PIMCO

First the Election, Now the Governing: Fiscal Policy Priorities, Challenges, and Implications

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VIEWPOINTS

First the Election, Now the Governing: Fiscal Policy Priorities, Challenges, and Implications

Washington will likely focus on fiscal stimulus immediately – but given the realities of governing and the pandemic, economic recovery will take time.

BY **LIBBY CANTRILL**, **ALLISON BOXER** | NOVEMBER 13, 2020

The dust looks to have (mostly) settled on the 2020 U.S. election: We share the market consensus view that Joe Biden is the president-elect, although the Trump administration continues to challenge the results. Democrats have kept their majority in the House of Representatives, albeit one that is diminished; and Republicans are likely to keep a narrow majority in the Senate, barring a surprise outcome in January's runoff races in Georgia.

As of this writing, markets seem to anticipate a divided Washington in 2021. The fiscal-stimulus-fueled reflation that markets had started to price in ahead of the election now looks unlikely in the near term, but tax hikes are likely off the table as well. While we still expect growth to reaccelerate later next year, thanks to some more modest stimulus and an improving public health situation, a broader recovery will take time and economic activity likely won't recover to 2019 levels until late 2021.

What could happen under a split government?

Without a full Democratic Congress, the Biden administration will have to pivot its policy priorities toward areas of bipartisan agreement:

- **A COVID relief bill:** While we could see movement on another round of COVID-related stimulus during the lame duck session of Congress, we believe it is more likely in 2021, in which case we expect it will be priority #1 for Biden and a new Congress. However, we anticipate the size of the deal to be materially smaller than what had been considered as recently as just a few weeks ago – probably around $1 trillion.
- **Drug pricing and healthcare:** While Democrats' hopes for a big healthcare bill are likely dead-on-arrival in a Republican-controlled Senate, we could see some agreement on prescription drug pricing reform and potentially on a bigger healthcare bill (addressing pre-existing conditions) if the Supreme Court rules against the Affordable Care Act and forces Congress' hand.
- **A relatively modest infrastructure bill:** The FAST Act, which authorizes the Highway Trust Fund, the primary mechanism that funds U.S. highways, is up for authorization in 2021. This could be a legislative vehicle for a bigger bill, but nothing like the multi-trillion-dollar climate-oriented

infrastructure legislation that Democrats were hoping to pass. There is also some bipartisan support for a large broadband build-out, which may be possible.

What is not likely to happen?

Without full Democratic control of Congress, several areas of the Biden campaign's proposals will not even be considered. Most notably for markets, tax changes are off the table, and corporate and individual tax rates will likely stay where they are. Reinstating the state and local tax (SALT) deduction is likely a non-starter as well.

What could a Biden White House do unilaterally?

Without cooperation from Congress, a President Biden could effectuate policy by executive action – a favored tool by President Trump and other presidents before him. Executive actions are not as durable since they can be undone by a future president, but for a Biden administration, executive actions could be a primary lever to advance several policy goals:

- **Climate:** We expect Biden to announce that the U.S. will rejoin the Paris Climate Agreement right after he is inaugurated, which will be followed by executive actions to roll back Trump's changes to fuel efficiency standards and emissions restrictions. Biden could also set climate standards for grants and funding commitments at various agencies.
- **Immigration:** Biden will likely focus on undoing much of what was put in place during the Trump administration – from canceling the ban on visas for those coming from predominantly Muslim countries to stopping work on the border wall. Biden is also likely to provide clarity on the Deferred Action for Childhood Arrivals (DACA) program in the first few days of his administration.
- **Healthcare:** Biden could bolster the Affordable Care Act by reopening insurance marketplaces to those who lost their jobs and providing incentives for those states that have held out to expand Medicaid.
- **Financial regulation:** A Biden administration is likely to be somewhat more hawkish on financial services regulation. However, many key seats for regulation, including on the Federal Reserve Board, require Senate confirmation, which is likely to lead to moderate nominations.

As the saying goes in Washington, "personnel is policy," and we should have more insight into the direction of many of these agencies – and policies – when the incoming Biden administration announces their nominations for the various cabinet posts, most likely in December. Assuming the Senate remains under Republican control, the Biden team is more likely to choose nominees from the more moderate camp of the Democratic wing.

What is the outlook on China policy?

While we anticipate a different approach to many policies in a Biden administration, we expect one thing to stay more or less the same: the U.S. approach to China. In fact, a harder line on China has broad bipartisan support in Washington, and an October Pew Research Center poll found that Americans have an all-time unfavorable view of China, indicating that the political zeitgeist favors a continued tough approach.

The tactics around China, however, are likely to be different under Biden. Gone will be trade policy by tweet, expected to be replaced by a more transparent, multilateral, and predictable – albeit still tough – approach. While trade is still likely to be a focus, Democrats will also focus on human rights issues, a particular priority for House Speaker Pelosi and Senate Minority Leader Schumer.

Wild-card scenario: runoff elections in Georgia

As of this writing, Republicans hold 50 U.S. Senate seats and Democrats hold 48. The remaining two seats, both in Georgia, are headed to a runoff election in early January, meaning that the direction of the Senate majority will not be decided until January. Historically in Georgia, Democrats in off-cycle runoff races have not fared well, but given changing demographics and the amount of money flowing into these races, a surprise Democratic win cannot be ruled out. A win for Democrats in both seats would bring the Senate to 50–50 with Vice President-elect Harris functioning as the tiebreaker. This would increase the scope of potential legislation and make it easier for Biden to appoint personnel.

However, keep in mind that while the direction of the Senate is clearly important for the legislative agenda and for markets, whichever party controls the Senate will have a very thin majority. With little chance of changes to the requirement for 60 votes to pass most Senate legislation, compromises would still be necessary.

Post-election economic growth outlook

With the Federal Reserve's policy rate likely pinned near zero for the foreseeable future, many investors – and central bankers – will be looking to fiscal policy to help bolster economic growth. The Biden administration will aim to answer that call, but the realities of governing in a divided Washington will limit the extent of policy change.

With virus cases soaring in much of the country, and existing fiscal stimulus fading, we expect the pace of the U.S. economic recovery should moderate meaningfully in the fourth quarter and into early 2021. Stimulus-driven consumer spending drove much of that third-quarter bounce following the dismal plunge in activity in the second quarter. However, many service sectors remain significantly impaired, and some sectors may struggle to recover even after the public health crisis is over.

The U.S. economic recovery has a long way to go. If Democrats and Republicans can compromise on additional fiscal stimulus during the lame duck session, we see the possibility for a smoother, though somewhat slower than previously expected, path of growth over the next several quarters. However, our base case is that we won't see additional stimulus until the new Congress is seated in 2021, meaning our growth forecast for the next couple of quarters is somewhat below consensus. Looking further ahead, modest stimulus and (we all fervently hope) an improving public health situation should help U.S. growth reaccelerate later next year; we have a slightly above-consensus view on the potential pace of economic activity later in 2021.

Investment takeaways

PIMCO's investment teams remain cautious on markets as the pandemic continues to have a massive impact on economies and communities around the world. Under a split U.S. government, PIMCO sees more modest fiscal stimulus leading to a greater tendency for interest rates to be range-bound and inflation to remain low in the near term. Corporate credit could perform broadly well amid expected fiscal policy, but we encourage active security selection as a split government could limit support for specific credit sectors. We also see select opportunities in emerging markets, given cautious optimism of virus containment.

Overall, given the many unknowns and potential disruptors ahead, PIMCO remains focused on fundamentals, portfolio diversification, and selecting from a global opportunity set.

Please visit our election page for more insights and updates on the implications of the U.S. election for markets globally.

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