W U T I S

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Case Study

Biden as President - elect 2020

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Executive Summary

- **As Donald Trump faces more and more critics of his capabilities in handling the Corona Crisis, we see a possible Joe Biden win for the presidential election 2020**
- **Though we expect the election outcome to be highly overshadowed by the current pandemic and its effects on the overall economy**
- **Biden's policy proposals would not have an immediate impact in the short run, but more so in the long run after the crisis**
- **We forecast a stable, slightly declining USD as the recovery progresses**

COVID-19. This virus has undeniably been one of the most impactful external shocks to the economy and financial markets we have ever witnessed. As health systems all over the world try to withstand high infection numbers, fiscal and monetary authorities have been stocking up and firing away massive amounts of stimulus ammunition. And politicians had several different ways of enacting lockdown measures. Some have done it better, some worse - Donald Trump being more of the latter type. Now he is facing backlash and his chances at being re-elected are at risk. With that in mind, we see a potential successful presidential election outcome for the Democrat Joe Biden.

In this report, we are firstly going to outline the current economic situation, which is mainly driven by the pandemic, and highlight fiscal and monetary measures as well as general consumer sentiment. In the second chapter, we will talk about how markets have performed under Republicans versus Democrats as elected presidents in order to find possible dependencies for different financial assets. Afterwards, we will discuss Biden's policy proposals in isolation, though we stress the fact that the business cycle is far more significant with regards to any market impact Biden's policies might have. And we conclude our research report with a broad macro outlook and our views on US equities and the USD.

Current Economic Situation

The COVID-19 crisis which had its starting point at the end of 2019 and showed its true global destruction starting in February/March 2020 made it impossible for economic life to continue normally. Besides that, it triggered a historical collapse in oil as it turned negative at the end of April 2020 for a short time. The global pandemic also led to negative shocks in the commodities sector which were particularly disastrous for commodity-exporting economies like the US. Globally – excluding the EU – GDP is expected to decrease by about 3% which is higher than during the Global Financial Crisis in 2008-2009. In 2021, it is expected to rebound by 5%.
The monetary and fiscal responses all over the world prevented a total macroeconomic fallout. In the European Union, policy announcements led to a stabilization of financial markets. In Europe, these liquidity measures amounted to 22% of the total EU GDP.

The function of banks will be particularly vital as borrowers are more likely to default and prices of securities decreased massively. However, it is expected that European banks are resilient enough to withstand the massive recession.

In Europe, private consumption is expected to have fallen by 9% in the first quarter as the lack of opportunity to spend resulted in "forced savings". But, it is forecasted that the bumper in private consumption will recover fast once the containment measures are lifted. However, the recovery will be incomplete as spending on travel will lag behind as the restrictions affecting these activities will last longer. Additionally, uncertainties about employment and therefore income prospects will also lead to precautionary savings.

„After the high impact of COVID-19 although, it is expected that according monetary policy, lower uncertainty and partial recovery in profits will lead to a sharp rebound."

One sector that is expected to be hit hard is business investment. The reason for that is that due to high uncertainty, future sales and investment plans will be cancelled. After the high impact of COVID-19 although, it is expected that according to monetary policy, lower uncertainty and partial recovery in profits will lead to a sharp rebound.

USA

Fiscal Measures

Package of 2.2 trillion USD – 11% of GDP. Aimed towards income support, expansion of employment insurance, business loan provision and more

After a solid increase of real GDP in 2019, experts forecast a sharp contraction of household consumption and private investment which will weigh heavily on the export sector in the first half of 2020. For the second half – in the absence of a second wave – private consumption is expected to recover fast while the recovery of the labor market will be slower. Also, private investment is expected to grow slower because of high debt levels in the corporate sector, the significant impact of very low oil prices in the energy sector, significant doubts about the profile of the economic recovery and the high level of uncertainty about the trade and the global outlook.

Total exports and imports are forecast to contract sharply in 2020 with a fast recovery in 2021. However, imports are expected to increase faster because of the significant recovery of private consumption compared to external demand. In terms of numbers, the current account is expected to contract by 6% in 2020 with a recovery of 5% in 2021.

In terms of macroeconomic policy, the current measurements taken by the government and the FED are particularly supportive in 2020.

Monetary Stimulus

Rate cut to 0-0.25%. Additionally, open-ended purchase of UST and MBS for liquidity in the markets

The fiscal stimulus amounted to 2.2 trillion US$ which are around 11% of the US GDP. This expansionary fiscal policy is addressed to the income support of many citizens, to expand employment insurances, to offer loans to business, and to provide additional resources to the healthcare sector.

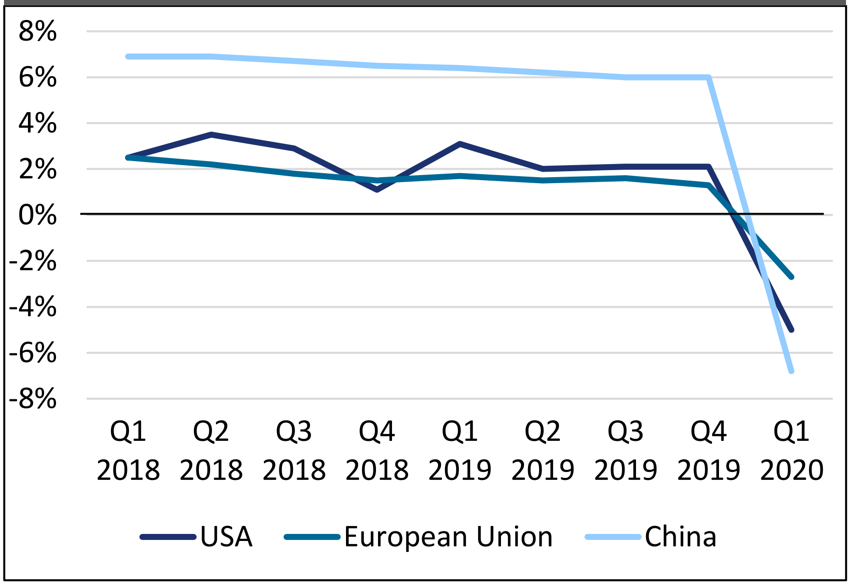
In terms of monetary policy, the FED cut its funds rate to 0-0.25% in March 2020. Then, it began an open-ended purchase of Treasuries and MBS securities at an even fast pace than during the Financial Crisis 2008. This unlimited QE is complemented by a set of other unconventional measures aimed at providing liquidity, restoring normal market functioning and easing financing conditions in order to support economic recovery.

„Unemployment reaches the highest number since the Great Depression in 1929 after it touched a historic low of 3.4% in 2019.“

Unemployment reaches the highest number since the Great Depression in 1929 after it touched a historic low of 3.4% in 2019. Sectors that are expected to be particularly hard hit are the tourism, retail, and aircraft industry. Consumer price inflation is expected to soften significantly reflecting depressed demand, the unprecedented collapse of oil prices, and the intense deterioration of the labor market.

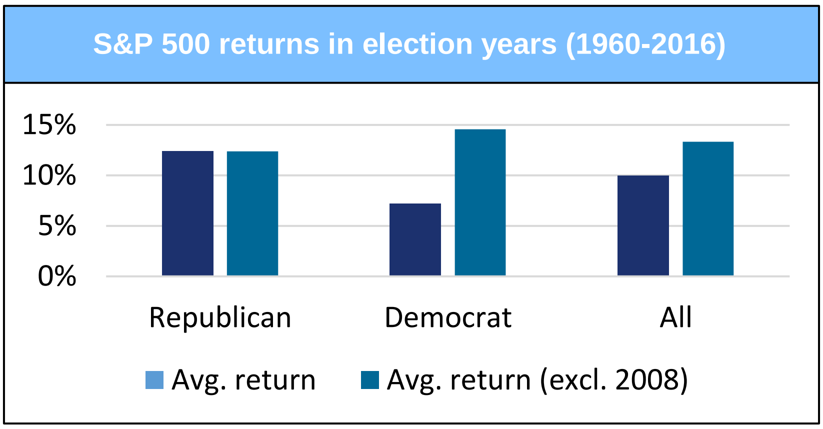
If the pandemic lasts longer than expected, the disruptions of the economic activity in the USA will be even higher as it will further expend the public health measures.

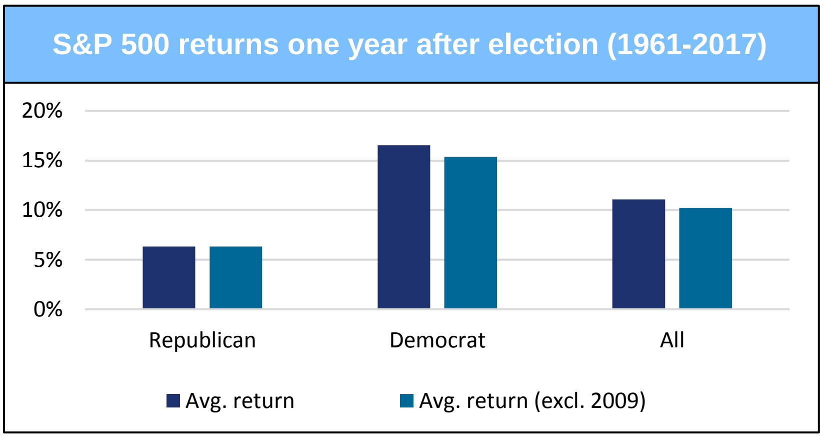
GDP growth per quarter, Q1 2018 to Q1 2020



Past Market Performance

No clear relationship ***during*** *election years, but take a look one year after*





If we take a look at market data regarding equity returns for US presidential election results and party representation, there seems to be a relationship between the average return in the stock market (here the S&P 500) and the party the elected president is representing – it is generally viewed that Republican candidates are proponents of more business-friendly policies, such as lowering corporate taxes and different forms of deregulation, and would thus create a better environment for stocks.

„We […] we have to put more weight on the current business cycle and possible policy proposals from presidential candidates.“

Now, this is a very simple generalization, too simple. Why? If we exclude the disastrous effects of the global financial crisis in 2008 from the average returns, a Democrat election outcome has the upper hand – now this described relationship suddenly looks a lot more blurred. Looking at equity returns one year after the election, now suddenly the market is far outperforming under Democrats.

This could be partly explained by the fact that coming out of a recession like in 2008 leads to higher growth potential in the economy. There is, of course, a lot more going on in the economy that affects the state of the stock market. We, therefore, have to put more weight on the current business cycle and possible policy proposals from presidential candidates.

Additionally, as new headlines about possible proposals and promises make the rounds, they will most likely only cause short-term market volatility and fade away in the medium-term where fundamentals such as monetary policy, the labor market and productivity growth matter more.

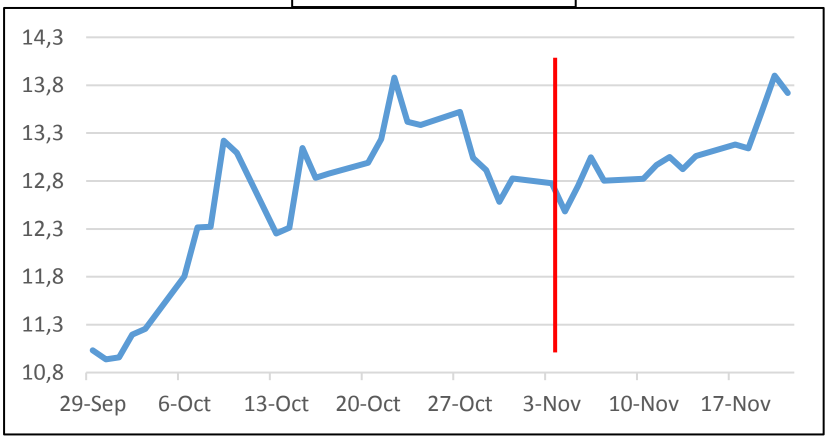
As mentioned above, the condition of the economy as a whole has a larger impact on markets. But what is particularly prominent is the US Dollar in some cases, as will be discussed later. During election years there seems to be massive upward pressure on the USD.

Everyone loves USD in uncertain times

Now, this may be explained through the expected political uncertainty that arises in election years where investors seek out safe havens such as the US Dollar – today, the Coronavirus pandemic adds another, a much bigger layer of uncertainty where the US Dollar has experienced a sharp increase. This subsequently pointed to weakness in the Mexican peso and also appreciation in emerging markets debt, as some of their bonds are issued in Dollars, which can pose significant problems in managing the debt burden and the corresponding interest payments – no one needs and wants a strong Dollar right now.

The start of the first and second term – more so the second term – of Obama's administration is a good example of uncertainty in the markets leading to a flight to USD. At the start of Obama's first term, he was already in the midst of the global financial crisis in 2008 inheriting massive economic and financial problems. Markets were wild and the outlook for the state of the economy and financial system was still very much blurred. Already before Obama was elected, the Dollar experienced a huge upswing as seen in the chart below (red line marking Election Day). And it still continued moving up.

USD/MXN (2008)

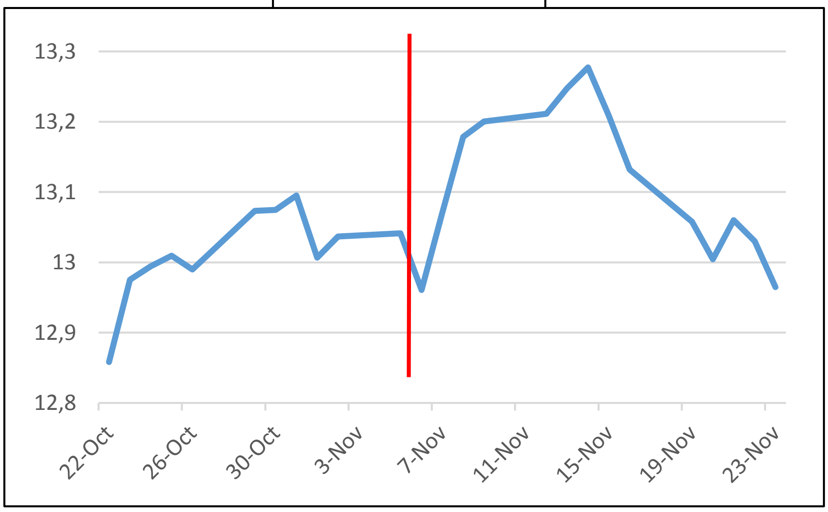


For Obama's second term in 2012, there were similar – albeit far less stressful – market circumstances. The most important one being: the fiscal cliff. First of all, the Bush tax cuts were expected to expire by the end of 2012. And secondly, the Federal government planned to reduce its spending. This was important, as the United States had wanted to get their debt burden under control and at least to slow the growth of their debt because the US Treasury set a certain limit on how much the debt could grow – the so-called debt ceiling.

„[…] the fiscal cliff […] lead to investors going into Dollars as they waited how Obama would handle the situation.“

But what effect would less government spending and higher taxes have on the overall economy? It is obviously not positive. The Congressional Budget Office (CBO) forecasted a mild recession with a high potential of growing unemployment – that sparked a rather negative short-term outlook. In addition, market participants were starting to imagine a possible scenario where the United States could default on its debt, which was deemed impossible – it is probably written in the Bible that the US cannot default on its debt. And that, as before, lead to investors going into Dollars as they waited how Obama would handle the situation (see chart below).

USD/MXN (2012)



Biden's Policy Proposals

This section predicts the scenario of Joe Biden winning the American Presidential election and estimates the enactment likelihood of some policy proposals and its possible influence on the market with a primary focus on US equity.

Before diving deeper into the possible impact of policies, it is important to stress that the presidential election outcome has a minor impact on markets in comparison to the economic cycle. Economic theory suggests that stock markets respond favorably to Republicans as they tend to lean towards generally more market-friendly policies. However, if we look into history we can find several exceptions. Under the Bush Jr. administration, S&P fell down a cumulative 22% mostly due to the dotcom bubble burst and 9/11 that led to a recession. On the other hand, markets rose significantly during Clinton's era as he enjoyed the booming years of the American economy. Therefore, in this part, we ignore the external macroeconomic influence and the impact of the economic cycle, as for example COVID-19 which clearly effected the economy vastly and focus primarily on Biden's policy proposals.

„[…] control over Senate […] is very tight and thus the control over Senate is predicted to be dependent on the outcome of the presidential election.“

Firstly, we analyzed the likelihood of enactment. We deducted from the election prediction polls that control over Senate, where 35 seats will be contested in November, is very tight and thus the control over Senate is predicted to be dependent on the outcome of the presidential election. The control of the House of Representatives is very likely to be "blue" as all polls predict Democrats to have the majority.
We picked 3 Biden's policy proposals that we assume will have the biggest impact on markets and examined them in more detail. The following policies are corporate taxes, energy, infrastructure and environment and personal taxes.

Figure 1

Likelihood and market impact of Biden's policy proposals

Policy proposals	Likelihood (if Biden elected)	Market impact (if proposal enacted)
Corporate taxes	✓	↓
Energy, infrastructure and environment	—	↑
Personal taxes	✓	→

Summary ratings: ✓ High — Moderate ↑ Positive ↓ Negative → Neutral

Corporate Tax

Biden promises to increase the corporate tax from current 21% to 28% Also, he wants to introduce 15% minimum tax on book income of companies that reported net income on more than $100mn in the US but paid 0 or negative federal income taxes. He also introduces the proposal to double GILTI, the minimum tax on foreign profits, from 10.5% to 21%.

Likelihood

Biden will only be able to pass these taxes with democratic control over Senate. However, we estimate that if he wins he will have the needed control. He also promises to use federal revenue gained from corporate taxes to invest $4tn over the next decade in climate change, education, health as well as infrastructure. Additionally, a rather big budget deficit and unfavorable increase in personal taxes due to Biden's democratic people-oriented presidential program, might not be the most attractive means of financing. Therefore, in order to find the necessary financing, we think that increase in corporate tax is most favorable and likely to be implemented.

„Due to the GDP reduction companies will have lower profits and a higher risk of default and thus we estimate higher yields that will compensate for this risk."

Market Impact

If successfully passed by Senate, Biden's corporate tax will hit companies broadly. We estimate a long-run GDP reduction. Also deducted from one research, we predict fall in S&P 500 earnings estimates and dividends and 11% reduction in 2021 EPS forecast. Based on dividend and EPS reduction we assume negative impact on US equity. Due to the GDP reduction companies will have lower profits and a higher risk of default and thus we estimate higher yields that will compensate for this risk. Furthermore, we predict a negative impact on those 300 companies including giants like Amazon or Netflix which fall under the 15% minimum tax on booked income. Doubled GILTI will mostly harm companies in healthcare and technology sector that are known to derive a lot of earnings from outside the US.

Energy, Infrastructure and Environment

Biden plans an $800bn infrastructure investment consisting of repairing existing roads, highways and bridges, stabilizing the highway trust fund, expanding broadband to every American household and also speeding the transition to electric cars by funding battery energy storage technology and building 500k charging outlets to make electric cars accessible everywhere in the USA. He also strives for zero-carbon emissions by 2050. Additionally, Biden wants to invest $1.7tn to tackle climate change including climate-related infrastructure and clean energy.

Likelihood
Regarding infrastructure plan, we think that Biden could be successful if he succeeds to fund it via federal revenue gained from corporate tax. However, policies that have a strong effect on the energy industry are harder to pass as they can face opposition.

Market impact
On one hand, we predict companies being disrupted by this policy. On the other hand, we see companies such as electric car manufacturers and firms with "green" solutions benefiting from it. We also do not expect this policy to have a large negative influence on oil and gas production. Additionally, we think utilities will benefit.

<u>Personal Tax</u>
Biden focuses to increase the top income tax rate from the current 37% to 39.6%. He also wants to increase capital gain tax to 39.6% for everyone earning more than $1mn a year. This would involve a lot of investors as past studies showed that 70% of capital gains go to people at the top of 1% of income. In addition, he will impose payroll taxes on income above $400k and cap the tax benefit of itemized deductions as 28%. Capital gains that were not realized will be taxed at death.

Likelihood
In order to pass this personal tax policy, Democrats would need control of both houses. However, based on our prediction it is that probable if Biden wins the presidential election.

Market impact
As stocks would become more expensive to sell, investors would be encouraged to hold their stocks, reducing the selling pressure and potentially moving price higher. However historical data has shown a rather arbitrary effect to capital gain tax changes. Even though in 1980s capital gains rate positively correlated with S&P500 based on the logic of holding a stock with unfavorable selling conditions, in 1997 when the rate was cut down the S&P500 continued the bull market it was already in and thus reacting differently as assumed. In addition, Biden will most likely invest the gains from personal taxes to new spending proposals and thus influence the market positively. Due to the uncertain and opposing effects, we predict neutral market impact.

„However, these impacts will be with high probability overshadowed by COVID-19 developments"

We conclude a high likelihood of corporate taxes and personal taxes policy proposals being enacted. Additionally, we consider energy, infrastructure and environment policy proposal as moderately likely to pass the legislation process. Regarding market impact, we think that increase in corporate taxes will have a negative impact on the markets while energy, infrastructure and environment will affect the market positively. Personal tax will have uncertain and opposing effects resulting in a neutral influence on markets. However, these impacts will be with high probability overshadowed by COVID-19 developments.

Macro Outlook

The following outlook contains forecasts including different aspects and assets which highly influence the US economy or are part of the US economy such as equity performance, the prime rate or the US Dollar.

The US economy was hit hard by the pandemic as well as the lockdown measures which had to be taken in order to save lives. Retail sales, which make up for approximately 2/3 of the US GDP fell 21.6% in April 2020. Nonetheless, US equity was recovering quite impressively, and one might ask how that is possible. Since horrifying economic results were already foreseeable and caused a slump in March, US indices were able to start a recovery early to the actual numbers. Moreover, the recovery in Asia seems to work better and faster than anticipated by experts.

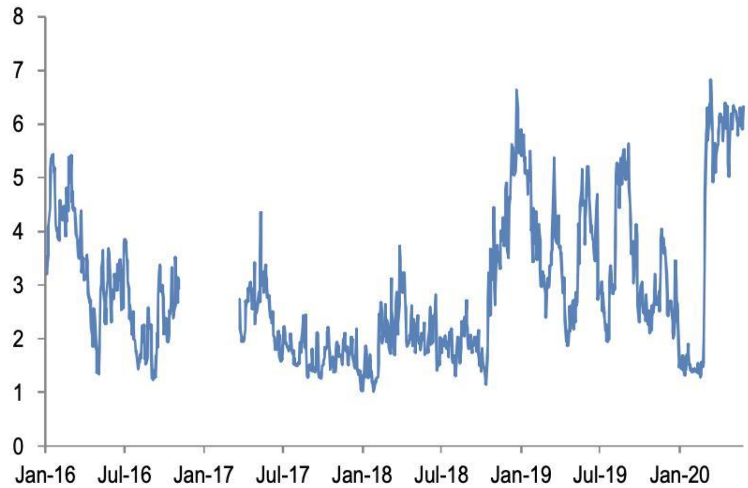
„Overall, we see a sustainable recovery as investors move their funds back into equity engagements in the coming months.“

US professional investors are, as of early June 2020, still underweight equity with around 40% allocation of non-bank investors, which is well below average (high = 49% in 2018). This suggests that there is still room for stock performances. Only Momentum traders show a dangerous leverage level on US equity indices. Overall, we see a sustainable recovery as investors move their funds back into equity engagements in the coming months.

Structural changes such as low interest rates, low sovereign bond yields and high liquidity on equity markets support the outlook of the prior paragraph. Moreover, we don't see any changes in US interest rates in the near future, especially no rate hikes. Hence, interest rates and continuing QE measures will support a potential equity rally.

Additionally, we investigated that the many short positions entered in February and March have not been covered yet as depicted in Figure 1. The US SPY ETF is highly oversold overall as well as in comparison to ETFs all over the world, on which approximately 60% of all short positions entered in March have been covered.

on loan quantity as a % share of share outstanding, last obs end of May, SPY US ETF



Source: Datalend, J.P. Morgan

„[…] we see Value and Cyclicals outperforming the market and continuatively driving indices in the coming months.“

Admittedly, futures positions on US Equity Indices of Asset Managers and Leveraged Funds are still at low levels, which implicates that mostly CTA's and Momentum Traders are highly engaged. Nonetheless, we don't see this causing a bear market, but rather a short pause or consolidation in the near future when these parties take profit.

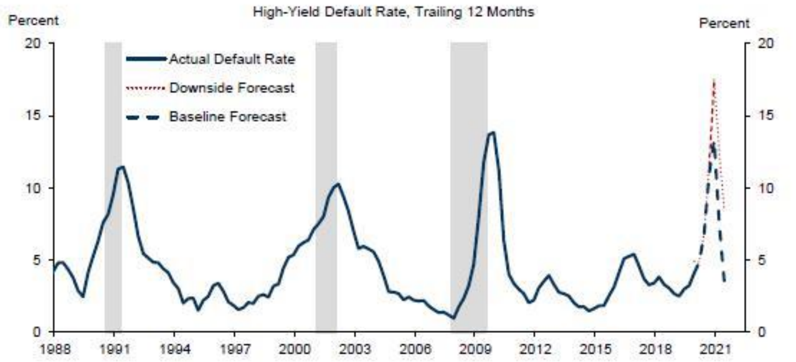
The so-far surprisingly fast recovery was highly driven by value investing, especially in the last few weeks. Value seems to have started its long-awaited rebound. FX Value is up 2.5% year-to-date as well. Hence, we see Value and Cyclicals outperforming the market and continuatively driving indices in the coming months.

„Regarding the US Dollar, we forecast a stable but slightly bearish development for the near future based on investors moving out of the Dollar as a safe haven asset as well as great fiscal and monetary stimulus“

Regarding the US Dollar, we forecast a stable but slightly bearish development for the near future based on investors moving out of the dollar as a safe haven asset as well as great fiscal and monetary stimulus. We have seen similar movements after the financial crisis in 2008 when the greenback fell about 13% from the crisis peak in only nine months.

Political Tensions between the US and China may not ease until November 2020 and can, therefore, disrupt the financial markets from time to time. We think that lockdown problems, the current economic slump as well as the disagreement on Hong Kong's autonomy will cause further tension. Consensus might be achieved after a sustainable solution to the pandemic, which is not predicted before 2021.
Nonetheless, the default cycle has started as of late May 2020 with rising bankruptcies, which is the current highest concern according to the Fed's Financial Stability report. Unique is the diverse impact on certain industries based on their exposure to the virus. Hence, certain industries might show a high number of defaults, which bears risks to the banking sector. However, analyses suggest that exposures of the banking sector are manageable based on tightened lending standards, high equity deposits and increased loan loss provisions. But small banks may be exposed more heavily due to less diversified portfolios. Even though financial stability seams manageable, significant downside risks remain if the recovery will be slower than expected. Ultimately the Fed has assured to do whatever it takes to help the financial system.

High yield default rate compared to prior crises



Source: Bloomberg Barclays, Moody's, Goldman Sachs Global Investment Research

Conclusion

All in all, the fiscal and monetary measures taken by countries all around the world have contributed to mitigating the external shock of the Coronavirus to the economy and financial markets. But the recovery is still met with some disruptions such as spikes in infection numbers in some states and is by no means complete. Left rail risks such as a potential second wave and a slower than expected recovery are still not off the table and pose uncertainty in the markets.

With that in mind, the presidential election in November 2020 will be highly influenced by the pandemic and the progress of the economic recovery. Therefore, we can only look at Biden's policy proposals within the macroeconomic landscape and health of the overall economy. Additionally, most of Biden's policy proposals will weigh in more heavily in the long term rather than in the short run after a possible successful election outcome for Joe Biden.

Whenever we witness severe market dislocations on a global scale, many investors put faith into the US Dollar as a safe haven – this is something we have seen at the start of the Corona Crisis as well. Now, as we rise again out of the pandemic, we expect the Dollar to stabilize and also have a slightly bearish view on its development in the coming months. Massive quantitative easing from the FED through the injection of trillions of Dollars support our outlook. But we still remain in a high-volatility-environment and thus have to stay cautious on market developments and any health news related to the Coronavirus as we head to towards the presidential election.

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