GENERALI INVESTMENTS

Focal Point
US: Split government not toothless on growth

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- Without the control of the Congress, President Biden may still find a compromise with the Republican controlled Senate on a US$1tn fiscal package, including funding for small business and tax cuts for low to middle incomes.
- Industrial policy to confront China on IT and renewables may be another area of cooperation. Infrastructure investment may come to the fore again, but disagreement on the priorities and funding are big roadblocks.
- The lower than expected fiscal boost and the still uncertain short-term economic outlook imply that the Fed keeps a big responsibility in maintaining easy financial conditions, but its effective contribution to growth is more uncertain.
- A moderate fiscal stimulus and a reduced political risk premium – alongside mounting vaccine hopes – should allow for a further yield curve steepening and support the rotation to more cyclical risk assets. Easing uncertainties in trade policies and persistent Fed accommodation point to moderate further USD weakness.

Narrow margins in several key swing states sent Democratic candidate Joe Biden to the White House. However, Republicans are more likely than not to keep the majority in the Senate, with voters in Georgia having their final say on two decisive seats on Jan. 5. This will have profound implications on economic policy. Yet, fears that a split government and a very polarized environment cannot deliver any fiscal boosts are probably exaggerated. In what follows we sketch what measures the new administration is likely to take, and the constraints it faces. We then discuss financial market implications.

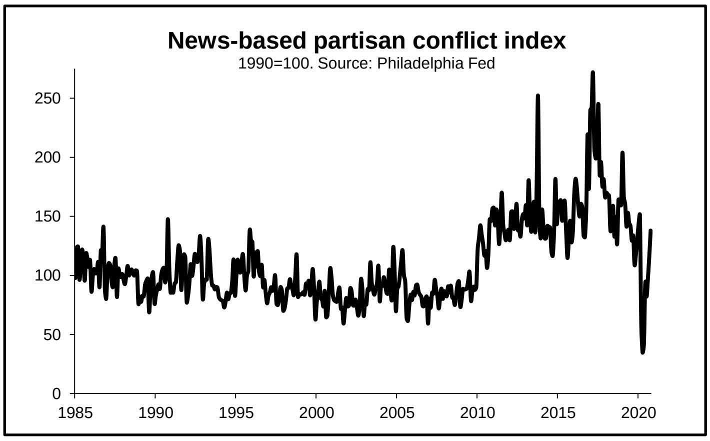
Scaled down fiscal package in Q1 2021 is reachable

Even before the new president is sworn in (January 20), the change in the political landscape can lead to fiscal policy actions. The measures signed by President Trump in October to ensure the funding of federal activity will expire on December 11; Congress will have to extend them to avoid a shutdown of non-essential government activities. Despite the high degree of political polarization, a bare bone agreement appears very likely. An upside risk is that the Congress finds enough unity to deliver a more ambitious package in response to the Q4 growth slowdown. Much will depend on the Republican attitude to the upcoming elections in Georgia. The state's two seats will be attributed in a runoff election on Jan, 5; if (but it does not seem likely) the Democrats take both they will get to 50 seats and gain the majority (vice president Harris would vote to break the 50-50 tie). In the next weeks, Senate Republicans may be willing to compromise in order not to be seen as an obstacle to fiscal relief, especially given the quick surge in new COVID cases. Then again, they may prefer to keep a tough stance to keep their voters mobilized, not giving the new administration an early advantage. Moreover, the outgoing administration will not be cooperative during the transition. President Trump could simply refuse to sign the bill.

In December, a compromise can be reached on a package aimed at avoiding a disruption in federal activity and providing some emergency relief, should the health situation deteriorate. We are more confident that a full package, worth up to US$1tn can be agreed on in Q1. Its size would be less than half of what Democrats could have achieved if controlling the Senate, and its composition will probably be weaker in terms of short-term support to the economy. Unemployment benefits are likely to be extended, but with smaller amounts and tighter eligibility than in spring. Republicans were fiercely against them in the past and the labour market disruption has affected more deeply Democrat-leaning states, with the exception of Texas. In the same way, we expect limited financial support for state and local governments. There is scope for an agreement on aid to the business sector, in the form of targeted measures to support industries heavily affected by the crisis (e.g. hotels, airlines) and to alleviate the cash crunch many small businesses risk to suffer. Tax cuts for low to middle income appear feasible, but would not do much to lift demand in the short run.

Extra money could be available once the new administration is in place. In March, Congress allotted $454 billion to the Treasury to support the Fed's emergency lending programs. So far, only $195 billion has been specifically committed to cover possible losses. The remaining funds could be used without any approval by the Congress.

After the Q1 package, we expect structurally high political polarization to prevent any significant fiscal policy measures, at least until the 2022 election for the Congress. Neither the rise in taxation promised by the Democrats nor any extension of the Affordable Care Act would survive the veto of a Republican Senate majority. Of course, if the Democrats win the two Georgia seats and gain the majority in the Senate, we can expect a bigger package, but this appears a lower probability upside risk.



Deals on infrastructure and industrial policy feasible

Political polarization does not need to prevent other measures to strengthen growth. Extra investment on infrastructure is a shared priority and President-elect Biden is known for his ability to negotiate with the Republicans (at least in the pre-Trump era). Two big stumbling blocs have to be overcome. First, how to finance the extra expenditure: Republicans favor public/private partnerships while Democrats prefer debt financing. Failure to bridge this gap was one of the reasons behind the lack of any initiative during the Trump administration. Second, Republicans do not share the Democrats' enthusiasm for green projects.

The two parties could find common ground on industrial policy if it is framed as a foreign policy issue; a few Republican Senators put forward the idea of a national investment strategy to help the US compete with China. Investment in areas like 5G technology can be presented as a way to secure supply chains and foster reshoring of good jobs. Large public investment is also needed to prevent China from consolidating its lead in strategic industries like electric vehicles: for example, China has some estimated 500,000 electric buses, the US just around 500.

Another casualty of the disappointing Democratic performance in the Senate election is the plan to tighten regulation on a wide range of sectors from energy to financial institutions. However, the new administration could use the president's large executive powers to roll back the cuts to regulation the Trump administration enacted bypassing the Congress. Agencies have a big power in interpreting regulation, so appointments at their head could have a non-negligible impact, but most of them need Senate approval.

More clarity on trade

Expectations are high on the impact of the new attitude towards trade. The return to multilateralism removes tail risks like a trade war with the EU. But we expect that the change of tack with China will be mostly in terms of tactics and communication. The strategic confrontation with China ranks high in the new administration's list of priorities. Concerns on unfair trade practices will be dealt with involving other countries, and addressing the WTO. Overall, a full U-turn on tariffs appears highly unlikely although the phase one talks will proceed in a more orderly and predictable way. Indeed predictability may be in the end the greatest benefit this split government can give to financial markets. Finally, under President Biden, the US will rejoin the Paris climate accord; environmental concerns could be addressed in the form of tariffs or other restrictions based on the trade partners' adoption of clean technology.

How big can the additional Fed support be?

The latest data show that the recovery remains rather strong. The private sector added 906k jobs in October and dismissals are slowing down. Manufacturing and construction are strongly benefiting from ultra-low rates and (the former) from the rebound in trade driven by Asia. The resurgence in COVID cases is a clear downside risk to the economy, even though mounting prospects of an effective vaccine lift the odds of a faster recovery in 2021. The buffer provided by the Treasury and the Fed may still not be enough to prevent a larger wave of corporate default. A split government will deliver a smaller than expected fiscal response and may be slow to react to another slump.

In this environment, the Fed may be required to provide additional support. As negative rates remain taboo, this can be done by stepping up bond purchases, taking in more duration risk and possibly targeting explicitly a segment of the yield curve. While these measures are useful to stabilize financial conditions, their contribution to boosting demand is not clear. The other tools deployed by the Fed, namely corporate and municipal bond purchases and credit guarantees, need approval and capital support by the Treasury. These measures will expire on Dec. 31, capital provision will be extended and it will be then up to the Fed to decide on the purchases. Additional capital injections have to be voted by the Senate and this may lead to changes in the type of securities the Fed purchases, at the expense of municipal bonds. However, the calls for fiscal expansion by Fed officials show that monetary policy is only a limited substitute to fiscal policy.

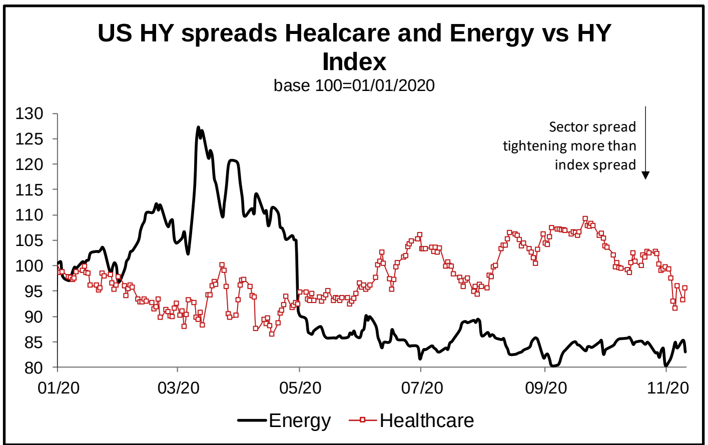
Financial market implications

Treasuries: The initial reaction of US rate markets to the decreasing likelihood of a blue wave was a bull flattening. However, as expected stress in financial markets evaporated quickly as Joe Biden secured a majority and medium- and long-dated yields rose. News of a promising vaccine has amplified to upward correction. 10-year US yields have risen to the highest level since March 2020.

Longer term, the weaker than expected fiscal stimulus and the possibility of additional Fed easing will limit the upward pressure triggered by the high supply. Still, even a more dovish monetary policy stance (taking on more duration risk) would not prevent the US Treasury net supply in 2021 from remaining well in positive territory. The bulk of upward pressure to yields (with the 10 year yields projected to rise by around 20 bps on a one-year horizon), will come from a more sustained recovery (helped by the positive news on the COVID vaccine) and a slow rise in inflation. All in, the US yield increase should be more moderate than in case of a full Democratic win, but we see more leeway for yields to move higher. Given the back-up in inflation expectations since March, the rise is likely to be driven mainly by real yields. As the short end remains anchored by the low-key rate the US curve should bear steepen. The scope for higher euro area yields appears more limited, implying a further widening of the transatlantic spread.

Like other risky assets, **EM sovereign bonds** have been rallying significantly in the wake of the US election result (and vaccine news). The US result may well be the best possible outcome for EMs. The easing of geopolitical tension and the only moderate rise in US yields are a good mix. That said, EM external debt tends to benefit from a better global growth and a smaller US fiscal package could limit the cyclical spill over to EMs. This could partially explain the HY underperformance versus IG. We will gradually shift our OW from IG to HY when the dust settles and vaccine hopes strengthen, focussing on the BB bucket.

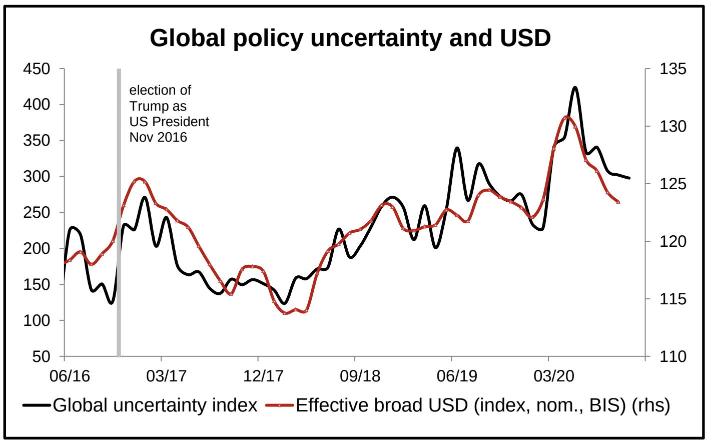
Mexico is in the best position to benefit from a Biden's victory thanks to a calmer outlook for trade. Turkey stands as one of the potential losers, especially after Biden's latest comments on NATO. At the margin, the Middle East, especially Saudi Arabia, could suffer from lower support from the White House. Finally, a higher engagement by the US administration with multilateral institutions could support EM distressed names.



Credit: Markets have kept rallying since the election. Both IG and HY spreads are now trading at their tightest level since the beginning of the pandemic, despite the prospect of a weaker fiscal stimulus and large health uncertainties. A divided government outcome limits the upside for Treasuries yields and their volatility, with beneficial effects on total returns expectations. A divided government outcome thus further reduces the risk of a negative feedback loop between negative total returns and accelerating outflows.

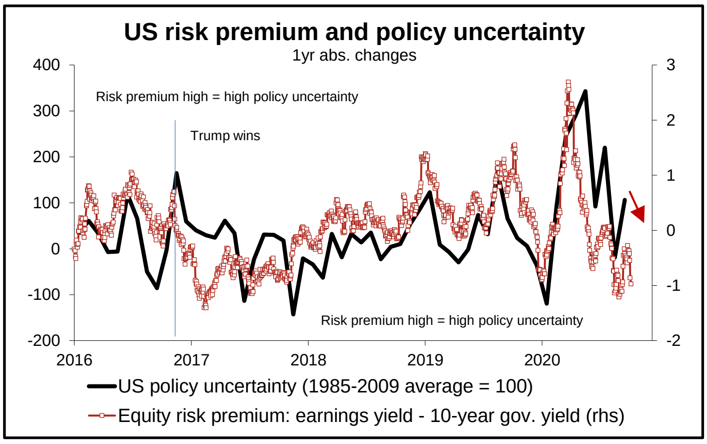
In terms of sectors, both Energy and Healthcare would be benefitting the most from a split government preventing Democrats from advancing on their regulation agenda. If Healthcare has effectively benefitted from the outcome of the result so far, it is not been the case for Energy, which performed in line with the US HY market. This is likely because certain potential restrictions on drilling may require only an executive order, so the regulatory risk in the sector is not entirely removed. Moreover, the Fed is expected to act as a backstop on US credit. Given the current level of credit spreads, while the congress will remain, the Fed may chose not to expand its credit purchases expiring in December into 2021 but stands ready to act should things deteriorate. Therefore, we think US credit spreads, both IG and HY are set to stay close to their present levels or, if anything, modestly tighter into year-end.

FX: With a big US fiscal stimulus less likely, the anticyclical USD is set to face less severe headwinds than those expected with a full Democratic government. Once uncertainties over pending lawsuits against the outcome are settled, the election results will maintain a further medium-term downside to the USD. A less erratic and more cooperative trade and foreign policy can help the still sizeable premium entailed in the broader USD to unwind.



Also, with the onus of further stimulus now falling on the Fed, speculation of extended QE will burden the greenback. Once the latest Covid-19 wave starts to ebb and vaccine hopes gain ground, we see further upside for the EUR/USD to break the 1.20 threshold.

Equities: The elections outcome compressed volatility from 40 to 24 currently. This is inducing some investors to invest a part of their high cash positions in risky assets as more clarity on politics reduces the equity risk premium. A lower likelihood of abrupt changes in tax and regulation will ease pressure on Financials, Energy, Pharma and Tech.



Even without a split government, fiscal policy will be more reflationary than in the case of a Trump victory. A steeper yield curve will support the rotation to cyclicals and value countries (euro area, Japan and EM) and sectors (Industrials, Financials, Materials), at the expense of growth ones, as shorter duration assets outperform longer duration ones. Cyclical exporters will benefit from a less confrontational attitude on trade. All this may contribute to at least mid-single digit total returns over the coming year. Finally, global themes (ESG, renewables, digital, Fintech, etc.) will continue to attract investors' attention.

Imprint

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Sources for charts and tables:	Refinitiv/Datastream, Bloomberg, own calculations Version completed: see front page

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