CIBC Private Wealth Management

The Purple Haze Election: Implications for Markets and the Economy

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CIBC PRIVATE WEALTH MANAGEMENT

THE PURPLE HAZE ELECTION: IMPLICATIONS FOR MARKETS AND THE ECONOMY

November 13, 2020

Straggling vote counts are still trickling in, as are the legal filings. But as we write this, it looks like the 2020 vote had us neither seeing red nor singing the blues. Instead, in what could be called the Purple Haze election, a blend of a Democratic blue presidency and House, and a Republican red Senate (if a Georgia runoff election goes as expected), will leave Washington under the influence of both parties. How will the political haze left in the wake of the 2020 election shape financial markets and the economy ahead?

Fighting the fire

First up on the agenda will be to fight the flames of the COVID-19 pandemic, which led to the deepest economic challenge to the global economy since the Great Depression. While there is positive news on a vaccine, we're still some months away from its mass deployment.

On the health side, parts of the US are not that far from the boiling point at which hospitals fill up and the disease becomes unmanageable without severe lockdowns and the associated economic damage. But the tools to manage the disease better are now well known: social distancing, mandated mask-wearing in indoor public spaces, aggressive testing and tracing, and (where needed) targeted and temporary shutdowns of activities tied to outbreaks.

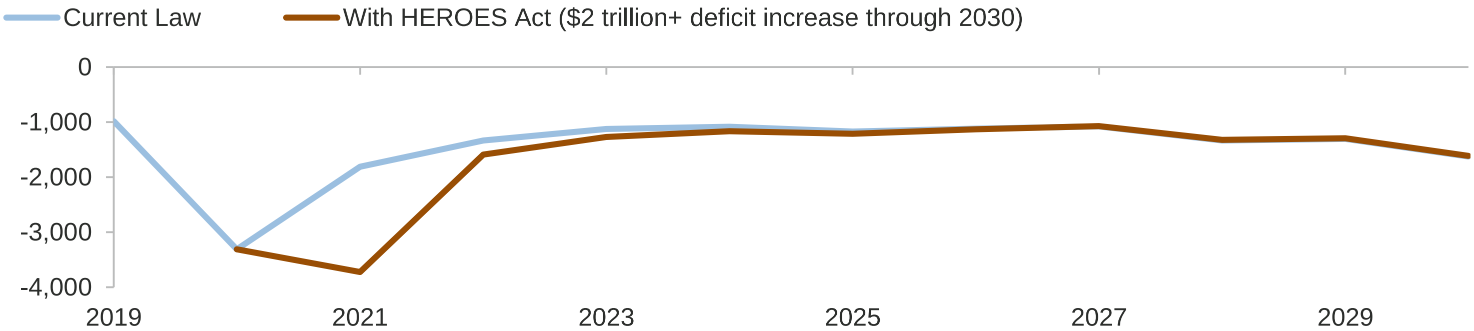
For 2021, our outlook for accelerating growth in the second half is dependent on an efficient deployment of vaccines towards mid-year, backed by an approval process that Americans trust. Overall, the most important fallout from the election could be the improvement in growth prospects that would arise if we see a more coordinated federal approach to the COVID-19 crisis.

The economy would also benefit from action on the second front, in the form of a follow-up stimulus bill. That will be a tad easier to achieve after Biden's inauguration in January, but could still be on tap for December. The inability to get a stimulus bill before the Senate may have partly reflected Mitch McConnell's concerns that his party would show itself to be divided on the issue ahead of the election. That might be less of a concern now, and a bill could pass with approval of Democrats and some Republicans if McConnell doesn't block it from coming up for a vote. The Democrats might allow a smaller bill to be passed in December, knowing they likely won't be controlling the Senate in January.

Absent a stimulus bill, the fading out of the earlier CARES Act package will represent a significant economic drag beginning this quarter, including layoffs by state and local governments. The Democratic-led House already passed a more than $2 trillion bill, which would leave deficits elevated for an additional year relative to the base case but have little impact on deficits thereafter (Chart 1). That would likely be too rich for the Senate's blood, but we look for a bill in the $1 trillion to $1.5 trillion range to be approved either in December or early in the new session of Congress. That needn't rule out some additional fiscal support should the need be apparent in 2021.

Chart 1: House bill only impacts short-run path

US federal budget deficit, $ billion (fiscal years)



Source: CBO, CIBC. Estimates are shown as of September 2, 2020, are based on current information and could shift over time.

Fiscal policy and deficits

Short-term rates can be well steered by the Federal Reserve (Fed), which has now extended its reach further out the yield curve with forward guidance and outright bond purchases under quantitative easing (QE). But long-term rates are also steered by other factors that impact Treasury supply-demand dynamics.

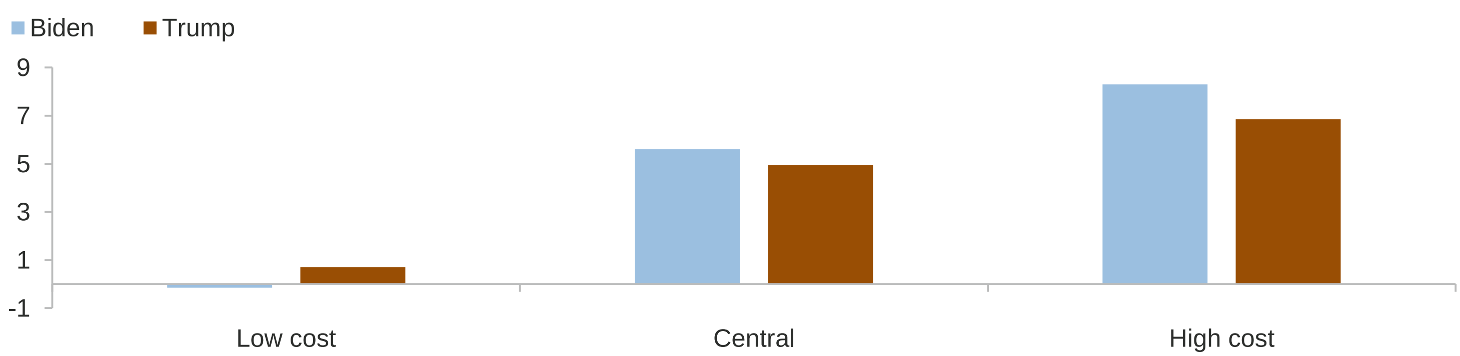
The market's perception was that deficits, and therefore financial requirements, would have been higher had the Democrats taken both the presidency and the Senate. More aggressive stimulus could also have slightly advanced the timetable for the first Fed hikes. Ten-year yields were climbing when the market priced in a blue wave preelection, but looked to be settling back into a trading range after the split-party election result, until jumping higher on optimistic news on a vaccine.

The facts don't necessarily support a definitive conclusion that deficits are higher under Democratic party rule. Deficits grew during Trump's term in office. Note that Biden's plan includes tax hikes that are estimated by the independent Tax Policy Center to yield an additional $2.1 trillion in the coming decade, reversing some of the impact of the rate cuts under Trump. Those hikes, centered on corporate taxes and high-income personal taxes, could now be blocked by the Senate. So, it's possible that deficits will actually be larger due to the split government.

So, what do we know about deficits ahead? They won't be modest, since the starting point was a deficit verging on $1 trillion, even before the COVID-19 crisis. But the impact of the election itself is unclear. While Biden's favorite debate phrase after "here's the deal" was "I have a plan," the Democratic platform was short on details in terms of the timing and costs of some of its proposals. (Trump's campaign offered even fewer details.) The result is that estimates for net fiscal impact of their policies in the coming decade by the Committee for a Responsible Federal Budget showed a very wide range of scenarios (Chart 2). But note that their central scenario wasn't materially different, with the 10-year total implying an average annual difference of only $0.065 trillion.

Chart 2: Wide range of possible deficit impacts

Deficit impact of agendas, 2021 – $30 trillion



Source: Committee for a Responsible Federal Budget, CIBC, October 7, 2020.

Now it's all up in the air due to the divided government. But best bets are that the federal government continues to run sizable deficits, putting upward pressure on bond yields as an improving economy allows the Fed to ease off on QE buying and, by 2023, begin to raise short rates. Make no mistake, neutral rates remain low, suggesting that this will still be a very gradual climb that will leave rates at modest levels by historical standards, allowing the government to remain in the red without running up onerous debt service bills.

Regulatory, tax and trade policy

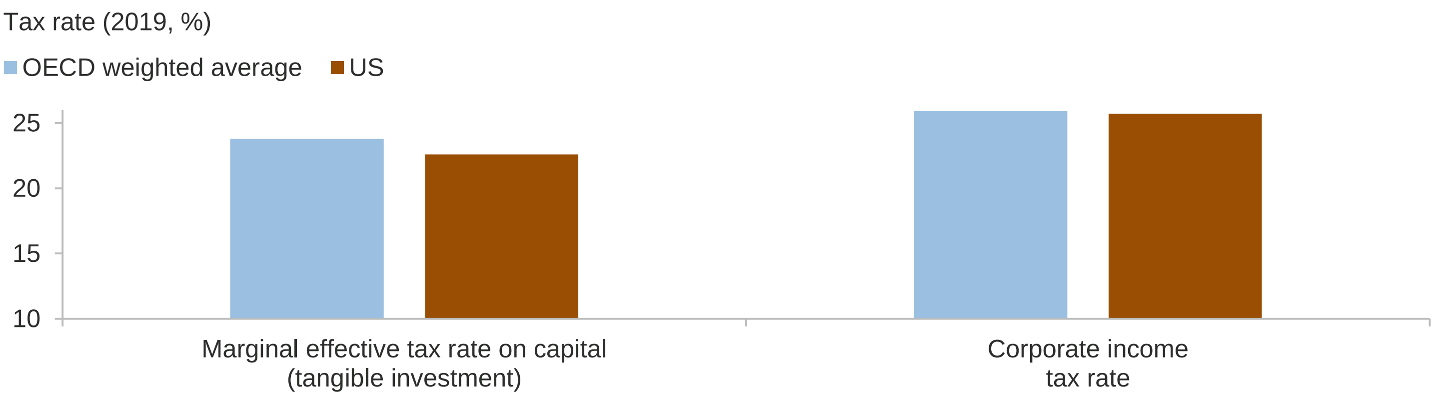
Biden's platform, if enacted, would likely offer a healthy dose of fiscal stimulus, but would also likely entail changes that impact America's international competitiveness. A tougher line on climate change and energy sector regulations would slow the recovery in the supply of shale oil, for example.

At least until the mid-term elections in 2022, policy moves on some of these issues will likely be more muted given the need to get Senate approval. As we saw during the Trump administration, the White House can engineer significant regulatory changes on environmental issues without Congressional oversight, though the White House could recommit to the Paris accords in a Biden administration. However, remember that presidential edicts can sometimes be challenged on constitutional grounds, and the Supreme Court is now decidedly conservative, with the Senate able to stand in the way of adding more judges (as Franklin D. Roosevelt threatened to do) to tilt its balance back to the left.

Biden has also made it clear that he will be more closely eyeing other countries to ensure they meet their promised reductions in greenhouse gas emissions. If the US can bring other countries more on board, the result will be a more definitive path towards a reduced usage of fossil fuels in the decades ahead in favor of renewables. US states also play a major role on these issues, as we've seen in California's proposals for the motor vehicle sector.

Tax policy changes proposed by Biden could impact America's competitive position in seeking new capital spending relative to other jurisdictions. Currently, when accounting for accelerated depreciation and other measures, the marginal effective federal/state tax on new tangible investments is lower than the comparable average across the Organisation for Economic Co-operation and Development (OECD), while tax rates on income are comparable (Chart 3). Biden proposes to add 7% to the federal share of that US corporate tax rate, but the passage of that measure now looks doubtful in the next two years.

Chart 3: US corporate tax rates

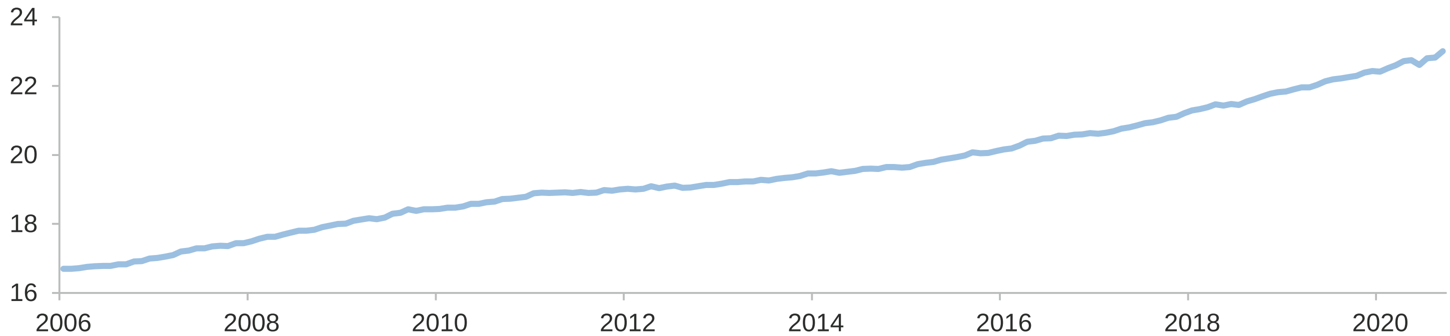


Source: Philip Bazel and Jack Mintz (The School of Public Policy), CIBC.

Biden's platform calls for the federal minimum wage to move to $15 per hour by 2025, from $7.25 currently. Senate Republicans again pose a barrier to such a move, although the new president could impose it as a requirement on government contracts. In any event, it was unlikely to represent a significant tilt in the playing field for exporters on the goods side of the economy, where competition with foreign businesses is most significant. Several large states are already at that level, with more on the way. Many of the industries with large numbers of workers below $15 per hour are in non-tradeable services, although tourism is a sector where US costs might climb with a higher minimum wage. While there are front-line factory workers with low wages, manufacturing wages are, at least on average, miles above the proposed minimum (Chart 4).

Chart 4: Average factory wages already above proposed $15 minimum

Average hourly manufacturing wage, production employees (USD)



Source: Haver Analytics, CIBC, October 2020.

There are other issues impacting location decisions, including trade policy. The Trump administration brought a lot of uncertainty for international businesses, including American companies that relied on imported products or components, or faced retaliatory measures from other countries that hurt their exports. The US ultimately reached a deal with Mexico and Canada that retained many of the most important features of the North American Free Trade Agreement, and some progress was made on trade issues with China.

Trade policy is likely to be more predictable under Biden, but there are still issues that could lead to barriers to both imports and exports. Biden has been a vocal advocate of “Buy America” provisions as part of a plan to ramp up infrastructure spending, a policy that would be seen as protectionist by America’s trading partners. Biden is more likely to seek a unified approach with US allies to address concerns over Chinese trade practices. A multilateral approach could see smoother waters in dealing with trade issues, as well as with the thorny questions on how multinational tech giants are taxed in each jurisdiction.

Immigration policy under Biden could improve America’s ability to attract global talent. Biden’s platform would open the doors to greater access for skilled immigrants. Many US business leaders, including those backing Republican Senate candidates, favor such a move. Biden’s income tax plan, which proposed higher burdens on those earning more than $400,000 annually, would have narrowed the gap with other, higher taxed jurisdictions. But it was unlikely to have been a deterrent for most immigrants, and its passage looks unlikely if the Republicans retain control in the Senate.

All that said, this is politics we’re talking about. With the split in party control, promises have a long road to become actual policies. So, here are a few things to watch in terms of honing expectations for businesses and investors.

- **Cabinet nominees**—Elizabeth Warren wants the Treasury job, and financial markets will likely react bearishly if she gets it. We expect Biden to look elsewhere, with the Fed’s Lael Brainard (who served in the Obama administration) being one of the safer and perhaps more likely choices.
- **Cabinet nominees in Energy and the Environmental Protection Agency** will be eyed as clues on how aggressive climate change policies will be. Remember that these appointments need Senate confirmation.
- On trade, **who gets the nod for US Trade Representative** could be an important signal. Trump’s team was led by notable trade hawks. Among Democratic-leaning trade experts, there are widely divergent views.
- **Fed appointments**—Other than replacing Brainard if she moves to the Treasury, there’s no reason for Biden to push out GOP-appointed doves like Jerome Powell or Richard Clarida. So, we expect no impact on monetary policy in the near term. Fiscal stimulus and effective management on the vaccine front are built into our call for the Fed to hike by 2023, a year earlier than the central bank has implied.

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