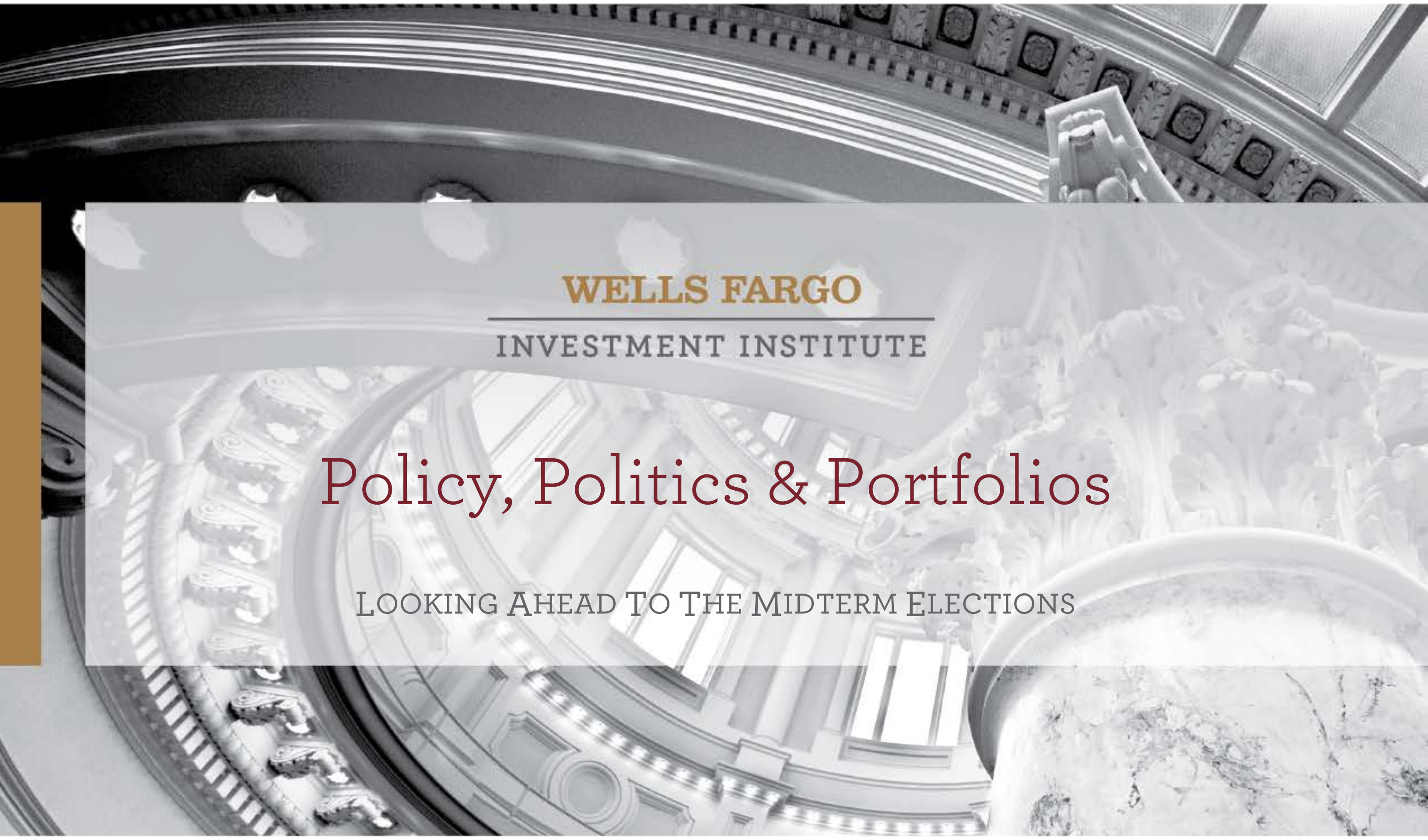

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Looking Ahead To The Midterm Elections

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Markets have been up for the 12-month period following midterm elections in every election since 1950.[1]

Source: Wells Fargo Investment Institute.

Key takeaways

- Markets have been up for the 12-month period following midterm elections in every election since 1950.
- Markets like certainty, independent of party. In the run-up to midterms, uncertainty increases and markets tend to experience corrections and higher volatility.
- We still believe in solid U.S. growth—and that investors should look through the headlines and focus on the current strong U.S. fundamentals as they adhere to their long-term investment plans.

Control of House and Senate viewed as a toss-up

While trade and geopolitics may be receiving most of the headlines, attention is turning to Washington and the upcoming midterm elections. There is a lot at stake for both parties, as Republicans seek to maintain their hold, while the Democrats look to take at least one house of Congress. Midterm elections have significantly lower turnout than we see in presidential election years, and energizing the base will be key for both parties.

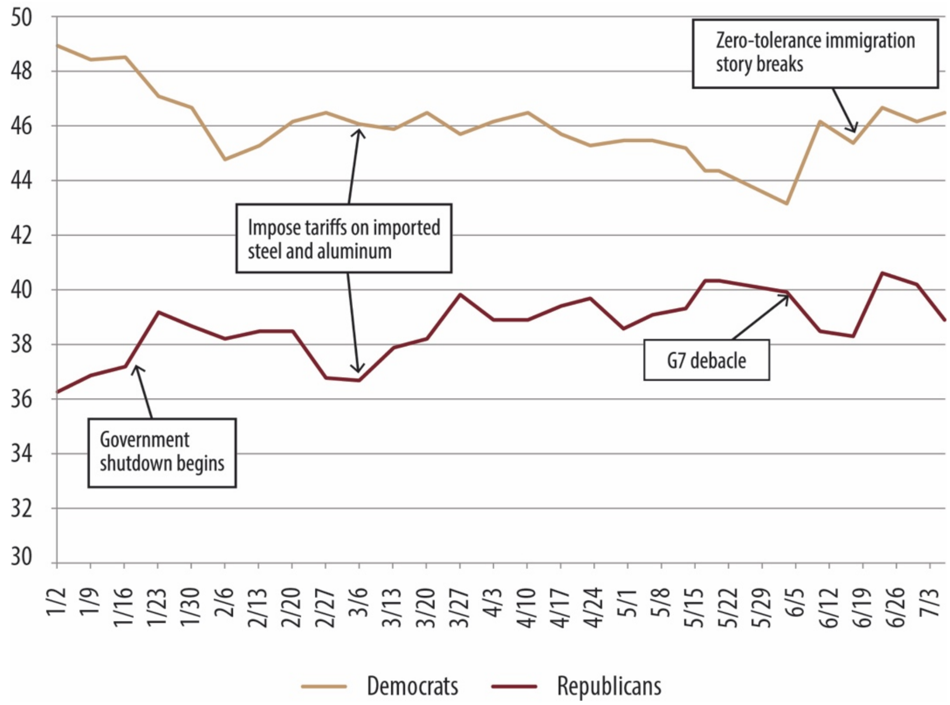
In the Senate, Republicans currently hold a razor-slim majority of 51 versus 49 Democrats. 35 seats (26 Democrats and 9 Republicans) are up for grabs in this election, but only 8 are currently viewed as toss-ups. Of these, 5 are held by Democrats and 3 by Republicans. Following the presidential election, there are some interesting dynamics taking place in certain races. Ten Democratic seats have been in states that President Trump won, while only 1 Republican seat is in a state won by Hillary Clinton.

The magic number for control of the House is 218. Republicans currently hold 235, while the Democrats hold 193 (plus 7 vacancies). Historically, the party of the president suffers significant losses in the midterm election, with Democrats losing 63 seats during President Obama's first midterm in 2010.

Chart 1 displays the Generic Congressional Vote, an average of polls tabulated by RealClearPolitics that asked individuals if they would vote for a Democrat or Republican regardless of individual candidate. The voting spread started the year at +13 for Democrats, and although it was volatile with headlines, the gap has narrowed and is currently +7. Based on this level, Republicans would be on track to lose approximately 23 House seats and turn control over to the Democrats. Yet, it is close enough that the race for control of the House is currently being viewed as a toss-up.

1. *There is no certainty markets will perform similarly in the 2018 midterm election year as they have in past midterm election cycles or in future midterm elections or produce similar returns.* ***Past performance is no guarantee of future results.***

Chart 1. Democrats still maintain a solid lead, but it is narrower than it was at the beginning of the year.



Sources: RealClearPolitics and Wells Fargo Investment Institute. Weekly average poll results. As of July 6, 2018.

However these races turn out, there also will be a lot of new faces. A significant number of Republicans, including leadership, have decided to retire before the next election. If the Democrats are able to take control of one or both chambers, we likely would see two years of legislative gridlock. The president would come under added scrutiny if a Democratic majority was able to control House or Senate committees. Yet, we would not expect such a result to have a detrimental effect on markets and the tax policies already put into place. Further, the tax policies would not be vulnerable to a rollback with a Republican president remaining in place.

Historically, the S&P 500 Index has provided positive returns in the 12 months following a midterm election. As the election nears, we will continue to monitor these races and analyze the impact on investors from potential changes in Congress.

Trade

2017 U.S. trade balance with China:

Exports: $130 billion

Imports: $505 billion

2017 U.S. exports:

Canada: $282 billion

Mexico: $243 billion

China: $130 billion

Source: Wells Fargo Investment Institute

Key takeaways

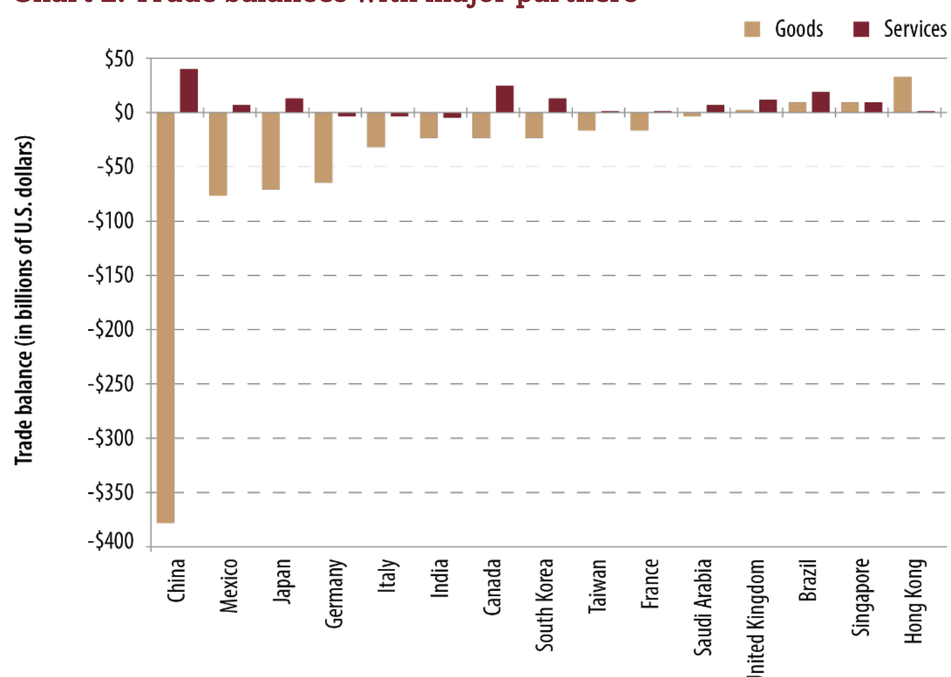
- The underlying economy remains strong. As a result, the market has shrugged off a lot of the trade concerns. We believe this trend can continue.
- Some downside probably has been priced in, but if markets perceive that the risk of a trade war has meaningfully increased, we could see a decline in equity prices.
- While trade tensions with China are dominating the headlines, a positive resolution to NAFTA (North American Free Trade Agreement), which we think is likely, is more important to the U.S. economy.

Changes in U.S. policy are increasing market volatility

Trade actions are one of the top worries currently impacting investors. Headlines abound on the ramifications of the U.S. pursuing a change in trade policy. While acknowledging that risks are increasing, we maintain our view that current administration actions are intended to change trading partner behavior, bringing trade partners to the negotiating table. We do not think the intent of U.S. trade policy is direct protectionism.

In the case of China, U.S. goals include changing business practices that require joint ventures between U.S. and local firms, including the forced transfer of intellectual property—and reduction of higher tariff rates. It is important to keep in mind that trade is one of President Trump's most consistent positions over time. He believes that it is important to resolve trade imbalances (shown in Chart 2) by leveling the playing field as much as possible, giving U.S. firms an ability to compete internationally. This applies equally to allies and to others.

Chart 2. Trade balances with major partners



Sources: Census Bureau and Wells Fargo Investment Institute. Trade deficits for goods and services on a balance-of-payments basis for 2017. As of July 3, 2018.

With regard to China, we believe that the most likely trade outcome will be prolonged negotiations that ultimately result in a positive resolution for the U.S.[2] The implementation of $34 billion in tariffs and immediate retaliation reflect the U.S. desire to change trade and the Chinese desire to maintain the status quo. The implementation of the next $16 billion in tariffs, with further full retaliation, would increase the risk, but it likely would remain tolerable from an overall global trade perspective.

Trade actions and headlines in the 24-hour news cycle have contributed to increased volatility in markets. Some downside likely has been priced in to equity markets, but the markets seems to consider a full-blown trade war a low-probability event at this time.

NAFTA negotiations had seemed to halt around the Mexican elections. With Andrés Manuel López Obrador having won the election, NAFTA talks were expected to resume fairly quickly.

At this time, we believe that investors should continue to follow their investment plan and remain well-diversified, while keeping a watchful eye on trade developments. Trade concerns are making headlines and leading to increased market volatility, but we do not believe that developments will escalate to the point that they will negatively impact global growth trends.

2. *"U.S.-China Tariffs: What's Next?" Wells Fargo Investment Institute, July 5, 2018.*

Federal debt held by the public

2018 actual: $15.5 trillion

2028 projection: $28.6 trillion

Source: Wells Fargo Investment Institute.

Key takeaways

- Rising debt levels leave less money for the federal government to spend on productive investments, after paying for nondiscretionary programs (e.g., Social Security, Medicare, Medicaid) and increased interest.
- Higher growth than the low baseline projections from the Congressional Budget Office (CBO) may result in lower deficits and less federal government borrowing.

U.S. budget outlook projects rising federal debt

The CBO revised its budget outlook last month, taking into account updated projections for federal revenues and expenses. Federal debt held by the public (roughly $15.5 trillion) is now at 78% of gross domestic product (GDP). Thanks to the Tax Cuts and Jobs Act of 2017 and the Bipartisan Budget Act of 2018, that debt is expected to reach 100% of GDP by 2028 and 152% by 2048. While that may seem to be a long time away, the effects will be felt much sooner. Larger interest payments from higher rates on rising levels of debt, as well as increased spending on Social Security and health care programs, will leave less money to spend on other areas, such as investment. Even though revenues continue to increase, the federal government continues to spend at an even faster rate.

It is the job of the CBO to create baseline forecasts to be used by policy makers. Historically, the CBO's estimates have required significant revisions. During the last round of tax cuts in 2003, it underestimated the supply-side effects and undershot growth. In the current analysis, it is projecting U.S. potential growth of only 1.9% a year out to 2048. Excluding the recent prolonged weakness in the current cycle, potential economic growth over the past three cycles since 1982 has averaged 3.0%.

Longer-term growth expectations that are well below the historical average are influenced by the slow growth in the labor force as our society ages. In addition, estimates incorporate a lower-than-historical average for workforce productivity. Productivity has indeed been weak in the current recovery, but improved business spending could lead to higher productivity levels in the future.

If growth ends up higher, due to improved economic conditions from tax cuts and government spending or higher productivity, deficits may come in lower than current estimates. The CBO's track record is to underestimate the economy's growth potential somewhat. If that bias is still the case, then the U.S. debt outlook may be slightly more tolerable.

High government debt levels have a deflationary effect over time as funds that may have been used toward investment and consumption must be diverted to service a growing debt burden. This redirection of resources can negatively impact long-term economic growth prospects. This dynamic between higher near-term deficits and tax cuts that were crafted to increase growth over time will be key to watch over the coming years.

RISKS CONSIDERATIONS

All investing involves risk including the possible loss of principal. Different investments offer different levels of potential return and market risk. You should be aware of, and understand, all risks associated with a particular investment product. Bear in mind that a diversified portfolio does not guarantee investment return or protect against loss.

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