WELLS FARGO
Investment Institute

Policy, Politics & Portfolios

What federal budget, regulatory, and trade decisions could mean for investors **July 25, 2023**

1. CHIPS stands for Creating Helpful Incentives to Produce Semiconductors, which became law in 2022.

Debt-ceiling reverberations worth watching

Gary Schlossberg
Global Strategist

Chapter 2

Heightened partisanship early in the fiscal 2024 budget negotiations increases the risk of stalemate and a government shutdown at the October 1 start of fiscal 2024. Hopes for greater bipartisanship after last month's joint debt accord were dealt a blow by a conservative GOP proposal for spending cuts as deep as those suggested early in the debt debate last March. The debt-ceiling accord requires all 12 appropriations bills to be signed into law by the end of calendar-year 2023 to avoid a 1% across-the-board cut in defense and non-defense discretionary spending at the start of 2025.

At risk in the tech industry from across-the-board cuts in discretionary programs would be $170 billion authorized for CHIPS Act research and development (R&D) requiring approval each fiscal year, beyond subsidies of $52 billion already appropriated to ramp up semiconductor output. Spending provisions in the Inflation Reduction Act are vulnerable too, particularly clean-energy production and investment tax credits and other provisions related to climate change.

Other House GOP proposals extend beyond the CHIPS Act and Inflation Reduction Act to non-discretionary entitlements spending. Medicare is left untouched by the House proposal, but competition would be increased by subsidizing such private insurance options. The GOP plan also would reduce Social Security costs by lifting the retirement age for full benefits to 69 years from the 67-year cap under current law.

For now, prospects for compromise tax legislation are a bit better than they are for appropriations bills, despite the Republican proposal to repeal clean-energy tax credits. First, there has been strong bipartisan support for some provisions, like renewed R&D tax credits and a higher income threshold for reporting online sales and gig work, and for a higher standard deduction on personal taxes. Second, a Democratic push for increased child-care tax credits could be used as a Republican bargaining chip for expired or expiring business tax incentives under the 2017 GOP tax law, like an increased expensing limit, to $2.5 million from $1.0 million, for depreciable business assets.

Our perspective

A broader array of policy-sensitive and other industries could be affected by a 2024 budget accord than defense, food, and other retailing most visibly affected by the debt-ceiling agreement.

Potential sector and industry effects are as follows:

1. An expanded child-care tax credit and an increased standard deduction on personal taxes should reverse some of the damaging effects of the debt-ceiling agreement on the Consumer Staples and Consumer Discretionary sectors in retailing.

2. The Republican proposal to restore the R&D tax credit and 100% expensing of capital investment should benefit more capital-intensive manufacturing, like Industrials, and producers of high-tech and other capital equipment.

3. Fossil fuel production and utilities (including hydroelectric power), survivors in the debt negotiations, should benefit from Republican incentives to boost output by further streamlining the permitting process for major infrastructure projects.

4. Managed care, pharmaceuticals, and hospitals likely would be hurt by the GOP proposals, to the extent proposed changes trigger reduced Medicare reimbursements. However, parts of the sector should benefit, to the extent that the industry becomes dependent on private-sector alternatives.

5. Another half-a-loaf agreement for defense, much like the debt-ceiling accord, would impose less stringent spending caps than those on discretionary non-defense appropriations. Although we are neutral on the Industrials sector, we favor the defense contractor sub-industry.

Proposals, to date, are aligned with our tactical preferences for the Health Care, Energy, and Materials sectors and a neutral view to hold the Information Technology and Industrials sectors at their market weights. However, we're still early in the fiscal 2024 budget debate and will be following developments affecting our current equity preferences.

A 10-year plan by GOP House conservatives would return the budget to surplus with spending cuts of $16.3 trillion, creating a long-term headwind to economic growth.

In our view, the tax and spending plan proposed by GOP conservatives could cut gross domestic product (GDP) growth by a peak 0.8% next year, or more if the economy is in or near a recession.

Student loan policy changes and implications for investors

Michael Taylor, CFA
Investment Strategy Analyst

Summer's over

Holders of student loans face two policy developments this summer: the expiration of the loan-repayment moratorium and the Supreme Court's rejection of the Department of Education's (DOE's) student loan forgiveness plan under the Higher Education Relief Opportunities for Students (HEROES) Act. Both measures could impact consumer spending, particularly in Millennial and Gen X households. Yet, a revised proposal with an extended "on-ramp" to repayment and expansion of income-driven repayment (IDR) eligibility could help borrowers adjust to monthly payments.

Two modifications

The student-loan forbearance will terminate next month with repayments to resume in September. The end of the moratorium that has paused loan payments since March 2020 was part of the debt-ceiling agreement passed in June. The DOE estimates the hiatus at roughly $5 billion/month.[2] In terms of economic impact, even if we assume that each dollar repaid is a dollar of lost consumption, at most, economic growth would likely be trimmed by only 0.2%,[3] with a maximum reduction in personal consumption expenditure growth of 0.5%.[4]

On June 30, the Supreme Court ruled 6-3 against a debt-forgiveness plan, decreeing that the administration does not have the authority to cancel outstanding student debt under the DOE proposal. The plan would have forgiven up to $10,000 in loans for individuals with incomes below $125,000 and couples making under $250,000. Forgiveness would have doubled to $20,000 for students who received Pell Grants.

President Biden's Plan B

Following the ruling, the Biden administration pledged to pursue a different legal strategy, the Higher Education Act. The new proposal includes a grace period for missed payments until October 2024, granting households time to prepare budgets to smooth the transition. Additionally, an expanded IDR could potentially offer borrowers similar benefits as the original forgiveness plan. Among the proposed changes, undergraduate borrowers would pay 5% (graduate borrowers 10%) of income above 225% of the federal poverty level (FPL) for 20 years versus 10% of income above 150% of FPL currently, lowering payments over an extended period.[5] Although the DOE has the authority to modify IDR programs, the revisions will take time to finalize and could face court challenges.

---

2. "Biden-Harris Administration Extends Student Loan Pause Through May 1, 2022," U.S. Department of Education, December 22, 2021
3. "Upcoming Supreme Court Decisions," Strategas, June 13, 2023
4. U.S. Census Bureau, National Retail Foundation, and WFII, July 3, 2023. Note: Upper-income borrowers (>$90,000) and those with post-graduate degrees represent much of the debt and monthly payments. Typically, these segments rarely make meaningful changes to spending habits. In our view, the spending and credit impact could be more noticeable in the 25 – 34 demographic due to lower relative income and a larger increase in borrowing during the moratorium.
5. "SCOTUS Strikes Down Student Debt Cancellation," Piper Sandler, June 30, 2023

Investment implications

With the Supreme Court's decision, the federal budget deficit is expected to be trimmed by $400 billion. Yet, with Congress focused on spending cuts, it is unlikely the surfeit will become discretionary stimulus.[6] The suspension of repayments has had a modestly stimulating economic effect, as households were able to redirect monthly payments. We expect the resumption of payments to be a slight, yet additional, headwind for an economy that continues to slow, especially in household spending by the lower three quintiles of income.

We are currently unfavorable on Consumer Discretionary and neutral on Consumer Staples. As the back-to-school and holiday shopping periods approach, the resumption of debt repayments may create some headwinds for the retail sector. We see soft goods (apparel) as the area likely to have the greatest risk of reduced spending. Inflation and the macro environment have caused consumers to defer discretionary purchases over the past 18 months — most often in apparel. Our sector guidance aligns with this downside risk to retail spending.

Roughly 43 million people (13% of the U.S. population) hold student debt, with an average balance of $35,000.

Source: "Student Loan Debt Statistics," Education Data Initiative, June 29, 2023

Wells Fargo Economics estimates a typical monthly student loan payment is between $210 and $314.

Source: "Summer Schooled: A Supreme Challenge & Payments Set to Resume," Wells Fargo Economics, June 26, 2023

6. "Three Student Loan Catalysts Ready to Hit and Loom Large Over U.S. Consumers," Strategas, June 23, 2023

Expectations for reduced liquidity

Douglas Beath
Global Investment Strategist

Michelle Wan, CFA
Investment Strategy Analyst

T-bill issuance post debt ceiling and how it could impact liquidity and markets

For equity markets to sustain a rally, we believe there has to be sufficient cash or liquidity available for investors. Two factors could affect liquidity materially in the short run and affect the trajectory of equity prices. First, the Federal Reserve (Fed) is in the midst of a program to normalize the size of its balance sheet, after a large expansion during the pandemic. Second, the end of the debt ceiling means that the Treasury is rebuilding its cash holdings. Both government initiatives have the potential to affect liquidity available to markets.

There are several factors driving the availability of cash for financial markets:

The Fed is more than a year into its program to allow securities to mature and roll off its balance sheet. As securities mature, the cash that the Fed used to purchase the securities is returned to the Fed, taking that cash out of the economy. The first week in July should see $39 billion mature, and these amounts should accumulate as 2023 progresses.

After hitting the debt ceiling in January forcing the U.S. Treasury to run down its spending account (called the Treasury General Account) between January and June, the Treasury needs to rebuild its cash balances. We expect the Treasury to issue $1 trillion in Treasury bills between June and September this year. If investors pay for their Treasury bills out of their bank accounts, bank reserves will rebuild the Treasury's cash reserve and become unavailable to the economy. But if the Treasury can persuade Treasury money market funds to purchase the bills, the payments could come from a source of funds that would not reduce bank reserves.[7] If money market funds pay for new Treasury bills by essentially transferring them from the Fed to the Treasury, there is no net new reduction in cash available to the economy. The Treasury and the Fed are trying to make Treasury bill purchases as attractive as possible to Treasury money market funds, in an effort to reduce the economic and market impact of selling $1 trillion in new bills. As long as the interest on the new Treasury bills exceeds the short-term rate available on reverse repos (essentially the federal funds rate) and as long as the Treasury issues bills instead of longer-term securities, we expect that money market funds should find the trade attractive.

How is it going so far?

$400 billion of the expected $1 trillion of T-bills have been issued since the debt-ceiling agreement was passed, as the Treasury works to rebuild its general account. The reverse repo (RRP) is currently offering an annualized risk-free return of 5.05%, slightly below the 5.20% available on the comparable Treasury rate but with more liquidity and less duration (a measure of interest rate sensitivity) risk. Investors are also likely to invest cash with the central bank overnight if the Fed is expected to continue tightening monetary policy, which we view as the most likely outcome. Against this backdrop, approximately half of the RRP money is buying Treasury bills, with the other half coming from bank reserves.

7. Treasury money market funds are allowed to hold reverse repurchase positions with the Fed. The reverse repo provides the money market fund with a Treasury security, and its interest, in exchange for cash, but on a very short-term and renewable basis. This option pays the fund interest and allows the fund the option to frequently renew the option. The important part for market liquidity is that a reverse repo puts money on deposit with the Fed and thereby removes it from the economy.

Meanwhile, the aforementioned monthly contraction of the Fed's balance sheet, known as quantitative tightening, continues, with an estimated $67 billion rolling off by the end of July and another $402 billion by year-end. The combination of quantitative tightening and the Treasury funding just half of its debt out of RRP will likely result in additional reductions of bank reserves. Indeed, bank reserves fell in excess of $130 billion over the two-week period ending June 30. The bottom line is that liquidity is not collapsing but was significantly lower in June and is on track to decline further in July.

What it means for investors

The issue of liquidity, and how it ultimately impacts capital markets, will likely be determined by how the U.S. Treasury continues to rebuild its general account post debt ceiling. To date, half has come from RRP, with the remaining derived from bank reserves — resulting in a fairly substantial liquidity drain. Going forward, bank reserves could decline further if Treasury bill yields do not exceed returns over RRP or if expectations of additional Fed rate hikes discourage money market funds from extending duration on their investments. Investors will be monitoring money market flows to ascertain the direction of liquidity. In addition, the relative performance of the Nasdaq Composite Index versus the S&P 500 Index has historically been a market-based indicator of liquidity. The recent outperformance of the tech-heavy Nasdaq Composite Index has flattened out, suggesting the onset of a potential liquidity drain, which would likely add to market volatility. As such, we reiterate our guidance of defensive positioning in portfolios, overweighting fixed income but maintaining equity exposure.

The relative performance of the Nasdaq Composite Index versus the S&P 500 Index has historically been a market-based indicator of liquidity.

Liquidity will be impacted by the yield differentials between T-bills and the RRP rate.

Risk considerations

Forecasts are not guaranteed and 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.

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.

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation, and other 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. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. 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.

U.S. government securities are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market risk. Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

Definitions

NASDAQ Composite Index measures the market value of all domestic and foreign common stocks, representing a wide array of more than 5,000 companies, listed on the NASDAQ Stock Market.

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.

General disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability or best interest analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company.

PM-01182025-5818164.1.1

