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Policy, Politics & Portfolios

NAVIGATING INFLATION AND REGULATORY CHANGES

March 29, 2022

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Confidence, inflation, and the midterms

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Slumping sentiment

As voters prepare for midterm elections in November, the economy — particularly, rising gas and food prices — and how consumers feel about current economic conditions will be top of mind for many. Although a tight labor market typically benefits workers and their wallets, inflation at a 40-year high has outpaced wage gains and has weighed on consumer confidence. The war in Ukraine is pushing commodity prices sharply higher — most notably, energy, industrial metals, and agricultural prices.

In the U.S., the average gas price is $4.28/gallon vs. $2.88/gallon a year ago and $3.53/gallon a month ago.

Source: AAA, March 18, 2022

Policymakers in the U.S. and Europe have alerted investors that higher short-term interest rates are coming to counter elevated inflation. Meanwhile, in February, both U.S. consumer confidence and consumer sentiment declined, with the latter hitting a decade low. This combination of uncertainties leaves investors and consumers alike asking: Where do markets and policy go from here, and is the U.S. economy at risk of slipping into recession?

A recent Gallup poll found that the most important problem facing Americans surveyed was "government and poor leadership" (23%). The second highest was "coronavirus" (20%).

Source: Gallup, January 2022

Sanctions and price effects

Gasoline and household staples' prices have been a perennial gauge of consumer and voter sentiment. Historically, midterm elections have tended to work against the majority party, so elevated inflation and low real incomes could portend challenges for incumbent Democrats.[1] The election assuredly will be influenced by how the Russia-Ukraine war proceeds, how the U.S. responds, and what happens with energy and other commodity prices. The outcome will largely depend on U.S. and European policymakers' efforts to blunt the impact of reduced Russian imports, especially in energy.

Russia is the world's third-largest oil producer behind the U.S. and Saudi Arabia. Yet, Russia is the world's largest exporter of oil, with about 60% of its petroleum exports going to Europe and 20% to China.[2] On average, the U.S. consumes about 20 million barrels of oil each day. Last year, the U.S. imported 672,000 barrels per day of petroleum from Russia, about 8% of oil imports.[3] The U.S. ban on Russian oil imports will likely have a minimal direct impact on the U.S., but the new shortfall comes at a time when supply has already been struggling to match demand. That gap will need to be filled. The one-time release of 60 million barrels of oil from the U.S. strategic petroleum reserve, in our view, will do little to slow energy price increases. We believe the longer-term energy policy challenge for U.S. policymakers is how to encourage the momentum behind renewables while keeping the reduction in global hydrocarbon supplies from triggering high inflation and economic recession.

1. "Why the President's Party Almost Always has a Bad Midterm," FiveThirtyEight, January 3, 2022
2. International Energy Agency (IEA), March 10, 2022; data period January 1, 2021, to December 31, 2021
3. The Wall Street Journal and U.S. Energy Information Administration, March 11, 2022

Direct impacts will likely be felt more so in Europe than in the U.S. Europe has announced plans to reduce Russian gas imports by two-thirds this year and completely by 2030. This is a much taller order, as Europe is highly dependent on Russian energy — 27% of its oil and 45% of its natural gas imports come from Russia.[4] European policymakers aim to increase natural gas supply from other major suppliers including the U.S. and Qatar and, longer term, accelerate the transition to clean energy. Beyond oil, Russia's export ban on agricultural goods and fertilizer (Russia is the world's largest exporter) is likely to raise food prices further.

Economic and investment implications

Is the U.S. economy at risk of recession? Higher commodity-induced rises in consumer prices reduce consumer purchasing power, and some of our recession indicators are starting to signal caution. But not all. Today's economy is more service-oriented than in the past; service sectors are experiencing a strong rebound as COVID-19 infection rates recede. We also are seeing robust labor market growth. Last month, headline employment made its biggest monthly gain since July 2021. Contrast today's conditions to those of the 1970s, when high commodity prices led to layoffs and unemployment. We believe this is an important distinction and supports our view that the next recession is not imminent. We also believe there is still significant strength in the U.S. economy, which could be a positive factor for congressional leaders and President Biden during the November midterm elections.

While recession remains a potential risk, our base case is for continued economic growth. Fighting inflation will rely on Federal Reserve (Fed) tightening policy. Curbing gas prices will require an effectual energy policy. Tactically, we continue to favor U.S. over international markets; in U.S. markets, we prefer high-quality companies with strong balance sheets. We advise being defensive in fixed-income investments, particularly in a rising-rate environment. For long-term investors, we favor adding incrementally and in a disciplined way to these, our preferred markets and asset classes.

Key takeaways

- U.S. inflation at a 40-year high is weighing on consumer and investor sentiment.
- Elevated inflation, low real incomes, and the war in Ukraine could portend challenges for Democrat incumbents in the midterm elections.
- While recession remains a risk, our base case is for continued growth. We favor U.S. over international markets; in U.S. markets, we prefer high-quality companies with strong balance sheets.

4. IEA, March 3, 2022, and Bloomberg, March 8, 2022

Biden's regulation recap

Mary Rumsey
Investment Strategy Analyst

A glance into Biden's first-year regulatory agenda

President Biden's first year has been filled with a rigorous regulatory agenda. While the focus of these rule changes has been on COVID-19 and reversing a number of the Trump administration's regulations.[5] Biden also began to advance his own agenda. Here, we'll review some of his most influential changes in regulations.

Medical regulations

Accompanying rules to mitigate COVID-19 were regulations meant to improve access to other medical treatment while social distancing was enforced. These include regulations to increase a doctor's flexibility when prescribing opioid-addiction treatments and new rules regarding telemedicine and telepharmacy.[6] Since implementation, the administration has signaled its intent to make these COVID-19-era rules permanent.[7]

In addition, the Biden administration has enacted a rule to require reporting of hospitals' medical expenditures in an effort to track the price of drugs and other treatments. In regard to health care costs, the administration has placed a ban on some surprise health care billing and hosted a special enrollment period for the Affordable Care Act.

Climate change

Many regulatory steps have been taken in the environmental arena, both to reverse the previous administration's policies and to chart a new regulatory course.

First, Biden's Environmental Protection Agency is working to reverse many Trump-era reductions in environmental protections. These efforts include reinstating the National Environment Protection Act; increasing the bodies of water protected under the Clean Water Act; and reinvigorating standards regarding average fuel economy, reduction of methane, mercury, and other pollutants, and gas pipeline safety requirements.

The current president has also created new regulations in an effort to protect the environment. These include establishing a cap-and-trade system to reduce hydrofluorocarbons, creating a way to monitor chemicals used to clean up oil spills, updating regulations on cross-state air pollution, and requiring government procurement to have minimal climate impact.

Proposed methane reduction regulations are expected to reduce emissions by the equivalent of 920 million metric tons of CO2 by 2035.

Source: Brookings Institute, January 24, 2022

The first report on prescription drug price patterns will be released in 2023 and updated every two years.

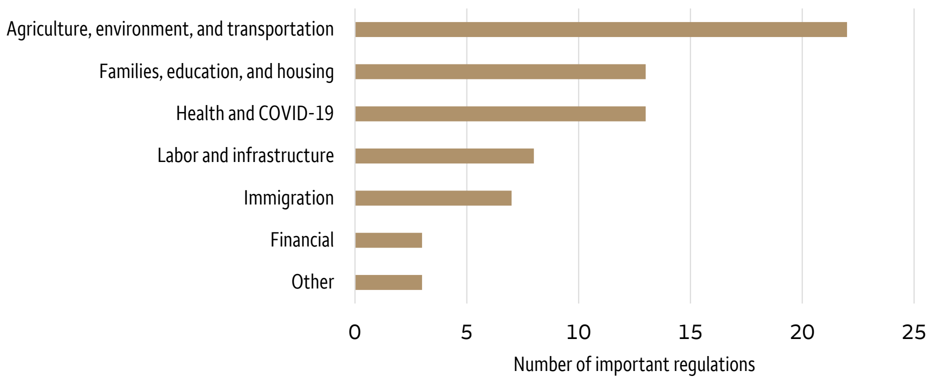
Source: Brookings Institute, January 6, 2022

5. "An Overview of Biden's First Regulatory Year," Brookings Institute, January 20, 2022
6. "Tracking Regulatory Changes in the Biden Era," Brookings Institute, March 1, 2022
7. "2021 Regulatory Year in Review," Regulatory Studies Center at the George Washington University, January 19, 2022

Pro-U.S. production and infrastructure

The last major category of the Biden regulatory agenda is on pro-U.S. production and infrastructure. To promote U.S. growth, the administration preserved the International Entrepreneur Parole Program, maintaining a way for foreign entrepreneurs to immigrate to the U.S. It also raised the standards for domestic products used in federal contracts. The administration concurrently instated a rule to make broadband easier to install and refined the definition of independent contractors. We believe these changes, along with the passing of the Infrastructure Investment and Jobs Act, create an environment for growth in the U.S.

Chart 1. A breakdown by topic of Biden's most important regulations



Sources: Brookings Institute and Wells Fargo Investment Institute, data as of March 1, 2022. Note: Some regulations were counted under multiple topics.

Investment implications

Because of these changes in regulation, we recommend that investors retain full allocations to the Health Care, Energy, and Industrials sectors. In addition, we reiterate our preference for domestic equities over international.

Key takeaways

- Some of the most influential arenas of regulatory focus were the ever-changing COVID-19 mask and vaccination mandates and reversing the environmental regulations created by the previous administration.
- Other regulatory focuses have been increasing medical flexibility and encouraging infrastructure development and pro-U.S. production.
- We suggest investors maintain full allocations to the Health Care, Energy, and Industrials sectors and reiterate our preference for domestic equities over international.

Opening a new front on antitrust

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Biden antitrust policies in the administration's first year

U.S. antitrust policy has gone through fundamental changes since President Biden took office a year ago. Antitrust philosophy has moved from the traditional Chicago School approach, analyzing the effect of mergers and acquisitions on economic efficiency, to focus on stakeholder welfare and the impact of business concentration on inequality and labor. As a result, U.S. antitrust policy has moved beyond a focus on technology to cover a wide range of industries and beyond the focus on vertical mergers.

Increased market concentration boosted industry sales-weighted price markups (sales price compared with the cost of goods) by 42% between 1980 and 2016.

Source: "Global Market Power and Its Macroeconomic Implications," International Monetary Fund (IMF), 2018

In addition to expanded antitrust coverage, both President Biden and the Department of Justice (DOJ) antitrust chief, Jonathan Kanter, have pledged to increase scrutiny of past and proposed mergers and acquisitions at odds with current thinking about the effects of industry concentration. The Federal Trade Commission (FTC) also began evaluation of tech companies that are suspected of using a loophole to avoid merger reviews. The head of the FTC, Lina Khan, is now cooperating with the DOJ chief in this effort with the goal of ending a relaxed policy toward horizontal mergers.[8] These officials have a long history of criticizing antitrust enforcement for its weakness and blaming large companies for harming consumers. Most recently, administration officials have assigned some of the blame for high inflation to the lack of competition in highly concentrated industries.[9]

President Biden issued an executive order to establish a new White House Competition Council focusing on antitrust.

Source: The White House

The current administration, in cooperation with a Democratic-controlled Congress, has proven to be much more aggressive than the Trump or Obama administrations in antitrust policy enforcement. In January 2022, the Senate approved an antitrust bill to prohibit high-tech and social media companies from using their platforms to favor their own products.

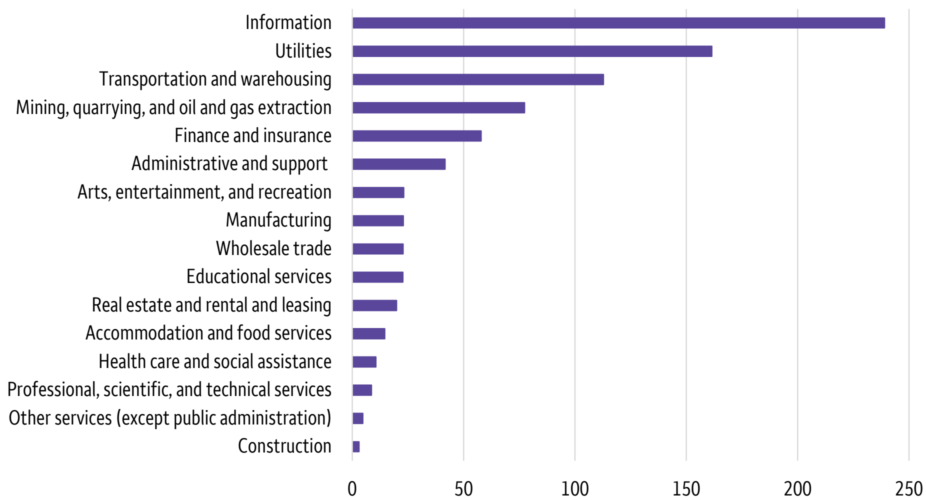
Information services' high concentration, illustrated in the table below, helps explain its exposure to antitrust action under the current administration. However, proposed legislation affecting technology is only part of an expanding list of industries exposed to antitrust policy actions. Other sectors of the economy affected by administration activism have included health care (insurance, hospital, and prescription drug), defense, airlines, agriculture, internet service, and banking and consumer finance, in addition to the high-tech sector.[10]

Other industries with low concentration ratios, such as health care and social assistance, haven't escaped administration scrutiny extending to large merger and acquisition deals in addition to industrywide conditions. This is consistent with the administration's new antitrust philosophy keyed to

8. "Biden's Merger Watchdogs Just Put Corporate America on Notice," Fortune, January 19, 2022
9. "Monopoly Games," New York Magazine, January 23, 2022
10. "Fact sheet: Executive Order on Promoting Competition in the American Economy," The White House, July 9, 2021

consumer or stakeholder welfare instead of economic efficiencies of the merger deals. The Biden administration also is gearing up antitrust policies in consumer-based industries to protect personal data and consumer privacy, in addition to dealing with uncompetitive pricing.

Chart 2. Concentration by industry



Sources: Wells Fargo Investment Institute and U.S. Census Bureau. Annual data as of 2017. Concentration is measured by the Herfindahl-Hirschman Index (HHI) of the 50 largest firms in the industry. HHI is a common measure of market concentration and is used to determine market competitiveness. Higher numbers indicate higher concentration. An index is unmanaged and not available for direct investment.

Investment implications

The ultimate effects of policy changes are hard to predict because they cover a wide range of industries. However, we believe the financial and market strength of technology and communication services firms in the U.S. will outweigh potential threats from tougher antitrust enforcement. Given the low fixed capital requirement, even if high-tech firms are forced to break up, we expect them to operate efficiently and retain value-adds. Looking ahead, in the scenario that a divided government results from the midyear elections, we expect continued bipartisan support for enhanced antitrust activities on high-tech companies. So far, both the Democrats and the Republicans agree on the direction but not on the detailed approaches.

That last point is important for regulatory efforts more broadly. We believe that an overhaul to a much more activist antitrust policy will take more time to implement than is available to this Congress. If the next Congress continues single-party government, we expect the debate to continue on the many details of a major regulatory change. If the midterm elections return a divided government, the prospects for an overhaul appear more remote still. Even on the idea of increasing high-tech regulation, where the two parties agree in principle, the details elude consensus. In the meantime, other macro and geopolitical concerns likely will take precedence. Therefore, we believe the risk of sustained and outsized market volatility as a result of antitrust policy surprises remains low.

Key takeaways

- Technology has attracted most of the attention, but the new antitrust policy has impacted a variety of industries, such as health care (insurance, hospital, and prescription drug), defense, airlines, agriculture, internet service, and banking and consumer finance, in addition to the high-tech sector.
- The impact of these antitrust policy shifts will take a long time to play out. We expect little near-term impact on companies caused by antitrust policy changes.

Risk considerations

Forecasts and targets are 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. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk.

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. **Communication Services** companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions.

A periodic investment plan such as dollar cost averaging does not assure a profit or protect against a loss in declining markets. Since such a strategy involves continuous investment, the investor should consider his or her ability to continue purchases through periods of low price levels.

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