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CIO Viewpoint

Democrats win narrow sweep as investors look beyond riots to recovery

Investment Solutions

11 January 2021

In the week that the US recorded its highest daily Covid-19 death toll and the incumbent president Donald Trump was accused of inciting a riot on Capitol Hill, voters in the state of Georgia handed control of both American legislative branches to the Democrats. That should unlock more generous economic stimulus under a Biden administration this year, and a more robust recovery.

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Key takeaways

- Democrats win a US Senate majority, making additional fiscal stimulus likely
- Riots on Capitol Hill highlight political divisions as economy struggles with effects of worsening pandemic
- Fiscal and monetary policy safety nets are in place to support the economic recovery
- We see a political sweet spot with the narrow Democrat win, leading to an improving environment for risk assets.

The path to the Democrats' mandate has not been straight. In September, six weeks before the presidential election, we suggested four possible outcomes, rating a Democrat sweep of the White House, Senate and House of Representatives as the most likely. While that is where we have ended up, our forecasts shifted in the immediate aftermath of the November election to expect a split Congress as Senate control depended on the Georgia runoff, where until now, voters elected Republicans in presidential elections since 1996.

Georgia's voters went to the polls again on 5 January 2021. The state's election rules demanded a re-run because no candidate won an outright majority on 3 November last year. Democrats Raphael Warnock and Jon Ossoff won both of the state's Senate seats, leaving the US upper chamber with a 50:50 split between Democrats and Republicans and any casting vote to Vice-President elect Kamala Harris.

That does not give the Biden administration a free legislative hand, as Congressional approval remains dependent on the support of every Democrat senator. Deeper changes, for example to the tax code, may need a two-thirds or three-fifths 'supermajority' in the Senate, although the Biden administration may, for example, be able to repeal tax cuts with a simple majority.

Inequality, division and scars

US politics started 2021 with a recording of Mr Trump calling on Georgia state election officials to 'recalculate' November's results, following on the president's year-long effort to discredit the election process. His consistent refusal to accept the election result culminated in a 6 January incitement to march on Capitol Hill, and rioting. Mr Trump then backpedalled with calls for peace as Democrats and Republicans alike began demanding his removal from office just two weeks before his White House term expires.

In time, the violence of last week may help the Republican Party to sever ties with Mr Trump. "Orchestrating a mob to pressure Congress is inexcusable," said the president's former attorney general, William Barr. Democrats, with some Republican support, are looking to remove Mr Trump from office days before his tenure expires, and may begin a second impeachment process that could stretch into the next administration's term.

The Democrat sweep cannot obscure the depth of polarisation in US politics. The share of the 74 million Americans who voted for the Republicans in November and still doubt the validity of the 2020 election will not be quickly convinced by the lack of any fraud evidence. Even after the rioting, 8 Republican senators and 139 House representatives voted to reject the certification of Mr Biden as the 46th US president.

The political and social scars run deep. The hurt inflicted by the Covid pandemic on the country's social and racial inequalities, disaffection with US political institutions and damage to international credibility, may take even longer to heal and will likely dominate political discourse in coming years. Inequalities may be exacerbated if the projected extra USD 500 billion in pandemic support were poorly distributed.

Securing growth

For the US economy, the most immediate consequence of Democrat control of Congress will be an even larger fiscal boost. Additional spending under the Biden administration, which may include provisions for unemployment, would come on top of a USD 900 billion package already agreed by Congress in December 2020. A new package may bring total pandemic support to around 18% of US gross domestic product (see chart) and add as much as 1% to GDP growth in 2021.

With Jerome Powell likely to remain at the head of the Federal Reserve (Fed) through his full term, which expires in February 2022, the central bank's guidance for no interest rate hikes until 2023 should hold. The Fed is also expected to work closely with the next Treasury secretary, former Fed chairwoman Janet Yellen to coordinate monetary and fiscal policy.

Fiscal support is vital as the US economy remains fragile in the face of the slump in activity. For example, data published on 7 January showed first time jobless claims for the week to 2 January amounting to 787,000 compared with 790,000 the previous week, along with the smallest increase in new jobs since May. This unemployment should prove temporary as it is likely linked to the recent spike in Covid infections.

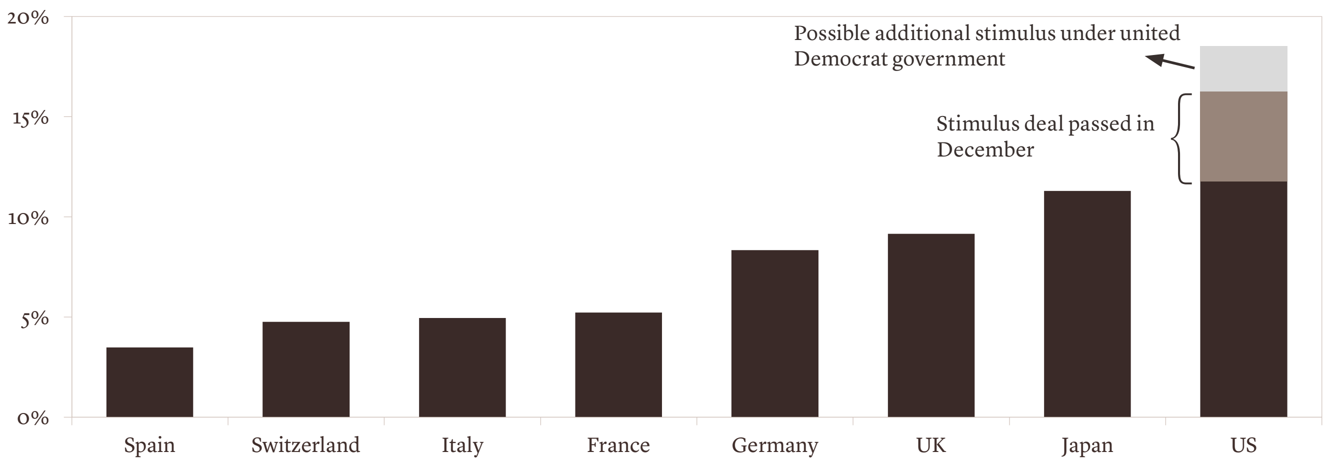
Nevertheless, fiscal and monetary safety nets, as well as the first Covid vaccinations, are now in place to support a US recovery. In August 2020, Federal Reserve Chairman Jerome Powell announced that the central bank was adjusting its inflation target to let inflation average 2%. While further fiscal stimulus may induce some inflation into the economy, this new framework allows the Fed to tolerate a temporary overshooting of the inflation target.

Market sweet spot

Markets last week focused on the longer-term implications of the Democrat sweep, rather than on either the pandemic or the riots. The yield on 10-year US Treasuries has risen as much as 20 basis points this year to 1.12% on 8 January, its highest rate since March. US equities also gained, taking the S&P 500 to a new record.

The political outcome is a sweet spot for markets because the Biden administration should prove more consistent in

1. US fiscal response to Covid-19 crisis: a vast scale
Government spending increase and tax reductions in 2020 (in percent of GDP)



Sources: IMF, Lombard Odier calculations its policies, and internationally cooperative rather than isolationist. The narrow Democrat majority in the Senate also means that there is less risk of higher regulation and corporate taxes.

Joe Biden will be sworn into the White House on 20 January, in the presence of outgoing Vice-President Mike Pence, but defying convention, without Mr Trump. The shift in balance of power and stimulus support for the real economy is combining to create a sound environment for risky assets, in particular equities. We maintain our exposure to US stocks, which are benefitting from strong performance in small capitalisations, information technology and healthcare. We continue to invest in the business recovery by diversifying our allocation towards more cyclically exposed regions, such as Europe and emerging markets, where we have just reinforced our equity position.

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