

MARKET INSIGHTS: PLANNING FOR POTENTIAL 2020 ELECTION RESULTS

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We are entering the homestretch of the 2020 presidential election season.

With two polarizing presidential candidates, an ongoing pandemic, a recession, social unrest and a mail-in ballot controversy, this cycle is truly like no other.

We are reminded of the expression, “Other than that, Mrs. Lincoln, how did you like the play?”

We don’t know who will win, but because of the expected increase in mail-in ballots, we do believe we may not immediately know the outcome on November 4. The polls, barring an unforeseen “October Surprise,” are likely to stay close. The presidential election may, once again, come down to the Supreme Court, as it did in 2000 when it declared George W. Bush the winner over Al Gore.

This, in turn, may have a significant impact on market volatility¹ until the outcome is determined.

Given that view, we lay out four possible election outcomes, with our thoughts on how the markets may react to each one. Our hope is that advisors can begin to think ahead and plan for different potential scenarios.

¹ Volatility: A measure of the dispersion of actual returns around a particular average level.

POTENTIAL OUTCOME 1: JOE BIDEN WINS, AND THE DEMOCRATS SWEEP THE HOUSE AND THE SENATE

We refer to this as a “Blue Wave” and believe there are at least two potential scenarios under this outcome. We do not anticipate that either party will gain a filibuster-proof majority in the Senate, but some Democrats have suggested they may attempt to overturn the filibuster provision if they win. This is possible because the filibuster is not a Constitutional issue—it’s a Senate tradition dating back to the 1850s.

It is also worth noting that the Democrats would not need to eliminate the filibuster in order to pass tax hikes—in many cases, all they would need is a simple majority.

We also believe a Biden presidency would retain Jerome Powell as Chair of the Federal Reserve, which would signal a continuation of a mostly “accommodative” monetary policy.

Scenario: A Democratic sweep of all levels of government results in slower economic growth, higher taxes, increased regulation, a less “business-friendly” governmental environment (including key cabinet posts), continued easy monetary policy and a continued bipartisan spending blowout. This prospect could create a heavy burden for the market to bear in the coming years.

Potential Market Reaction:

+ Equity Markets:

- Overall, we view this scenario as largely negative for the equity markets, especially if it results in an increase in corporate tax rates.
- We expect more infrastructure and deficit spending, causing infrastructure-related investments to do well (materials and industrials).
- While tax policy and regulation are a negative for equities, corporate tax hikes may not be passed until 2022.
- Another possible negative for equities and all financial assets is the increased potential for a financial transaction tax.
- Higher unemployment benefits and minimum wages would be good for consumer companies.
- More predictable trade negotiations could be a positive for Asian emerging markets—and China relations, which we expect to remain intense, may improve.
- But if the Fed has to raise rates to curb inflation², it would likely cause a more risk-off³ scenario for equities. It could also lead to some defensive sectors performing well, benefiting the Utilities and Telecommunication sectors, which are more levered and typically have lower volatility. Consumer companies that can pass along price increases to the end users of their goods and services also would benefit.

² Inflation: Characterized by rising price levels.

³ Risk-on/risk-off: Refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

+ Fixed Income Markets:

- Short-term interest rates stay low because of slower growth, the lack of an inflationary backdrop and an accommodative Fed policy.
- The budget deficit will remain a trillion-dollar phenomenon, which could curb enthusiasm for intermediate- to longer-dated Treasuries beyond the initial flight to safety.
- There will be high volatility as capital markets nervously reassess the implications of a new policy landscape.
- The initial flight to safety is likely to be bullish for bonds and the dollar, but it is also likely to be temporary.

+ U.S. Dollar:

- A combination of inflation pressures and reduced trade tensions should be positive for foreign currencies and lead to a weaker dollar.

POTENTIAL POSITIVES OF A “BLUE WAVE”

Under a Democratic sweep, fiscal gridlock is lifted and roadblocks preventing the passage of additional recovery packages are removed. Without the spending checks of a Republican Senate, Democrats are emboldened to increase spending to help the U.S. recover from the pandemic and subsequent recession. The wish list of the progressive wing falls short of gaining enough traction within the party to move forward with its most ambitious goals, but additional stimulus checks, expanded unemployment insurance and support for small business and local governments have overwhelming support among progressives and moderates alike.

Potential Market Reaction:

+ Equity Markets:

- Equity markets continue to rely on the hope—and delivery—of stimulus, treating all positive political developments with risk-on enthusiasm.
- Cyclical and value stocks that are most closely linked to GDP⁴ growth and that were most significantly impacted by the shutdown finally catch a bid and begin to close the gap on their growth counterparts.
- Global relations improve, leading to general global growth and trade recovery.

+ Fixed Income Markets:

- Potential for higher yields in Treasuries⁵ if growth picks up.
- Credit spreads⁶ tighten with the support of both a monetary and fiscal backstop.
- The path of the dollar is mixed, balancing weakness, given the widening deficit, and strength, given the more stable path forward for the economy.

⁴ Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

⁵ Treasury yield: The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

⁶ Credit spread: The portion of a bond's yield that compensates investors for taking credit risk.

POTENTIAL OUTCOME 2: JOE BIDEN WINS, AND THE DEMOCRATS RETAIN THE HOUSE, BUT THE GOP RETAINS THE SENATE

Scenario: Political gridlock remains in Washington, DC, with lower growth, a bipartisan spending blowout and an environment where Fed policy is once again a primary driver of and influence on economic and market outcomes.

This scenario may also see an “easing” of anti-China rhetoric. While both parties are currently “anti-China” (for different reasons), Biden is likely to soften the rhetoric against this important trading partner.

Potential Market Reaction:

+ Equity Markets:

- From a tax perspective, this is a positive scenario for U.S. equity markets and should lead 2020’s success stories seeing even more upside—technology leading at the expense of the more cyclical reopening-sensitive sectors like small-cap value strategies.

+ Fixed Income Markets:

- Fed policy remains on “autopilot” based upon its new policy framework of average inflation targeting.
- Short-term rates remain anchored, but intermediate- to longer-dated yields will be influenced by how this “new” policy framework is executed.
- We recommend securing incremental income from spread products, which are poised to outperform Treasuries.

POTENTIAL OUTCOME 3: DONALD TRUMP WINS, THE GOP RETAINS THE SENATE, AND THE DEMOCRATS RETAIN THE HOUSE

Scenario: A continuation of the economic landscape under the Trump Administration after the 2018 election (which resulted in a split Congress) but prior to the pandemic—a faster-growing economy, political gridlock, a bipartisan spending blowout and a continuation of easy monetary policy.

Potential Market Reaction:

+ Equity Markets:

- The economic reopening should support a cyclical reversion in 2021, with small cap cyclicals⁷ benefiting from the pent-up demand created in 2020. Sector-wise, we see strong global growth benefiting cyclicals over defensive sectors.

⁷ Cyclical sectors: The Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

+ Fixed Income Markets:

- Similar to outcome 2, Fed policy remains on “autopilot” based upon its new policy framework of average inflation targeting, keeping short-term rates anchored.
- Intermediate- to longer-dated yields will be influenced by how this “new” policy framework is executed, and the yield curve⁸ could steepen.
- We recommend securing incremental income from spread products, which are poised to outperform Treasuries.

POTENTIAL OUTCOME 4: DONALD TRUMP WINS, AND THE GOP SWEEPS THE HOUSE AND THE SENATE

Scenario: We refer to this potential outcome as a “Red Wave,” and we believe it may result in a continuation of the bipartisan spending blowout, a continuation of easy monetary policy, additional tax cuts, a more “business-friendly” regulatory environment and an increased potential for higher inflation as the economy heats up. This could potentially result in the Fed having to reverse its current policy and step in to quell inflation.

Potential Market Reaction:

+ Equity Markets:

- Similar to outcome 3 above, the reopening of the economy should support a cyclical reversion in 2021, with small-cap cyclicals benefiting from the pent-up demand of 2020. Sector-wise, we see strong global growth benefiting cyclicals over defensive sectors.
- China hawks would pressure emerging markets relative to the U.S.
- We see Financials and Energy being two sectors that perform well under Trump. We could also see relief for groups like airlines and hotels—and perhaps real-estate investment trusts—with more confidence in an economic reopening.

+ Fixed Income Markets:

- Risk-on tends to prevail, as the 2016–2017 episode of the “Trump Reflation Trade” is revisited.
- The yield curve would likely steepen as inflation expectations rise.
- Credit would outperform safe-haven fixed income on a relative basis, but absolute returns are likely to be challenged. Secure income while limiting duration risk.
- The Fed outlook gets revisited, with the timetable for potential rate hikes and balance-sheet normalization being pushed up.
- The dollar would be vulnerable during initial risk-on, but its future direction will be dictated by the interplay between increasing Treasury supply and the Fed’s gradual reduction of accommodation.
- EM local debt is well positioned to perform in this environment.

⁸ Yield curve: Graphical depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.



Against all of these potential outcomes are two longer-term unknowns: (1) the continuing evolution of the COVID-19 pandemic and its impact on the economy, the markets and the overall human condition; and (2) the continuation of massive debt and deficit spending.

On the first issue, we are reasonably optimistic—we can envision a tomorrow where vaccines and effective therapeutics are available. We do not know when, but we believe that day will come.

The second issue is more predictable—we are borrowing from the future to pay for today, in a completely bipartisan manner, but eventually the piper is always paid. We will experience lower growth and higher taxes at some point in the future.

But not today, not tomorrow, and not next year. It is an existential but not immediate issue, and we do not suggest advisors plan for those ramifications (yet).

A final unknown is the state of fiscal stimulus legislation. This will be a known outcome if a package is agreed upon to prior to the elections. However, the actual outcome of any stimulus package may be wildly different if it is not enacted until after the elections.

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