress and President-elect Trump both agree with repealing and replacing the Affordable Care Act. A replacement could feature market-oriented solutions, such as health savings accounts and increased interstate coverage. The use of block grants to states for Medicaid spending could grant states flexibility (but may not cover all constituents).

The Overall Economic Impact: Policy changes are not likely to reach the economy for several quarters or longer. More aggressive fiscal policy and trade restrictions have the greatest negative potential to raise borrowing costs, inflation, and undercut the dollar's value, but delay and dilution from Congress should help to mitigate these effects. The policies above that have the greatest positive economic potential are tax reform and deregulation.

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<sup>2</sup> Wells Fargo Investment Institute, *Guide to the Elections*, September 2016, page 2.

**Table 1: Key Policy Areas and Their Possible Equity-Sector Implications**

Policy Area	Likely Market Implications
Government Spending and Taxes	<ul style="list-style-type: none"> <li>• Tax cuts and additional spending should stimulate the economy in the coming year or two, but new debt is a long-term weight on the economy</li> <li>• Infrastructure spending should support the Industrials and Materials sectors</li> <li>• Repatriation of overseas corporate profits should benefit Information Technology, Financials, and multinational Consumer Staples and Pharmaceutical companies</li> </ul>
Trade	<ul style="list-style-type: none"> <li>• Trade tariffs are likely to trigger retaliation and may reduce global trade and weaken the U.S. dollar</li> <li>• Multinational corporations in the Industrials, Agriculture, Financials and Consumer Staples areas could be harmed the most</li> </ul>
Economic Policy and Regulation	<ul style="list-style-type: none"> <li>• Approval of stalled pipeline and drilling projects would benefit the Energy sector</li> <li>• A Republican victory should derail the threat of an increased federal minimum wage, affecting the Retail and Restaurant industries</li> <li>• Decreased regulation should be positive for economic growth, especially for Financials and Energy</li> </ul>
Immigration	<ul style="list-style-type: none"> <li>• Immigration restrictions should negatively impact the Hospitality and Leisure industries</li> <li>• Information Technology may underperform, if reforms limit visas for immigrant engineers</li> </ul>
Healthcare	<ul style="list-style-type: none"> <li>• Republicans can more easily repeal the Affordable Care Act’s subsidies and tax credits—negative for Hospitals and Insurance Companies</li> <li>• The pressure to control prices should be reduced, benefitting Pharmaceuticals and Biotech</li> </ul>

Source: Wells Fargo Investment Institute, 11/9/16.

**Market Implications: Four Key Takeaways**

- We strongly recommend keeping perspective on campaign promises and being patient when considering portfolio changes. Many factors may yet determine future policies.
- Financial markets may see increased volatility as investors digest the election results in the coming weeks, but we do not foresee any immediate or direct impact on the U.S. economy’s growth path.
- The coming weeks may offer opportunities to take exposures in markets that show value but have sold off on sentiment.
- Until policy and priorities evolve further, we believe that investors should follow their long-term investment plans and our outlook for a steady economy.

### ***Risk Factors***

All investing involves risks including the possible loss of principal. 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.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

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