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Democrats take control of the Senate…by a thread

Their policies could end up boosting growth, though companies may get a smaller slice

The Democrats' completed a clean sweep with surprise victories in both Georgia Senate seats that were up for grabs in run-off elections. They will control the White House and both chambers of the 117th US Congress. This has significant implications for the US economy and potentially its financial markets as well.

Before the election, we set out what was then a contrarian argument that a Biden presidency with a split Congress was a very market-friendly outcome over the medium term. Contrary to what many surveys of institutional investors predicted markets did indeed welcome the result. Those same surveys predicted an even worse outcome should the Democrats complete the sweep. In a survey of 1,377 institutional investors by Citi, 48% of respondents believed that the US stock market would fall by more than 5% (23% by more than 10%), with few taking the opposing view that the market would rally.

Will they be wrong again? After all, we observed no significant correlation between the odds of a Democratic clean sweep and equity markets either before or after November's presidential election. Furthermore, following Joe Biden's victory and the galvanization of Democratic support in Georgia since then, some of that risk should have been assimilated into the price of financial assets already.

Why so calm?

As we write equity markets in the US and elsewhere are calm. Perhaps, that's because past elections have had limited impact on the broad market. Looking at over 50 years of data – covering equities, the dollar, Treasuries and corporate bonds – we've found that presidential elections generate a little noise, but rarely any signal. Popular ideas such as Democratic presidents being worse for investment returns don't stand up to scrutiny. Even sectoral ramifications are often hard to identify. What were the two worst performing sectors during the Obama years? Financials and energy. The worst under Trump? Financials and energy. There are bigger forces at work.

Or perhaps investors have looked at the stock market reaction to notable transitions from right- to left-leaning governments over the last three decades. We have identified such changes in nine countries and again there is no discernible pattern to the market reaction.

Perhaps markets are calm because economic history is on the Democrats' side. In their book *Political cycles and the macroeconomy*, Nouriel Rubini and Alberto Alesina showed that the Democrats tend to preside over faster growth, lower unemployment, and stronger equity markets than Republican presidents. Recessions are almost invariably caused by imbalances built up by Republican loosening of regulation. Nothing destroys stock returns like a financial crisis.

Or perhaps it's because investors are focused on the factors responsible for driving markets higher in 2020. To our mind, they are (i) hope for a timely, effective vaccine (ii) supportive fiscal policy; (iii) supportive monetary policy; (iv) a levelling-off of previously escalating Sino-US trade tensions. Does a clean sweep alter these four factors? While Biden is no dove when it comes to China and foreign policy (as we shall discuss more below) the risk of erratic policy moves of the sort that have unnerved markets over the last four years diminishes. Fiscal policy is likely to be even more stimulatory under Biden than it was likely to be under Trump (more on that below too). Historically, a presidential candidate committing to very loose fiscal policy would have caused markets to expect tighter monetary policy. But the US Federal Reserve has committed to holding interest rates near zero until the end of 2023, even if inflation rises above 2%. As such, is it as simple as this –the outcome with the most stimulatory fiscal policy is the most positive for markets?

A shift to the left, but razor thin

But Biden's agenda is more left-leaning than Democratic presidents have tended to be in the past. We can't be so sure that this is a benign outcome. As discussed below, Biden's policies may well result in greater economic growth. GDP may go up due to larger, better-targeted fiscal stimulus, for example. But GDP is not the same as profits. The corporate share of GDP is likely to go down. For some companies and sectors, at least, the net effect on future returns may be a negative.

That said, it's important to note that the Democrat's clean sweep was achieved with razor-thin majorities in both chambers. In the House of Representatives, the Democrats lost seats. Counties that swung to Biden still returned Republican congressmen and women, arguably suggesting that moderate voters didn't like the fact that the Democratic party had shifted further to the left than Biden. In the Senate, the Democrats and the Republicans have 50 seats apiece. The Vice President will break the tie. That means the Senate's moderate Democrats will wield veto power. To pass legislation and to survive the midterm election in 2022, Democrats may need to curb their most redistributional impulses and write bills that centrists can get on board with.

There is also an economic constraint on enacting Biden's campaign agenda. The COVID recovery will stutter over the winter months. Unemployment is still very high. Generalized corporate tax hikes could jeopardise growth at a crucial moment. Statements from Biden and his transition team in the next week could give investors crucial insight into what to expect in 2021.

COVID stimulus – now, please
At the end of 2020, after months of negotiation, Congress agreed to another round of fiscal stimulus to help Americans navigate a path through new emergency COVID restrictions. The $900 billion relief package extends emergency unemployment benefits for 14 million Americans until mid-March by topping up benefits for 11 weeks. Many households will receive stimulus cheques of $600 per qualified individual and child, and there are other smaller measures for businesses.

With a clean sweep, we expect Democrats will start negotiations and pursue an additional more generous package, adding another $1400 cheque to the current $600 one. But this is a legislative item that requires a 60 person "supermajority" in the Senate, and that may take some time. If Democrats are bold, they may take the fight to the wire, jeopardising another extension to unemployment benefits if they are needed in March. The market reaction is difficult to predict. Judging by reaction to stimulus in 2020, investors would likely welcome a bigger fiscal package to shore up the ongoing recovery while we edge closer to a vaccinated world. But they may not want to worry about another cliff-edge in March.

Spending and taxes: net positive
Various reputable think tanks, economic consultancies and bipartisan institutions estimated that Biden's campaign tax plans would raise almost $4 trillion (trn) over 10 years (split 50-50 between firms and households earning >$400,000 p.a.), with spending plans tallying to between $6-7trn. The net effect is a big boost, and explains why most non-partisan economics teams, such as Oxford Economics, assess US GDP to be larger if Biden's plans are enacted compared to Trump's.

Biden's spending proposals are particularly focused on boosting investment and the economy's productive potential. This lessens the inflationary risks over the long run, but in the near term, before those supply-side boosters kick in, the inflationary risks are higher. Investors' inflation expectations may begin to rise if they start to worry about where the Democrat's deficit spending may end. Still, over the next year at least, we expect the lasting effects of the COVID recession, on top of longer-term structural forces, such as digitalisation, to exert pronounced disinflationary effects (as we set out in our July Investment*Update* on inflation).

Biden pledged to increase corporation tax to 28%, from 21% today. In an interview with CNN in September, he said he would do this on "day one". But given the threat to the COVID recovery, we think that's unlikely.

He may raise corporate taxes in two more subtle ways, however, which could nevertheless have important implications for specific companies. A 15% minimum tax on book income for firms with income greater than $100m (book income is pre-tax profits reported to shareholders, rather than the profits reported to the IRS, which differ due to accounting conventions), and a doubling of the minimum tax on foreign income (known by the amusing acronym GILTI) to 21%.

Although Biden's tax plans are far from small, it's important to remember the starting point. The Trump administration has slashed the broad tax take to 16% of GDP, the lowest revenue share in half a century. Under Biden, the revenue share would return to around 19%, still below the average during Bill Clinton's second term - a period of strong economic growth – and less than the 21% of GDP recommended in 2010 by the bi-partisan National Commission on Fiscal Responsibility and Reform. It's also low by international standards. Including a hike in the headline rate, analysts estimate that together these tax measures would reduce S&P 500 earnings per share by 9%-10%.

However, the impact could differ widely across sectors. For example, Pharmaceuticals, technology and communications services are most exposed to the GILTI. Investors must keep an eye on which parts of his tax plan Biden prioritises.

As we noted in our post-election update Biden has also spoken openly of a carbon-border tax. Such taxes are essential to ensure that domestic manufacturing doesn't lose out to cheaper, 'dirtier' processes of markets with less stringent environmental policies if Biden aims to make America carbon neutral. We believe such taxes are likely to come into play at some point in the next decade.

The important point about US taxes is that while the statutory rate has hovered around 35% since the late 80s, the *effective* tax rate – what US companies actually paid – has trended down substantially. This is due to the use of tax havens and an increasing number of tax credits and deductions, but also other non-tax trends such as offshoring of supply chains. It's not as simple as looking at the headline rate, and investors must scrutinise exactly what any new plans mean for individual companies' post-tax earnings.

Infrastructure at last?
Biden has pledged to oversee $2trn of spending on clean energy and infrastructure over the course of his first term. Of course, a succession of presidential candidates and congressmen and women have promised federal infrastructure investment. It's an increasingly rare bipartisan issue, and some investors question whether it will ever arrive. But for reasons we also highlighted in our post-election update, we expect an infrastructure bill to pass. This is all the more likely in the new Democrat-controlled Congress.

Biden's green infrastructure push, which could also be enabled by a Democratic clean sweep, is designed to bring the US to net zero emissions by 2050, and by 2035 in the electricity sector. Designed correctly, such a bold target could boost the economy. As we've noted before, energy revolutions have preceded the great productivity revolutions of the past.

Fossil fuels and economic reality
Needless to say, fossil fuel producers won't be treated kindly. Biden will repeal certain tax incentives that the industry enjoys. But we note that a plank of the Democratic party platform calling specifically for eliminating *all* such provisions was deleted before ratification at the Democratic National Convention. Biden advocates limits on production of new fossil fuels, especially on Federal lands and waters. But, again, these are limits not outright bans, and he recognises the sizable contribution to jobs and the economy from the sector. Biden's position papers never mention fracking. At a recent CNN town hall in Pennsylvania he said that fracking will continue as the US moves to net zero by 2050, and banning fracking would cost too many jobs.

You can also read more on our view that unified Democratic control won't be as damaging for big pharma and big tech as some may fear in our post-election update linked above.

Minimum wages: policy v reality
Biden proposes to increase the federal minimum wage from $7.25 to $15 an hour, although he hasn't indicated over what time period. He also wants to introduce better paid sick leave and childcare, particularly for gig-economy workers. But given that low wage workers tend to be employed in sectors hardest hit by COVID, such as hospitality (n.b. Biden also wants to eliminate the concept of the "tipped minimum wage" used here), we do not expect Biden to pursue this until 2022.

As long as the economy is back on an even keel, we're not too concerned about the impact. Many states and cities have already raised their minimum wages over the last five years or so. As a result, nine out of 10 workers who earn the minimum wage earn more than the *federal* minimum wage already, according to Evercore ISI economist Ernie Tedeschi, who calculates that the average wage of a minimum wage worker was $11.80 in 2019. That's already 63% above the federal minimum wage. Therefore if we assume that Biden's $15 proposal is a 10-year target, it may not actually have much of an impact on labour costs in his first term, even with some front-loading.

Same trade policy, different style
As we said in our introduction, the style of American trade policy will change under Biden, but not necessarily its substance – at least regarding China.

Biden has plans for a new offshoring tax penalty, as well as a new proposal for a "Made in America" tax credit, aimed at revitalising closed or closing factories and growing domestic facilities, bringing jobs from overseas to the US and expanding manufacturing payroll in general. These are policies that Trump touted, but never actually implemented.

Again, you can read more about our views on trade policy in our previous update, and why we believe it might be a mistake to think a Biden victory would be good for China.

What it all means for investors
If political and economic constraints do continue to limit Biden's ability to implement the most redistributional elements of his agenda, as we set out above, equity markets may continue to be unperturbed. We'll need to watch speeches and statements in January more closely than ever.

Greater fiscal stimulus and more inflationary risk are likely to put upward pressure on bond yields, which would lower the valuations of growth companies relative to 'value' companies. That's because their relatively larger future payoffs will be discounted back into today's price at a slightly more punitive rate. Some of the most expensive companies are also exposed to Biden's proposed tax increases on foreign income, while bigger fiscal stimulus could also improve the prospects of more cyclical companies. As a result, we are even more convinced of the need to rotate away from the most expensive names and into cyclical companies with quality factors (e.g. low debt levels, strong profit margins, consistent returns on capital invested, etc.), which fall somewhere between growth and value (as we set out in our recent quarter-end outlook).

The threat of more redistributional policies also plays into our theme of starting to favour non-US markets again. As we set out in our previous note when we thought a split Congress was on the cards, from a global perspective this election is about whether global policy uncertainty will continue its dramatic ascent in recent years. Huge increases in uncertainty, particularly around what American protectionism means for foreign export-oriented economies, have augmented the outperformance of US equities relative to non-US markets and the long upward trend in the dollar. Uncertainty has become greater outside of the US than within it because the US is a more insular economy, with a lower ratio of trade to GDP. In our view, that's benefited US assets relative to non-US assets because its stock market is less cyclical than many others and less sensitive to the global trade cycle. And the dollar is a safe-haven currency.

Downhill for the dollar?
As we always say, we are highly sceptical of anyone who claims they can predict the *short*-run movements of currencies. Currencies just don't have a consistent enough short-term relationship with common variables. And that includes around elections. On a long-term basis, the dollar is overvalued against most major currencies on a variety of frameworks, such as purchasing power parity, our own Behavioural Equilibrium framework (which looks at relative trade prices, relative productivity, relative savings), and others.

Over the next few years large monetised fiscal deficits (government borrowing that's funded by central bank bond purchases), large current-account deficits (trade and investment income) and low savings rates could push the dollar lower. These are more likely under a Democratic sweep. If US inflation-adjusted interest rates remain entrenched deep in negative territory, while the current account deficit widens further on the back of strong domestic demand, the dollar may continue to weaken. Particularly if tariffs are relaxed.

'Blue wave' fears exaggerated
In the short run, markets may be volatile as investors worry about the potential implications of the Democrats' re-distributional platform. But the razor-thin margins in Congress give moderate Democrats the upper hand. That alongside the constraints of more COVID disruption this winter could waylay the policies investors fear most.

We think there are good reasons to believe that President-elect Biden's 'tax and spend' policies – which unified Democratic control could enable – would boost US GDP. Companies in general may find they have a smaller slice of the pie, but the effects could be worse for some sectors than others. This is something we'll be watching closely.

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