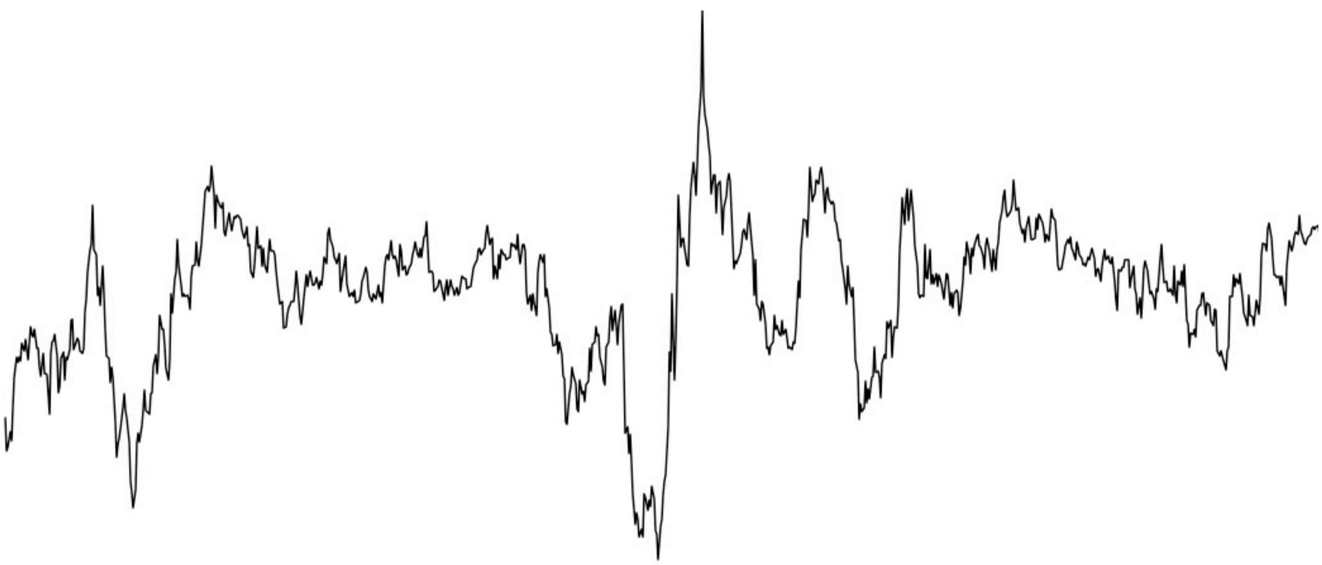
ALPHA SOURCES

OCTOBER 12, 2020



HEY JOE

It's fair to say that markets are now starting to pay some attention to the outcome of the U.S. presidential elections, and its potential implications for the price of key asset classes. As far the result goes, the incumbent Mr. Trump looks like a sitting duck. Mind you, that wouldn't have been my position a month ago. I have been prejudiced towards the idea that a hapless Joe Biden and a "silent majority" in favor of Trump—or in opposition to the Democrats—would carry the president to a second term. Mr. Biden still seems hapless to me, and I suspect the silent voter is still on the president's side. But neither of these tailwinds are likely to be enough to protect the incumbent from what is an increasingly disastrous performance in the face of the pandemic. Sure, we can argue that Trump has been dealt an unfortunate hand this year, but that's the way the cookie crumbles.

My predictions notwithstanding, the simple reason a Biden presidency is worth contemplating is because it is the outcome that markets are now entertaining. Recently, this view has been augmented with the taster in the form of the idea of a Democratic sweep of the Senate and the House. To the extent that it is possible to summarise markets' assumptions about what a triumph for the Democrats will look like, it seems to be a relatively positive story, for now. Once Republicans have been put out to pasture, the counterproductive wrangling over the next stimulus bill will make way for a huge fiscal push in Q1, and the Fed will welcome such action with unlimited and soothing QE. As analysts from BoFA put it succinctly on Friday:

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"A blue wave U.S. election outcome has flipped from consensus bear catalysts to bull catalyst in recent months"

By contrast, the prospect of a lame-duck second term for Mr. Trump promises stalemate on all fronts. It is ironic in this respect that the White House now suddenly seems very interested in a stimulus bill, despite Mr. Trump's confrontational tweet to the contrary earlier last week. That ship now looks to have sailed, though. The Unicorn summarizes it nicely;

"7-10 days ago I think there may have been enough GOP Senate votes for a bipartisan package. But for Trump the last week or so have been terrible; McConnell et al may be happy to cut him off now and start strategising for a post Trump world."

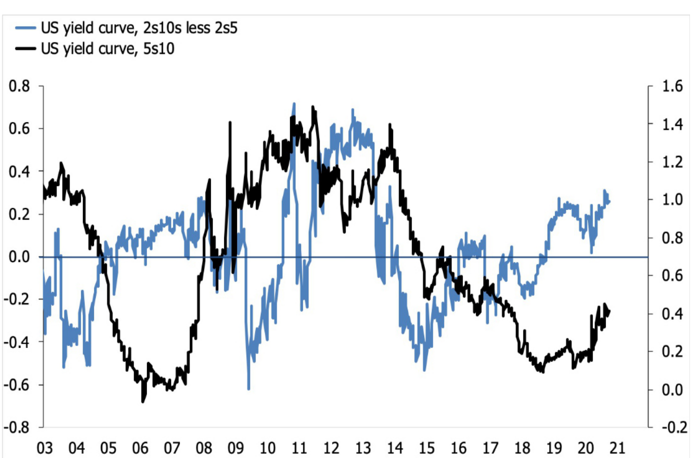
My boss Ian Shepherdson concurs;

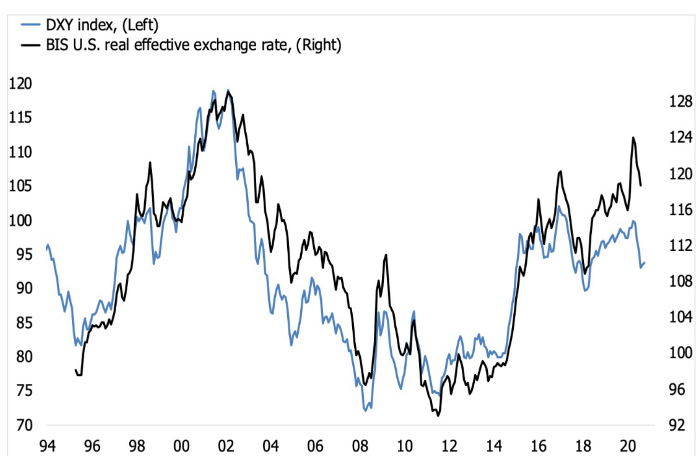
"If McConnell thought Trump will be re-elected, he'd work hard to get a big stimulus through, and would then cling to Trump after the election in order to safeguard his position as leader, having annoyed the red state fiscal hawks. But he's doing… nothing. He knows Trump is gone."

These assumptions might be challenged soon enough, but the main point for *markets* I think is that a Democratic sweep could be riskier than investors believe. An injection of several trillions worth of fiscal stimulus sounds great, but investors need to ask whether it will come with strings attached in the form of higher interest rates and nasty tax hikes, or even an antitrust crusade against the very heart of the bull market in the U.S. equites?

For now, markets don't think so. Equities have rebounded recently alongside a rise in long-term bond yields, which seems to view the world through very rose-tinted glasses. In other words, we should now be looking very closely at the long bond in the U.S. for signs that a true fiscal bazooka is being priced-in. With the Fed sitting on the front-end and belly via its forward guidance, the difference between the 2s10s and 2s5s would be a good place to start. **In a world with aggressive forward guidance, but not an outright yield cap on long-term rates, the 2s10s should have legs** *relative* **to the 2s5s.** The 5s10s is another, simpler, way to express this view. My first chart shows that the split between the 2s10 and the 2s5s are now indeed motoring higher, though they aren't extreme by any stretch of the imagination. Give it 40-to-50 more basis points on the 10y, though, and things will get interesting, for two reasons. Firstly, this should be enough to test the link between the bull market in equities

fig. 01 / A threat to the equity bull? - **fig. 02** / Will will a Biden presidency do to the dollar?





and outperformance of growth stocks, leading to the second point. If financial conditions tighten in response to a steeper yield curve, will the Fed finally be called on its promise to impose some form of yield curve control, either via an outright cap of Operation Twist 2.0? My hunch is that the answer to this question is yes, but time will tell.

Meanwhile, on the other potentially market-unfriendly aspects of a Biden presidency, I guess it is too soon to speculate, but I'd venture two broad points. Firstly, it will be difficult to for Mr. Biden to defuse the trade conflict/ negotiations with China by rolling over, though nothing would please me more, intellectually, than if the U.S/China trade hardliners got the *market-based* outcome they're yearning for, a weaker dollar, via the anti-thesis of their political preference, a geopolitical climbdown in the face of China. I suspect the alternative, however, is more likely.

Secondly, as far as tax hikes and antitrust proceedings against big tech are concerned, I think we can analyze them in the same way as we have been analyzing the trade wars during Mr. Trump's tenure. They will hover as risks over the market, but because of their tendency to tighten financial conditions, lawmakers will walk back from the brink before it gets serious. In other words, we'll probably soon be able to say "Hey Joe", but hopefully he won't have a gun in his hand, prompting us to ask where he is going with it.

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