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POST-ELECTION ISSUES AND INVESTMENT IMPLICATIONS

October 25, 2022

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An array of legislative issues is creating hope for bipartisan momentum established this year to carry over to the next Congress. Our favored Information Technology sector, supply chains, and green energy are among the sectors potentially benefiting most from dual-party support for new legislation.

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This year there has been a dramatic increase in labor organization movements across industries in the United States. Although the Biden administration has taken an active pro-labor stance, we see union movements affecting the transportation and retail industries in the months to come.

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What could this year's lame duck mean for markets?

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Setting priorities and trading horses

A lame-duck session of Congress occurs after an election, between mid-November and year-end, when departing lawmakers still hold voting power to pass legislation. Next month's midterm election outcome should surely influence the agenda and tone of this year's lame-duck session. Should Republicans gain the majority in either the House or the Senate, this could become a catalyst for an active session, given the brief window to pass legislative priorities.

Congress is scheduled to reconvene on January 3, 2023.

In 2010, the lame-duck legislative session impacted markets, as President Obama sought a new payroll tax. A similar scenario to 2010 may unfold this year as President Biden aims to pass a child tax credit expansion while Republicans oppose certain tax increases set to take effect. This year's lame duck could pose headline risks for markets as lawmakers horse trade under a tight time frame. Specific sector implications may depend on how the final version of the bill shapes up.

The Bipartisan Policy Center estimates the debt ceiling will likely arrive no earlier than the third quarter of 2023.

Source: "Debt Limit 'X' Further Out than Expected, but still looms Ahead," by Erin Meade, Bipartisan Policy Center, June 14, 2022

Ducks in a row

This year's lame-duck session could be an active one, particularly if Democrats lose at least one chamber of Congress. Here are a few items we expect to be included in the lame-duck legislation:

Fiscal year 2023 budget and appropriations: Although Congress passed a continuing resolution last month extending federal funding through mid-December, it has yet to pass a fiscal year 2023 spending bill. We expect lawmakers to do so in December. Both parties are likely waiting for the midterms to see which party will have the upper hand in negotiations. The top Senate appropriators (Leahy D-VT and Shelby R-AL) are retiring at the end of this Congress, so the spending bill is likely to pass ahead of their departures. Within the spending bill, we expect increased defense spending, though we feel the line item will likely be larger if Republicans have the upper hand. The debt ceiling limit may likely be addressed in the lame-duck session, in an effort to avert gridlock and a potential government shutdown next year (see Sidebar 2).

Tax reform: The research and development (R&D) tax credit may likely be a key component of the lame-duck legislation. President Trump's tax reform in 2017 moved the R&D tax credit from writing off expenses immediately to amortizing over five years beginning in 2022. This poses a tax increase for the largest U.S. companies, estimated at 3%.[1] Companies have lobbied for a reversal; bipartisan support exists to do so, and we believe the reversal will pass, either in the lame-duck session or in the next Congress. Reversing the expiration of the tax credit is an important provision for Republicans, and

1. Source: "Expect an Active Lame Duck Session of Congress," Strategas, September 27, 2022

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Democrats may call for other tax changes, such as a one-year extension to the child tax credit, in exchange for their support. In the unlikely event that the democrats control both chambers of Congress in the new session, President Biden may push for an expansion of the child tax credit.

Retirement reform: In 2019, Congress passed the Secure Act, facilitating the process for companies to provide retirement plans for employees. In March, the House passed the Secure Act 2.0. Key provisions of the bill include raising the age limit for required minimum distributions (RMDs) and reducing tax penalties for delaying RMDs, increasing retirement account catch-up contribution limits, and offering tax benefits for small businesses establishing employee retirement plans. In response, the Senate drafted similar legislation with slightly different provisions. A compromised version of the bill may be included in the lame-duck package. If not all of these provisions make it in the final bill, we would expect negotiations to continue into the next legislative session.

Some other items that might be on the agenda include health care provisions, energy permitting reform, and electoral college reform. But given their lower priority, these may likely be moved to the 2023 legislative session.

Economic and investment implications

During the lame-duck session, headline risk for markets is a potential risk as lawmakers firm up the legislative package, particularly the fiscal year 2023 spending and appropriations bill. Both chambers of Congress support increases in defense spending, and if Republicans gain the House majority, we would anticipate more funding allocated to defense.

The R&D tax credit change, if reversed, we feel would be positive for the Information Technology sector (currently favorable), but also for Industrials (currently neutral) and, specifically, defense contractors — an Industrials sub-industry. The shift from expensing to amortization could also impact capital-intensive industries like manufacturing and, specifically, firms with heavy capital expenditures yet low effective rates. If the tax credit is not reversed, a higher corporate tax bill could potentially weigh on the earnings and performance of the affected companies. Although overshadowed by aggressive Federal Reserve (Fed) tightening, the potential for reduced earnings based on the outcome of the lame-duck session may likely add to recession fears, and potentially resulting in higher market volatility.

We believe any additional specific equity sector implications, positive or negative, will depend on how the final version of the lame-duck package shapes up.

Key takeaways

- This year's lame-duck session could be an active one, particularly if the post-midterm balance of power shifts back to a divided government.
- Items likely on the agenda include fiscal year 2023 budget and appropriations, tax reform, and retirement plan reform.
- This year's session could pose headline risks for markets as lawmakers negotiate the package.

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Bipartisanship lives!

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Congressional bipartisan opportunities in 2023

We highlight key bipartisan opportunities for the 118th Congress with an above-average likelihood of passage, along with potential investment implications.

Taiwan free-trade agreement

Bipartisan support for a free-trade agreement with Taiwan, the world's dominant chip producer, should further incentivize investment in the U.S. through subsidies and tax breaks for countries with a U.S. free-trade agreement under the Inflation Reduction Act and the CHIPS and Science Act (CHIPS Act). Under these two policies, production costs could be reduced and certain benefits only apply to countries that have a free-trade agreement with the U.S. Additional benefits of free trade with Taiwan would extend beyond technology to the farm sector and other U.S. industrial companies, supported by eliminating Taiwan's tariffs of 15.0% and 4.1%, respectively, on agricultural and industrial-goods imports. Bipartisan investment incentives also are possible for industrials, oil and gas, and renewable energy.

Taiwan's 50% share of the global foundry market for semiconductors — including 90% for U.S. firms — has been a driving force behind bipartisan legislation for a free-trade agreement with the country.

Sources: "Localization of Chip Manufacturing Rising," TrendForce, April 25, 2022, and "Tough Road Ahead for U.S. Firms Trying to Cut Reliance on Taiwan Chipmakers," CNBC, April 13, 2021

China and supply-chain issues

The bipartisan $52 billion CHIPS Act's modest size compared with the $556 billion semiconductor industry[2] has encouraged a joint-party effort to boost security further by building on that legislation to include higher-end chip products. This would restrict China's access to U.S. advanced chips for the development of artificial intelligence.[3]

"Near-shoring," viewed as a multi-country alternative to U.S. reshoring as a means of securing supply lines, would inevitably sacrifice some efficiency and growth potential by diverting critical-industries output from low-cost centers in China and in other less friendly areas. Still, bipartisan support for near-shoring features of the CHIPS Act, the Inflation Reduction Act, and the Defense Production Act — including North American content requirements for electric vehicle battery production and funding for U.K. and Australian production of strategic materials — signal potential for expanded efforts in the next Congress. A build-out of the regional infrastructure for fresh legislative initiatives in the next Congress is being created by recent regional initiatives in Asia and in Europe.

Bipartisan support for legislation building on the $52 billion CHIPS Act is based partly on its modest size compared with the $556 billion semiconductor industry.

Durbin-Marshall Credit Card Competition Act

The Durbin-Marshall Credit Card Competition Act is a bipartisan legislative proposal to address credit interchange fees and enhance credit-card competition. Credit-card surcharges on certain military personnel have provided an opening for the bill's sponsors to attach the proposal to the National Defense Authorization Act.

2. "2021 State of the U.S. Semiconductor Industry," Semiconductor Industry Association, 2021
3. "US to Announce New Limits on Chip Technology Exports to China," Bloomberg, October 3, 2022

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That increases the odds of passage with bipartisan support by shifting consideration from the Banking Committee to the friendlier Armed Services Committee.

Investment implications

Here are our views for potential implications for equity sectors and sub-sectors from a Taiwan free-trade agreement and policies that could impact semiconductor production:

1. Favorable impact on industrial and semiconductor industries: These industries should show a quicker response to the Inflation Reduction Act and CHIPS Act subsidies. We also foresee increased near-shoring supporting sub-sectors in semiconductors, semiconductor capital equipment, and industrial software. Recent efforts to restrict chip exports to China may negatively affect a few U.S. companies producing relevant high-end products. However, the negative longer-term impact, particularly on semiconductor equipment manufacturing, can be expected to be partially offset by the benefits from the CHIPS Act. At this stage of development, we don't expect the impact to change our overall favorable view of the Information Technology sector.
2. Neutral impact on the Industrials sector: Capital goods and other industrials (rated neutral by Wells Fargo Investment Institute) may see only moderate support, at best, from bipartisan legislation enhancing Inflation Reduction Act and CHIPS Act-like incentives. Therefore, we remain neutral.
3. Negative impact on the air freight sub-sector: Industrials' air freight sector may be among the most exposed to near-shoring's rotation away from the critical Chinese market.

On the face of it, Durbin-Marshall credit-card legislation could compound the adverse effect of the Secure Act 2.0, discussed in the previous section, on the Financials sector. However, the biggest players in the credit-card industry should weather the adverse effects of the bill through fee restructuring, according to our Global Securities Research equity analysts.

Key takeaways

- An increase in near-shoring may potentially support a number of sub-industries within our currently favored Information Technology sector.
- The industrial and semiconductor industries may potentially benefit as companies and countries utilize the tax credit and subsidies offered by the Inflation Reduction Act and the CHIPS Act over the next 10 years.

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The state of the unions

A look into the implications of increased labor organization in the United States

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The COVID-19 pandemic fundamentally shifted many workers' priorities surrounding work-life balance. Then, as inflation increased and real wages decreased, workers began to take advantage of a strong labor market to negotiate better working conditions — reflecting their desire for not only wage growth but also more time off, safer working conditions, and more say in how workplaces operate. Work stoppages and labor organization have occurred across industries and across the country, from teachers in Ohio, Washington, and Minnesota, to therapists in California, to restaurant workers in Alabama and New Mexico. But the two industries for which we see the most investment implications of labor organization are the transportation and retail industries.

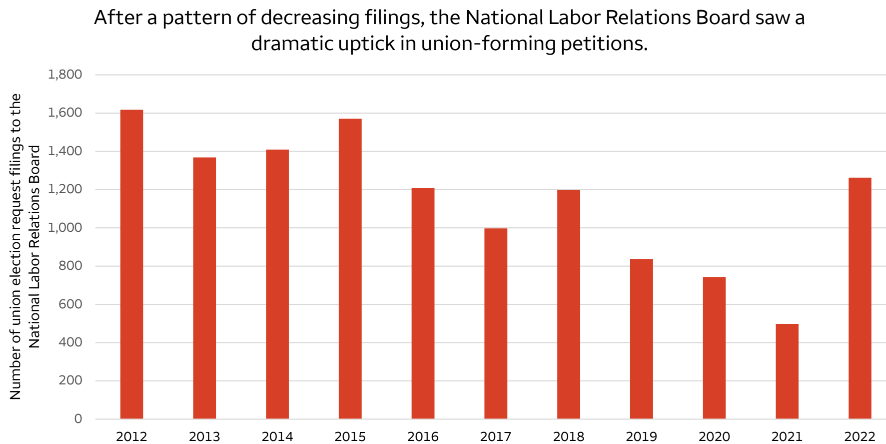
National union membership sits at around 11% of the population.

Source: Bureau of Labor Statistics, January 2022

In the first six months of 2022, there were 180 strikes across the U.S., up more than 76% from the same period in 2021.

Source: Cornell University School of Industrial and Labor Relations, June 30, 2022

Chart 1. Union filings reverse trend in 2022



Source: National Labor Relations Board/Wells Fargo Investment Institute, September 30, 2022

Transportation

One industry challenged by labor negotiations has been the transportation industry. Unions supporting port and rail workers spent a large portion of the summer embroiled in negotiations. In the middle of September, rail unions reached a tentative deal with railroad companies, with the ratification process expected to conclude in mid-November. So far, four unions have ratified the agreement, seven vote tallies remain outstanding, and one has rejected it. This unsatisfied union has agreed to delay any work stoppages until at least mid-November to allow for more negotiations. New contracts will most likely include increases in wages through 2025 and additional access to paid time off and paid sick time.

While rail unions and companies have made progress toward an agreement, port workers remain working without contracts, as they have since July. Negotiations center on wage increases and automation expansion.

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In addition, a shipping contract, the single largest private union contract in the country, will also need to be renegotiated in the beginning of 2023. There will likely be great national attention on this negotiation, and the outcome may set a precedent for wage expectations in other labor negotiations. Further disruptions to the supply chain developing from work stoppages has the potential to raise inflation, presenting a potential downside risk to our macroeconomic forecasts. Without a functioning transportation system, it's possible that few domestic goods, commodities, or imports have a chance of efficiently reaching their final destination, sending headwinds into nearly every equity and commodity sector.

Retail

Retail companies have also seen upticks in labor activities. In this space, like in the transportation industry, goals for negotiations have shifted from wages to non-wage issues, like union members having a say in how stores are managed and seeking a better work-life balance. Labor organization in the retail space has tended to be more grassroots than the large, established unions in the transportation industry, but labor movements may start to raise the cost of doing business in the retail industry, supporting our unfavorable view on the Consumer Discretionary equity sector.

The administration

President Biden has also been a vocal supporter of labor movements. Even before instructing his Labor Secretary to take an active role in preventing a rail shutdown, the president created, and accepted the recommendations of, a task force to explore how the executive branch can systematically support collective bargaining through encouraging unionization and using the federal government as a model for best practices.[4] Biden acted swiftly to reverse Trump-era rules and replace Trump appointees. Lastly, while President Biden supports the Protecting the Right to Organize Act, a bill passed in the House that makes it easier to unionize, we believe the chances that the bill will pass the Senate in the near term remain low, especially if midterm elections create a split Congress in 2023. Yet there remains a chance that Democrats try to push through some of the provisions in the bill in the lame-duck session.

Key takeaways

- The COVID-19 pandemic, a strong labor market, and inflation have contributed to an increase in collective bargaining, focusing on working conditions and wages.
- In the transportation industry, further work stoppages could significantly derail supply chains, increasing inflation and deepening the coming recession.
- In the retail industry, grassroots unionization efforts could significantly increase operating costs.

4. The White House, February 7, 2022.

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