Janus Henderson INVESTORS

2020 U.S. Election: Which Way Do Markets Turn?

Markets rally on the prospect of a divided government in the U.S.

Making Sense of the 2020 U.S. Election

On November 5, Janus Henderson Investors hosted a global webcast exploring the market implications of the 2020 U.S. election. Although the final vote was still unknown at the time, Democrat Joe Biden was projected to take the White House and Republicans were expected to remain in control of the Senate, even as polls prior to the election had suggested that a Democratic sweep, or "blue wave," was likely.

With that backdrop in mind, our panel of investment professionals – Ashwin Alankar, Ph.D., Head of Global Asset Allocation; Jim Cielinski, CFA, Global Head of Fixed Income; and Matt Peron, Director of Research – joined moderator Bruce Koepfgen, Head of North America, to discuss what the result could mean for financial markets and investors. Following is a summary of that discussion.

KEY TAKEAWAYS

- Although the prospect of a split government suggests there will be less fiscal spending in coming years, other policy risks have eased.
- Even without a "blue" sweep, we believe lawmakers will pass some form of fiscal stimulus to help revive economic growth, particularly as the COVID-19 pandemic continues.
- With the election over, investor confidence could start to return, helping boost stocks. Meanwhile, low-to-negative policy rates could benefit credit.
- The election is just one of many factors to consider in today's market. COVID-19 remains a dominant force, both in terms of upside potential and downside risk.

The risk of extreme policy measures has eased, lifting markets

Although a split government suggests there will be less fiscal spending in the coming years, other policy risks have eased. More moderate infrastructure spending, for example, could reduce the possibility of runaway deficits. Without big tax hikes, corporate earnings face one less headwind. And a measured approach to trade policies could boost the prospects of emerging markets (as evidenced by recent weakness in the U.S. dollar), while slow and steady economic growth could favor high yield. Already, we've seen the health care and technology sectors react positively to the lower risk of policy intervention, while Treasury yields, which had been climbing leading up to the election, have reversed.

Fiscal stimulus – albeit reduced – is still possible and could aid economic growth

Even without a "blue" sweep, we believe lawmakers will pass additional fiscal stimulus to help revive economic growth, particularly as the COVID-19 pandemic persists. However, the size of that spending could be more modest, potentially $1 trillion over the next few years rather than the projected $2 to $3 trillion under a Democratic majority. Still, even that amount could help the U.S. economy recover starting in 2021.

That said, fiscal spending alone may not be enough to sustain economic growth over the long term. Research shows that, historically, every $1 in government spending has resulted in less than $1 in gross domestic product growth. The phenomenon has proven especially true in the case of direct wealth transfers (i.e., sending checks to individuals and companies), which characterized COVID-19 relief packages passed earlier this year.

- **Equities could have more room for upside**

  Since bottoming in March, U.S. equities have been climbing the proverbial “wall of worry” as the market prices in an eventual economic recovery, while at the same time investors remain skeptical. This gap between performance and sentiment is typical of a recession bottom, and the eventual return of confidence (which could occur with the conclusion of the election as well as potential advances in COVID-19 vaccines) could help push stocks higher. What’s more, the return to economic expansion could benefit not only U.S. equities but stocks globally.

- **The U.S. Federal Reserve (Fed) will likely continue to support markets**

  Interest rates globally remain near or at record lows, giving central banks little room to cut policy rates further. Still, the Fed has communicated its willingness to continue to support financial markets and can do so through direct intervention in markets via asset purchases. That stance is unlikely to change under the next administration.

- **With rates likely to stay range-bound, the search for income could support credit**

  With the Fed’s benchmark rate locked at zero, we expect rates to stay range-bound in the near term, barring a surprise uptick in inflation or economic growth. Corporations have benefited from the ample liquidity provided by central banks this year in response to COVID-19, leading credit to rally in past months. With the easy gains in corporate bonds likely achieved by this point, we believe future returns will be more dependent on fundamentals. Even so, the outlook for default rates remains constructive. Furthermore, the search for income in a low-rate environment is a formidable force – one that is likely to continue driving demand for riskier assets, including credit.

- **Once again, options prices proved a better election indicator than polls**

  In the weeks leading up to the election, options signaled the U.S. presidential race was much tighter than what consensus polls suggested. Specifically, the ratio of a basket of stocks projected to do well under a Donald Trump win versus a basket of stocks that would outperform under a Biden win began to tilt in favor of Trump. The same trend occurred in 2016, when polls projected Hillary Clinton to win while options favored a basket of Trump stocks.

- **Options favor equities over fixed income**

  Currently, options prices suggest equities offer a more attractive risk premium than fixed income, particularly when it comes to U.S. stocks, the technology sector and high-growth companies. At the same time, although the market has lowered forward volatility expectations in recent days, volatility remains elevated relative to the post-Global Financial Crisis period as a result of the ongoing pandemic and rising government debt levels. Consequently, in addition to fixed income, investors may want to consider alternative ways of mitigating downside risk.

- **Populist movements globally could begin to take a backseat**

  The tail risk associated with extreme policy measures could now ease in the U.S. – as well as in other parts of the world. The reason: a more moderate U.S. government could create a spillover effect, prompting more centrist thinking worldwide. Such an outcome would be positive for markets, which like neither uncertainty nor government intervention that disrupts the efficient distribution of capital.

- **The election is just one of many factors to consider in today’s market**

  Although the U.S. election created uncertainty for markets, it is not the only factor influencing returns. COVID-19 remains a dominant force, both in terms of upside potential (should a vaccine help end the pandemic) and downside risk. Secular stagnation is another consideration. Record low rates have failed to ignite private credit creation and demand throughout the developed world. Will that change in 2021?

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