October 15, 2020

US Elections: The Colour Purple

The colour purple, a mix of Republican red, and Democratic blue, the colour that could herald yet more gridlock on Capitol Hill when it comes to important issues such as fiscal stimulus, a colour that markets are increasingly apprehensive about. The

US elections are now only a fortnight away and 12 million Americans have already voted. While focus falls on whether Trump or Biden will take the Oval Office, the composition of Congress is of even greater significance: Regardless of who is President, there are three degrees of separation between that candidate's agenda and the implementation of said agenda.

As it stands, the Republicans hold the White House and the Senate, while the Democrats have a majority in the House of Representatives. Bickering between the reds and the blues has stalled the roll-out of a second, much needed fiscal stimulus in response to the pandemic, leaving millions of American households and businesses dangling over the edge of an income cliff, risking long-term, structural damage. The Democrats are calling for a huge relief package, worth at least $2.2 trillion and continue to block Republican proposals (most recently $1.8 trillion) which they view as insufficient.

While a divided government is often praised for encouraging more policing of those in power by the opposition, the pandemic has underlined that with such extreme political polarisation in the US, it can also create legislative gridlock, affecting the efficiency of the government which in this case is hampering the economic recovery. This is one of the underlying reasons why markets were surprisingly bullish about Biden's widening lead in polls and about the growing prospect of a "Blue Wave".

WHAT IS A BLUE WAVE?

A blue wave refers to a Democratic sweep in which they take control of all three branches of government. Already, the Democrats control the House and it is widely expect that they will hold on to this. Since the presidential debate on September 29th, polls show increased likelihood not only of a Biden presidency, but of a Democrat majority in the Senate. If the polls are wrong and the Republicans keep a majority in the Senate, they will be able to obstruct certain elements of the Democratic agenda, in the event that the White House is lost. If the Republicans keep the White House and the Senate, we can expect more of the same.

THE PRESIDENT	HOUSE OF REPRESENTATIVES	THE SENATE		
		As at today		
Biden vs Trump	All 435 voting seats up for election; 218 seats are necessary for a majority. It's widely expected that the Democrats hold on to their majority	53 Republican	45 Democrats	2 Indep.
		35 of 100 seats are up for re-election		
		Republicans defend 23	Democrats defend 12	

THE BLUE SKIES THAT MARKETS ENVISAGE...

Since polls revealed an increased likelihood of a blue wave, markets have risen, notably cyclicals and small-caps which lagged bigger names in the ascent that began in March.

The market's reaction to polls has indeed been contrary to traditional intuition: Democratic policies (higher taxes[1], higher public spending and more regulation) have typically been perceived as "bad for business", while "Trumponomics" have been very supportive of stock markets; Trump was quick to slide the knife through corporate tax rates (decreasing them from 35% to c.21%) and he has presided over an equity market that skipped from new high to new high, as well as a 50-year low in the unemployment rate.

However, markets now seem to favour the outcome that is most likely to give the stimulus-thirsty economy what it needs, ASAP. A blue wave would make it easier for the Democrats to roll-out a significant fiscal stimulus plan. While giving up any vestige of fiscal conservatism sounds scary over the longer term, it seems that for the meantime, investors are consoled by Fed Chair Jerome Powell's recent pledge to work "side by side" with Congress (code for "you have our balance sheet for your financing needs"?). It could also be perceived that by not doing enough now is scarier, as it could leave lasting economic scars that take years to heal.

If the Senate remains in Republican hands
or if there is a Trump victory combined with a divided Congress, further delays with regard to stimulus might be expected. In turn, this could be detrimental to the economy and markets will be continue to tank and crest on discussions around the timing, shape and size of a support package.

FOREIGN POLICY

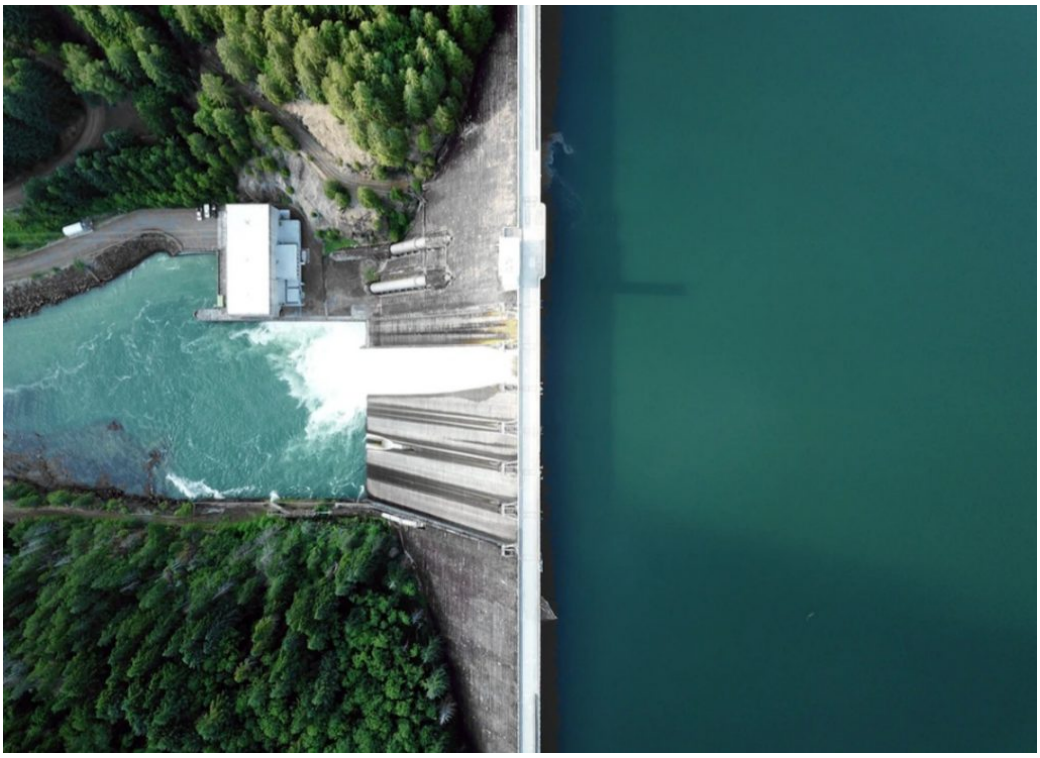
There is another reason why a blue victory
may be welcomed by markets… When it comes to foreign policy, Biden may adopt a less bellicose rhetoric, especially on trade. In 2019, the US-China trade war was a major headwind for global growth and before the coronavirus pandemic stole the show, markets were held hostage to US trade policy (often communicated bluntly via the Trump Twitter feed), resulting in elevated volatility. While frictions with China – especially with regard to technology and intellectual property – are unlikely to go away (opinion polls show that both Republican and Democratic voters support a tough stance on China), it is expected that Biden would adopt a less impulsive communication policy.

SECTOR IMPACTS

While the market as a whole is warming to
the idea of a blue wave, the election outcome will have varying implications for different sectors and areas of the economy. Initially, a Republican stronghold should support corporate confidence (no risk of higher taxes) and increase their propensity to resume investment. Democrat success should foster wealth redistribution (e.g. Biden supports a $15 minimum wage), supporting consumption at the lower end of the income spectrum

The sectors that are likely to benefit the most from a blue wave are utilities, consumer staples and materials. Contrasting with Trump who withdrew the US from the Paris Climate Accord, a central tenet of Biden's campaign has been based on greening the economy and achieving

carbon neutrality by 2050. This could be a catalyst to unlock significant capex opportunities towards renewables and carbon capture. Just on the anticipation of a blue wave, "green stocks" have rallied in the past weeks. The aforementioned sectors are likely to be key beneficiaries of any switch towards decarbonization.



Detroit Dam, Oregon. A renewable power source.

On the same note, the Energy sector faces prominent headline risk around the election. The medium to longer-term implications from an administration focused on decarbonisation (vs. the status quo) are significant while a Biden win could also mean stringent regulations on fracking.

The outcome for financial stocks is more difficult to ascertain. Wall Street has enjoyed halcyon days with Trump in the Oval Office and tighter regulations under the Democrats could be challenging. However, price movements in recent weeks suggest that market participants potentially think the benefits of stimulus-induced economic growth from a Biden win would outweigh the costs of a stricter regulatory regime.

Health Care is traditionally the first sector on investor minds when discussing political repercussions. From the Democrats, Biden campaigned against Medicare for All, but an extension of the Affordable Care Act (aka Obamacare) or Medicare to particular segments of the

population could be expected with a potential impact on Healthcare Services companies. For pharmaceutical companies, the political rhetoric related to drug pricing will probably be less relevant in the current context and for as long as the majority of the population is not vaccinated against Covid-19. MedTech remains largely insulated to regulatory and pricing risk via-a-vis the broader sector.

Information technology is exposed to headline risk on Big Tech regulation and breakups from both parties. Criticism around privacy, misinformation and monopolistic behavior is abound on both sides of the Atlantic, while tighter regulation on China could impact hardware supply chains. But ultimately, those firms involved in the advent of the Fourth Industrial revolution and digitalisation are likely to be relatively unaffected by the political backdrop.

Bottom-line, at least we can agree that a
blue wave will be green and that ongoing structural trends will persist.

BUT
WHAT ABOUT THE GREENBACK?

The composition of government, however the
chips may fall, will have a blend of pros and cons for the dollar.

What we should remember is that while the stars were aligned for a stronger dollar prior to the crisis, it simply did not happen. Policies unveiled during Trump's tenure such as tax cuts, those that encourage the repatriation of overseas earnings and deregulation of many industries were all dollar-friendly. A blue wave and the reversal of some of these policies could indeed bring about a weaker dollar. Moreover, the resulting twin deficits risks from higher spending risks eroding the dollar's credibility. If the Republicans hold onto the Senate, they will still be able to constrain spending to some extent.

CONCLUSION

The fulcrum of investor sentiment seems to have become fiscal stimulus. Cognizant of this, there is always the chance that Trump waits until the last minute to unveil his own large-scale stimulus plan. While it has not been forthcoming, he recently tweeted "STIMULUS! Go big or go home!!!".

Readers are reminded that we have no magic 8 ball – polls and prediction markets have little success when it comes to divining the outcome of elections. This is especially so in the US where the Electoral College[2] system means that Presidents are not elected on overall popularity. The election result could still swing either way. Let's stay humble, market prognosticators are notoriously bad at this stuff even if the sell-side industry is full of convictions about how the November 3rd vote will spur regime shifts in financial markets. The consolation is that a well-diversified portfolio and robust investment strategy should better navigate short term financial market turbulence, regardless of a red, blue or purple outcome.

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[1] Biden's proposed tax plan involves a partial reversal of the 2017 Trump tax cuts, from 21% to 28% and a new minimum corporate tax rate of 15%. Source: https://taxfoundation.org/joe-biden-tax-plan-2020/

[2] To win the election, a candidate must receive a majority of electoral votes from the Electoral College. The Electoral College consists of 538 electors, and an absolute majority of at least 270 electoral votes is required to win the election.

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