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What federal budget, regulatory, and trade decisions could mean for investors **July 30, 2024**

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- We believe tariffs are part of a trend toward a more fragmented, protectionist foreign economic policy, likely to continue regardless of which party wins the White House.
- The goal of tariffs has broadened beyond economic issues of industry protection and reciprocity to national security issues amid mounting geopolitical tensions.
- Tariffs' initial boosts to inflation, interest rates, and the dollar are vulnerable to reversal from their dampening effect on economic growth.

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- The price inflation that we expect from tariffs would weigh on the American consumer, whose spending capacity is already stretched.
- Since COVID-19, U.S. management teams have been diversifying supply chains away from dependency on any one country, particularly China.
- Similarly, imposing tariffs could impact more equity sectors and classes, like Consumer Discretionary or small caps. Broad-based tariffs across goods and countries would likely be more impactful on consumer wallets and corporate earnings.

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- Proposed tariffs may drive heated campaign rhetoric, but we believe the long-term impact would be an acceleration of U.S. multinationals' plans to bring production home (re-shoring) or to reroute production to a country that isn't exchanging tariffs with the U.S. (friend-shoring).
- We believe that U.S. large-cap companies are best positioned to navigate through the changes and that the U.S. dollar will remain a beneficiary of proposed tariffs.

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Campaign 2024: The potential economic impact of proposed tariffs

Jennifer Timmerman
Investment Strategy Analyst

Trade policy amid heightened geopolitical tensions

Foreign trade policy is a key campaign issue with potential candidate overlap as well as significance for our economic outlook and overall investment guidance.

As certain as death and … tariffs

Tariffs are taxes imposed on certain imports from another country. Congressional backing is not needed to impose tariffs, making their swift implementation attractive among presidents seeking to make their mark on foreign trade. Their purpose has evolved over time. Until the Civil War, they were the main form of U.S. government revenue, accounting for 90% of federal receipts.[1] Their focus then shifted to protecting domestic manufacturers from competing imports until the 1934 Reciprocal Trade Agreements Act permitted the president to negotiate lower duties with other nations willing to ease their restrictions. "Reciprocity" refers to this presidential authority. Tariffs most recently have combined earlier goals of protection and reciprocity with national security, sacrificing efficiency for trade diversification away from China in a more fragmented global trade system.[2]

Former President Trump's proposed tariffs have garnered much attention this campaign season, and rightly so. The 2018 – 2019 tariffs he imposed on imports from China covered thousands of products valued around $380 billion, intensifying competition with the world's second-largest economy and rerouting global supply chains.[3] During the 2024 presidential campaign, however, we believe tariffs have become part of a broader trend away from free trade toward policies driven more by national-security concerns and industry revitalization, with public proposals from both Trump and President Biden and now presumptive Democratic party nominee and current vice president, Kamala Harris, differing only in size and scope.

Of course, campaign rhetoric may not exactly match actual policy, but to us, increased tariffs appear all but certain given the party overlap on this high-profile issue. Further, the size and scope of additional levies and trade restrictions could be used as a negotiating tool to extract concessions from China and other trading partners.

On this year's campaign trail, Trump has touted a 60% tariff on all Chinese goods, a 10% levy on all other U.S. imports, and retaliatory tariffs raised by 100% or 200%.[4] Also up for review are potential restrictions of imports manufactured by China in Mexico and other third-party countries. Tariffs imposed by President Biden have been more targeted — aimed to protect certain domestic industries, like clean energy — and were meant to compete with Trump's "tough on China" stance. The president's proposals (which at this time we see extending to Harris' campaign platform) reach beyond the tariffs and other trade barriers favored by both candidates to investment and other foreign economic policy restrictions, fostering manufacturing re-shoring and near-shoring

1. Douglas A. Irwin, "Clashing Over Commerce: A History of US Trade Policy," 1962
2. Greg Ip, "Tariffs Wielded as a Geopolitical Tool," The Wall Street Journal, May 31, 2024
3. Erica York, "Tariff Tracker: Tracking the Economic Impact of the Trump-Biden Tariffs," Tax Foundation, June 26, 2024
4. Alicia Diaz and Stephanie Lai, "Trump Vows to Boost Reciprocal Tariffs on Imports If Reelected," Bloomberg, March 2, 2024

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away from China.[5] Biden's trade measures have been part of a more active, tech-oriented industrial strategy that restricts technology transfers to China, encourages similar restrictions by U.S. allies, and subsidizes U.S. tech-oriented industries.

Weighing the immediate economic impact of tariffs

Initially, tariffs tend to contribute to inflationary pressures by restricting low-cost supply of targeted imports and boosting the pricing power of domestic-produced equivalents and, often, their close substitutes. Added pressure can come from tariffs imposed on upstream facilities producing inputs for finished goods facing cost pressures. Higher inflation carries with it the likelihood of higher interest rates, contributing to an economic slowdown led by housing and other credit-sensitive sectors of the economy. Often, however, tariffs can ease the pressure on inflation and interest rates, but only by acting like most other tax increases in squeezing spending on affected goods and other discretionary items.

Likewise, the margins of domestic companies and businesses producing close substitutes initially benefit from tariffs. However, margins are squeezed for multinationals producing affected goods abroad and for downstream producers impacted by cost. The recent experience of a U.S. appliance manufacturer is a good example of how U.S. companies can be affected both ways: protection from tariffs on washer-dryers, but input costs raised by steel tariffs. Ultimately, margins across the broader economy can be squeezed by the dampening effect of any broad-based tariff on economic growth and pricing power. Tariffs tend to be regressive in their impact on the consumer, making producers and retailers catering to the lower end of the market particularly vulnerable.

Tariffs are combining earlier goals of protection and reciprocity with national security, risking a loss of efficiency through trade diversification away from China.

Trade-policy similarities aside, Biden's (and presumably Harris') focus on a more broad-based strategy to revitalize industrial policy contrasts with Trump's more tariff-centric approach.

5. The term "near-shoring" refers to the process of moving manufacturing processes from China to countries closer to Europe or North America. "Re-shoring" refers to moving manufacturing processes back to the U.S. or Europe

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Two possible tariff scenarios for 2025

Tony Miano, CFA
Investment Strategy Analyst

Michael Taylor, CFA
Investment Strategy Analyst

A potential economic headwind

Pew Research Center recently found that Americans' top policy priority this year is strengthening the economy.[6] In our view, any policy proposal that would increase prices, be it tariffs or added regulations, could pose a risk for consumers and the economy — and, eventually, votes. We believe tariffs could become a headwind to a 2025 economic recovery, but the longer-term economic and market effects depend heavily on the flexibility of consumers and companies.

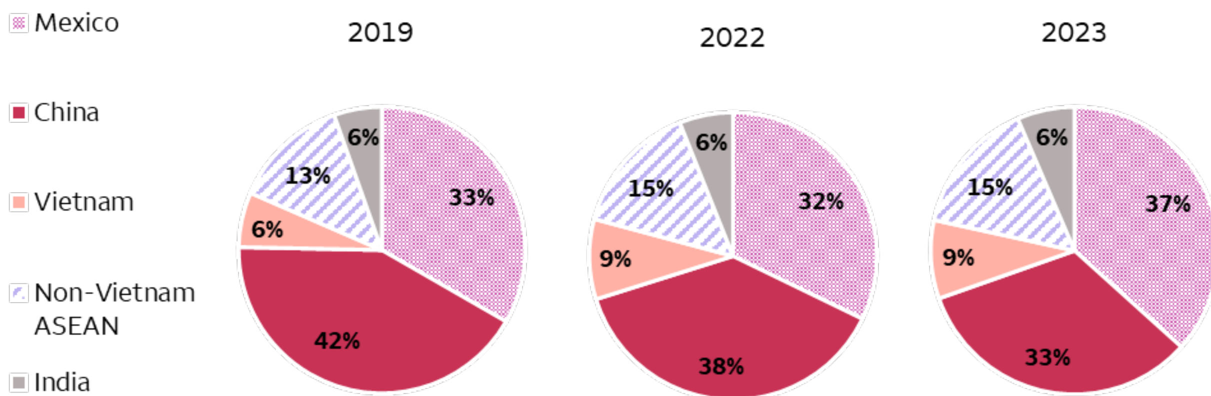
Two possible scenarios for levying new tariffs

Given messaging on tariffs from both camps, we see two possible scenarios:

Scenario 1 — Limited tariffs: In the event that imposed tariffs are limited to certain countries and not so extreme as to trigger retaliation that escalates into a global trade dispute, we do expect that consumers and businesses will have to modify the sourcing location of goods. These adjustments eventually should circumvent tariffs on China and its companies working in other countries. This scenario would be our assumption for a Democratic-led administration or for a Trump administration that is selective in applying tariffs.

We believe supply chains are diversifying and management teams are sufficiently nimble to navigate tariffs under this scenario. As the chart below demonstrates, the supply chains of certain goods since 2019 have started to expand in countries like Vietnam and Mexico, but it is unclear how much of this growth has been diversified away from China, or if China may be responding by offshoring factories to these countries (or others) to remove the "Made in China" label. If management teams are given adequate notice, we do not doubt that the flexibility gathered during the pandemic would help them circumvent the brunt of new levies. We believe that this is the more likely of the two scenarios.

Chart 1. U.S. imports of key trade partners by country of origin, 2019 – 2023 (in billions of dollars)



Sources: U.S. Census Bureau USA Trade Portal, Office of Technology Evaluation, data as of July 11, 2024. ASEAN he = The Association of Southeast Asian Nations.

6. Pew Research Center, February 29, 2024

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Scenario 2 — Widespread and aggressive tariffs: Diversification likely would help less if the tariffs are widespread and high. This prospect is worth considering given hard-line[7] posturing from Trump on a potential 60% tariff on Chinese imports and a ubiquitous 10% tariff on all goods entering the U.S.[8] Widespread tariffs would be more difficult for management teams to circumnavigate. Shifting all or a major portion of production lines back to the U.S. in a short time frame is not feasible for most industries. In this scenario, consumer goods would likely see a combination of sustained consumer price inflation and profit-margin pressure. While it is possible that Trump's statements are merely the opening bid in a bargaining strategy with other governments or that bilateral trade deals might offset portions of a universal tax levy, this scenario is still a possibility, although not currently our base case.

Domestic investment implications

Trump's tariffs in 2018 significantly increased volatility for several equity indexes.[9] We would expect a similar market effect with a new round of meaningful tariffs. More speculative sectors and asset classes, such as Consumer Discretionary, high-yield bonds, and small-cap equities, may be particularly hard hit under such an extreme scenario. We currently hold unfavorable or most unfavorable guidance ratings on these asset classes.

Downside risks to the economy from trade restrictions could collide with an already slowing economy and a consumer weakened by the cumulative effect of recent price inflation. This potential risk reinforces our investment focus on quality, by which we favor domestic companies with strong balance sheets and cash flow capable of weathering a challenging economic environment. Longer term, we believe the legitimate goal of national security will impose a cost to economic growth and inflation tied to the shift from more open, efficient trade to a more costly, fragmented system. The main economic effects from tariffs could eventually be mitigated as the U.S. diversifies its imports, but this requires structural shifts in supply chains that take time and likely would provide limited immediate relief. In the near term, additional tariffs likely will restrain economic growth and put upward pressure on inflation, interest rates, and the U.S. dollar — all factors considered in our existing macroeconomic outlook.

More high-income consumers are purchasing from traditionally discount retailers, a sign of widespread stress on household budgets.

Source: "It Looks Like High-Income Shoppers Are Becoming Increasingly Loyal to Walmart," Business Insider, Feb 21, 2024

A flat 10% tariff on all imports would increase annual expenses by roughly $1,700 for the average U.S. middle-class household.

Source: "Why Trump's Tariff Proposals Would Harm Working Americans," Peterson Institution for International Economics, May 2024

7. "Trump Floats 'More Than' 60% Tariffs on Chinese Imports," CNBC, Feb 4, 2024
8. "Why Trump's Tariff Proposals Would Harm Working Americans," Peterson Institution for International Economics, May 2024
9. As measured by 90-day volatility of the S&P 500 Index and the Russell 2000 Index, Bloomberg, July 5, 2024

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Global tariff response and implications 2.0

Douglas Beath
Global Investment Strategist

Michelle Wan, CFA
Global Investment Strategist

How China may react

As the political discussions gain momentum, potential tariffs remain center stage, as the implications can shed light on the course of global trade and how U.S. multinationals may allocate resources in the next four years. The presumptive Democratic nominee Harris and former President Trump disagree on details, but directionally, China seems to be where the proposed tariffs would focus. We believe China would retaliate while seeking alternative options to sustain its export-led economy. U.S. multinationals could face retaliation in China and in other countries subject to U.S. tariffs, and we expect this treatment would only accelerate U.S. plans to re-shore or friend-shore.

China's response from the government and corporations

Beijing has already started to respond in kind to the Biden administration's tariffs. China's Ministry of Commerce (MOFCOM) promised that China will take resolute measures to defend its rights and interests.[10] Beijing may prefer rhetorical replies, but they have shown neither hesitation nor reluctance to retaliate in kind, even dollar for dollar in the case of the 2018 tariff exchange.

Meanwhile, Chinese companies will be weighing options to avoid tariffs. One option is to open factories abroad or reroute products through third-party countries. Chinese exporters already do this by producing U.S.-bound solar panels in Southeast Asia or developing battery facilities in U.S. free trade–aligned countries such as South Korea and Morocco, in an attempt to qualify for Inflation Reduction Act subsidies.

Chinese electric-vehicle makers have been building new supply chains and distributions as they brace for the prospect of hefty tariffs in Europe. According to The Wall Street Journal, some Chinese manufacturers have already started building factories on the continent while others have set up joint ventures there to maintain access to one of their most promising markets.[11] Still others are looking at exporting to Europe from third-party countries, such as Thailand, while some are turning away from Europe altogether, rethinking their road map to growth and turning to markets where they have a better shot at displacing incumbents.

Responses from U.S. multinationals in China

American firms in China are being squeezed by escalating geopolitical tensions, tit-for-tat measures on trade and exports, and China's drive for self-sufficiency. The Chinese market's shining crown as the world's manufacturer is wearing off. China's economic growth fell to its slowest rate in decades last year; consumers there are spending less, especially on foreign brands; and its once-unstoppable export machine is faltering. In our view, the path has been set since the initial trade war began during President Trump's administration. Since 2018, China's share of U.S. imports has changed direction. We believe as the geopolitical tensions accelerate, with both presidential candidates likely introducing additional tariff measures, the pace of further disengagement would exacerbate, but we do not anticipate the path would revert.

10. "China Vows 'All Necessary Measures' Against Additional US Tariffs," Global Times, May 14, 2024
11. "China's EV Makers Saw Europe Tariffs Coming, and Many Already Have a Plan" The Wall Street Journal, June 13, 2024

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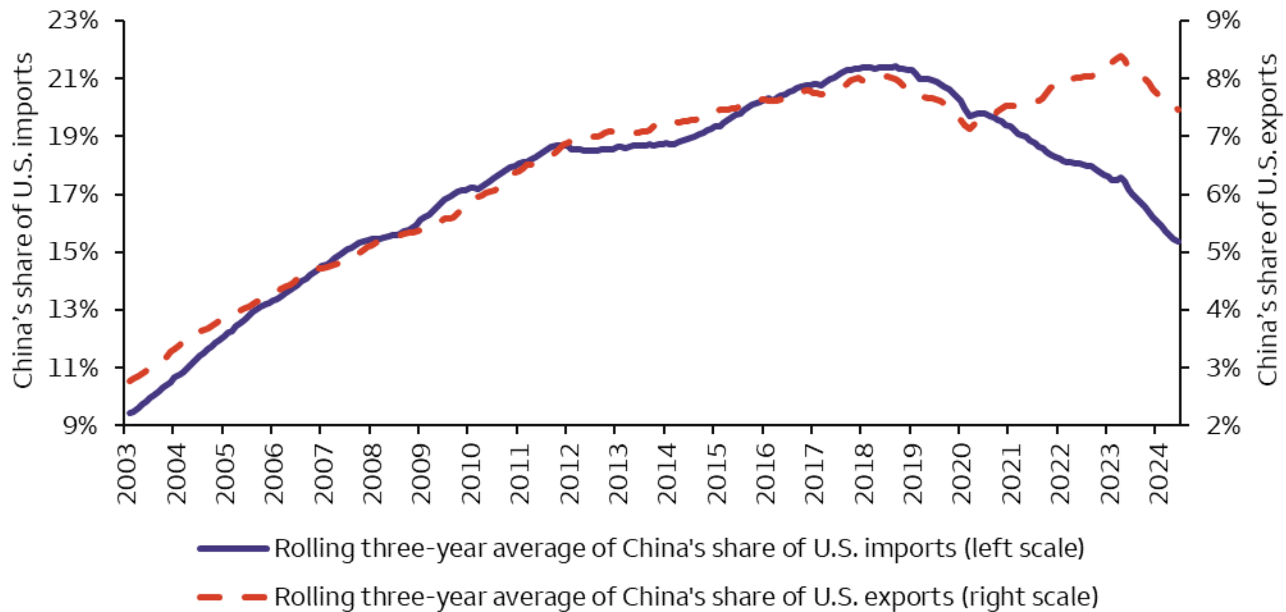
Chart 2. China-U.S. trade dependency has been declining



Sources: Bloomberg and Wells Fargo Investment Institute, data as of June 30, 2024.

International investment implications

Tariffs can directly impact exchange rates by appreciating the currency of the tariff imposer and depreciating the currency of the tariff payer. With the tariffs of 2018, we attributed a significant amount of the Chinese offshore renminbi's fall to U.S. tariffs.[12] We believe that any tariffs would be beneficial for the U.S. dollar, but widespread or aggressive tariffs such as those proposed by Trump could slow global trade and economic activity. Over the past 40 years, global tensions have tended to drive international investors into U.S. markets, thereby boosting the dollar's value. For an investor whose primary currency is the U.S. dollar, a stronger dollar undercuts the returns from international investments and tends to favor domestic allocations instead. Compared with international financial markets, we prefer commodities (already priced in dollars) and U.S. financial markets, both because of the relative strength of the U.S. economy and because of the risks to international markets if higher tariffs become reality after this election.

12. We track the renminbi in offshore markets because China's central bank manages the currency's exchange rate within China

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Risk considerations

Forecasts are not guaranteed and 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. Small- and mid-cap stocks are generally more volatile, subject to greater risks and are less liquid than large company stocks.

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.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation, and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

Definitions

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.

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.

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.

An index is unmanaged and not available for direct investment.

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