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What federal budget, regulatory, and trade decisions could mean for investors **January 30, 2024**

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- Congressional lawmakers are crafting a $135 billion, bipartisan package to expand the child tax credit (CTC) in exchange for extending three of the 2017 tax cuts for businesses.
- The expansion of the CTC would boost disposable income for consumers while tax benefits would provide retroactive relief to businesses, particularly in the Industrials, Information Technology, and Health Care sectors.
- Even with this assistance, however, our view is that the economy will continue to slow, mainly due to the lagged impacts of aggressive Federal Reserve tightening.

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- Infrastructure spending has helped push the economy ahead over the past year.
- This large spending is intended to benefit the economy through 2030 and likely beyond.
- Some segments of infrastructure spending are well underway while others have been slower to have an economic impact.

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- Consumer spending likely would be the chief beneficiary of the major policy initiatives now being implemented or discussed in Washington, with support extending to small businesses and to capital equipment.
- Our view is that delays and offsets to government stimulus programs will dampen stimulus, while any net positive federal efforts to rev up the economy will sustain inflation above the Federal Reserve's (Fed's) target, keep interest rates higher for longer, and ultimately disappoint the financial market optimism that opened the year.

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What's in the economy's election-year toolkit

Douglas Beath
Global Investment Strategist

Michael Taylor, CFA
Investment Strategy Analyst

Tax cuts

Reports have materialized indicating that a small group of lawmakers are crafting bipartisan, bicameral legislation to expand the child tax credit (CTC) in exchange for extending three of the 2017 tax cuts for businesses. The provisional package includes a combined $135 billion in CTC and business tax breaks that are set to extend through 2025, broken out as follows:[1]

Child tax credit: The credit's value was temporarily increased from $2,000 to $3,600 a year per child in 2021 as part of the American Families and Jobs Act that was passed during the COVID-19 pandemic. As the expanded credit lapsed in 2022, lawmakers now aim to make the credit retroactive to include 2023 and to increase benefits through 2025.

Business tax breaks: A potential deal would involve a retroactive renewal for 2023 of an expired research and development break as well as a deduction for some kinds of interest and expanded depreciation of investments like equipment.

Under the newly conceived package, Congress would accelerate the end of the pandemic-era employee retention tax credit program.[2] Under the terms of this latest bid, savings of roughly $100 billion would partially finance the combined cost of $135 billion to extend the CTC program and business tax breaks. Consequently, households and businesses would benefit from the tax credits, but the economy would see a partial offset from the end of the employee retention tax credit.

As of this writing, President Biden has signed a continuing resolution (CR) to avert a complete federal government shutdown through March 8. Meanwhile, lawmakers have not settled firmly on whether they will propose stand-alone legislation or attach it to a larger CR bill next month or a national supplemental funding bill. But time is of the essence. Indeed, this is a difficult task in a month in which Congress is also negotiating details over sending more aid to Ukraine and rewriting the country's immigration and border laws.

1. "Year-End Tax Deal Could Cost Over $800 Billion If Made Permanent," Committee for a Responsible Federal Budget, November 17, 2023. Press reports give the total of CTC and business tax credits of $78 billion for 2024, but that is only an annual average over the 10 years, 2024-2033, covered by the legislation. The actual total of credits for 2024 is approximately $135 billion.
2. The employee retention credits were refundable federal tax credits, which Congress made available to help qualifying firms retain employees on the firms' payrolls during the COVID-19 lockdowns and in the immediate aftermath. The IRS is in the process of processing backdated claims.

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What it means for investors

For the present, even with the offset, the expansion of the CTC would represent a direct, albeit modest, boost to disposable income that would immediately benefit consumers. It would also provide retroactive relief to businesses at a time when COVID-19 stimulus programs are winding down.

A potential longer-term economic impact would be meaningful upward pressure on the deficit. The U.S. budget deficit currently stands at $2.1 trillion, representing 7.7% of GDP (gross domestic product). In addition, U.S. federal debt as a share of the economy climbed from 33% in 2001 to 97% in 2022 and is projected to reach 115% in 2033, assuming the tax cuts expire after 2025.[3] Should the U.S. economy decelerate as we expect, the fiscal situation would deteriorate significantly.

As the $135 billion tax-cut negotiations progress, we have identified equity sectors and industries that would likely be most affected by the potential outcome.

- **Consumer Staples and Consumer Discretionary:** Increasing the CTC payments will result in additional funds flowing directly into consumer's pockets, supporting consumer staple purchases. This would also benefit consumer discretionary sectors such as retail and restaurants as well as retail-oriented computer and electronics companies. Although we expect a modest benefit to these sectors from the CTC, we remain neutral on Consumer Staples and unfavorable on Consumer Discretionary due to expectations of an economic slowdown and sector underperformance in the near term.

- **Industrials, Information Technology, and Health Care:** Starting in 2022, the Tax Cuts and Jobs Act (TCJA) required companies to amortize their research and development (R&D) costs over five years instead of deducting them immediately each year. Lawmakers from both parties have agreed this should be reversed but were unable to forge a deal, and the new tax went into effect in 2023. A return to full expensing of R&D would benefit a range of companies in the Industrials, Information Technology, and Health Care sectors — particularly tech companies that reinvest a significant portion of their profits back into innovation. We hold a favorable rating on the Industrials and Health Care sectors. As for the Information Technology sector, these proposed changes support our neutral rating but are insufficient to trigger an upgrade to favorable.

- **Capital-intensive industries:** The 2017 TCJA also enacted a new limit on interest deductions for businesses, which became more restrictive in 2022. Equities of capital-intensive industries that traditionally own more property and equipment than service-oriented businesses were adversely impacted in 2023. Delaying the tighter limit on interest deductibility — as the U.S. Chamber of Commerce recommended to members of Congress in December 2023 — should help boost stock prices of capital-intensive companies.

Although the $135 billion bipartisan proposed tax relief would be designed as a provisional package through 2025, many speculate that lawmakers aim to make these provisions permanent, which could cost taxpayers over $800 billion through 2033.

Source: Committee for a Responsible Federal Budget, November 17, 2023

3. See footnote 1 for these figures. Separately, we note that interest costs currently exceed 16% of tax revenue, above the 14% threshold that has historically resulted in higher yields required by bond investors and/or cuts in government spending, according to Strategas, January 10, 2024.

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What's in the economy's election-year toolkit

Scott Wren
Senior Global Market Strategist

Infrastructure spending

Three post-pandemic laws broaden the traditional infrastructure categories to include broadband access, renewable energy, national security, and cleaning up pollution. Other recent pieces of legislation focus on domestic semiconductor chip and electric vehicle (EV) battery production and are infrastructure initiatives. The legislation and spending priorities now in place aim at a wide array of projects and goals.

These three new federal laws that promote infrastructure spending are the Infrastructure Investment and Jobs Act, the Inflation Reduction Act, and the Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Science Act. The Infrastructure Investment and Jobs Act alone allocates $1.2 trillion of federal funds toward transportation, energy, and climate infrastructure projects over the 10 years following its enactment (November 2021).[4]

According to the U.S. Department of the Treasury, business spending in the post-pandemic period has been brisk when compared with other past recoveries, and at least some of this investment has been due to these federal initiatives.[5] They partially overlap on a number of projects and support the general goals of cleaner energy, transportation improvements, and more production of needed technologies here at home. The administration is also working to ensure that traditionally underserved communities are seeing first-hand benefits from the spending on these various projects, as they are taking place in these very neighborhoods.

While road and airport projects are easy for many Americans to grasp as they see the construction on a daily or frequent basis while driving or traveling, other large projects targeted by the CHIPS and Science Act and the Inflation Reduction Act have been slower to come to fruition and have experienced a few speed bumps along the way. As an example, a number of major domestic auto manufacturers have downsized or delayed plans for EV battery plants due largely to the lack of adequate demand for electric vehicles. Some of these same producers have also cut back on EV output. Recent data shows that EV dealer inventories are on the rise and stand near 114 days. Total dealer inventory for new vehicles represents 71 days of sales.[6]

There have also been delays in the construction for the semiconductor chip fabrication plants. Finding skilled labor has been a problem, according to some chip companies, and there have been delays in the permitting process. In fact, major chip manufacturers asked Congress to get involved. In response, in December 2023, the U.S. Senate passed the Building Chips in America Act, which is intended to quicken the permitting process and lessen regulatory burdens for constructing fabrication plants. The bill now has been forwarded along to the House for further action.[7]

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4. Eric Van Nostrand, Assistant Secretary for Economic Policy, “Infrastructure Investment in the United States,” U.S. Department of the Treasury, November 15, 2023
5. Eric Van Nostrand, Assistant Secretary for Economic Policy, and Laura Feiveson, Deputy Assistant Secretary for Microeconomics, “The Inflation Reduction Act and U.S. Business Investment,” U.S. Department of the Treasury, August 16, 2023
6. Market Insights, Cox Automotive, December 14, 2023
7. “Senate Passes Chips Permitting Exemption, Sending Bill to House,” Bloomberg News, December 14, 2023

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While there have been some delays, the trajectory of spending is intended to increase for infrastructure through at least 2026 with additional funding for other projects and initiatives outlined in these bills that will continue to benefit portions of the economy through 2030 or longer.

From an investment perspective, at a high level, our favored Industrials and Materials sectors should benefit in the near term and in coming years from the spending and incentives included in these various infrastructure-related pieces of legislation, as should the Information Technology sector (currently rated neutral).

The Infrastructure Investment and Jobs Act alone directs $1.2 trillion of funding into transportation, energy, and climate projects.

Source: Eric Van Nostrand, "Infrastructure Investment in the United States," U.S. Department of the Treasury, November 15, 2023

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Summarizing the economy's election-year toolkit

Jennifer Timmerman
Investment Strategy Analyst

Gary Schlossberg
Global Strategist

Risks and implications of election-year federal fiscal stimulus

U.S. presidential election outcomes involving incumbents typically hinge on the economy's performance. The record shows that incumbent elections have been won or lost on the economy's ability to avoid a recession in the two years prior to the presidential vote.

Policy options past, present, and future

Incumbents could benefit from several growth-supporting measures already in place, by executive order, or potentially available through bipartisan compromise — all of which could cushion an economic slowdown and ease pressure on household budgets. Perhaps the biggest "bazooka" in the current administration's arsenal has been support to liquidity from increased Treasury-bill issuance financed by money market funds.

There has been a strong connection between liquidity and the S&P 500 Index. Liquidity is essentially cash available for the economy and for investors, and the size of the Fed's balance sheet reasonably proxies liquidity. Rising and falling liquidity tends to lead the S&P 500 Index higher or lower. Notably, the policy-driven liquidity increases in April and November 2023 led the two rallies in the index last year. Liquidity support from the U.S. Treasury now appears to have turned lower, but a Fed pivot later this year to more accommodative monetary policy should infuse more liquidity. This pivot could come through some combination of interest-rate cuts and a wind-down of the Fed's current policy that shrinks the size of its balance sheet and, thereby, reduces cash available for financial markets.

Beyond support from market liquidity, more stable relations with China, limits on credit-card late fees, and measures to contain oil prices, top-of-the-list economic stimulus measures available to support growth in 2024 include the following:

1. **Restarting the employee retention tax credit (ERTC):** ERTC disbursement of $150 billion in tax refunds to small business owners bolstered economic growth and small business employment over a six-month period last year. An estimated $150 billion of tax refunds likely will be available this fiscal year, boosted by the Internal Revenue Service's accelerated revenue processing before the proposed end-January deadline.[8]

2. **A $135 billion bipartisan tax cut + partial restoration of expanded child tax credit:** Enactment could buoy discretionary spending, and thus Consumer Discretionary equities, but not by enough to change our currently unfavorable rating on the sector.

3. **Accelerated investment spending through past infrastructure legislation:** The combined net federal spending from the Infrastructure Investment and Jobs Act of 2021, Inflation Reduction Act of 2022, and CHIPS and Science Act of 2022 likely will amount to as much as $80 billion in 2024 net of certain corporate taxes, according to estimates from Strategas. However, delays in state-government approval, along with industry and labor market conditions, noted earlier, could continue to slow implementation

8. "Tax Bill Has Growing Momentum; Election Year Stimulus Likely Adds $300BN to the Deficit in 2024," Strategas, January 19, 2024

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of projects tied to the three Acts though a portion could be delayed by needed state-government approval.[9] Even partial implementation of disbursed funds supports our favorable rating on Industrials, Materials, and Energy. As for specific industries, we prefer Multi-Industrials (favorable rating), Construction Machinery and Heavy Truck Equipment (neutral rating), Construction Materials (favorable rating), and Industrial Gases (favorable rating).[10]

4. **Student-loan relief:** The Saving on a Valuable Education (SAVE) Plan is another program already being implemented without congressional action. This initiative focuses on easing income-driven repayment plan rules for federal student loans and is poised to provide borrowers with additional benefits in February and July 2024. At most, we estimate $17 billion in potential savings if the program reaches full enrollment by July.

Investment implications

The changes mentioned above would provide considerable stimulus of as much as roughly $380 billion, equivalent to nearly 1.4% of current-dollar economic output, but these efforts face several headwinds. Program delays and offsets are likely to reduce the spending benefit. Meanwhile, any federal fiscal efforts to rev up the economy are likely to sustain inflation above the Fed's target, keep interest rates higher for longer, and slow the economy. Finally, if Congress fails to pass a budget law by April 30, discretionary spending faces a 1% cut. On balance, our view is that federal fiscal spending will be positive but will not be enough, by itself, to change our defensive and selective portfolio guidance.

The often sizable increases in fiscal deficits to support the economy underscore the political importance attached to economic growth in an election year.

We estimate that as much as roughly $380 billion in budget stimulus could be available from the top four stimulus measures now being implemented or under consideration, or a material 1.4% of current-dollar GDP.

9. "Three Major Fiscal Policy Measures Not Baked Into the Economic, Debt, or Inflation Forecasts," Strategas, December 11, 2023
10. Multi-Industrials includes conglomerates, electrical equipment, industrial machinery, and trading companies and distributors.

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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. 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.

Definitions

An index is unmanaged and not available for direct investment.

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.

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