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Institute Alert

FIRST ANALYSIS

News or events that may affect your investments **July 22, 2024**

Paul Christopher, CFA
Head of Global Investment Strategy

Gary Schlossberg
Global Strategist

Jennifer Timmerman
Investment Strategy Analyst

Reactions versus rotations – The election takes a turn

Key takeaways

- In the first three weeks of July, capital markets have moved sharply alongside dramatic and surprising announcements from the two major U.S. political parties, and in parallel with important economic data.
- As markets and voters process President Joseph Biden's weekend decision to end his re-election campaign, we believe it is important to differentiate between reactions to political headlines and fundamental changes that tend to drive long-term market rotations.

What it may mean for investors

- Reactions and rotations sometimes share conclusions, but the former are less reliable.
- Our fundamental analysis reiterates our long-standing unfavorable on U.S. Small Cap Equities and our recently added favorable on the S&P 500 Index Financials sector.

Q&A on latest election campaign developments

In the span of barely three weeks this month, capital markets have seen sharp market moves and dramatic and surprising announcements from the two major U.S. political parties. And the pattern very likely has not played out yet. This report summarizes what we believe investors most need to know, so far, and how to think about the events yet to develop in the days and weeks to come before election day on November 5.

Question: In the latest news, President Biden announced on July 21 that he will end his campaign for re-election. What should investors watch for next from the Democratic party?

Answer: Biden threw his support to Vice President Kamala Harris, and many key Democratic endorsements followed quickly, but we believe the party has two basic options.[1]

Option 1: Hold a virtual convention to officially nominate candidates for president and vice president. Biden's support for Harris may help party leaders to build support quickly around a replacement presidential candidate. The

1. For more details on both options, see Bonnie Berkowitz, Szu Yu Chen and Adrián Blanco, "How Democrats can pick a new candidate, step by step", *The Washington Post*, July 21, 2024.

party already had planned a virtual vote to formally nominate Biden. If the party can quickly coalesce around its candidate, then the ticket could be set heading into the August 19 – 22 party convention in Chicago. Time is short, especially because the state leaders of the party will have to get the new names on the state ballots, which all have different deadlines. This option also buys time for the new ticket to meet voters and capital markets.

Option 2: Hold an open vote at the party convention. This option would give the party's voting delegates more time to decide but prolongs the uncertainty over the coming month. Moreover, many will remember the contested 1968 party convention, after which the party changed how it runs the formal nomination process to avoid open conventions. There are nearly 4,000 delegates from the states. They are pledged to Biden and selected for their loyalty to him but are free to vote their consciences on that first ballot. A majority may align with Harris, and thereby avoid further ballots. If there are additional ballots, 749 party leaders may vote and could tip the balance.

Party leaders have promised a quick decision on how to proceed.[2] We view Harris as the favorite, and her selection in many respects continues the Biden administration's policy priorities. We have outlined these in prior reports and believe that from an investor perspective, fiscal policy, trade, and immigration top the list.[3]

Question: What happened at the Republican National Convention?

Answer: The Republican party rallied around former President Donald Trump and his vice-presidential pick, Ohio Senator J.D. Vance.

Populist policies and party unity were the underlying themes of the convention. The party added Vance to their ticket as the vice-presidential nominee, and the selection reinforces the policy priorities, which we introduced last November.

Vance supports Trump's demand for across-the-board tariffs on all imports, particularly from China; is in line with Trump's policy to deport undocumented immigrants; and promotes fossil fuel production and could work to repeal at least some renewable energy provisions of the Inflation Reduction Act.

Question: Does market pricing reflect yet a particular election outcome?

Answer: Since the presidential debate on June 27, Trump's polling has improved. There are some signs of market pricing consistent with a Trump win, and even a Republican sweep of congressional leadership, but the potential for new surprises reminds us to resist reallocating in portfolios.

We note some outperformance by the S&P 500 Energy and Financials sectors, and by the Aerospace and Defense Index. Most notably, U.S. Small Cap Equities (proxied by the Russell 2000 Index) have outperformed the S&P 500 Index by roughly 9.3% between July 9 and July 19. These equity market moves are consistent with Trump's focus on conventional energy, deregulation, defense spending, and tax cuts.

But, for several reasons, we are not quick to tie our guidance to a "Trump trade." First, some euphoria is typical around party conventions. The Democrats will have their opportunity to gain momentum in mid-August. If their choices of candidates attract independent voters, Trump's current lead could change. Second, even with single-party leadership in Washington, neither party is likely to secure the 60 votes in the Senate needed to pass controversial legislation. Gridlock — or at least extended legislative debate — is our base case absent informal or "backdoor" bipartisanship. Further, intra-party divisions on both sides of the aisle will further complicate

2. Statement from DNC Chair Jaime Harrison, July 21, 2024.
3. "Campaign 2024: Political issues with staying power", Wells Fargo Investment Institute, November 20, 2023

compromise on an array of issues, no matter how unified the Republican National Party Convention may have appeared.

The persistence of the past month's political surprises remains to be tested, especially as we await more events in the coming months before election day. Bloomberg data showed the PredictIt betting market had priced Trump's likelihood of winning at 69% on July 15, but one week later, the percentage slipped back to its July 12 level of 60%. He remains the front runner, but the odds already have shown large shifts higher and lower.

Investment implications: Recognizing reactions versus rotations

Stronger market price persistence is much more likely to come from recent and notable economic signals. A second consecutive soft inflation reading (for June), published on July 11, helped push interest rates lower, but so did Federal Reserve (Fed) Chairman Jerome Powell's remark last week that inflation would not need to fall all the way to the Fed's 2% long-term target before policy makers lower interest rates.[4]

That combination was potent. Futures markets have gone from pricing a single 2024 Fed rate cut as recently as May 1 to now pricing three, plus three or four more for 2025. Even if, as we suspect, six or seven cuts in 18 months seem too many, a more modest number can still benefit a sector such as Financials. The two-year U.S. Treasury yield, a proxy for short-term interest rates, had already fallen from 4.75% to 4.62% between June 28 and July 10 but slid further, to 4.42%, on July 16 after these two events. That was the largest 12-trading-day decline so far this year.

In fact, most of the sector outperformances noted above all began on the day of the June inflation report. The Trump Trade became a market curiosity last week, but the simultaneous market views for a stronger economy and lower interest rates seem a more reliable basis. This is the difference between market reactions and rotations. Reactions (for example, the Trump Trade) can change with the headlines. But a rotation follows fundamental changes and is typically more durable. Last week, we added the Financials to our other favorites (Industrials, Materials, Energy and Health Care), because we believe the fundamental economic and interest rate outlook that we have been expecting now favors that sector.[5]

The explosive rally in small-cap equities also illustrates the difference between reaction and rotation. We believe that Trump policies would try to extend business tax cuts and reduce regulation, but the analysis is just headline and is incomplete. Other Trump policies — most notably tariffs — could damage small companies, which tend to have relatively more trouble than larger ones to source products internationally, or to space out their shipments to avoid tariffs. In 2018, the Russell 2000 Index abruptly reversed months of outperformance against the S&P 500 Index after Trump announced tariffs on China.

Most importantly, a reaction to headlines about tax benefits and deregulation misses fundamental flaws. Surging small-cap equity prices mask that over 40% of the Russell 2000 Index constituents are not profitable. Current and forward index earnings projections are decelerating compared to earnings of the S&P 500 Index. As the Russell 2000 earnings yield (earnings/price) falls, small caps look increasingly expensive compared to a benchmark 10-year U.S. Treasury yield. The fundamental case for a rotation to small caps appears strongly negative.

We are not suggesting that elections don't matter, only that analyses based on events in a campaign season are usually incomplete and changeable.

4. Howard Schneider, "Powell opens key week of Fedspeak as rate cut case develops", Reuters, July 15, 2024.
5. Adjusting equity sector guidance, Wells Fargo Investment Institute, July 19, 2024.

Risks Considerations

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. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks.

Definitions

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity 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.

S&P 500 Energy Index comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.

S&P 500 Financials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.

S&P Aerospace & Defense Select Industry Index comprises stocks from the S&P Total Market Index that are classified in the GICS Aerospace & Defense sub-industry.

An index is unmanaged and not available for direct investment.

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