AA View

Is a Biden presidency really that bad for markets?

Summary

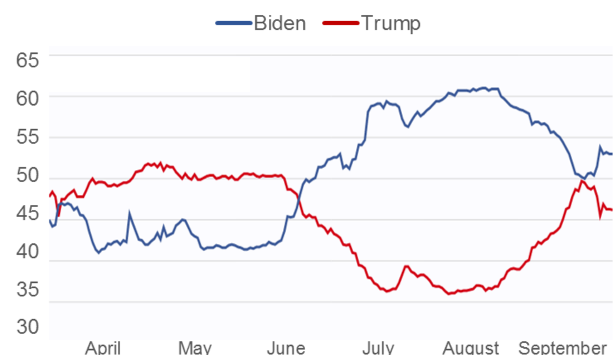
- The polls point to victory for Joe Biden and the Democrats in November, and even a possible "blue wave" although the betting odds have narrowed following the conventions.
- This scenario cannot be taken as a given due to uncertainty surrounding polling, a high proportion of postal voting and pandemic developments.
- The evidence does not support the assumption that Democratic administrations are bad for equity returns, especially if we look at performance over whole terms.
- Nonetheless, Joe Biden's tax proposals are likely to reduce corporate earnings for 2021. Taxes are likely to rise regardless of election outcome, though, due to exploding deficits created by the pandemic.
- The looming election is likely to be an important driver of market volatility in the near-term, but we think that broader economic factors will dominate over the medium-term. It will pay to look through the election impact.

Polls point to a Biden win in November, but the race has narrowed

"Get ready for a blue wave!" A Joe Biden victory, along with Democrat control of both the House of Representatives and the Senate has increasingly been seen as the most likely scenario by pollsters and markets alike.

Following the two parties' conventions, the gap in the polls between the Republicans and the Democrats has narrowed only a little, but the betting odds have come in sharply. Indeed, the blue wave scenario will very likely be tested in the next few weeks for a number of reasons.

Betting odds narrow after conventions
RealClearPolitics betting average



Source: RealClearPolitics, data as at September 11, 2020

Market data sourced from Factset.

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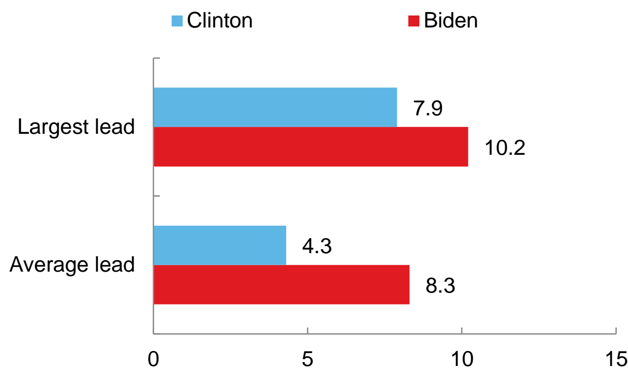
Firstly, as the 2016 election proved, victory does not necessarily follow a strong polling lead over the summer. Hillary Clinton was leading in the national polls over the pre-election summer but lost in the Electoral College.

Biden's polling lead is large, but so was Clinton's in 2016
National poll leads vs Donald Trump between June and August



Source: RealClearPolitics, average data between June and August 2016 and 2020

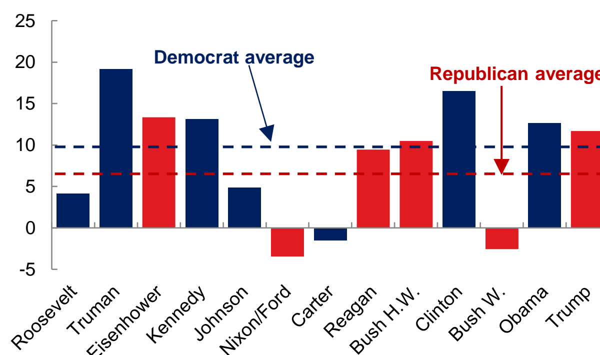
A second reason to test the blue wave scenario is the polling in the key battleground states – the states that have been identified as providing the crucial number of Electoral College votes on the way to overall victory. In the key battleground states of Florida, Wisconsin, Pennsylvania and Michigan, Joe Biden's lead in the polls is smaller than for Hillary Clinton – all of which Donald Trump won in 2016. The pollsters have stated that their methods have become more accurate since last time, but this can only be confirmed after the election itself.

Another important reason for caution is the unique circumstances of the pandemic and social distancing. All indications point to a surge in postal voting this time, although it should be noted that postal voting has been on an uptrend for a while (from 7.8% of voters in 1996 to 20.9% in 2016). While it is not obvious in the polling data that votes for one party will dominate over the other in the postal voting, this does mean that many more minds will be made up early – possibly as early as shortly after the first Presidential debate on September 29th. The other implication of the large postal vote is that the odds of a delay to the final result of the election are higher. What if the results on the day point to one winner, but the postal vote result a few days later swings the result the other way? We think that the risk of a fraught battle in the courts in the event of a close result is significant.

Little evidence that Democrat administrations are bad for markets

There are many assumptions that have been hard to break during US elections. These include the assumptions that Republicans are better at law and order, the management of the economy and are more market-friendly. Of course, even if this were true, being market-friendly does not equate to strong market performance. Indeed, the equity market data simply does not support the assertion that returns are stronger under Republican administrations. As the chart below shows, the average market performance of Democratic administrations has been superior to that of Republican administrations. This analysis is biased by the strong bull market in the 1990s under Democrat, Bill Clinton, and the subsequent twin crises of the Dotcom bubble bust and the Global Financial Crisis of the George W. Bush-led Republican administration. However, even after these are removed, the gap in equity market performance is very small.

Stock markets fare better under Democrats than Republicans
Annual real total return, %, S&P 500



Source: Schroders, data incorporates whole presidential term to end-July of election year. Trump term data to end-2019

This is not to say that markets will not have an initial reaction to the election result, indeed, we expect some elevated volatility in the run-up to and the aftermath of the election. But it is important to have a longer-term perspective on the impact of administrations. It is simply wrong to assume that the political party in charge has any lasting or significant impact on market performance. There are many other drivers of returns, such as the economic cycle, innovations and global competition, and the picture is even more complicated this time by the pandemic. Indeed, the chart above shows that many Democratic administrations have enjoyed strong markets, even while taxes have been raised. Most of the market impact of elections tend to be near-term and to manifest themselves as volatility.

Biden's proposals in detail

As the previous discussion highlights, a Biden victory, much less a blue wave, should not be taken as given. Nonetheless, if we assume that the Democrats do take control of the White House and both houses of Congress, what are the key policy pledges that are most likely to have an impact on the US economy and markets?

The core of Joe Biden's plans is something he calls "Build Back Better", which promotes clean energy, improved care and education support for the majority of individuals, infrastructure investment and the promotion of American manufacturing. He intends to pay for these with tax increase on wealthy individuals and companies. In particular, he proposes to raise the corporate income tax rate from 21% to 28%, introducing a 15% minimum book tax on corporations with income equal to, or greater than, $100m and doubling the Global Intangible Low Tax Income (GILTI) earned by foreign subsidiaries of US firms from 10.5% to 21%. In terms of the corporate income tax rate hike, it is worth

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remembering that this was cut to its current rate from 35% in 2017. He also intends to increase taxes and reduce deductions on those earning more than $400k, essentially repealing large parts of President Trump's Tax Cuts and Jobs Act (TCJA).

Significant revenue raising but also major spending plans
Selected tax and spending proposals of the Joe Biden campaign

Major tax proposals	Major spending proposals
Raise **$800bn** by treating capital gains as income for people who earn more than $1m.	Increase the value of tax credits under the Affordable Care Act. Insurance premium cap for marketplace plans at 8.5% of income. Approximate cost of **$1trn**.
Raise **$730bn** by raising the corporate income tax rate to 28% from 21%	Invest **$750bn** in expanding access to free education.
Raise **$340bn** by taxing foreign profits at 21%, double the current rate.	Federal investment of **$1.7trn** into clean energy initiatives.
Raise **$400bn** by introducing a 15% minimum book tax on firms with $100m or more of net income that pay little or no Federal income tax.	Invest **$775bn** on schemes for elderly and primary caregivers, covering healthcare costs and expanding childcare options.
Raise **$400bn** by raising top individual income tax rate to 39.6% from 37%, reversing the cut introduced by the Tax Cuts and Jobs Act, and capping tax deductions for the wealthy.	Spend an additional **$400bn** to increase US government purchases of products made in America.
Raise **$440bn** by ending the stepped-up basis adjustment on inherited assets used to minimise capital gains tax.	Allocate **$300bn** for innovation, research and development to support US companies as they compete on the global market.

Sources: Bloomberg, Washington Post, New York Times, Vox, the Tax Foundation. All quoted figures are 10-year estimates and are subject to change

Various thinktanks have estimated that these tax changes would raise around $4trn in revenue over the coming decade. From an economic perspective, these tax measures have been estimated to reduce GDP growth over the long-term. However, the issue with these estimates is that it is very difficult to model the impact of incentives to promote certain sectors, meaning that the expenditure side is often much vaguer than the revenue side. Put another way, whilst we can put figures on Biden's spending plans, the ultimate benefit for the economy will be based on so many assumptions as to render forecasts highly speculative.

Redistributive policies will add to near-term market volatility

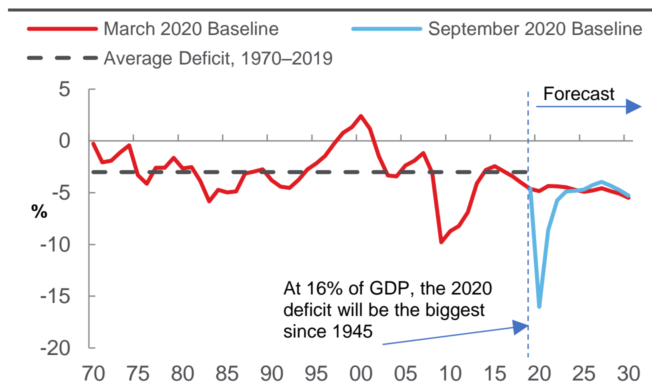
Progressive policies that aim to redistribute wealth from the rich to the poor are a highly controversial area in the US. On the one hand, the US has now reached a level of inequality not seen since the 1930s – the top 0.1% own more wealth than the bottom 80%. History tells us that highly unequal societies tend to be politically volatile with frequent civil unrest. Unequal economies also tend to mean that the tax base is narrower than more equal countries, skewing policies to smaller interest groups. On the other hand, attempts to redistribute are often seen as reducing incentives to work hard, thus ultimately reducing economic productivity.

Joe Biden's approach is to raise taxes on the extremely wealthy and to focus spending on the middle class and the poor. In terms of personal taxes, along with the increase to income tax (see table on the left), markets have also been focusing on the increase to the top capital gains tax rate from 23.8% to 39.6%. There is evidence that previous increases in capital gains have triggered stock selling as investors looked to lock in the lower tax rate ahead of the change. Will this happen again? We think that this will add to near-term volatility, but it will not set the tone for markets beyond that. Three-quarters of the US equity market is owned by institutions, which will not be affected by the capital gains tax increase, and it only applies to those that earn in excess of $1m, so the pool of those affected will also be small.

Context is crucial – the pandemic impact will likely dominate in the coming year

It is important to remember that the US elections are not happening in a bubble, with no external or extenuating factors that could derail party policies. Indeed, the pandemic has presented enormous challenges to the government, with a huge impact on economic activity.

The pandemic has created an enormous debt burden
Federal deficit as a % of real GDP



Source: Congressional Budget Office, data as at September 2nd, 2020

At the same time, the various stimulus measures, along with weaker tax revenues, have blown a hole in the government's finances – the Congressional Budget Office forecasts that the Federal deficit will be 16% of GDP this year, which is the largest since 1945, and that government debt will hit 107% of GDP by 2023, the largest in US history.

The implication is that, regardless of who becomes President in November, the economic agenda is likely to be similar. In the near-term, there will be pressure for an economic recovery

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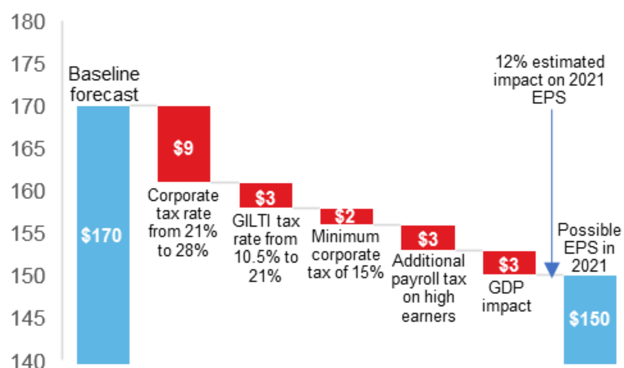
stimulus package, whilst over the longer-term, taxes will likely need to trend higher as the administration, whoever it may be, attempts to rein in deficits. From a monetary policy perspective, the Federal Reserve's recent relaxation of its 2% inflation target implies that interest rates are likely to remain low for a long time to come, even when inflation starts to trend higher. Higher Treasury supply to finance the debt may have a long-term impact on yields but we are not expecting substantial yield increases over the next year at least.

Company earnings set to be hit by tax rises – sector impacts will likely vary

Joe Biden's tax policy changes are likely to have a negative impact on company earnings over the near-term. Goldman Sachs has estimated that S&P 500 earnings per share will be $20 or 12% lower in 2021, with around half of this coming from the corporate income tax increase to 28% (see chart).

A significant hit to earnings likely from proposed tax hikes
Breakdown of Goldman Sachs EPS impact estimate for 2021



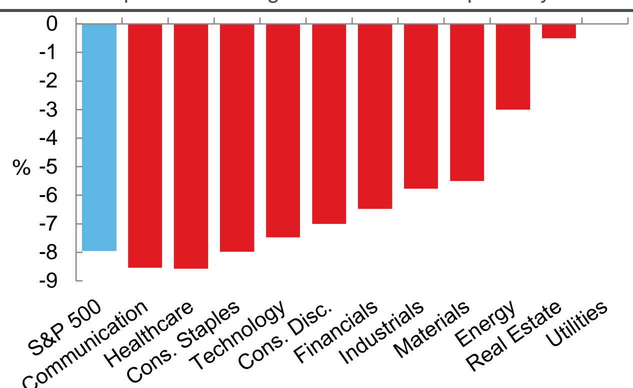
Source: Goldman Sachs, data as at September 22nd 2020

The Goldman Sachs estimate is at the higher end of market views – Northern Trust thinks earnings will fall by 6-7%, whilst UBS estimates profits will decline by 8% - and few of these take into account the offsetting effects from probable economic stimulus measures. So, again, whilst there is likely to be a negative impact on company earnings, especially in the near-term, the overall economic backdrop will matter more over time. Also, the effective tax rate paid by corporations is often different from the headline rates and this will not change. Our view is that the impact on earnings next year of Joe Biden's policies is unlikely to be as large as the quoted 12%, but we should expect a degree of headwind that will fade in its influence over time.

Additionally, the negative impact of Biden's policy proposals to earnings will not be uniform across sectors. The most adverse effects are likely to be in communication services, healthcare, consumer staples and technology. In contrast, the headwind is likely to be light for the energy, real estate and utilities sectors.

For some of these sectors, taxation will be the key driver. The doubling of the global minimum tax rate would have a significant impact on the major technology firms, for example. For other sectors, Biden's non-tax-based policies are a bigger headwind. One example is the healthcare sector – drug pricing control and the aim to create a public health insurance option would likely be important factors for future earnings.

Biden tax plans set to hurt some sectors more than others
Estimated impact on earnings from announced plans by sector



Source: UBS and Schroders, data as at September 22nd 2020. Indices cannot be invested in directly. Please refer to Appendix for Index Definitions.

Our take

Overall, the likelihood is that Joe Biden becomes President in November but many risks to this scenario remain. For his policies to be enacted fully or close to fully, the Democrats will need to take control of the Senate in addition to the House of Representatives. In such a "blue wave" scenario, we expected next year's corporate earnings to be negatively impacted, but we stress that analyst estimates may be a little too aggressive as they do not take into account the stimulus measures that are very possible in the near-term.

All of this will likely inject extra volatility to the markets in the near-term. We must acknowledge that the high risk of a disputed election in the event of a close result, coupled with a surge in the postal vote, will likely also add to volatility. But there is no evidence that the party in power has any lasting impact on market performance. This is crucial and points to a wider truth: long-term investors should focus on broad trends in economic and fundamental factors and should avoid making large allocation changes based purely on election result scenarios.

The US and many economies are facing an enormous challenge from exploding debt and the fight to pull growth back to trend levels. This will not be altered by the election result. In other words, the prospects for the asset markets are much more dependent on these trends and investors should continue to focus on appropriate diversification and building risk mitigation into portfolios.

Past performance is no guarantee of future results.

Appendix: Index Definitions

S&P 500 Index – The market-cap-weighted index includes 500 leading companies and captures approximately 80% of available market capitalization.

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