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Markets rally on a split Congress

Todd Mattina, PhD
Senior Vice President, Chief Economist,
Portfolio Manager, Team Co-Lead
Mackenzie Multi-Asset Strategies Team

Jules Boudreau, MA
Economist
Mackenzie Multi-Asset Strategies Team

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Highlights

- Joe Biden has been elected President and Democrats have about a one-in-four chance of gaining control of the Senate in January based on betting odds.
- A Covid-related fiscal stimulus is still plausible in the near term, though potentially smaller and more dependent on economic developments with the news of an effective vaccine. However, a watered-down version of the Democratic stimulus proposal would still be a boon to aggregate demand.
- We think that a divided Congress will allow the new White House to pass some beneficial policies, while warding off less friendly ones for long-term economic growth.

Joe Biden has been elected the 46th President of the United States, but the Blue Wave implied by pre-election polls and betting odds did not come to pass. Biden will end up comfortably crossing the 270-electors threshold, but his winning margins in swing states are razor thin. Democrats also lost ground in the House, while Republicans will likely keep control of the Senate. Donald Trump is contesting the election and his team's legal cases are proceeding, although they are unlikely to reverse the ultimate outcome of the race.

The Senate race is on hold, hinging on run-off elections in January for the two Georgia seats. Democrats need to gain both seats to split the Senate 50-50, with VP-elect Kamala Harris having the power to settle ties. Betting markets give Democrats about a one-in-four chance of eventually gaining Senate control[1], which would result in less policy gridlock. But even a 50-50 Senate would not make the adoption of the Biden economic plan a sure thing, as moderate Democratic senators would likely restrain spending increases and limit tax hikes. The threat of Republican filibusters could also force Democrats to compromise in a 50-50 Senate, and a smaller majority in the House will keep them in check as well.

Policy plans should be judged for more than their measured economic impact. But examining it through this narrow lens, several sections of the Biden plan project to be detractors to long-term economic growth. A divided Congress would limit the likelihood that these policies be implemented.

Figure 1 shows the respective headline policies of Republicans and Democrats for the 2020 election. The overlap contains possible Biden policies which could garner support in a Republican-controlled Senate. A Covid stimulus bill is one of those policies which we think can get to the finish line in the coming months.

1 PredictIt odds as of November 9.

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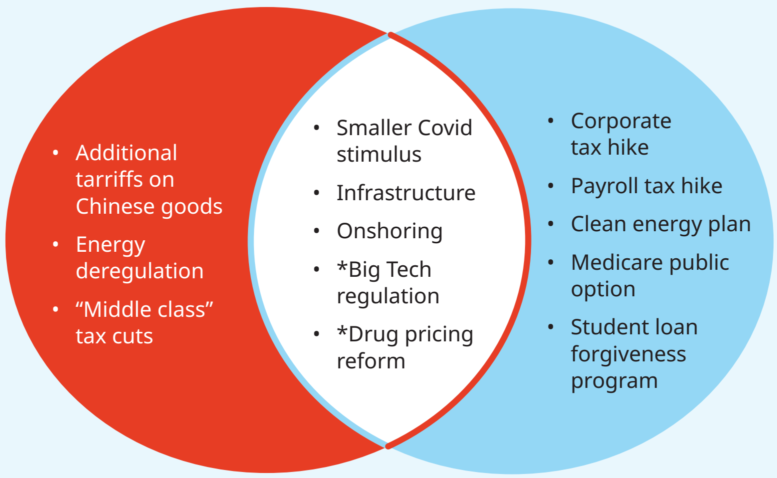
Figure 1 | Potential for a subset of Biden's policy propositions to gain traction in a Republican Senate

(Trump vs. Biden policy plans)



Notes: The red circle represents Republican policies and the blue circle outlines Democratic policies. The overlap identifies policies with possible bipartisan support. Policies preceded by a star (*) are ones where collaboration is less likely but still possible. See main text for details. With data from www.joebiden.com, www.donaldjtrump2020.com, Oxford Economics, Cornerstone, The Economist.

Compromise Covid stimulus bill still plausible in the near term, but getting less likely

The narrative of a Democratic Sweep being salutary for the US economy was centered around Democrats fast-tracking a large Covid stimulus plan. While the US economy has recovered faster than expected from the Covid crisis, it has shown signs of slowing down in recent months. An accelerating trend of Covid cases threatens to cause further drag on spending and employment, creating renewed importance for a stimulus package to boost aggregate demand. Pre-election, markets seemed to react positively to hints of progress towards the adoption of a stimulus package.

The package favored by Democrats is much more generous than the Republican one. The latest plan passed by the Democrat-controlled House, containing $2.2 trillion in new spending, is a compromise compared to their initial plan for a $3 trillion package. But it remains above the White House's Oct. 9 offer of $1.8 trillion and, especially, the Senate's proposition of a $650 million "skinny" bill. On one hand, Republicans and Democrats seem to agree on including in the Covid bill a $1,200 stimulus cheque, an extension to the Paycheck Protection Program for businesses, and funding for airlines. On the other hand, Republicans dislike Democrats' propositions to fund local and state spending, extend the $600/week top-up to unemployment benefits and expand the Earned Income Tax Credit.

The announcement of an effective vaccine on Monday makes it less likely overall that a sizable stimulus will get passed, especially if Democrats miss the 50/50 mark in the Senate in January. While the virus can still disrupt the economy in the near term until mass inoculation is possible, the prospect of a vaccine may increase the reticence of Republicans to approve a large Covid-related spending package given their concerns about the sharp rise in the national debt to pay for the pandemic. We believe the Republicans were always going to be more reactive than proactive with a large fiscal stimulus, waiting for clear indications of deteriorating economic and market conditions before acting. This announcement makes it even less likely that they pull the trigger in the coming months and lowers the expected size of the package if they do. But a bill closer in size and scope to Republican preferences would still provide a critically needed boost to the economy, as the policies on which both parties agree, especially the stimulus cheque and Paycheck Protection Program extension, are the key ones for stimulating aggregate demand.

Republican Senate as a check on growth-inhibiting policies

In the longer-term, Biden's economic plan is a mixed bag in terms of promoting long-run economic growth. We think that a divided Congress would allow the new White House to pass some beneficial policies in the near term while warding off some that are potentially detrimental to long-term growth.

Infrastructure investment is a promising area for bipartisanship. Well-designed infrastructure plans could stimulate business investment and boost long-term productivity, especially if Republican pushback can curb the less productive projects which risk crowding out private spending.

With Trump out of the White House, trade policy should become less hostile and less unpredictable. While we don't expect a Biden White House to revert fully to pre-Trump free trade policies, it should at least avoid imposing new tariffs on traditional allies, including Canada, Mexico, Europe and Japan based on a flawed understanding of the main causes of the US trade deficit. Biden's positive stance towards immigration should also boost innovation and growth, although the power to increase immigration levels and naturalize non-citizens ultimately lies with Congress. Biden's economic plan does contain some protectionist measures aimed at onshoring businesses, which may garner support from Republicans. But these measures – reorienting federal procurement towards local suppliers, mainly – should have a relatively benign effect on growth.

On the other hand, Democrats may need to give up on sharp corporate tax increases if facing a Republican Senate. Higher taxes on capital lower the return to investment. In the long run, this implies a smaller stock of capital, which means less output per worker and thus lower real wages. Ultimately, the incidence of higher corporate income taxes may fall heavily on labour. The Tax Foundation estimates Biden's corporate tax plan would depress long-term GDP by at least 1.5%.[2] In addition, a Blue Wave would have heightened the risk of increased regulation for Big Tech firms and pharmaceuticals, hindering investment in the most dynamic and high-growth sectors of the US economy. Controls on drug pricing and Big Tech behaviour were also policy goals of the Trump campaign, so bipartisan bills are a possibility, but these types of regulations go against the free-market intuitions of "conventional" Republicans.

A Republican Senate should constrain overall public spending, reducing deficits and limiting the level of government debt. The Congressional Budget Office is projecting large and widening structural deficits in the future, as health care expenses grow and underfunded Social Security plans likely require government funding. Public debt hinders business investment in the long term because of higher expected future tax burdens and more policy uncertainty. Debt accumulation also increases macroeconomic risk, as it limits fiscal space for stimulus in future crises.

The critical risk around the taxes, deficits and regulations that would have accompanied a Blue Wave is not that they reduce the expected *level* of national income through a one-time shock to production, but that they lead to a permanently lower rate of long-term economic *growth*. With the magic of compounding, a slight drop in growth leads to depressed production and welfare in the long term.

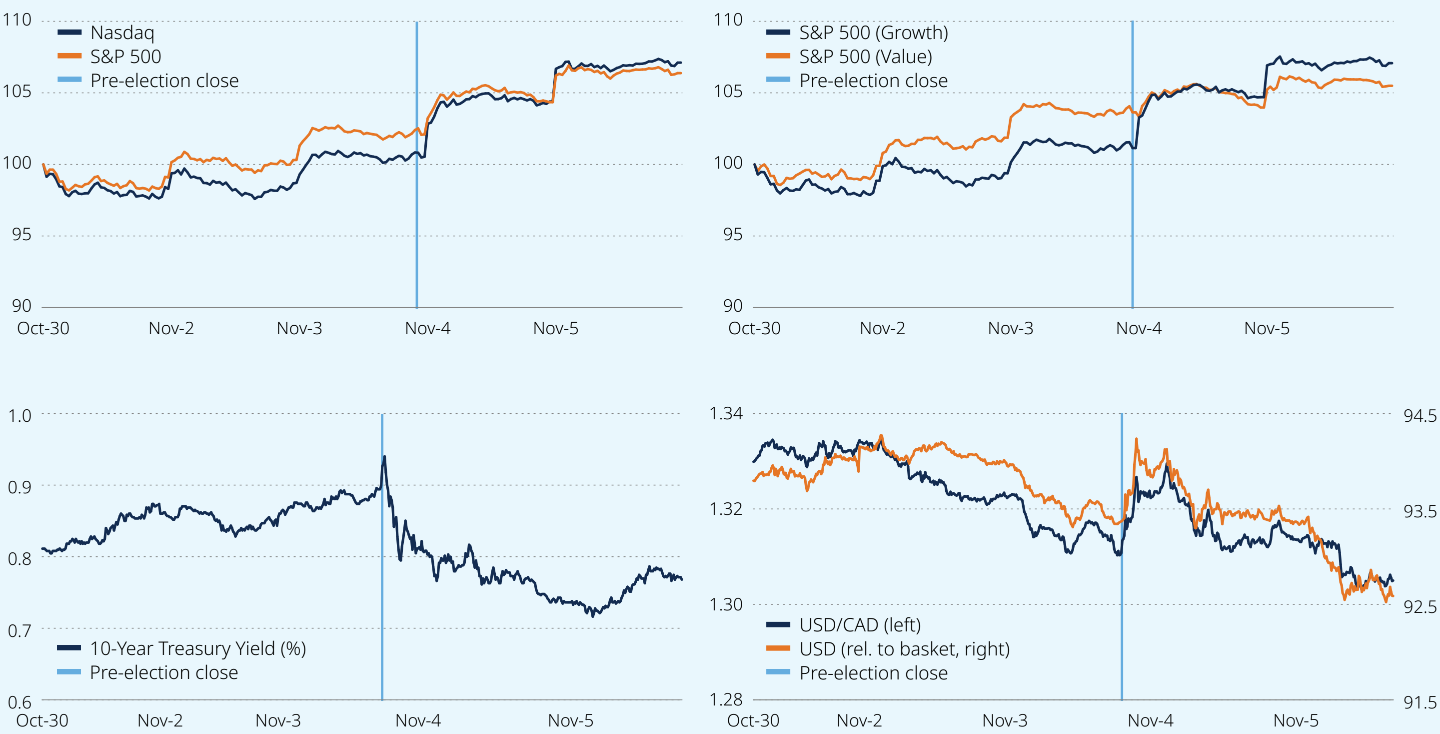
Markets reacted positively to potential gridlock

Figure 2 shows that markets reacted broadly positively to the likely outcome of a Biden win with a split Congress. Yields drifted down, reacting to the prospect of lower inflation, lower probability of future Fed rate hikes, and less future Treasuries emissions than in a Democratic Sweep scenario.

2 Tax Foundation, "Details and Analysis of Democratic Presidential Nominee Joe Biden's Tax Proposals", Sept. 29, 2020, https://taxfoundation.org/joe-biden-tax-plan-2020/.

Figure 2 | Financial markets rallied on the prospect of divided US government

(Financial series before and after the Presidential election)



Notes: Financial data from Bloomberg. S&P 500, Nasdaq, S&P 500 (Growth) and S&P 500 (Value) rebased to 100 at market open on October 30. S&P 500 (Growth) is an index of S&P 500 stocks with "growth" characteristics, S&P 500 (Value) is an index of S&P 500 stocks with "value" characteristics. Stocks that don't fit clearly in either category are included in both indices.

Markets responded to the election results by unwinding pre-election positions favouring value versus growth as a divided Congress became a more likely scenario. In the lead-up to the election with betting odds indicating a landslide Democratic Wave, investors priced in higher benchmark Treasury yields while cyclically sensitive value stocks outperformed growth stocks. In a scenario with a Biden White House and split Congress, growth stocks (Nasdaq, S&P 500 Growth component) benefit from lower corporate taxes, lower yields and potentially higher long-term economic growth. Morgan Stanley predicted S&P 500 earnings would have permanently drop by 9% upon implementation of the proposed Biden tax hike, with tech stocks being among the most impacted.[3] Value stocks lost on a relative basis, but still gained, consistent with hopes that a compromise Covid bill could yet stimulate aggregate demand.

Last week highlighted again the challenge for investors in trying to time asset markets based on predicting both the outcome of an election and the market response. For long-term investors, we believe a more reliable strategy is to hold a well-balanced portfolio mix that is diversified across asset classes, geographies and currencies, providing sensitivity to many possible future economic and market scenarios.

3 Morgan Stanley, "Corporate Taxes: Sizing Blue Proposals", Aug. 6, 2020.

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