

## Pricing the Post-Election World

In the days leading up to the US election, markets seemed to be pricing in (1) uncertainty that would drag on after a contested presidential election and/or (2) a “blue wave” that would bring forward a Democratic agenda. This pricing was reflected in a -6.34%, -6.63% and -7.74% drop in the S&P 500, Dow Jones, and NASDAQ, respectively, between mid-October and November 2<sup>nd</sup>.

In the days immediately following the election, markets shot higher, shrugging off the chaos swirling around the presidential contest and riding on projections that Republicans would keep control of the Senate. On Monday of this week, markets continued their ascent, roaring past all-time intraday highs following news that preliminary data showed Pfizer’s Covid vaccine candidate to be 90% effective and the presidential election was called by all mainstream media outlets for Joe Biden over the weekend.

While markets have cooled off since their Monday surge, they still seem very convinced that the Senate will remain controlled by the GOP come January. This is despite the fact that two very tight Senate races in Georgia face a run-off after Democratic and Republican candidates in both contests failed to reach the 50% threshold needed to call the election under state law. If Democrats turn out in large numbers for the run-off, the end result would be a 50-50 tie in the Senate between Republicans and Democrats (including two independents), forcing the Vice President-elect, Kamala Harris, to cast a tiebreaking vote. If this scenario were in fact to play out, the “blue wave” long-feared by markets could resurface.

A team member of Evergreen had a chance to sit in on a Zoom call with one of the Republican Senators seeking re-election in Georgia this week. While he remained optimistic about his chances, he recognized that he and his Republican counterpart would be outspent 3:1 in the race, and that anything could happen because the run-off will be more about voter turnaround than winning new voters. The first post-election run-off poll shows both Republican Senators ahead in the race but, then again, pollsters have an iffy track record of late.

Admittedly, that’s a lot of “what ifs,” but with markets seemingly convinced that the United States will be operating under a split federal government come January, the reality of the present political situation poses a risk to this complacent view. And with uncertainty (the market’s biggest adversary) still rearing its head for the time-being, the question becomes: “How should investors respond to the stock market’s pricing of a post-election world?”

This week, we are presenting a very timely missive on the matter from Anatole Kaletsky, the “Kal” in Gavekal. (It will soon become evident to readers that Anatole leans somewhat left-of-center, in contrast to his other senior partners, Louis and Charles Gave; diversity of opinion is supported at Gavekal, unlike in much of today’s media.) As you will read, Anatole also remains unconvinced that the Senate party lines have been drawn, leaving room for varying market outcomes in the months and years ahead. He also makes a valid point that Donald Trump’s reluctance to concede may produce a backlash in Georgia against the GOP, hurting Republican chances of retaining the Senate.

For once, everything went according to plan. The US election has passed without any big surprises—and the initial market reaction has been exactly what would be predicted in any

textbook of finance, when a centrist and predictable conventional politician replaces an extreme and erratic populist as US president.

Late last year, in trying to assess the risks facing the world economy and markets in 2020 (before anyone had heard of Covid-19), I suggested that one of the biggest dangers would be a US presidential contest pitting Donald Trump against Bernie Sanders or Elizabeth Warren. This would have presented investors with the choice between four more years of a Trump presidency unconstrained by the imperatives of reelection and a socialist experiment unprecedented in American history.

Faced with this awful dichotomy, I suggested that stock markets would take off like a rocket if the Democrats nominated a centrist candidate. This is exactly what happened immediately after March 20, when Joe Biden won the Super Tuesday primaries, forcing Sanders to withdraw on April 16 from the Democratic race. Of course, many other events connected with Covid and fiscal stimulus doubtless played a bigger part in the enormous market rebound that began on March 23, three days after Super Tuesday. Still, this suggestive timing coincides nicely with the gains of 6% in the S&P 500 and 9% in the Nasdaq composite in the three trading days since the election.

The obvious reason for these gains was simply the reduction of uncertainty— both the short-term intrinsic unpredictability of any election and the long-term structural unpredictability created by Trump's unusual personality. But beyond this natural stabilization in US investment conditions, there are several fundamental reasons why a Biden rally in risk assets globally could continue in the months ahead.

Roughly two weeks ago, I suggested four reasons to expect a post-election rally regardless which candidate were to win: the short-term near-certainty of further fiscal stimulus; the medium-term likelihood of a Keynesian macroeconomic regime change; the long-term possibility of a global investment boom driven by the new energy transition; and, in the background to all these other events, the steady decoupling of Chinese economic and financial conditions from anything that may or may not happen in America and Europe. Now that Biden has been elected, all these developments are even more likely. So, are they already discounted in asset prices? I think the answer is "No".

There is an obvious contradiction in market pricing between near-zero or negative bond yields and the possibility that global growth in the rest of this decade will be both stronger and more capital-intensive than it was in the past 10 or 20 years. And the further decline in US and global bond yields since the election suggests skepticism rather than confidence, about the short-term fiscal stimulus, the medium-term shift towards Keynesian policies and the long-term boom in energy and transport investment suggested above. This skepticism is based on widespread market views that the Democrats will fail to win the Senate, and that their failure will immediately paralyze Biden and prevent Covid relief, thwart fiscal expansion or block new energy and infrastructure investment. In short, conventional wisdom believes that the Republicans will simply follow their playbook for sabotaging the Obama presidency after he lost the Senate majority in 2010.

This seems to me a miscalculation, because there are five features of current American politics this conventional wisdom overlooks:

1. A big Covid relief bill is very likely to pass through Congress even before Biden becomes

president. Now that the election is over, the demands for government support from business lobbies will become overwhelming on Senate Republicans, while the Democrats have to create conditions for a strong economic recovery in the first few months of the Biden presidency. Thus there is every chance of a “quick and dirty” compromise, whereby Republicans agree to a package of over US\$1trn, Democrats accept previously rejected conditions such as immunity for employers from liability for Covid—and Trump takes credit for the whole deal.

2. Once Biden becomes president, he will find it much easier to maintain public support for government spending and resist pressures for budget consolidation than Obama did after losing the Senate in 2010. This is for several reasons. The Covid crisis has transformed public attitudes to government spending and borrowing. But even before the Covid crisis, voter interest in government debts and deficits was rapidly eroding because the Trump administration’s policies clearly demonstrated that deficits did not cause the economic damage that conservative propagandists had claimed. While fiscally conservative Republicans will probably try to resurrect the Tea Party movement in the long run, they have very little chance of doing this until the Covid recession is over—and even then, the Tea Party’s unlikely alliance of fiscal and social conservatives will be hard to recreate.
3. The Republican Senate majority is by no means secure or rock-solid. While the Republicans will certainly stop Biden from raising taxes, Mitch McConnell will find it difficult to maintain absolute unity against a Biden fiscal stimulus plan, especially if the stimulus is delivered mainly through tax cuts for the middle class. A one- or two-seat Senate majority may also be unable to block expansionary public spending if government money is carefully targeted to local projects in key senators’ states. Two factors could make the Washington tradition of using pork-barrel spending to influence Congressional votes particularly effective in the years ahead. The first is Biden’s 36 years of experience as a senator. He starts his presidency with Washington influence and connections unmatched since Lyndon Johnson. The second is that at least six of the Republican senators who are next up for reelection are from swing states—Florida, Georgia, North Carolina, Ohio, Pennsylvania and Wisconsin—where they will face challenging prospects in 2022: in this situation, it is far from certain that the Republican leadership can assume that all the senators running for reelection in states that have just voted for Biden will openly sabotage the new president and vote blindly against popular policies such as middle-class tax cuts or pork-barrel spending in their own states.
4. The Republicans may not even control the Senate. To keep their majority, they must win at least one of the two Senate seats to be contested in Georgia on January 5. Now that Georgian voters have backed Biden, albeit by a razor-thin margin, it is doubtful they will reverse this decision in two months. Conventional wisdom assumes Democrats will be less motivated to vote again because winning the White House will lull them into complacency, while Republicans will be desperate to check the new president’s power. But the opposite is just as likely. Democrat voters may be energized to an even bigger turnout by their unexpected victory, while Republicans may be so disillusioned that they stay at home. A lower Republican turnout is even more likely because Trump will no longer be on the ballot and many of his fervent supporters may be less interested in voting for more conventional politicians once he is gone.
5. Finally, a new kind of Trump disruption may soon hit US politics, starting with the Senate election in Georgia. Trump plans to spend the next two months pursuing lawsuits which few Republican politicians will support. Responding to this perceived betrayal, Trump could turn his fury as much against “treacherous” Republicans as against “cheating” Democrats. This means that Trump will be unlikely to campaign for Republicans in the

Georgia Senate race. And without the galvanizing effect of Trump's rallies, his hard-core base may not vote. In short, Trump's refusal to accept defeat makes it harder for Republicans to keep Senate control. In the longer term, Trump's constitutional defiance could permanently split American conservatism between the new army of Trump zealots and the legacy Republican politicians who still believe in an orderly transfer of power. With Trump railing against the conventional Republicans who will now "stab him in the back", as he attempts to cling to power, the monolithic conservative unity that has dominated US politics throughout this century could soon start to erode.

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