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Georgia Election has Key Market Implications

This time last week, the decisive Georgia Senate runoff elections were well underway, with news outlets progressively discounting any chances of the Republican party taking control of the Senate as votes continued to be counted. Ultimately, by Wednesday evening it had been officially confirmed that both of the Democratic nominees had won their respective runoffs. With markets having priced in a Democratic House and a Republican Senate since November, financial markets reacted to the news as investors factored in the latest results into their investment expectations. As Joe Biden's inauguration date approaches, it is useful to analyse why the updated policy expectations caused the movements in financial markets that were evident last week, as well as to analyse some of the key policy actions the Democrats will likely pursue with their narrow majority within Congress.

Georgia Runoff Recap

From December 14th to January 5th, registered and eligible Georgia residents could begin their in-person voting to determine which of the two parties would eventually control the Senate. Prior to the final Senate election, the Republicans had won 50 Senate seats, whilst the Democrats had won 48 Senate seats. In order for the Democrats to achieve a narrow majority, they would have to win the remaining two Senate seats in order to give Vice President-elect Kamala Harris the tiebreaking vote in future decision making. It was widely known that the Democrats would face challenges in winning the two remaining seats, with Georgia's last Democratic Senator being in 1996. That being said, our last market update of 2020 highlighted that Political forecast platform Predictit Markets had been consistently increasing the odds of a Democratic-controlled Senate as the result grew nearer.

On January 6th, the results were clear as both Democratic Senate candidates Jon Ossof and Raphael Warnock won their respective races. As expectations grew of a Democratic sweep ahead of the official announcement, financial markets were quick to factor in the potential policy decision making that could happen under a Democratic Congress. From January 4th to January 12th, The US industrial index increased 2.80%, the top 500 US large caps increased by 2.72% and the technology-biased large cap weighted index rose by 2.95% over the period. The results had therefore caused a broad share price increase across US industries as the overall stimulus expectations is expected to benefit equity prices in 2021. That being said, the Democratic sweep has led investors to alter their policy expectations in a number of other key areas for the next four years, as certain policy pursuits can now be passed with greater ease and with increased urgency than what was expected under a divided Congress, which in turn could have key implications for the outlook going forward.

Biden's Policy outlook

Having accounted for the latest Senate election victories, some of Biden's key policy pursuits will range from stimulus support and immediate pandemic responses in the short-term, to overhauling the country's energy industry in the longer-term.

- ***Short-Term Stimulus Support***

Directly providing US citizens with additional fiscal support will be a top priority of Biden's within the first quarter of 2021. As Joe Biden campaigned in Georgia before the runoff elections, the President-elect vowed that $2,000 stimulus checks would be sent out immediately if the Democrats won the state, which could amount to a total bill of $300 billion as predicted by Goldman Sachs. Additionally, there is expected to be further support for state and local authorities which have been long blocked by Republicans, although this will require cooperation from a handful of Republicans to pass. Morgan Stanley economists therefore expect a substantial fiscal expansion of up to $1 trillion in Covid-19 relief. Although the majority in Congress will support the Democrats in passing the legislation they desire, the quickest way may be for the numerous stimulus bills being passed in stages, which could allow the $2,000 direct stimulus payment to be passed through Congress as soon as early February.

- ***Combating Coronavirus***

The president-elect has promised 100 million Covid vaccinations within 100 days, having criticised Donald Trump's failing to vaccinate 20 million Americans by the end of 2020. The President-elect has already taken crucial action by establishing a 13-strong Covid-19 task force to help direct policy action over 2021, and one of Biden's next appointment will likely be the supply commander who is to be responsible for the production and distribution of vaccines and equipment. Interestingly, the president-elect is also likely to implement an education campaign to combat vaccine scepticism, which could support Biden in hitting his vaccine targets as more sceptics uptake vaccine enrolment. With US Covid-19 cases remaining near all-time highs, Biden's ability to meet his election promises will come under greater scrutiny as he attempts to vaccinate 100 million Americans by the beginning of May.

- ***Long-Term Tax Plans***

Although this is not expected for the next 12-18 months, the Democratic sweep could make it easier for Biden to pass his tax plans further down the line. Biden has long proposed an increase in taxation for the wealthy, which he defines as those with an income of more than $400,000 per year. His proposition is to increase the tax rate from 37% to 39.6% for the nation's top earners which he hopes will also include capital gains and dividends in the income tax bracket, whilst trying to protect low and middle-income families through personal tax benefits. His desire to reduce the inequality gap within the US does not end there, either. Joe Biden is also determined to increase the corporate tax rate from 21% to 28%, which will be achieved by repealing Trump's tax cut act that was passed with a thin majority in 2017. Conscious of imposing contractionary measures during a period of economic need which needs expansionary measures, it is unlikely that US individuals will see the tax plans implemented before the US economy has recovered. That being said, when the economy is back on track and the global pandemic is no longer a major issue for the US economy, Joe Biden will likely pursue his tax plans with some urgency as the US government would seek to begin lowering the heightened budget deficit, which currently stands at over $3.13 trillion.

- ***Foreign Policy***

Joe Biden has been a critic of Donald Trump's nationalist approach to foreign policy, where the outgoing president has withdrawn the US from numerous global accords and significantly altered the US' relationships with the likes of Cuba, North Korea, China, Iran and Mexico. Biden is keen to rebuild many of these relationships, as well as with key allies, whilst he will be expected to re-join

NATO and the WHO. Additionally, a key priority of Biden's will be to enter into another international deal with Iran, which has continued to enrich uranium that can be used to make nuclear bombs after Trump broke off the previous US-Iran agreement.

- ***Environmental Approach***

A specific objective of Biden is to achieve his ambitious climate plan. The end goal is to achieve 100% emissions-free power by 2035, which will be driven by a pledge to invest $2 trillion in clean-energy infrastructure, along with a promise to build 1.5 million new energy-efficient homes. Much of this plan is said to be funded by a mix of government investment and increasing the corporate income tax rate. It is unlikely Biden will pursue a ban on fossil fuels due to the potential affects on millions of Americans who work in the oil and gas industry, however investors have come to expect numerous incentives for clean energy projects and renewable-focused firms, which will likely accelerate the transition from fossil fuel consumption to renewable consumption over the next 15 years.

Economic and financial market implications

Accurately identifying the economic and financial market implications for the next 12 months ahead is difficult to do without the significant assumptions required on factors which are largely uncontrollable by the government: The seamless production and distribution of a vaccine that is effective against all unique strains of the coronavirus allows the nation to fully re-open by July 2021, a successful reduction in Covid cases as a result of the movement restrictions and firm defaults remaining at manageable levels over the next 6 months. That being said, holding these assumptions constant, the policies which Joe Biden plans to implement can be analysed and general guides can be considered to illustrate the potential effects on the economy and financial markets.

Firstly, inflationary pressures are expected to rise over the next 12 months. With the rise in minimum wages, stimulus support for individuals & governments, increased spending on infrastructure projects and the release of pent-up demand by the second half of 2021, household and disposable income is expected to increase, which increases consumption, and leads to an increase in gross domestic product. This, in turn, will translate into higher prices, therefore leading to inflationary pressures. After a period where demand has been depressed, the inflation rate could finish the year near the lower bound of the Fed's target of 2%. This is further supported by the Fed's new inflation-averaging strategy in which they will allow inflation overshoots above their target levels in order to get a desired average inflation rate, something which was not achieved over the last decade. In the surprise case where inflation exceeds expectations, financial markets could expect higher yields on bonds and other fixed income products as the real return falls for investors, however the new policy means that rate tightening may be delayed further.

Additionally, cyclical value stocks are expected to be key beneficiaries from larger stimulus and infrastructure plans. Not only will the infrastructure spending help to create new jobs within the US, but it will also help to drive the share prices of infrastructure and manufacturing firms who will be expected to complete the capital products. Having been an unloved sector for much of 2020, certain value stocks are expected to benefit upon Biden's inauguration. Additionally, the long-term benefits are also key from infrastructure spending, as it increases the potential supply capacity of an economy and therefore improves economic growth prospects over the long term.

A big winner from the Biden presidency is expected to be the renewable energy sector. As highlighted above, with the stimulus support and legislative prospects proposed by Biden, investors will likely continue to adjust their portfolios as Biden seeks for the renewable energy sector to help front run

the economic recovery. His desire to re-join the Paris climate agreement will also help to realign the US to global expectations on environmental regulations, which can help contribute to global progression in achieving their climate goals. As a result, clean energy firms will likely outperform over the next four years when compared to the previous four years under Trump's tenure.

A final point to consider is the impact on the technology sector. Since the election, investors have speculated about Biden's approach to mega cap tech firms, amid calls from Democrats for further regulation on the sector which has faced increased anti-trust and monopoly-power scrutiny over the last few months. It is too early to determine the effect on technology, and what regulation is likely to be passed, however it is fair to assume that the mega cap tech firms in the US will face headwinds over the next 12 months, having been the market leaders for growth in 2020.

Our View

A Biden presidency, coupled with control of the Senate, has a number of key implications for the US economy, as listed above. The Democratic sweep will allow more Democratic-aligned policies to be passed, which will likely be in the form of stimulus, taxation, and environmental regulation. We expect Biden's policy making to support the economic recovery within the US as policy remains accommodative, which will be key to preventing potential firm defaults and rising unemployment. That being said, certain industries will likely suffer as the president-elect encourages the transition to renewable energy, and potential regulation could reduce the attractiveness of mega cap tech over the medium term. In order to pass more contested bills, Biden will require the support from the Republicans on certain issues, which will help to control which partisan policies are enacted. A Biden presidency is also expected to be more predictable than the previous Trump presidency, which will help to provide certainty and clarity to markets over the next four years, to the benefit of the majority of firms. As a whole, we expect short-term volatility for US equities as pandemic news flows continue to develop, and in the medium to long-term it is our view that value stocks will benefit from the rotation out of US growth stocks, while small caps remain well positioned to benefit from the recovery in the domestic economy.

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