Cantab
ASSET MANAGEMENT

Politics and Markets: Challenges Ahead

October 2020

With a global pandemic dominating headlines and Central Bank and Government stimuli impacting markets and economies, political developments have taken something of a back seat in recent months. In more normal times, the death of a Supreme Court Justice weeks before a US election would be of global interest; and Brexit negotiations would be top of mind for a majority of UK press publications. The political uncertainty we are facing in the final quarter of the year has, until recently, received relatively little focus. For investors with a long-term horizon, this may be a blessing; we always encourage clients to look beyond short-term political noise. However, with liquidity currently supporting asset prices and the economic fallout from global lockdowns yet to be fully felt, market foundations are looking less resilient to possible political shocks than they might usually be. This note briefly explores some of the potential outcomes of the upcoming US election with a view to sharing the context of some of our current asset allocation choices.

The choice facing US citizens on 3 November is a second term under Republican Donald Trump; or an administration led by Democrat candidate Joe Biden. President Trump's first term has been unconventional, with policies developed over social media; distrust of mainstream press; and a willingness to tackle previously politically unpalatable topics. Evidence of economic success is mixed, but markets have enjoyed President Trump – the MSCI US Index has soared >70% since the beginning of November 2016 in USD terms.

Fiscal Plans

1. Corporate and Personal Taxation

There are fundamental differences in the candidates' proposals for taxation which will have direct implications for corporate earnings and consumption. President Trump's Tax Cuts and Jobs Act of 2017 slashed the corporate tax rate from 35% to 21%, providing a meaningful profitability boost for US companies. A second term under President Trump would likely see this tax rate maintained, or attempts to push through further cuts. Biden has proposed partially reversing the cut, increasing the rate to 28%, as well as doubling the tax rate on the foreign income of US companies from 10.5% to 21%.

Trump has proposed further income tax cuts focussed on the middle class, as well as extending some of the temporary provisions from his 2017 package. The most meaningful boost to consumption would likely come from a reduction on the 22% rate of tax – payable on income between c. $40k-$85k – to 15%. Biden's personal tax proposals focus on the most wealthy; reversing the 2017 cuts and raising capital gains tax and social security taxes for high earners.

The proposals for corporate tax changes would likely impact technology stocks more heavily than many other sectors, given their relative profitability and proportion of overseas earnings.

Personal tax changes under Trump would likely be more meaningful for consumption than under Biden, whose plans for boosting consumption focus more on regulatory change – including an increase in the federal minimum wage from $7.25/hour to $15/hour. However, changes to tax policy in either direction would prove difficult with a divided Congress. Either candidate would likely require a reasonable majority in the Senate in order to secure major changes in taxation or spending.

2. Stimulus and Spending

Biden seeks corporate tax reform with a view to increase federal spending; particularly on healthcare ($450bn), education ($750bn), housing ($640bn), infrastructure ($1.3tn), federal procurement and research and development ($700bn), and climate change mitigation ($2tn). He has also been a supporter of fiscal aid for states and municipalities facing revenue shortfalls; an area on which President Trump has been vocal in his opposition. It is likely that the impact of any tax increases under Biden would be at least partially offset by higher levels of fiscal stimulus. Indeed, analysis from the Tax Policy Center estimates the impact of Biden's tax plan to be an increase in Federal revenues of $4tn over ten years, below the $4.5tn in additional spending outlined.

Both Presidential candidates have signalled support for fiscal measures to counter the effects of the pandemic. Although we have seen challenges in reaching consensus between the parties thus far, we expect continued fiscal support for the economy under either Party. As we have seen, a divided Congress has the potential to make things more complicated; but even if this situation persists, we anticipate cross-Party support for stimulus measures designed to tackle the economic impact of lockdown.

Global Trade

There were hopes that a Democratic President may relieve some of the global trade tensions seen under President Trump. We do not see significant differences between Biden and Trump in this area; the current stance with China appears to resonate across the political spectrum and is popular with the US electorate. Although Biden is more vocally in favour of free trade than Trump, he would likely continue to pursue the political agenda around intellectual property rights between China and the US. We see the ongoing impact of the pandemic as being potentially more damaging to global trade than the outcome of this election.

Energy and Infrastructure

Biden has stood on a platform of increased investment in clean energy and infrastructure, an area not shown significant attention by President Trump. Under a Biden administration, we would expect to see potentially tighter regulation of high-carbon industry, accompanied by a focus on reducing carbon emissions. Biden announced his intention to invest $2tn over four years to tackle climate change, providing a powerful boost to companies facilitating a move to a less carbon-intensive economy. Trump's spending plans would likely benefit a broader range of industry, having previously shown reticence towards environmentally-driven policy.

Under either candidate, increased infrastructure spending is likely as a means of fiscal stimulus. Interestingly, beneficiaries of these types of policies are likely to be those companies featuring heavily in ESG-mandated portfolios – an area we remain positive on and have discussed in recent Investment Outlooks.

Technology and Healthcare

Biden is a relatively moderate Democrat with regards to his views on healthcare. It is generally considered that the likelihood of significant reform to US health insurance under a Biden administration is fairly low. However, both candidates have been supportive of changes to drug pricing, which could impact Pharmaceutical companies. Any changes would likely be more aggressive under Biden, particularly if the Democrats were to win a meaningful majority in the Senate.

The technology sector has faced increasing regulatory attention in recent years, both in the US and Europe – we believe that this would continue under either candidate's administration. Concerns over competitive practices, privacy and data security have been growing alongside the dominance of global technology companies. These concerns form part of a wider global debate over the role of technology in homes and workplaces, as well as the level of access and control governments and individuals wish technology companies to have.

We believe that it is important for investors to retain a long-term horizon and focus on the big picture. This is particularly the case when considering both the technology and healthcare sectors, both of which are beneficiaries of powerful secular and structural trends. Technology companies are enjoying unprecedented digitisation of economies, accelerated by the pandemic. Increased demand for the technology necessary to work remotely; changes to the way that content is consumed; shifts from physical retail to e-commerce; and the transition from cash to electronic payments are all examples of pre-existing trends which have seen rapid accelerations. In healthcare, demographic trends continue to underlie increased demand, whilst spending on research and development has the potential to be permanently impacted by an increased focus on the potential effects of pandemics.

Contested Election

Concerns over the possibility of a contested election have been rising. President Trump has repeatedly claimed that postal voting is more susceptible to fraud than physical voting at ballot boxes, although evidence to support this assertion is limited. In the context of the Covid-19 pandemic, the share of postal voting will be significantly higher than previous elections. This is likely to lead not only to delays in processing – and of confirmation of a result, in the event of a tight race – but also to an increased likelihood of President Trump refusing to transfer power in any scenario outside of a Biden landslide victory.

> *'We're going to have to see what happens… This will end up in the Supreme Court'*
>
> (President Trump, September 2020)

In the event of a contested election and refusal to transfer power, the Supreme Court could come into play. It therefore becomes clearer why the Republican party are keen to move forwards with the nomination of a new Supreme Court Justice ahead of the election.

Moving away from the legal and political technicalities around a contested election, we consider the economic and market implications. As a general rule, markets dislike uncertainty. Analyst forecasting and business outlooks become more challenging; commercial investment decisions can be delayed; and speculative market activity can increase. Perhaps most importantly though, a lengthy legal battle over the election result would make it much more difficult for further fiscal measures to be employed against the impact of Covid-19. With the US still leading daily new cases and countries around the world experiencing second waves, this lack of flexibility could have significant economic ramifications.

Where the sources of market uncertainty are short-term, we would typically not expect equity investors with a reasonable time horizon to be adversely impacted. Indeed, despite the continued political 'blustering' around this election, we believe that the likelihood of long-term disruption remains relatively low. However, the economic environment that this election is being held in is fragile. Governments and Central Banks have thus far been able to avoid lockdown-induced economic collapse through fiscal and monetary firepower. With interest rates now near zero, monetary tools start to become less powerful. We therefore believe that a lengthy contest around this election – and consequently an inability to respond effectively with fiscal stimulus over the winter months – would have concerning consequences for both the US economy and US markets.

Investment Implications

Political uncertainty is usually unwelcome, but this is particularly true in a world facing so much economic and epidemiological uncertainty. Although Biden and Trump come from philosophically very different places, we believe that the long-term differences in economic terms arising from the two potential administrations would be relatively limited. This would be particularly true in the event of a continued split between the Senate and House of Representatives. Administrations led by either candidate would be likely to keep fiscal policy expansionary and would encourage continued loose monetary policy.

Despite President Trump's rhetoric, we do not see a sustained political and legal battle around the Presidential election as the most likely scenario in November. Although election outcomes are difficult to predict, we remain hopeful that the Constitutional integrity of the process can be maintained, including through a smooth transfer of power if the result dictates this. However, we remain comfortable with our relatively defensive overall equity positioning within portfolios entering these months of uncertainty. In particular, we continue to favour an underweight position to the most economically sensitive areas of the US market. We prefer more defensive industries such as Consumer Staples, where companies usually have internationally diversified revenue streams; as well as long-term secular winners including Healthcare and Technology, despite the potential policy uncertainty facing some companies in these sectors.

As ever, we encourage clients to retain reasonable time horizons when considering equity investments. Whilst political developments can increase volatility and provide significant dramatic effect, we are optimistic that the outlook for US (and Global) equities will not be significantly determined by the outcome of the election. We see the economic impact and evolution of the pandemic as of greater importance for long-term growth and continue to see attractive opportunities arising from structural shifts occurring in both developed and developing economies.

cantabam.com

Cantab Asset Management Ltd
50 Station Road, Cambridge CB1 2JH
01223 52 2000
advice@cantabam.com

5th Floor, 8 Angel Court, London EC2R 7HP
020 3651 0570
advice@cantabam.com