

Macro

# Election 2020: Polls, policies and market impacts

With the U.S. election now less than two weeks away, markets are squarely focused on the outcome and implications for the economy, interest rates and equities. Polls currently point to a possible “blue wave,” with Democrats controlling both houses of Congress and the White House. This outcome could mean major policy changes and therefore implies greater uncertainty. While polling suggests this scenario has become increasingly likely, much uncertainty remains around both the outcomes and the market impacts.

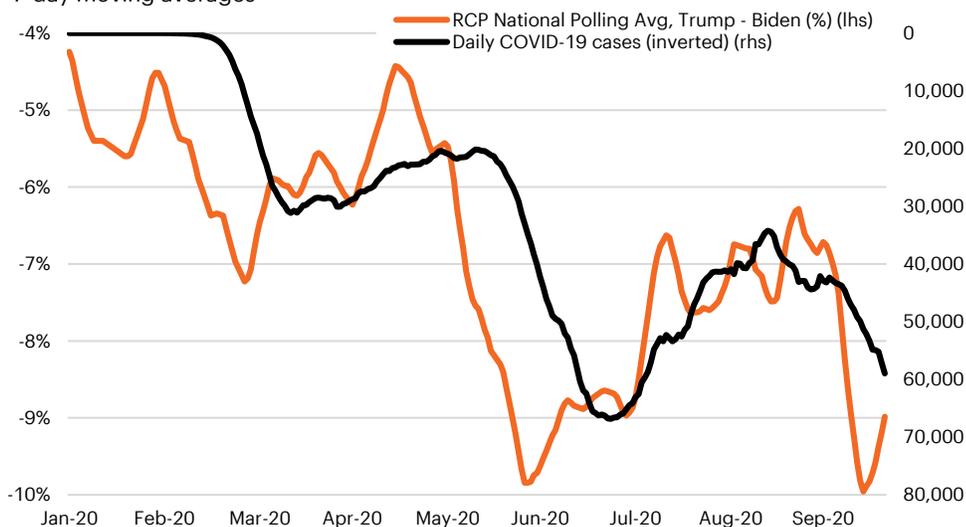
## Feeling blue?

Current polls suggest Democratic challenger Joe Biden has a roughly 9-percentage point lead nationally over Republican President Donald Trump, with a lead in many major battleground states, according to Real Clear Politics.<sup>1</sup> The pandemic has emerged as the single overriding issue of the election, driving much of the polling, even as the economy has staged an extraordinary bounce in the third quarter that has far outpaced what economists had expected.

### Key takeaways

- Current polling suggests Joe Biden holds a national lead over President Donald Trump, though uncertainty remains.
- A “blue wave” would likely result in the most significant policy changes.
- The ability of either candidate to implement their policy platform depends significantly on whether their party controls the Senate.
- The election poses significant uncertainty for both equity markets and interest rates.

**Presidential election polling has tracked virus path**  
7-day moving averages



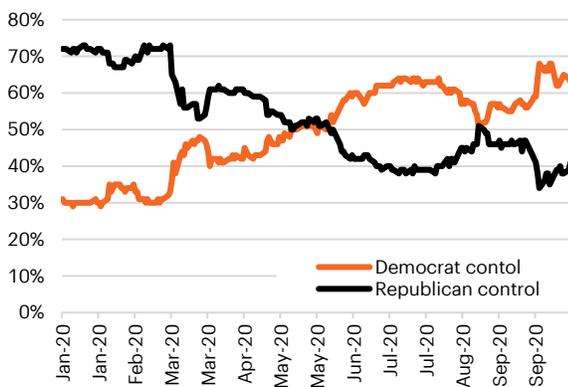
Source: Real Clear Politics, The COVID Tracking Project, as of October 20, 2020.

<sup>1</sup> Real Clear Politics, as of October 20, 2020.

Even if Biden were to win the presidency, however, policy implications would likely hinge significantly on whether the Democrats can gain majority control of the Senate as well. Currently, Democrats face a 53-47 deficit in the Senate and would need to turn at least three seats in order to gain control. (If the chamber is split evenly, the vice president is the tie-breaking vote, meaning the party winning the presidency would have effective control in the Senate.)

Betting markets currently show a 63% chance of the Democrats taking control of the Senate and a 53% chance of a blue wave, which entails Democrats controlling of both houses of Congress and the White House.<sup>2</sup> However, outlier outcomes have been the norm for 2020, not the exception. It is worth considering the policy proposals of both candidates as the November 3 election nears.

### PredictIt Senate control odds



Source: PredictIt, as of October 20, 2020.

### Peeling back policy proposals

There are significant differences between the two candidates on a host of different topics. The most immediate issue at hand is further fiscal stimulus. Congress and the president have continued to discuss a new deal, though as of this writing it remains unclear whether a deal can be reached prior to the election. The CARES Act, passed in late March, aimed to help individuals, small businesses and ailing industries, and in many ways it succeeded at bridging the economy through the acute period of lockdowns. Yet it has become clear, as the pandemic continues to weigh on a full economic recovery, that another stimulus package is likely needed to boost economic growth, especially given the continued dislocation in the labor market.

The Biden campaign has put forth a fiscal stimulus plan that resembles a slimmed-down HEROES Act, the \$3.4 trillion behemoth of a package passed by the House in early June.<sup>3</sup> A blue wave scenario would be likely to result in a robust fiscal stimulus package that reinforces many of the supports offered up by the current House proposals, including reinstating many elements of the CARES Act while adding provisions for state and local governments, hazard pay for essential workers, and student loan relief.

President Trump so far has favored stimulus that centers around direct payments to households. Both sides of the aisle agree that further fiscal stimulus is needed. Should the election outcome deliver a divided government, however, negotiations could drag on, delaying further stimulus well into 2021. It is important to acknowledge the magnitude of spending that is being discussed here. The \$2.2 trillion CARES Act represented about 10% of total U.S. GDP. For reference, the Troubled Asset Relief Program (TARP) passed in 2008 was less than \$900 billion. The proposed dollar amounts for the next round would result in government spending amounting to another 5%–10% of GDP.<sup>4</sup> The enormity of even the more moderate proposals means the timing and nature of any deal will be a crucial factor in the economic outlook for the next several years.

Apart from the immediate issue of pandemic relief, the Biden and Trump platforms call for very different policies regarding taxes and government spending. Although Republicans did not release an official party platform this year, instead opting to reaffirm their 2016 platform, President Trump's policy stances would likely follow the path of the last four years. On taxes, he would likely push to make permanent those areas of the Tax Cuts and Jobs Act (TCJA) that are set to expire. These include the modified individual tax rates and full depreciation expensing for corporations. On the spending side, a second Trump term would likely focus on defense and infrastructure. Of course, many of these items require an act of Congress. The TCJA was passed when Republicans controlled both houses and the White House; a Democratic-controlled House and/or Senate would complicate this effort.

2 PredictIt, as of October 20, 2020.

3 Biden campaign website.

4 U.S. BEA, as of June 30, 2020.

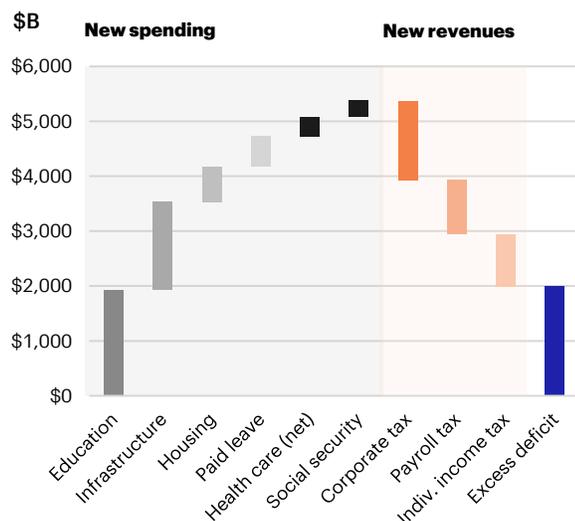
The Biden campaign has released a comprehensive list of policy proposals that amount to increased taxes and spending. On the tax side, a Biden administration would look to partially roll back the TCJA, among other items. The Biden tax plan includes restoring the top marginal individual tax rate to 39.6%, up from 37% currently; raising the corporate tax rate to 28% from 21% (in other words, reversing half of the TCJA corporate tax cut) and implementing a 15% minimum effective tax rate on corporate income; and taxing capital gains at ordinary income rates for high-earners.<sup>5</sup>

The Biden platform also calls for additional federal spending. On education, Biden proposes provisions for universal pre-K, two years of free community college, and free public college for students from families with incomes below \$125,000. Additionally, Biden’s plan includes increased investment in infrastructure, including clean energy R&D and 5G, and significant spending on housing, social security, health care and paid leave.<sup>5</sup>

The University of Pennsylvania’s Wharton School has estimated the proposed tax plan would raise an additional \$3.4 trillion in revenue while adding \$5.37 trillion to federal government spending over the next 10 years. Adding it up, Wharton figured the Biden plan would increase the deficit over the next decade by about \$2 trillion.<sup>5</sup>

**The Biden plan**

Impact on federal revenue and spending, next 10 years

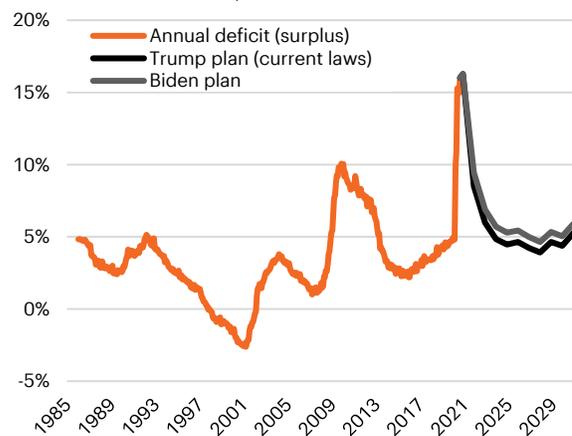


Source: Penn Wharton Budget Model, FS Investments, as of September 25, 2020.

This is against a backdrop of a federal deficit that has already drastically widened in 2020 amid the COVID-19 pandemic due to the associated loss of tax revenue and large increase in spending. The CBO projects that the deficit will skyrocket to \$3.3 trillion, or 16% of GDP, for full-year 2020, followed by an additional 8.6% of GDP in 2021.<sup>6</sup> The CBO estimate holds constant existing laws governing taxes and spending, which is unlikely given that another large fiscal aid bill will likely be passed in the coming months no matter who wins the election. Any additional fiscal spending could materially change the outlook on the deficit. The chart below shows the estimated annual federal deficit, absent another fiscal stimulus package, over the next decade under both the Trump plan (i.e., current laws) and Biden plan.<sup>5,6</sup>

**Deficits have skyrocketed**

Annual federal deficit, % of GDP



Source: Macrobond, BEA, CBO. Projections based on CBO budget estimates and GDP projections from 2020–2030. Data for Biden plan assumes \$2 trillion in excess deficit is allocated pro rata over the next decade.

Ultimately, presidential candidates generally subscribe to the “shoot for the stars, land in the clouds” mantra. A candidate’s policy platform is usually more useful as a statement of priorities than a realistic expectation for what will actually be signed into law. Of course, a president whose party controls both houses of Congress can expect to have more success in passing their policy proposals—President Obama passed the Affordable Care Act in 2010 when the Democrats controlled the House and Senate, and President Trump was able to sign the TCJA into law when Republicans controlled Congress in 2017.

5 Penn Wharton Budget Model, as of September 25, 2020.

6 Congressional Budget Office, September 2020 projections.

Even when one party has control, there are hurdles to passing major legislation—the filibuster can raise the bar in the Senate to 60 votes. There are ways around this, usually by using so-called budget reconciliation, but this tool can be used only sparingly and comes with its own restrictions. Ultimately, we would expect that a blue wave would result in a significant fiscal stimulus bill and would be the outcome most likely to produce more new policy beyond that, though there are no certainties.

Beyond differences in domestic tax and spending policy, the president has significant say in other areas of policy that could have major economic impact. These issues include immigration, energy and banking regulation, among many others. Dealing with China on trade has become a bipartisan issue—according to Pew, 72% of Republicans and 62% of Democrats hold negative views of China—though the candidates disagree on how best to deal with the issue.<sup>7</sup> Additionally, the next president will hold sway by being able to nominate or appoint cabinet members, trade representatives and Federal Reserve officials. All of these could have significant impact on financial markets in the coming months and years.

### Equities look for direction

One added source of uncertainty in this election is concern around the timeliness of election results. Markets have latched onto the idea that because of the pandemic, larger-than-expected mail-in voter turnout could lead to a lack of clarity on election night, and that this could spark market volatility. As Biden's lead in the polls has appeared to solidify over the past month, some of this concern has ebbed.

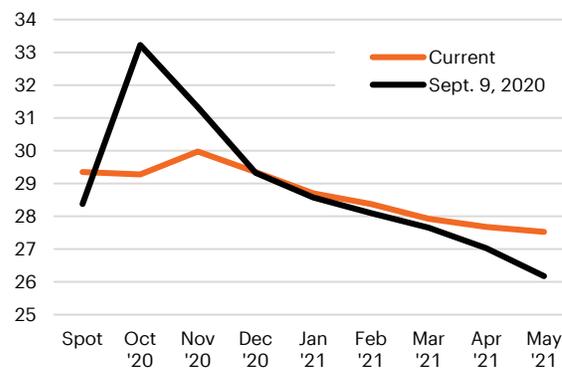
The VIX futures curve now, compared to early September, shows a shift in expectations for volatility. A month ago, the October contract (which measures expected November equity volatility as implied by S&P 500 options) showed a significant uptick in expected volatility around the election, followed by a decline in the following months. Now, the implied volatility shows concerns around the election has receded, but expectations for volatility in the months following have actually risen.<sup>8</sup>

This suggests two things regarding election-related volatility: First, it appears that market expectations for a contested or drawn-out election have

diminished, as shown by the lower implied relative volatility around Election Day. Second, the higher implied equity volatility in the first half of 2021 would seem to suggest that markets have begun to price in a higher probability of a blue wave. Potential major policy changes are likely adding to increased economic policy uncertainty and thus have the potential to elevate market volatility.

### Election volatility concerns have faded

VIX term structure



Source: Bloomberg Finance, L.P., as of October 20, 2020.

Beyond general volatility, the election figures to have substantive impact on the equity market. PredictIt's odds of a Biden victory have risen from 57% to 65% since September 25. Over the same period, the Russell 2000 has outperformed the S&P 500 by more than 500 bps, suggesting the potential for more aggressive fiscal stimulus could be boosting sentiment around the cyclical and more domestic-focused small-cap stocks that have lagged during the recovery. Certainly, this is anecdotal, but as the election draws nearer, these dynamics bear monitoring.<sup>2,8</sup>

7 Pew Research, October 2020.

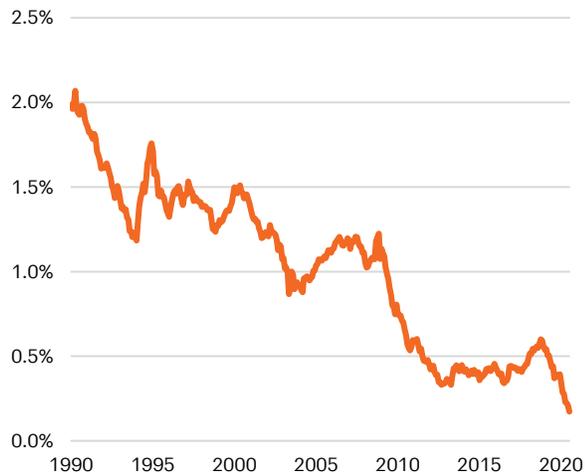
8 Modified duration of the Bloomberg Barclays U.S. Aggregate Bond Index.

## An underrated risk

The larger concern for investor portfolios continues to be on the interest rate front. Election Day will mark almost two years to the day since the 10-year Treasury was at its post-2011 high of 3.23%. In the two years since, the 10-year yield has fallen by about 250 bps to 0.79% currently, driving exceptional price gains for core fixed income assets like Treasuries and investment grade bonds. However, it has put fixed income investors in a bind—with rates so low, income is scant. Duration, which reflects an asset’s price sensitivity to changes in interest rates, on these types of assets has risen to all-time highs.<sup>8</sup>

### Yield per unit of duration

Barclays Agg



Source: Bloomberg Finance, L.P., as of October 20, 2020. Represents the ratio of Bloomberg Barclays U.S. Aggregate Bond Index yield to worst to its modified duration.

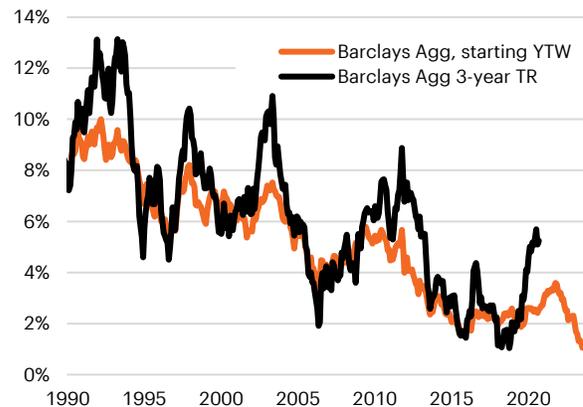
We continue to expect interest rates to remain low over the long term, part of the decades-long structural trend driven by demographics, low growth and contained inflation expectations. In 2020, however, the pandemic and the Fed’s policy response accelerated this trend further, driving yields to historic lows. As investors consider the impact of the upcoming election, the risks to yields in the short to medium term may be to the upside. A Biden victory—indeed, one could argue, any election result—is likely to lead to persistently high budget deficits. A blue wave could bring significant expansionary fiscal policy, which would have the effect of boosting demand and growth in the short term.

If growth and inflation surprise to the upside, that could place upward pressure on interest rates. Given such exceptionally long duration, investors have likely gotten complacent about their exposure to interest rate sensitivity. Even a small move higher in

rates could sharply erode returns on core fixed income asset classes.<sup>8</sup>

With monetary and fiscal policy likely heading into uncharted waters, investors may look to diversify their fixed income portfolios with higher-yielding and low-duration assets. While the election and its impact on rates remain uncertain, the risk to core fixed income assets should interest rates rise has increased; over the long term, low yields still portend low returns for these assets.

### Core fixed income returns tend to revert toward level of yield



Source: Bloomberg Finance, L.P., as of October 20, 2020.

## Lara Rhame

Managing Director, Chief U.S. Economist

Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economy and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

## Andrew Korz

Associate

Andrew is an Associate on the Investment Research team at FS Investments, where he leads research efforts on the energy sector and the U.S. commercial real estate market. He also assists in the development of the firm's long-term views on the economy and the impacts on the investing environment. Andrew holds a BBA in Finance and Economics from Villanova University and has prior experience with structuring and pricing interest rate derivatives.

## Investment Research

Robert Hoffman, CFA  
Managing Director

Lara Rhame  
Chief U.S. Economist  
Managing Director

Andrew Korz  
Associate

Kara O'Halloran, CFA  
Associate

Contact  
[research@fsinvestments.com](mailto:research@fsinvestments.com)

Unless otherwise stated, all references equities refer to the S&P 500, and references to the Barclays Agg refer to the Bloomberg Barclays U.S. Aggregate Bond Index.

This information is educational in nature and does not constitute a financial promotion, investment advice or an inducement or incitement to participate in any product, offering or investment. FS Investments is not adopting, making a recommendation for or endorsing any investment strategy or particular security. All opinions are subject to change without notice, and you should always obtain current information and perform due diligence before participating in any investment. FS Investments does not provide legal or tax advice, and the information herein should not be considered legal or tax advice. Tax laws and regulations are complex and subject to change, which can materially impact any investment result. FS Investments cannot guarantee that the information herein is accurate, complete or timely. FS Investments makes no warranties with regard to such information or results obtained by its use, and disclaims any liability arising out of your use of, or any tax position taken in reliance on, such information. FS Investments cannot be held responsible for any direct or incidental loss incurred as a result of any investor's or other person's reliance on the opinions expressed herein. Investors should consult their tax and financial advisors for additional information concerning their specific situation.

Any projections, forecasts and estimates contained herein are based upon certain assumptions that the author considers reasonable. Projections are speculative in nature, and it can be expected that some or all of the assumptions underlying the projections will not materialize or will vary significantly from actual results. The inclusion of projections herein should not be regarded as a representation or guarantee regarding the reliability, accuracy or completeness of the information contained herein, and neither FS Investments nor the author are under any obligation to update or keep current such information.

All investing is subject to risk, including the possible loss of the money you invest.

© 2020 FS Investments

NOTE-ELECT-10-2020