For professional investors - November 2020

US ELECTIONS 2020: BIDEN AND THE UNCERTAIN SENATE

Democratic candidate and former Vice President Joe Biden has won the 2020 presidential election and will be the 46th President of the United States of America. The Democrats have maintained control of the House of Representatives with a reduced majority. Control of the Senate will remain uncertain until runoff elections in Georgia on 5 January 2021.

Donald Trump is the first president to not win re-election since George HW Bush in 1992, but the voters' endorsement of Biden and the Democrats was more muted than the pre-election opinion polls had suggested. Although some recounts and legal action may still be outstanding, US equity markets have rallied strongly since the election on the back of less policy uncertainty and positive news with regard to possible vaccines against COVID-19.

Biden did flip back the 'blue wall' states – Wisconsin, Michigan and Pennsylvania – that went to Trump in 2016. He also won Arizona, the first Democrat to do so since 1996. Currently he leads in Georgia (a recount is underway) and won the popular vote comfortably. His margins of victory were however narrower than polling ahead of the election had implied. In addition, although Democrats kept control of the House, their majority has shrunk. The stage has been set for a potentially tough battle for control of the chamber in the 2022 midterms.

BNP PARIBAS ASSET MANAGEMENT

The asset manager for a changing world

THE RACE FOR THE SENATE – ALL EYES ARE TURNING TO GEORGIA IN JANUARY

There is a deep philosophical divide between the two parties. The ability of President Biden to convince Congress to pass some, or indeed any, of the major legislation needed to enact the substantive parts of his campaign platform – including the possibility of a major fiscal stimulus in the New Year – rests upon Democrats controlling both chambers of Congress. He cannot count on any assistance from Republicans.

While the Democrats have maintained their control of the House of Representatives, they potentially face a major obstacle in the Senate.

Currently, the Republicans have 50 Senators while the Democrats have 48 Senators. Two outstanding races are still to be determined in runoff elections held in Georgia on 5 January 2021.

The Democrats therefore still have a chance to tie the Senate by winning both of the runoff elections. In the event of a tied Senate, the Democrats would have overall control thanks to the casting vote allocated to Vice-President Kamala Harris.

If Republicans can take one, or both, of the seats in the runoff elections, they will be well placed to block any legislation Democrats may want to advance and would have veto power over Biden's cabinet appointments, heads of executive agencies and, of course, judicial nominations. Conversely, if Democrats can win both seats, the door will reopen to a significant fiscal stimulus and other important elements of Biden's platform.

Clearly, the outcome of those runoff elections will have substantial implications for American politics for the next few years and both parties will make incredible efforts and spend large sums to win these seats.

History would suggest that the Republican candidates start with an edge. The highest profile recent runoff election in Georgia was in 2017. That saw Democrat Jon Ossoff (who is standing in one of the races to be decided in January) lose to Republican Karen Handel despite outspending her, in what was then the most expensive race in US House history.

However, Georgia's demographics have been changing in recent years and an extensive voter registration campaign led by Stacey Abrams has helped change the dynamics of the state's elections: Biden is poised to be the first Democrat to win the presidential vote in Georgia since Bill Clinton in 1992.

That leaves the race for control of the Senate tight. Republicans likely need only one victory in the runoffs, rather than two, and if turnout is lower in January than it was last week, that may favour them. But it would be premature to totally write off the Democrats' chances.

What is clear is that Democrats' hopes of gaining a robust Senate majority have gone. That sort of majority would in principle have enabled them to have endured a small number of defections by moderate Senators on any given vote and increased the odds that the Democrats would have taken the plunge and eliminated the Senate filibuster[1] rule.

Removing the filibuster would be necessary to enable Democrats to make major, even radical, changes such as a big increase in the federal minimum wage, giving statehood to Washington DC and changing the composition of the Supreme Court. In principle, the elimination of the filibuster is still possible with 50 seats (plus VP Harris's tie break vote), but it would be a difficult feat to pull off. A sole Democrat defection on the vote would mean failure and at least a few Democratic Senators have qualms about removing the filibuster.

1. This Senate rule allows a minority of 41 (in this case Republican) Senators to block most forms of legislation.

BIDEN'S ADMINISTRATION – OPENING ACTIONS AND STAFFING THE GOVERNMENT

Biden is in the unusual position of having won the presidential election, but not knowing whether Congress will be lined up behind him after his inauguration. His transition team will have to plan for stubborn Congressional resistance to his agenda, while hoping that Democrats can win in Georgia in January, which would create the opportunity for legislative achievements.

Away from the Georgia runoffs, much of the remaining near-term attention of market participants will be on the potential executive orders Biden could sign when he comes into office and who he favours for key cabinet positions such as Treasury Secretary and Secretary of State.

Biden's team have already begun briefing media contacts about actions they want to take in the first few days of his presidency. At the top of the list are initiatives to tackle the COVID-19 pandemic. They include grabbing control of the management of the supply chain for PPE and other essential equipment, requiring masks be worn on federal property, revamping the testing and tracing programme, and using the expertise of federal agencies to help states open their economies and societies without undue risk of an explosion in new cases.

Climate policy is also an area where Biden is expected to swiftly change tack from the Trump approach. Re-joining the Paris Agreement on climate change and reversing the purge of environmental regulation under Trump are both likely in the first few days of his presidency.

During his campaign, Biden told voters he would bring unity back to politics and broader society, promising to represent all Americans. To demonstrate this, and somewhat to the frustration of some left-wing Democratic activists, he went so far as to invite Republicans such as Cindy McCain, the widow of former Arizona Republican Senator John McCain, and John Kasich – who sought the Republican presidential nomination in 2016 – to speak at the Democratic convention in August.

Who Biden chooses to run his administration – possibly including Republicans in the hope of getting a better hearing in Congress – will influence how his team goes about implementing his campaign vision. After all, Biden's pledge to 'Build Back Better' likely means something quite different to someone with a successful career in the corporate sector or on Wall Street than it might to someone who has been steeped in the labour or environmental movements.

The desire to defeat Trump had buried most of the disagreements between the centrist and progressive parts of the Democratic Party, but now that the battle is over, those tensions are unlikely to stay hidden. The death of Justice Ruth Bader Ginsburg in the middle of the election campaign and Trump's successful nomination of a third justice to the Supreme Court, creating a 6-3 conservative majority, briefly brought these conflicting views into the open. Left-wing activists began talking about expanding the number of justices on the court to prevent it overturning existing and future rights and legislation Democrats hold dear. More centrist party members and those campaigning in Republican-leaning states and districts felt this was too radical a move and worried that it might cost them electorally.

Biden eventually quelled this debate by saying he intended to put together a bipartisan commission to study the Supreme Court appointment system and report back in six months. Given Democrats will, at best, have a razor-thin majority in the Senate, radical reform of the court will be rather unlikely, but the same basic challenge will confront Biden on every issue. How aggressively should the new administration pursue its goals?

The left will likely argue for a maximalist approach, pushing for the most aggressive interpretation of regulation, legislation and executive power, while more centrists Democrats will be hoping Biden reaches across the aisle and tries to win Republican allies. Who Biden chooses to fill his administration will be an early signal about how he intends to handle this problem.

A LEGISLATIVE AGENDA – IT ALL HINGES ON GEORGIA

Biden's campaign had multiple planks of ambitious legislation. Beyond the immediate priority of virus containment and an enormous fiscal stimulus to speed the economy's recovery from the pandemic, it promised more infrastructure spending (particularly to address the challenge of climate change) and a broadening of health insurance coverage through reform and expansion of the subsidies in Obamacare. To help pay for all this, corporations and the highest earning individuals were set to pay significantly more tax.

These proposals were all part of a broader framework that was attempting to address inequality by redistributing income and implicitly saw the government playing a larger role in citizens' lives than it has done traditionally in the US. Other policies that would push in the same direction and tend to raise labour's share of national income include a higher federal minimum wage; encouraging greater participation by unions in wage setting; and more rigorous enforcement of existing labour legislation. On top of this, some Congressional Democrats remain keen to re-examine competition law enforcement and take further steps to reign in the power of technology companies and other sources of corporate influence.

All of these policies could have significant market implications. But many of them could only be implemented on anything like the scale Biden's campaign envisioned if Democrats controlled Congress, once again underling the importance of the elections in Georgia.

In the near term, it is conceivable that Congress can pass another round of fiscal stimulus, but the scale that is plausible, perhaps USD 500 billion, is far short of the USD 2 trillion (and more) amount that Democrats have been arguing the economy needs.

FOREIGN POLICY AND GLOBAL TRADE

The major foreign policy challenge left behind by the Trump administration is how to handle China. Under Trump, the US and China saw trade and technology very differently, to which a Biden administration may add a human rights element. While Trump and Biden would agree on some problems, their approaches to finding solutions are expected to differ radically.

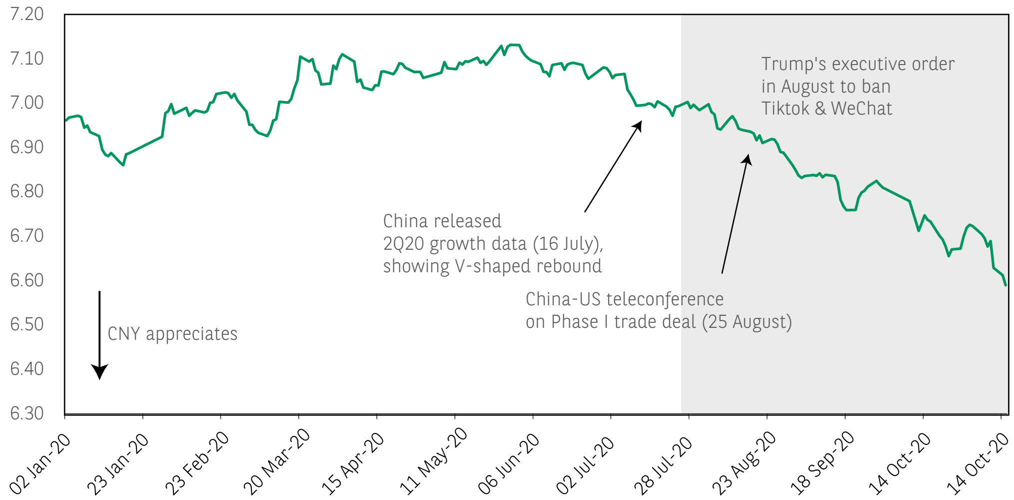
Trump rejected the traditional American approach to foreign affairs. He saw international alliances and global free trade as a scam that deprived America of wealth, power and jobs. His approach to resolving these issues was different to that of past presidents and he seemingly prided himself on his unpredictability in foreign relations. He believed his ability to startle, and to offend traditional international allies, gave him more clout to make other countries change policies he did not like, and he thought his readiness to raise tariffs would force companies to bring manufacturing jobs back to the US. Biden will have a more traditional and considered approach, building upon his long experience in foreign affairs. He sat on the Senate Foreign Relations Committee for many years, and part of the reason Obama chose him as his vice-president was his international and national security experience.

Under Biden, America is expected to resume its role as a lynchpin of the international order. Gone are the days of withdrawing from the WHO during a global pandemic or questioning the role of NATO. And while deep scepticism about the merits of free trade will remain, President Biden is not going to slap tariffs on countries such as Canada on spurious 'national security' grounds. A less erratic approach to foreign policy and trade should help reassure companies around the globe that operate, and rely upon, global supply chains.

My colleague Chi Lo, our senior economist for Greater China, provides his analysis of the implications for China below:

> **The implications of a Biden administration for China**
> Beijing has come to the conclusion that the bilateral relationship with the US has fundamentally and permanently shifted away from the benign state of the pre-Trump era. There is now bipartisan support in the US for a tougher stance on China. Beijing nonetheless sees a Biden administration as more predictable and easier to deal with than Trump and his seemingly mercurial policy choices.
>
> **Trade wars and tech wars**
> A Biden presidency likely means the end of the trade war since his trade policy is based on multilateralism. He opposes unilateral tariff increases and has promised to roll them back if elected. So the probability of tariff-war escalation should diminish. This is positive for trade between the two countries and the renminbi exchange rate.

Exhibit 1: The renminbi has appreciated versus the US dollar so far this year – Graph shows exchange rate for Chinese renminbi versus US dollar from 2 January 2020 through 9 November 2020



Source: BNP Paribas Asset Management, as of 09/11/2020

This does not mean that the tariff rollbacks will be easy. Biden has said that he would decide on China tariffs after consultation with allies. Meanwhile, Beijing will still need to offer favourable terms to facilitate new Sino-US trade negotiations. Before any new deals, China will still need to fulfil its commitments in the 'phase one' trade deal.

Moreover, an end to the trade war does not mean the end to the tech war. There is a strong consensus in the US for curbing China's access to critical technologies. Biden is unlikely to reverse the Trump administration's tech export controls and we could see even more controls in the next four years, albeit less frequently. The Biden administration will nonetheless be more flexible in handling tech-related national security issues and some tech companies on both sides may yet get a reprieve.

DIPLOMATIC RELATIONS

One of the top candidates for Secretary of State is Tony Blinken, Biden's senior advisor and former deputy Secretary of State in the Obama administration. Beijing knows him and feels it would be easier to communicate with him.

Biden's stance on Taiwan and the South China Sea is to keep the status quo while committing to both the One China Policy and the Taiwan Relations Act. He has been clear on his intent to re-enter the Iran nuclear deal. These are areas of cooperation with China.

Indicators to monitor improving diplomatic relations include the possible revival by Biden of the Strategic and Economic Dialogue with China and reopening the consulates in Chengdu and Houston.
Climate change

China and the US jump-started cooperation on climate change and energy during the Obama administration. Biden was part of that. He has set an ambitious goal of US carbon neutrality by 2050 and Xi Jinping has pledged the same by 2060. Beijing may try to cooperate with the Biden administration on climate change issues.

MARKET IMPLICATIONS BY DANIEL MORRIS, CHIEF MARKET STRATEGIST

A key determinant of the ultimate reaction of asset prices to Biden's victory is whether the administration will be able to pass major legislation. This depends on the outcome of the elections in Georgia.

If the Democrats can prevail there, they are likely to pass a major fiscal stimulus as the first order of business in the new Congress. That would push up the incomes of US citizens and businesses, promote more spending on goods and services and create more jobs, leading to US economic outperformance relative to its major trading partners.

In the past, the US Federal Reserve has tended to react to major fiscal expansions by raising interest rates more quickly than it would have otherwise done, fearing that the labour market would tighten too much, which would risk an outbreak of inflation.

But after the pivot in the Fed's reaction function this summer from worrying about the unemployment rate falling too low toward a focus on ensuring it finally meets its inflation objective, we believe there is little prospect of monetary tightening in the next few years.

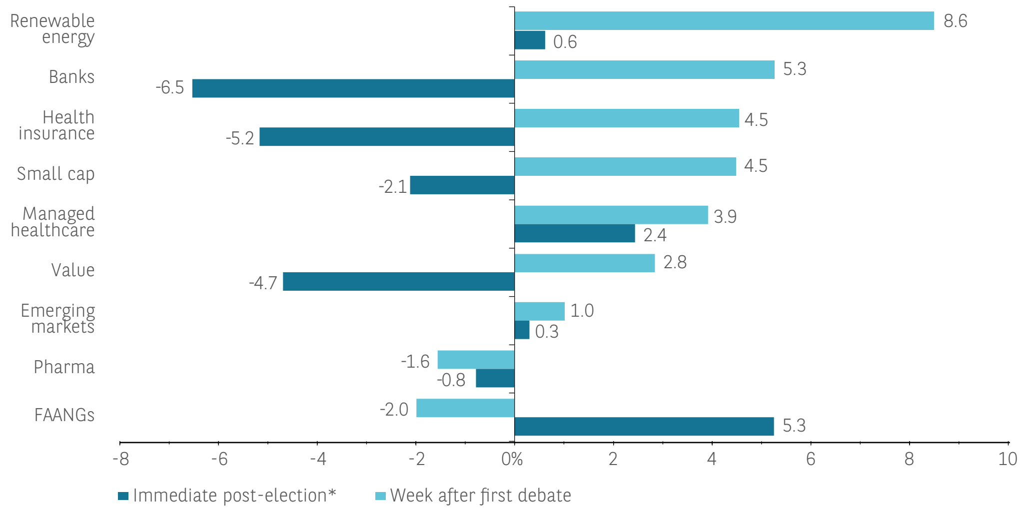
The crucial conclusion our fixed income team draws from the developments of the last six months is that monetary policy has now largely exhausted its options for providing stimulus. At this point, the role of monetary policy is to accommodate fiscal expenditures by purchasing the required amount of Treasury issuance to prevent real yields from rising, because only fiscal policy is now able to provide a significant impulse to growth.

Assurances on the inflation targeting framework are important since they clarify the policy reaction function and shape expectations, but they are secondary to the question of how stimulus can be provided when monetary policy has reached the effective lower bound. Discussions on whether the Fed will tolerate an inflation overshoot are moot if the fiscal and monetary policymakers do not have the means to generate inflation to begin with.

The outcome of the US election suggests that inflation and bond yields will stay low. As such, the process of 'Japanification' is likely to continue.

The outlook for the equity market equally depends on the outcome of the elections in January. The initial reaction of the markets in the days following the election was to unwind the 'blue wave' trades that counted on major fiscal stimulus and significant legislative or regulatory changes affecting the energy, financial, healthcare and technology sectors.

Exhibit 2: Relative returns of selected equity indices



Data as at 9 November 2020. Note: Returns relative to S&P 500 except emerging markets, relative to MSCI World. *Through 6 November 2020. Source: FactSet, BNP Paribas Asset Management

With the prospect of legislative changes much lower and regulatory changes more limited, fiscal stimulus becomes the remaining driver. Whether any stimulus is passed at all, either during the 'lame duck' Congress or in the new year, how large it is, and what sectors benefit, will be key points of attention for investors over the coming months (aside from developments on the pandemic and vaccine developments).

Absent major changes coming out of Washington, the pandemic and vaccine news, alongside equity market fundamentals and the outlook for the economy, will become paramount. While the recent announcement of better-than-expected vaccine trial results have boosted risk assets, at the same time coronavirus cases are surging and economic activity may be hit this winter. Markets will be balancing the near-term risks to growth against what should be a more positive medium-term outlook.

The lesson from the third-quarter earnings season — when S&P 500 companies beat estimates by nearly 20%, nearly two-thirds of the companies that provided an earnings outlook raised their guidance, and earnings revisions ran 2.2x up-to-down for next year — is that even if lockdown restrictions are re-imposed this winter, earnings can recover quickly once the restrictions are removed.

While there may be less stimulus forthcoming in the short term absent a Democratic 'blue wave', there is also less risk of tax increases or re-regulation in the medium term. Markets may not always get what they want, but sometimes, they get what they need.

BIOS

Mark ALLAN,
Senior economist

Mark is a senior economist at BNP Paribas Asset Management. He is responsible for analysing and forecasting the US economy and the outlook for Federal Reserve monetary policy. Mark joined the firm in 2020 and is based in London.

Before joining us, Mark was Senior Economist at Autonomy Capital, where he was lead DM macroeconomic analysis and was a key member of the investment team. Prior to that he worked as a Senior Economist at Axa Investment Managers, and an Economist within the monetary policy directorate of the Bank of England.
Mark has 17 years investment experience and holds an MSc in Economics from the London School of Economics.

Chi LO,
Senior economist

Chi is the senior economist for Greater China of BNP Paribas Asset Management (BNP Paribas AM) based in Hong Kong. Chi joined BNPP AM in 2010 through HFT Investment Management (HK), BNPP AM's joint venture partner in China, where he was CEO.

Prior to joining HFT, he was head of overseas investment at Ping An of China Asset Management (HK) Ltd. Chi's other positions in Asia included Asia research head for the British private property fund Grosvenor, chief economist and strategist for Asia at Standard Chartered Bank and research director for Greater China at HSBC in Hong Kong.

Chi did his economics graduate work at the London School of Economics and Political Science (LSE) in England and the University of British Columbia (UBC) in Canada.

Daniel MORRIS,
Chief market strategist and co-head of our Investment Insights Centre

Prior to joining us in 2015, Daniel was managing director, global investment strategist at TIAA-CREF, where he was responsible for advising clients and portfolio managers on investment strategy and asset allocation. Prior to that, Daniel was global market strategist at J P Morgan Asset Management, senior equity strategist at Lombard Street Research, and US equity strategist at Bank of America Securities.

Daniel has 23 years of investment experience. He holds a BA in Mathematics from Pomona College, an MA in International Economics and Latin American Studies from Johns Hopkins University, as well as an MBA from The Wharton School of the University of Pennsylvania. Daniel is a CFA Charterholder.

November 2020 - Design: AM STUDIO - P2011022

WWW INVESTORS' corner

BNP PARIBAS
ASSET MANAGEMENT

The asset manager
for a changing
world