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Investment impacts of Election 2020's final chapter

Key takeaways

- Democratic wins in Georgia's two runoff elections have resulted in a 50-50 split in the U.S. Senate. With a Democratic vice president positioned to cast tie-breaking votes, this allows Democrats some control of legislation.
- Market reaction was swift, pricing in a higher likelihood of additional spending policies, which, in turn, could imply differentiated equity performance, higher interest rates, and a weaker U.S. dollar.

What it may mean for investors

- Our current guidance already aligns with the view for a stronger economy and modestly higher interest rates in 2021, and we reiterate our preferences for portfolios.

Two runoff Senate elections in Georgia on Tuesday were extremely close. By Wednesday afternoon, the Associated Press had called both races for the Democrats. Overseas ballots from military personnel are due by Friday, and we expect to see recounts, so reporting the final results may take days or weeks longer.

If these results hold and the Democrats capture both Georgia seats, the Democrats technically would control the U.S. Senate, by virtue of the vice president's potential tie-breaking vote. This would be the Democrats' first unified control of Congress and the White House since the 2009-2010 Congress.

Market reactions were swift — interest rates moved higher and the U.S. dollar slid further. Equity prices did not move uniformly but showed some strong reactions in some market segments. For example, information technology companies tended to move lower, while small-capitalization companies gained.

We believe that these price movements adjust some market moves since November but reinforce many others. After the November 3 national elections, markets moved to price in a divided government. Equity prices rose on expectations that the extensive Biden tax plan would be dashed, and rates moderated as prospects for large spending programs dimmed. What does seem to have changed in the market consensus is the view that a 50-50 split between the two parties in the Senate gives the Democrats somewhat more room to maneuver on spending, even if the most controversial policies proposed by then-candidate Biden remain unlikely.

Our perspective on potential policies

The main issues for markets surround the possibility of some action on spending, taxes, and appointments.

Spending: We believe chances for another out-sized spending package to support the economy have improved with what appears to be a Democratic sweep in Georgia's runoffs. Democrats could push to reinforce state and local finances — a priority that Congress rejected in December 2020. Added infrastructure spending also is a possibility, but the Republican push for small-business liability protection is less likely.

If the election results hold, a 50-50 Senate opens the prospect for other spending programs, including expanding access to the Affordable Care Act (depending on the pending Supreme Court ruling on the law), improving and expanding infrastructure, and broadening spending on green energy. Smaller-scale projects such as these have a strong probability to pass (in some combination).

Taxes: President-elect Biden as a candidate proposed a wide array of tax hikes, and some could gain enough support to pass, including corporate taxes (from 21% to possibly 25% as a compromise on the 28% proposed last year) and taxes on corporate income earned overseas (which could affect multinationals in the S&P 500 Index, such as pharmaceuticals, financials, and technology companies). More controversial are proposals for higher levies on capital gains and top-tier income, as well as the restoration of some deductions lost in 2017.

It remains to be seen which campaign-trail tax proposals might become legislation, however. Tax reform takes time and always has involved bargaining, even when a party enjoys significant majorities in both chambers of Congress. In 2017, tax reform took seven months of wrangling, even without a divided government. The task appears substantially more difficult in 2021. Democratic control of Congress rests on razor-thin margins. The Senate likely will be evenly split, and Democrats' margin in the House of Representatives is only three votes. If haggling over tax increases takes much of 2021, then by year-end, Congress could be facing a vote on higher taxes early in the economic recovery (with many still unemployed) and with the next congressional election cycle looming. Consequently, our view on taxes is that the timing and sensitivity about the economy may permit only limited and much-diluted tax increases.

Appointments: Also key to policy is the list of appointments, including cabinet but also sub-cabinet, regulators, and judges. Democratic control, based on Wednesday's results, likely pushes nominations further leftward. For example, labor-market reforms are an administration priority, signaled by the strong labor background of several appointments and nominations for the president's economics team.

Investment implications

We would caution investors against overreacting to incoming election returns. The split between moderates and progressives within the Democratic Party leaves unclear the breadth, timing, and extent of those proposals this year if, in fact, election results hold after remaining votes are counted. The need for compromise within a divided party or across the aisle argues for a light touch on last year's campaign proposals.

What does seem reasonable to us is that the economy is likely to receive more public spending atop the accelerated recovery in private spending we already were anticipating for the final three quarters of 2021. Our current preferences already align with the view for a stronger economy and modestly higher interest rates in 2021. In particular, we have established and now reiterate our preferences as follows:

- U.S. large- and mid-caps over international equities. However, since the fourth quarter, we prefer a neutral position on emerging-market equities and U.S. small-cap equities and we favor taking these positions toward their long-term strategic allocation targets.

- Among the equity sectors, we retain favorable views on Information Technology, Consumer Discretionary and Communication Services, which we believe should continue to enjoy accelerated adoption among households and businesses in 2021. We also favor Health Care, which we believe should benefit from expanded federal spending on health coverage. Finally, we favor Materials, which we believe should benefit from further public spending, and prefer a neutral weighting towards other cyclically oriented sectors, such as Industrials and Financials. There may be additional opportunities to add to these as policy priorities become clear in the coming weeks and months.

- In fixed income markets, we favor high-yield, preferred securities, and investment-grade credit as ways to add yield over U.S. Treasuries. In addition, we expect the prices of municipals, including high-yield municipals, to appreciate from additional state and local government financing.

- In real-asset markets, we continue to favor commodities and real estate investment trusts (REITs) that can benefit from information technology and trends towards online buying.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. **Preferred securities** have special risks associated with investing. Preferred securities are subject to interest rate and credit risks. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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