



Policy, Politics & Portfolios

What federal budget, regulatory, and trade decisions could mean for investors

May 28, 2026

Our base case is that geopolitics, fiscal pressure, and artificial intelligence (AI)-related infrastructure demand are combining to potentially keep inflation and long-term yields structurally firmer than consensus expects¹, reinforcing our preference for financials, selective AI-related companies, and intermediate over long-duration fixed income.

The Iran war's enduring impact 2

- We see fallout reverberating across the global economy well after the Iran war ends, including elevated fossil fuel and food prices, despite a gradual unwind of economic distortions.
- Looking beyond the war's end, ongoing geopolitical uncertainties may reinforce demand for military and security tools driven by AI, while persistent oil price volatility likely dilutes OPEC+² influence over crude oil prices.

New chair unlikely to change the Fed quickly 4

- Federal Reserve (Fed) Chair-designate Kevin Warsh has been confirmed by the Senate and will succeed Jerome Powell. While Warsh may hold some unconventional views, we believe policy changes are unlikely to occur quickly or without majority approval from other Fed officials.
- Regardless of Fed action and policy, we see long-term yields rising, supporting our unfavorable view on U.S. Long Term Taxable Fixed Income and most favorable view on Financials within Equities.

The evolving regulatory landscape for data centers in the U.S. 6

- Despite regulatory pushbacks, the momentum behind AI remains strong, with capital expenditure (capex) related to AI projected to reach an all-time high of \$750 billion in 2026.
- We are favorable on the AI theme, while closely monitoring valuations. In early April, we upgraded the Information Technology sector within Equities to favorable following a market pullback. We also see continued upside potential for Utilities and Industrials as beneficiaries of ongoing AI-driven investment.

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1. As of May 21, 2026, the Bloomberg weighted average of consensus estimates for the year-end 2026 10-year U.S. Treasury yield was 4.17%, versus our year-end 2026 target range of 4.25-4.75%.

2. The Organization of Petroleum Exporting Countries and its allies.

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The Iran war's enduring impact

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Not quite over 'til it's over for the global economy

The Iran war is the latest in a series of conflicts in a strategically important region. This conflict stands out for its duration and the disruption to global trade from the extended closure of the Strait of Hormuz. The impact has also been uneven across countries. The U.S. has been more insulated due to its role as an energy exporter, while both the U.S. and north Asian economies have been more insulated from ongoing AI investment.

We expect the global economic effects to linger even after the war ends. In our view, fossil-fuel prices — and to a lesser extent food prices — are likely to remain elevated while energy-supply disruptions should gradually fade in a lagged response to the reopening of the Strait of Hormuz. Some emerging-market governments may also face added fiscal and political strain as they increase subsidies to offset cost-of-living pressures. After the war, we anticipate a gradual normalization that could include businesses drawing down elevated inventories and consumers shifting spending back toward travel and other discretionary purchases deferred during the conflict.

Longer-term impacts to watch

We note the potential longer-term geopolitical, financial, and trade effects of the conflict:

1. **More global economic fragmentation:** The pandemic-driven switch to redundant supply chains is well along, but the war adds a new wrinkle. We see more countries, such as the U.S., Brazil, and Nigeria, potentially expanding their energy production, while energy importers seek that kind of diversification. The search may extend to other natural resources (like rare earth metals) and international payment systems to compete with the U.S. SWIFT system.³ The reliance on multiple ways to do business globally may increase production costs.
2. **Sometimes alliances must evolve to stay healthy:** Relationships on occasion need time and a reason to catch up to events, and the catch-up can feel disorienting. Likewise, clear challenges from Russia, China, and Iran in recent years have pushed the U.S. to review how it participates in its international alliances. While we expect the NATO⁴ and other alliances to endure, some political uncertainty may persist while the changes develop.
3. **New — but limited — competition for the U.S. dollar:** Trade fragmentation and loud but limited opposition from China and others to the U.S.-guided international order are likely to elevate the use of some other currencies with narrow international circulation. At the margin, this may accelerate some erosion of the U.S. dollar's payment role, however, we believe the competition is unlikely to replace the U.S. dollar as the world's main reserve currency.

2. The Society for Worldwide Interbank Financial Telecommunications (SWIFT) system is a global messaging network that enables secure and efficient international money and securities transfers.

3. The North Atlantic Treaty Organization (NATO) is a political and military alliance of countries from Europe and North America.

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4. **Potential diversion of foreign capital away from the U.S.:** If Gulf governments redirect financial surpluses toward reconstruction and defense, they may invest less in U.S. assets at a time when U.S. Treasury borrowing needs are already high. Gulf states held about \$315 billion in U.S. Treasury debt at the end of 2025 (just over 1% of total U.S. Treasury debt held domestically and abroad); however, U.S.-dollar assets account for approximately \$2 trillion of the more than \$5 trillion managed by Gulf sovereign wealth funds.⁵

Investment implications of the Iran war

Even after the Strait of Hormuz reopens, it may take two to three months for shipping flows to fully recover in Asia and elsewhere. We expect markets will remain sensitive to headlines while supply chains normalize. In equities, we continue to prefer areas that have historically tended to benefit from steady economic activity, including Financials and Industrials.

Outside the U.S., economies are already feeling the effects of the disruption more directly. For example, Indian Prime Minister Modi recently advised his country to work from home as much as possible and to avoid travel, and some European airlines have limited the number of short-hop flights.⁶ If conditions improve as we expect, we still view Emerging Market Equities as appropriate at a neutral, or full, portfolio allocation — particularly markets tied to the AI investment cycle (notably in north Asia). In fixed income, we believe moderating inflation later this year could help support shorter-maturity, higher-quality bonds and keep credit spreads relatively contained. We still view intermediate-term fixed income (3-7 year maturities) as offering the most value with attractive coupons and less duration (a measure of interest rate sensitivity) risk than longer-dated bonds.

Within the Industrials sector, we see mixed but overall positive implications for Aerospace and Defense. In our view, the conflict reinforces higher military spending and multi-year procurement programs. Over time, an eventual improvement in travel conditions could also support demand for commercial aircraft and related equipment. We remain cautious on Airlines, where elevated fuel costs may pressure earnings. We also see potential benefits for Machinery and Electrical Equipment as inventories rebuild and longer-term supply-chain shifts support demand.

The Middle East is an important link in the AI supply chain, producing about 30% of the world's helium and acting as a conduit for 30% of the total transmitted internet traffic worldwide.

Source: "AI, Iran and the Gulf 101," Deutsche Bank Research Institute, April 13, 2026.

5. "Should We Worry About Gulf Countries Reducing Investments in the U.S.?" Forbes, March 7, 2026.

6. BBC, "Modi urges Indians to WFH and limit foreign travel as Iran war continues," May 11, 2026.

New chair unlikely to change the Fed quickly

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A long-awaited transition in leadership

Kevin Warsh recently was confirmed by the Senate and will succeed Jerome Powell as chair of the Fed. While markets are focused on what this leadership change could mean, we believe investors should look beyond the headlines. We believe key drivers of interest rates — like inflation, economic growth, and government borrowing — are likely to matter more than who leads the Fed.

A Fed insider with unconventional plans

Warsh is a Fed veteran, having served as a governor from 2006 to 2011, including during the Global Financial Crisis. At the same time, some of his views differ from the current consensus. He has signaled support for lower interest rates and has suggested that AI-driven productivity could help cool inflation over time. He also strongly supports shrinking the Fed's "balance sheet," meaning reducing the U.S. Treasury and mortgage-backed securities the Fed holds after years of bond buying both during and after crises.

Warsh argues that reducing those bond holdings could support the case for lower short-term rates. But it can also push in the opposite direction for long-term yields. If the Fed owns fewer bonds, private investors may need to absorb more Treasury issuance and may demand higher yields. In his view, a smaller balance sheet and lower interest rates can work together to support the economy in a healthier way, without the market distortions and asset bubble created by years of bond buying.

The Fed was not built in a day

Even with a new chair, the Fed typically changes direction slowly. Policy decisions are made by the Federal Open Market Committee (FOMC), which has 12 voting members. Meaningful shifts usually require a majority, not just the chair's preference. Recent Fed communications suggest limited appetite for near-term rate cuts given a resilient labor market and still-elevated inflation. As a result, we expect any change in policy stance to take time and to depend on broader agreement across the committee.

Another factor that could support Fed policy continuity is that Jerome Powell intends to remain on the Fed's Board of Governors through 2028. While uncommon, we think this could add stability during the leadership transition and may reduce the odds of abrupt policy shifts.

Table 1. Fed decision-makers at a glance

Name	Position	April 2026 Vote	Notes
Jerome H. Powell	Chair (Expired in May)	Neutral	Remaining on the Board of Governors after his term as chair ended
Philip N. Jefferson	Board of Governors Vice Chairman	Neutral	
Stephen I. Miran	Board of Governors	Dovish	Replaced by Warsh as chair
Christopher J. Waller	Board of Governors	Neutral	
Michelle W. Bowman	Board of Governors	Neutral	
Lisa D. Cook	Board of Governors	Neutral	Under federal investigation
Michael S. Barr	Board of Governors	Neutral	
Beth M. Hammack	Cleveland Federal Reserve	Hawkish	In April, voted to remove easing bias
Lorie K. Logan	Dallas Federal Reserve	Hawkish	In April, voted to remove easing bias
Neel T. Kashkari	Minneapolis Federal Reserve	Hawkish	In April, voted to remove easing bias
John C. Williams	New York Federal Reserve	Neutral	
Anna Paulson	Philadelphia Federal Reserve	Neutral	

Source: Wells Fargo Investment Institute as of May 11, 2026.

What it may mean for investors

We believe investors should focus less on headline noise around leadership changes and more on the broad forces driving interest rates and yields — especially inflation, economic growth, and the federal government’s borrowing needs. Inflation remains elevated amid the ongoing Iran war, and the U.S. Treasury is expected to issue substantial debt (to fund the deficit and refinance maturing bonds). We believe these forces can keep upward pressure on longer-term yields regardless of who chairs the Fed. One key driver is the *term premium* — the extra yield investors demand to hold longer-maturity bonds — which we expect to rise.

We remain unfavorable on U.S. Long Term Taxable Fixed Income and prefer the intermediate portion of the yield curve where we see a potentially better balance of risk and return. A change in Fed leadership cannot, by itself, offset the volume of Treasury issuance that is required to meet growing deficit needs. When coupled with inflation readings above the Fed’s 2% target, we think these factors are likely to push long-term yields higher over time. As the yield curve remains steep (longer maturity yields higher than shorter maturity yields), we believe the Financials sector within Equities should benefit from the greater spread between short-term deposit rates being paid on deposits and long-term rates being received on loans. As a result, we are most favorable on the S&P 500 Index Financials sector.

Chair Powell intends to stay on as a governor after his term as Fed chair ends. Powell is the first chair to do this in almost 80 years.

Source: The Wall Street Journal, “Why Jerome Powell Decided to Stay at the Fed,” May 3, 2026.

Since the Fed began lowering interest rates in 2024, the Federal Funds rate has fallen by 169 basis points (or bps, 100 bps equals 1%) while the 10-year Treasury yield has risen by 70 bps.

Source: Bloomberg, May 6, 2026.
The Federal Funds rate is measured by the Federal Funds effective rate.

The evolving regulatory landscape for data centers in the U.S.

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Regulators are challenging the AI buildout, but momentum remains strong

Data centers — the buildings and equipment that power cloud computing and many AI applications — are expanding across the United States quickly. That growth is drawing attention from state and local policymakers, especially around electricity costs, grid reliability, and how limited power is allocated. By early 2026, more than 300 data-center-related bills had been filed across 30-plus states; as of early May, none had been enacted into law. We expect companies to keep making the case for data centers by addressing local cost concerns and emphasizing broader economic benefits.

How the industry is responding

One example is the Ratepayer Protection Pledge, signed in March 2026 by seven of the largest cloud providers (often called “hyperscalers,” or companies representing the largest providers and users of computing capacity). In this pledge, the signers commit to fund the full cost of the new power generation needed to support their projects. In our view, that directly addresses a core concern — that households and small businesses could end up subsidizing data center demand through higher utility rates.

Where new data centers are being built

The buildout is geographically flexible. When regulations or permitting become more restrictive in one area, companies are likely to shift projects to states with more supportive policies and available power. Today, Texas and the Midwest account for roughly one-third of operational hyperscale capacity and are projected to absorb 53% of new builds over the next few years.⁷

Momentum check

Despite the policy debate, we still see strong underlying momentum. Technology remains a key driver of U.S. growth, and much of the next leg of investment is tied to AI and the data centers that support it (see Chart 1). Recent quarterly corporate earnings results from several large operators exceeded expectations, including capital expenditures (capex). As of early May, estimates suggest AI-related capex could reach roughly \$750 billion in 2026 — an all-time high.

At the same time, the basic “plumbing” needed for the buildout is getting tighter — including limited supply of new power generation, grid connections, and key electrical equipment. Even with these constraints, demand for AI-related infrastructure continues to rise.

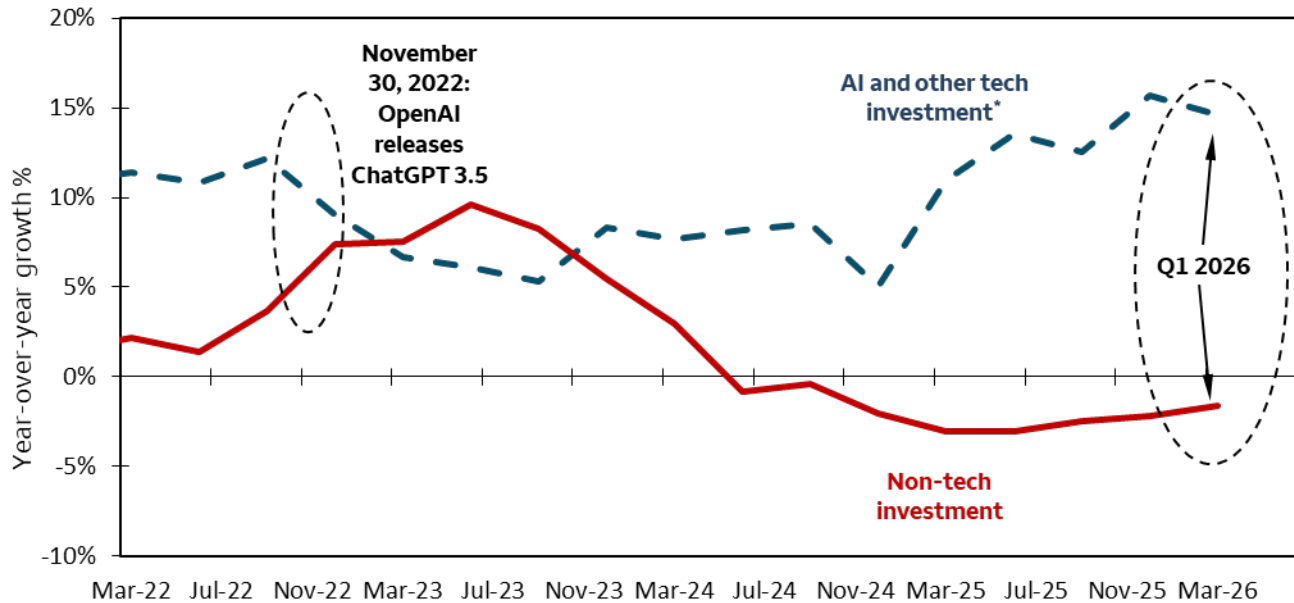
Key constraint: power

The most immediate constraint has been power. Data centers require large, steady electricity supply, and new grid connections and power contracts often depend on state and local approvals. When the grid cannot keep up, the largest cloud providers (hyperscalers) are increasingly turning to on-site, off-grid generation — most commonly natural-gas turbines. Demand has been strong enough that major turbine manufacturers now report order backlogs extending into 2029 and beyond.⁸ For now, suppliers appear able to increase production to meet demand.

7. Synergy Research Group, “U.S. Hyperscale Investment Shifts Decisively Inland,” 2026.

8. Utility Dive, “GE Vernova Expects to End 2025 With an 80-GW Gas Turbine Backlog That Stretches Into 2029,” December 11, 2025.

Chart 1. AI driving investment spending in U.S. GDP growth



* Data centers, power, tech and other electronic structures, info-processing equipment & software.

Sources: Wells Fargo Investment Institute, U.S. Census Bureau, and U.S. Department of Commerce. Quarterly data as of March 31, 2026. GDP = Gross Domestic Product. For illustrative and educational purposes only.

What it may mean for investors

Why it matters: If new rules meaningfully slow AI-related capex, they could weigh on U.S. growth. For example, AI-related spending supported first-quarter real gross domestic product (GDP) growth, contributing nearly 1.3 percentage points of the 2.0% total.

What markets are signaling: Hyperscaler capex has continue to exceed expectations, and the Information Technology sector has outperformed the S&P 500 since the Middle East conflict began. To us, that suggests markets do not view AI regulation as a near-term, high-probability threat.

What to watch next: The industry is increasing engagement with policymakers. A newer group, the National AI Association (NAIA), has been meeting with lawmakers, and major technology firms have increased lobbying and advertising aimed at positioning data centers as economic drivers for local communities.

Portfolio positioning: We remain favorable on the AI theme while closely monitoring valuations. We believe U.S. large- and mid-cap equities are well positioned to benefit from sustained AI demand. In early April, we upgraded the Information Technology sector to favorable, which we viewed as well supported by strong fundamentals and more attractive valuations following an early-year pullback. We also see continued upside potential for Utilities and Industrials as possible beneficiaries of ongoing AI-driven investment.

Following first-quarter earnings results, capex from major hyperscalers is projected to approach \$750 billion in 2026, largely directed toward AI chips, servers, and data centers.

Source: Forbes, "Big Tech's AI Spending Spree Could Reach \$750 Billion This Year," April 30, 2026; Bloomberg NEF, "AI Data Center Build Advances at Full Speed: Five Things to Know," March 24, 2026.

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.

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 the **Financial** services companies will subject an investment to adverse economic or regulatory occurrences affecting the sector. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation, and government regulations, among other things, all of which can significantly affect a portfolio's performance. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market. **Utilities** are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

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In addition to the risks associated with investment in debt securities, investments in mortgage-backed securities will be subject to prepayment, extension and call risks. Changes in prepayments may significantly affect yield, average life and expected maturity.

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