

The Senate Upheaval

Introduction

The U.S. political scene took center stage this week as many American's sat stunned as we witnessed unbelievable footage of the riot on Capitol Hill. Yet, nearly as surprising was the reaction of the stock market, which rose 1.1% on Wednesday and another 1.48% on Thursday, despite the chaos that erupted during Wednesday's Congressional electoral college vote. As we highlighted last week, we are in the midst of a stock market recovery that has seemingly outpaced that of the underlying economy itself. Equity valuations remain extended, and our message to non-client *EVA* readers last week (also seen by many Evergreen clients) suggested that investors should carefully consider their allocation to stocks and reduce risk somewhat. This a step we've already been taking on behalf of our clients. Beyond our view of market fundamentals, there remain other serious and unanswered questions that could have an equal, if not greater, impact on investors. I'll highlight the three biggest risks we see followed by a persuasive piece from our partners at Gavekal that speaks directly to one of those risks.

In the short run, the rollout of the Covid vaccine will likely have the most immediate impact on restoring economic growth. Should the vaccines begin to show ill side-effects and/or worse than expected efficacy, the recovery will face a profound setback. Alternatively, we also acknowledge that a quicker and more widespread distribution could serve as a strong market catalyst. Over the longer term, central banks and world governments have entered even deeper into uncharted waters with interest rate policies and stimulus packages. As the global pandemic surges once again, leading to renewed lockdowns, massive amounts of government debt continue to accumulate. We've written at length about this topic and, while important, we believe that the consequences are unlikely to shape one's investment decisions quite yet.

It has become clear this week that the Democrats will have a mandate, controlling the presidency, Senate and House. Whether you are a Democrat or a Republican, you now know that for at least the next two years, you must prepare for this inevitability as an investor. I've heard from many clients who think Georgia's election results spell certain doom for investors. The following is a piece from Will Denyer and Yanmei Xie, who, we think, provides a well-reasoned analysis of what may follow in this new political environment; one that doesn't represent Armageddon.

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There are drawbacks as well as benefits to covering the US economy and capital markets from our perch in Asia. A benefit is having a good chunk of Wednesday to assess Georgia's Senate run-off elections, which look to have delivered the Democrats the thinnest of majorities, and with it, full control of the US government. A drawback is being tempted into opining on the matter before the results are fully tabulated. Still, with all the normal provisos, it does seem that a somewhat

unexpected result has unfolded, spurring immediate market moves, mostly to the downside.

Assuming that Rev. Raphael Warnock and Jon Ossoff are duly elected to the US Senate, Democrats will have just enough votes to pass fiscal bills, which can bypass filibusters through the “budget reconciliation” parliamentary maneuver. They will no longer face procedural hurdles that Mitch McConnell, as Republican Senate leader, could throw up on bill scheduling.

This matters for investors because President-elect Joe Biden has promised fiscal programs of at least US\$3.5trn to both aid recovery from the Covid-19 induced recession and advance liberal causes like combating climate change, shrinking the wealth gap and enhancing welfare provision. He has also vowed to partially undo President Donald Trump’s tax cuts.

Two months ago, we argued that the prospect of a Democrat-run White House and likely divided Congress favored investors. The Georgia results upend that assumption and will radically alter the nature of Biden’s first two years in office. The key point, however, is that he will still be constrained in pursuing his agenda.

While Democrats will soon control the White House and both chambers of Congress, this hardly amounts to a “blue wave”. In the House of Representatives, Republicans beat expectations and shrank Democrats’ majority. The overall result is a repudiation of Trump but does not endorse the Democratic agenda. Indeed, with razor-thin majorities in both chambers, moderate Democrats will wield veto power. To pass legislation and to survive the midterm election, Democrats will thus have to curb their more liberal impulses and write bills that pass muster with their centrists. Additionally, the still-fragile recovery and high unemployment rate will, for now, constrain the chance of generalized tax hikes, as these could crater growth.

Instead, Biden is likely to push through Congress more fiscal stimulus early in the year, particularly relief for individuals, small businesses and state and local governments. But he may need to scale back programs that promote renewable energy at the cost of fossil fuel.

He is unlikely to push for a corporate tax hike this year, even though he may try to raise taxes on very high-earners and multinational corporations to fulfill his campaign promise of reversing Trump’s tax cuts. The risk of a corporate tax hike rises next year, particularly if the economy regains a steady footing following vaccinations. But given Democrats’ likely wafer-thin majority in Congress, the chance is probably below 50%. Living up to the label of the “tax and spend” party is politically risky, and Democrats cannot afford to lose any seats in the 2022 midterm election.

Market Implications

Our case two months ago that investors would be best served by a divided US government was based on Biden giving US firms a more predictable and less protectionist trade policy and a split Congress cutting the chance of big-bang public spending and corporate tax hikes. More constrained deficit spending meant less chance of a big spike in bond yields. Hence, Democrats’ apparent taking of the

Senate is—certainly at the margin—a negative outcome for US equities and bonds.

As a counterpoint, however, we would argue that on top of the Democrats' political constraints, reasons for cheer include the Covid-19 vaccine roll-out, which since mid-November has become the key driver of the US market. Hence, all things considered, investors should position for the following:

- US equities to underperform the rest of world. The increased risk of tax hikes down the road and regulatory tightening on US corporations will likely weigh on US equities and the dollar relative to the assets of foreign markets that stand to get a competitiveness boost. This only adds to the valuation argument for overweighting non-US equities and currencies.
- US bonds to sell off as both the election result and the vaccine roll-out are likely to further stir inflationary pressure.
- Outperformance of value stocks and “Covid-loser” stocks. If bond yields maintain the trajectory seen since the Georgia vote tallies started racking up, growth stocks (which discount earnings far into the future) will be hit more than value stocks (which derive more of their worth from near-term earnings). Investors should also focus on Covid-losers like offline retail and travel providers as vaccines will benefit them the most. These are also reasons to overweight non-US markets, which tend to be heavier in these categories.

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