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ELECTIONS | 2020
INSIGHTS & IMPACTS

Policy, Politics & Portfolios

THE EVOLVING POLICY DIMENSIONS OF THE PANDEMIC

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The coronavirus pandemic and its economic fallout are likely to be a predominant platform issue in the 2020 elections. As with the presidential election, it is unclear how COVID-19 will impact congressional and gubernatorial campaigns.

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The Coronavirus Aid, Relief, and Economic Security (CARES) Act is the largest economic relief package in U.S. history, providing loans for both large and small businesses. The total CARES Act cost is more than double the amount authorized during the financial crisis in 2008 and 2009. Yet, it is becoming apparent that U.S. lawmakers intend for this relief to come with a few costs and several strings attached.

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The coronavirus pandemic is bringing into focus the debate over China's future position in the global economy—as China's relations deteriorate with the U.S. and other trading partners. It is in no one's economic interest to allow current tensions to slide toward a "Cold War II." Restraints on both sides increase the odds of changes that are more evolutionary than revolutionary.

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Coronavirus and the U.S. elections

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Is COVID-19 a game changer for congressional and gubernatorial elections?

In response to the COVID-19 pandemic, U.S. lawmakers passed a series of relief packages, including the CARES Act (Phase 3), worth $2.2 trillion. This was followed by a $484 billion (Phase 3.5) package to replenish the Paycheck Protection Program (PPP) for small businesses and to provide hospitals with support. Phase 4 has passed the House; it is now in the Senate. Most of the relief packages have garnered bipartisan support—and for good reason. Nearly 90% of U.S. adults said that the CARES Act was the right thing to do. It is difficult to argue that relief was unnecessary for the millions of displaced workers and shuttered businesses as the virus spread. But some now are concerned with the United States' ability to service the debt—and that could become a platform issue.[1]

In a previous report, we noted that COVID-19 makes the presidential race too close to call.[2] Recession is often to blame in those instances when an incumbent president loses a second term. Yet, President Donald Trump's vulnerability may be mitigated, since this was a forced shutdown to save lives. The key is how voters perceive the economic reopening and control of any subsequent outbreaks. Although the coronavirus overshadowed the Democratic primaries and debates, former Vice President Joe Biden has become the Democratic Party's presumptive nominee. In some polls, Trump currently trails Biden, particularly in vital swing states that helped carry President Trump to victory in 2016.[3]

As we enter election season, questions do remain. It is uncertain whether social-distancing constraints will allow for traditional conventions to be held this summer. There are concerns about voter turnout, rumors about postponing the election, and discussion among Democratic lawmakers about adopting a vote-by-mail approach. It also is unclear how COVID-19 will impact congressional and gubernatorial elections.

Implications for congressional elections

The coronavirus and its economic fallout likely will be a predominant platform issue in 2020 congressional elections. The massive amount of stimulus and the United States' debt capacity have raised concerns among Republican legislators. Calls for higher taxes to offset the federal debt have come from some lawmakers, but raising taxes could derail a fragile economy as it mends. Infrastructure and public works projects have been a priority for President Trump, while Democrats are pushing for election reform and bailouts for debt-laden states. Republicans support tax cuts and business

Relief versus stimulus:

Economic relief addresses the immediate fallout from a crisis like the COVID-19 pandemic, while stimulus aims to restore economic activity. Relief typically precedes stimulus.

COVID-19 hits home:

Forty-three percent of U.S. residents polled say that someone in their household has taken a pay cut or lost a job as a result of the coronavirus outbreak.

One key implication for voters is how effective the relief measures are and how quickly they will take hold.

Source: Pew Research Center, April 21, 2020.

[1] See: the Institute Alert titled "How the U.S. Government Could Pay for the Stimulus," Wells Fargo Investment Institute, April 6, 2020.
[2] Policy, Politics, & Portfolios: "COVID-19 Changes Policy and Election Politics," Wells Fargo Investment Institute, April 27, 2020.
[3] RealClearPolitics, May 12, 2020.

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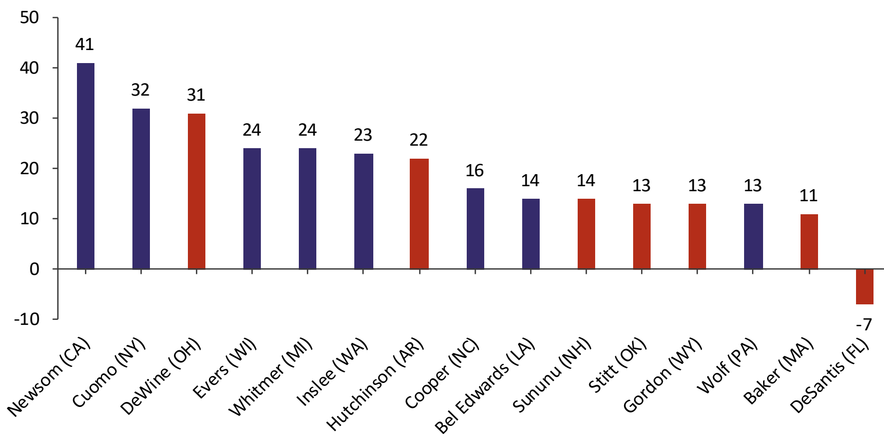
liability protection. Voters will pay close attention to how successfully states and municipalities open up local economies and the role that legislative leaders play in the process. More broadly, U.S.-China relations will be "front and center" in the minds of voters.

The U.S. Senate currently has 53 Republicans and 47 Democrats (including two independents). There are 35 seats up for election in November (including special elections in Arizona and Georgia), with 23 of those seats currently in Republican hands. Democrats will need to gain three or four seats to take control. All 435 congressional seats are in play this year. The Democrats currently control the House of Representatives, where 218 seats are needed to maintain control. Generally speaking, incumbents may have an edge during a crisis period, particularly if voters perceive that they have handled the crisis successfully. Moreover, increased media attention could bolster incumbents' campaigns by offsetting social-distancing constraints to campaigning efforts, suggesting another split Congress.

Chart 1. Change in governor approval ratings during the COVID-19 pandemic



Sources: Strategas and Wells Fargo Investment Institute, as of April 10, 2020.

Effects on gubernatorial and state elections

The nation's governorships are nearly split between the two parties, with 26 Republicans and 24 Democrats. Eleven states will hold gubernatorial elections in 2020; seven incumbents are Republican, and four are Democrats. Two key issues could sway voters ahead of the election. The first is how successfully states navigate reopening of their economies. Each state is responsible for the path to reopening, and governors are tasked with overseeing this work. There has been some backlash against strict lockdown orders, particularly among unemployed workers and small business owners. Business owners also are concerned about liability protection. The other key issue for state leaders is solvency. States with underfunded pensions and perennial budget deficits may need financial assistance to avoid bankruptcy. Moreover, the loss of tax revenues during the economic shutdown exacerbates the issue for many states. This has become a sticking point for Phase 4 negotiations, and it is split down party lines. Like their congressional incumbents, governors who manage through the crisis successfully may have an upper hand at the ballot box.

Key takeaways

- The coronavirus and its economic fallout likely will be a predominant platform issue in 2020 congressional and gubernatorial elections.
- Voters will pay close attention to how successfully states and municipalities open up local economies and the role that legislative leaders play in the process.
- Incumbents may have an edge during a crisis period, particularly if voters perceive that they have handled the crisis successfully.

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Strings attached

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The price for public support

An old adage is that "there is no such thing as a free lunch." For recipients of Paycheck Protection Program (PPP) loans and other government relief through the CARES Act, it may seem like the U.S. government is "reaching for the bill" with no complaints. The CARES Act is the largest economic relief package in U.S. history, providing loans for both large and small businesses. Its costs total more than double the amount authorized during the financial crisis in 2008 and 2009. However, it is quickly becoming apparent that U.S. lawmakers intend that this relief will come with a few costs and several strings attached.

Chief among these restrictions is a halt to common stock dividend payments and share buybacks during the four-year term of the loan (plus one year in the case of stock buybacks). Similar bans have been implemented around compensation for higher-level employees. These restrictions don't apply to small business loans through the PPP; they are intended for larger businesses that are receiving the roughly $500 billion contributed to the Treasury's Exchange Stabilization Fund. Even companies that are not accepting federal support may stockpile cash during this economic contraction. It is not unusual to see dividends trend lower during economic recessions.[4]

In the first quarter, 29 S&P 500 companies suspended dividends, while 15 cut dividend-payout levels.

In the second quarter (through May 11), 32 S&P 500 firms had either cut or discontinued dividends. And at least 53 S&P 500 companies have suspended stock buyback programs.

Source: S&P Global, May 12, 2020.

Many small businesses have benefited from PPP loans, with fewer restrictions than for the Treasury's Exchange Stabilization Fund. More than $669 billion in business loans has been granted through the PPP. Under the PPP, small businesses may apply for loans that total 2.5 times their average monthly payroll costs (up to a maximum of $10 million) to help cover payroll, rent, and other expenses. Full loan forgiveness is available to businesses that maintain employment of all full-time employees at 75% of their previous calendar quarter's payroll over the loan's term. However, some issues have arisen over the definition of a "small" business, resulting in some borrowers choosing to return loan funds to maintain their company's reputation.

More than 300 publicly traded companies received a total of roughly $1.18 billion from the PPP.

As of May 4, roughly $378 million has been returned or will be returned to the U.S. government.

Source: The New York Times, "Public Companies Return Millions in Loans Set Aside for Small Businesses", May 4, 2020.

Some investors may be asking "what does the federal government get out of this, aside from supporting hard-hit U.S. companies?" For large companies, the answer is fairly simple—the government receives an equity stake. As part of the CARES Act, the Treasury Department is authorized to receive warrants and other financial instruments to provide compensation for government assistance. This is most apparent in the $46 billion in funds earmarked for airlines and other industries that have been deemed vital to national security.

[4] For additional information, please see our Investment Strategy report article from May 18, 2020, titled "Cash is king—firms cut dividends and buybacks."

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This has led to concerns about a potential "nationalization" of airlines, medical supply chains, or other vital industries. There has been precedent for the U.S. to take equity interests as a condition for financial support (e.g., in 2008-2009). Yet, we believe that a more likely course may be for the federal government to seek to influence company policies, such as moving some supply chains back to the U.S., or at the least, away from certain countries overseas. We also note a new bill in the House of Representatives, the "Made in America Emergency Preparedness Act," which would define essential products to be produced in the United States.

Overall, the CARES Act restrictions are likely to be more company-specific than wide-ranging. Its dividend ban is likely to affect mainly energy producers, airlines, and real estate firms. And, it could have an impact on publicly traded, small-cap companies, particularly those facing challenges or with lower-quality balance sheets and financial metrics. Larger and high-quality companies often have better cash flows and an established history of dividends. Historically, dividends are slower to be cut and faster to be reestablished than stock buybacks. As such, corporate decisions to eliminate stock buybacks potentially could be longer-lasting, especially if their political unpopularity causes a more widespread or longer-term stoppage. Most importantly, even if companies reduce stock buybacks, there are other ways of returning value to shareholders (or creating it for them). Consequently, we continue to favor U.S. large- and mid-cap equities over small-cap equities. Within large-cap sectors, we prefer cyclical equity sectors with companies that exhibit strong balance sheets and healthy earnings prospects.

Key takeaways

- A combination of the CARES Act and economic uncertainty is likely to significantly impact larger U.S. companies' dividend yields and share buybacks in the near term.
- In our view, equity stakes in U.S. companies being granted to the U.S. Treasury Department are unlikely to lead to nationalization or government involvement in corporate decision-making.
- Cessation of company share buybacks and issuance of new equity shares is likely to significantly impact earnings per share and longer-term valuations.

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A "Cold War II" with China?

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Another pandemic watershed?

Globally, the "great pandemic of 2020" has focused debate over China's future in the global economy— as it has aggravating U.S.-China strains. Despite the moderate $4.5 billion amount involved, the U.S. decision on May 12 to pull federal retirement funds from investment in Chinese equities enters new ground in an ongoing confrontation with China.[5]

Worsening relations with trading partners also have highlighted China's central position in the global supply chain. China's share of global imports in intermediate manufactured goods has doubled to 20% since 2005, including a 30% share for the United States and 40% for Asian economies.[6]

Any Western delinking from China likely would be negative for emerging markets in its early stages—on balance—as opportunities from supply-chain rotation out of China are countered by weaker economic results for countries that are commodity producers, from lower exports to China's vast market, and from stiffer Chinese export competition, if China's yuan suffered from the global delinking.

The ties that bind

It is in no one's economic interest to allow relations with China to slide toward a Cold War II, in a global economy that is more integrated now than it was during the face-off with an economically smaller (and less vibrant) former Soviet Union.

Putting rhetoric aside, a deep U.S. recession and a looming presidential election should encourage the White House to move cautiously on tariff increases and other policy changes that would add to costs and business uncertainty.

Even global supply-chain restructuring from the U.S. could proceed slowly, beyond drugs and other critical products. China's enormous production and logistics network, maritime infrastructure, still-attractive wages, and sizable domestic market help to explain why a March 2020 survey by the American Chamber of Commerce in China showed that more than 70% of respondents had no plans to relocate because of the pandemic.

Access to a large global market should encourage China's restraint—as it supports economic growth that is needed to accommodate China's heavy debt burden and maintain Communist Party legitimacy by boosting Chinese living standards. Economic weapons, beyond tariffs, are likely to be less potent than they appear. Disruptive Chinese sales of U.S. Treasury debt holdings would

Evidence of China's role as a key part of the global supply chain:

China has a 20% share of global intermediate-goods imports and a 30% share for the U.S.

Source: Bloomberg Economics, May 11, 2020.

Percent of Chinese respondents in a March 2020 survey that had no plans to relocate because of the pandemic:

More than 70%

Source: American Chamber of Commerce in China, March 2020.

Decrease in China's U.S. debt holdings from a November 2013 peak of more than $1.3 trillion:

$225 billion

Source: American Chamber of Commerce in China, March 2020.

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[5] Source: Bloomberg, "Trump Plan to Pull Out of China Stocks Invites Retaliation," May 12, 2020.
[6] Source: Bloomberg Economics estimates, March 2020.

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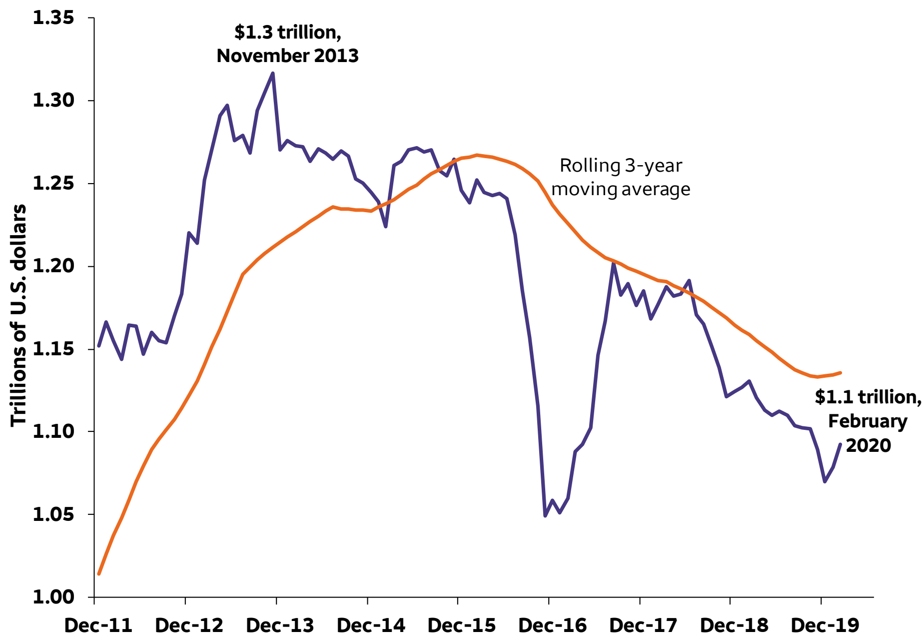
reduce the country's holdings of highly liquid, quality investments with a relatively attractive yield versus other global developed market bonds. Dwindling U.S. Treasury securities holdings for China—down $225 billion from the $1.3 trillion November 2013 peak—already are undercutting China's debt weapon. Likewise, China's capital controls and bouts of financial volatility make the yuan's threat to the U.S. dollar (as the key currency in global trade and finance) a distant goal.

Accommodating China's rise as a global power will be complicated by the difficulty of absorbing a quasi-market system (that is less sensitive to price signals) into a market-based world economy. Changes will come, but they likely will be more evolutionary than revolutionary.

Chart 2. China's Treasury holdings have been on a downward trajectory from a November 2013 peak



Source: U.S. Treasury Department, May 2020.

Key takeaways

- As China's relations deteriorate with the U.S. and other trading partners, the coronavirus pandemic is focusing debate over China's future position in the global economy.
- It is in no one's economic interest to allow current U.S.-China tensions to slide toward a "Cold War II." Restraints on both sides increase the odds of changes that are more evolutionary than revolutionary.
- Nonetheless, resulting geopolitical tensions have added to support for higher-quality and more liquid "perceived safe-haven" assets. Emerging markets are among the investments that would be most at risk if unexpected dollar strength were to add to deflation pressures.

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