The US Election
A European Perspective

November 2020

For Professional Clients, Qualified Investors and Qualified Clients/ Sophisticated Investors only.

Oliver Collin
European Equities Fund Manager

In this piece we try to outline the equity market reaction to the US election, why it is relevant to us and the 5 points as to why we believe that buying long duration assets is not the right answer.

Ahead of the US elections

It is never easy at the best of times to predict the outcome of political elections. Most of the recent elections are proof of that. Would pollsters be right this time? Would Trump pull another rabbit out of the hat? Might it be a close contest? – likely resulting in lengthy legal battles. Would there be a 'Blue Wave'? As such, markets approached this election cautiously, selling off into the event. All of this at a time when markets were already at all-time highs, dominated by a small number of US stocks.

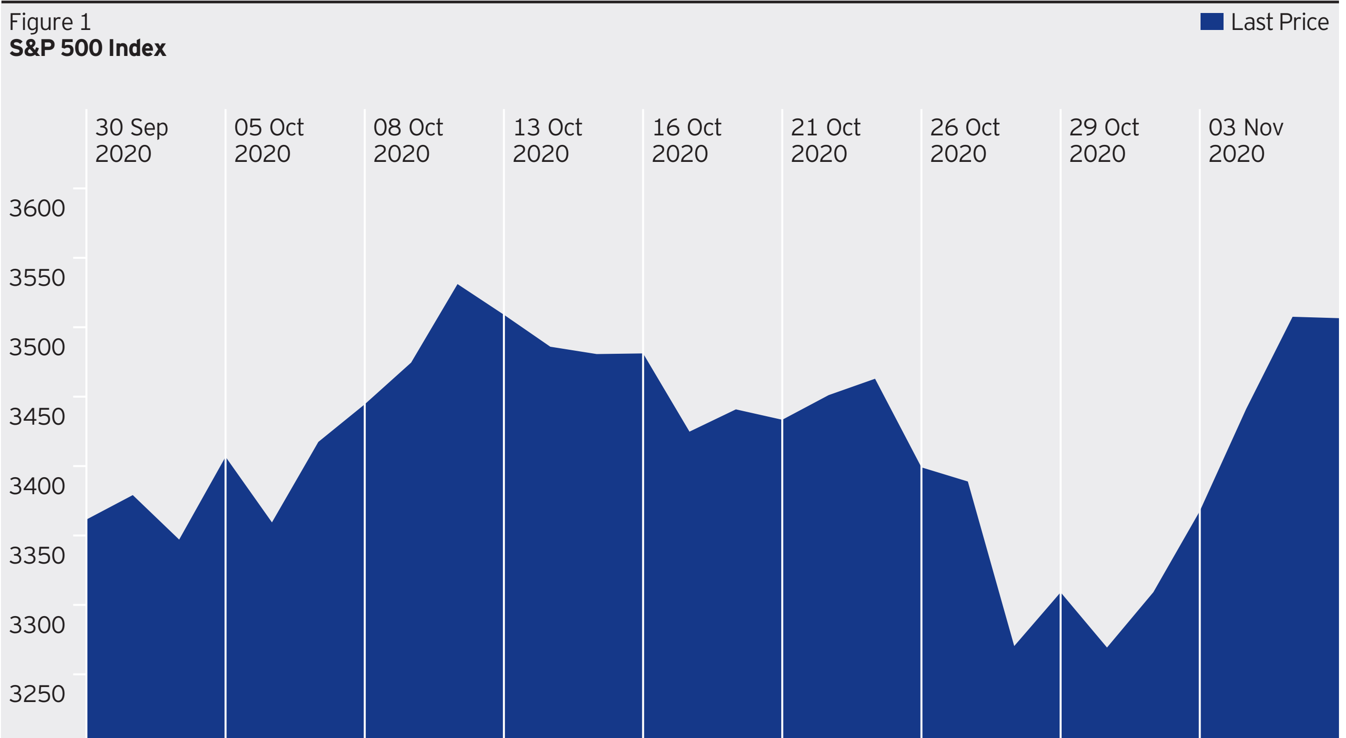
The US election result

As markets opened on Wednesday morning, an outright Trump win seemed inevitable and certainly any thoughts of 'Blue Wave' were dead in the water. More government intervention and regulation, more profligate spending and higher taxes could be ruled out.

Whilst sad for liberals, this wasn't a bad outcome for the markets: 4 more years of Trump, a known, with the inevitability of a new fiscal package and a much-reduced probability of tax hikes was a satisfactory outcome – markets liked it and rallied. Then as time moved on, the likelihood of Trump winning reduced, as postal ballots – heavily skewed in Biden's favour – were counted. However, without the 'Wave', specifically a Democrat Senate, the ability for a huge reform agenda with tax reform and fiscal largesse seemed a low risk... and so the market continued to re-risk; markets went up 'bigly'.

Market moves are only part of the story, however. What the market bought was arguably more important. The skew on Wednesday and for part of Thursday's trading sessions (European markets) was 'Quality' and 'Momentum' names at the expense of 'Value' or short duration. A Biden clean sweep, as mentioned, meant fiscal spending because there was a will (policy) and a way (the Senate). Without a clean sweep the risk is a 'lame duck' presidency, meaning Biden struggles to pass incremental legislation let alone reform. Under these circumstances any new fiscal packages are likely to be small and certainly do not reflect a regime shift, i.e. the Fed, with monetary policy, remains the only game in town. Result: yields fall, buy 'Growth', buy duration and sell 'Value'.

Figure 1
S&P 500 Index



Source: Bloomberg, as at 6 November 2020.

What does all this mean?

We do not believe that a split Biden presidency means buy long duration assets, particularly when thinking about Europe. Points 1-3 are obviously very US centric, but they matter for markets globally and, for sentiment, regarding short duration assets vs long duration assets.

1

Both Democrats and Republicans agreed on the need for a new fiscal deal before the election, but with neither side wanting to be seen to capitulate ahead of the election no deal was struck. Post-election, perhaps with Republican politicians wanting to rebuild credibility following Trump's fraud claims, might we get something before Christmas? It's not out of the question, and whilst not the 'best' case of $3trillion, it will still likely be more than $1trillion (c. 4-5% of GDP). That's still big fiscal and funded by a larger deficit, which are typically inflationary as per the chart below. It would be unwise to ignore Treasury cash reserves either (TGA), providing another $800bn of potential fiscal spending.

2

Fed fund rates today are 0.25% today vs 2.5% in early 2019, and 5.25% back in 2009 (before the Global Financial Crisis). Negative US rates are not inevitable, far from it, given they are rightly perceived to be a tax on savers. With little room for rate cuts, that only leaves monetary stimulus and so we should probably expect more QE from the Fed, but QE/monetary policy alone won't be enough in the wake of COVID-19.

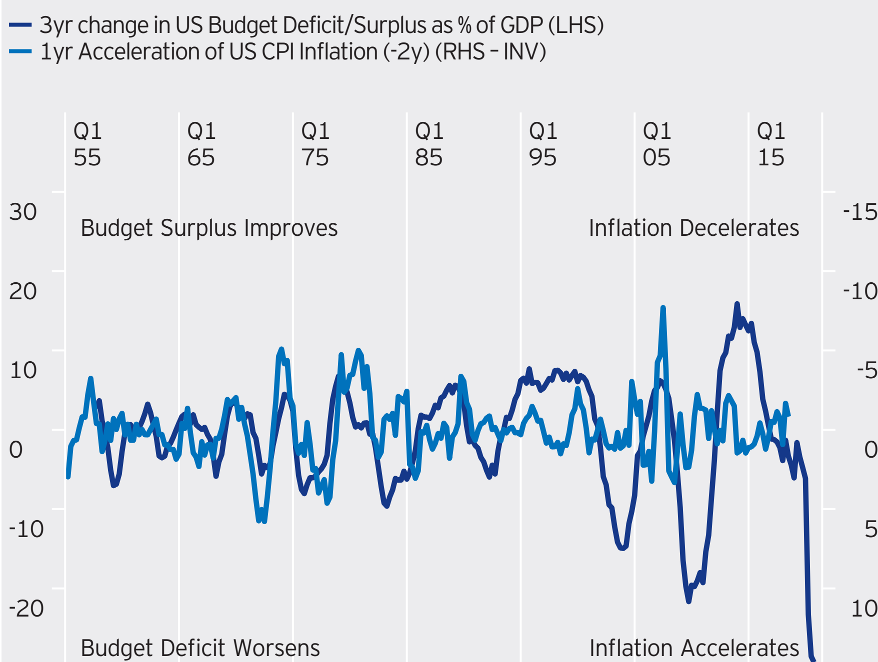
3

At the time of writing, Biden has been declared winner, however, Trump hasn't accepted the decision ("lamestream media doesn't get to decide"). Over the weekend, the Biden-Harris "Build Back Better Transition" website outlined their 4 key priorities. COVID-19 is one, as is racial equality, economic recovery and climate change.

Reform won't be easy but it's probably wrong to assume the market won't pay any attention to this agenda, which will most likely be good for short duration assets vs quality growth given detail includes infrastructure investment, auto electrification, public transport, renovation, updating the social contract (worker compensation) and paying fair taxes. This is particularly true given the route to a Democrat Senate isn't completely shut. With the two Republican Senators failing to secure majorities, they face run-offs into January – there is a small risk of fiscal profligacy still.

The Transition plan doesn't specifically mention big tech, however, there remains a vein of the Democratic party that believe these companies, such as Amazon, are abusing their market position. This doesn't feel an insurmountable issue to get bipartisan agreement on in the wake of tech's involvement in the 2020 election.

Figure 2
US Budget Balance % of GDP (3yr change) Leads Inflation Acceleration



Source: ASR. 31 October 2020.

"President-elect Biden is working to ensure that corporate America finally pays their fair share in taxes, puts their workers and communities first rather than their shareholders, and respects their workers' power and voice in the workplace."

4

Back to Europe. We should remember that it's not just in the US that monetary policy dominance is waning, the same is very much true in Europe with the pending E750bn (c. 5% GDP) European Recovery Fund, with a focus on digitalisation and to support the Green agenda. We should also remember that it's not just Powell lobbying for more fiscal (he did again the day after the election), but Lagarde at the ECB has been pushing for this since becoming President and even before that whilst in her role as head of the IMF. Messages from central bankers to government is clear: spend and we will fund. Lastly, and linked to this message, is the issuance of mutualised EU debt – centrally issued. Whilst this is known to be a one-off in nature, perhaps Friedman's quote that "nothing is so permanent as a temporary (government) program" is appropriate.

5

Nobody is pricing a return of any European inflation. Whether you look at the EU 5y5y as a guide or the chart below based on the option market. This is crucial because when outcomes become so consensual so too does positioning. We do not believe in the rampant inflation of the Weimar Republic or Zimbabwe, however, when expectations are so deflationary, any inflation pick-up is likely to have a disproportionate impact on market positioning. In the wake of COVID-19, with staff unable to work, productivity gaps widening and savings rates rocketing, there's no sign of inflation today. However, the market is a discounting mechanism and so as the fiscal policy is enacted, with continued funding by loose monetary policy, then inflation expectations will increase to the benefit of nominal growers, short duration, cyclical business – so called 'Value'. Likewise, as the COVID-19 crisis abates – either naturally because we learn to live with the virus better or medically because of a vaccine – so the effects of policy already in place, as well as a cyclical recovery will begin to be priced.

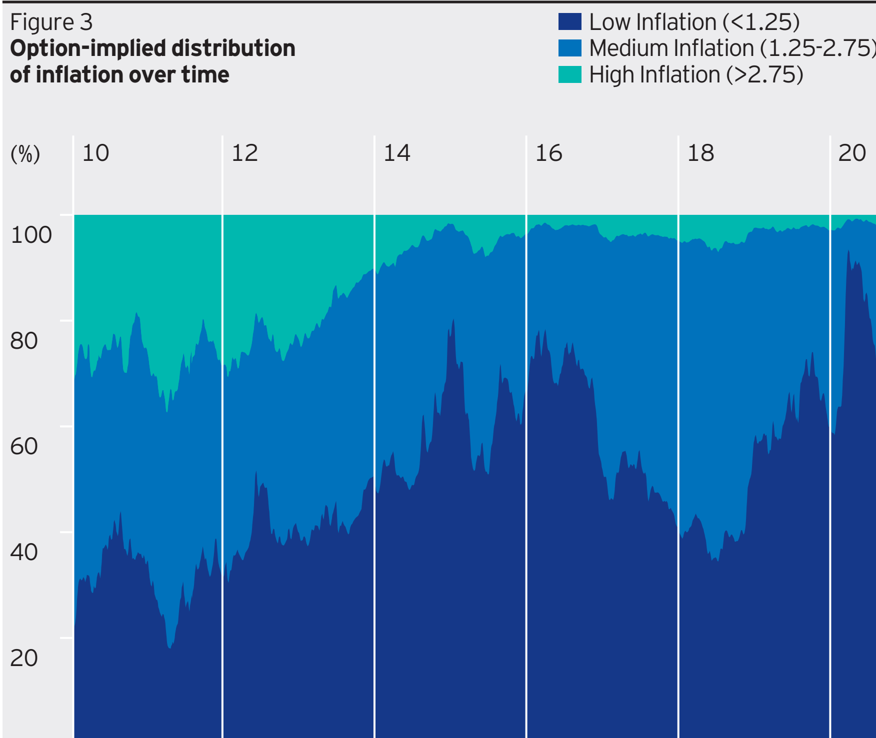


Figure 3
Option-implied distribution of inflation over time

Source: Goldman Sachs Global Investment Research, 30 September 2020.

Like the rest of the market, we've been enthralled by the drama of the US election and the various twists and turns. However, we don't see the world having changed much by this outcome. Yes, a Democrat sweep would have accelerated inflationary expectations, but what's happened doesn't unwind the changes already underway. We see monetary dominance being inevitably replaced by fiscal and that's an unstoppable shift; the key issue of social inequality will not be resolved without it.

Our long term, active and valuation discipline means that our European fund range is currently dominated by 'Value' or short duration equities. It's no secret that our funds will benefit from more inflation; however, we don't own 'Value' for the sake of it. We own what we describe as quality value, meaning companies with low leverage, high returns and earnings stability… but also with improving pricing power prospects. Short duration is different to not having barriers to entry. As such, fund activity during the election week has been relatively marginal and more based around the current reporting season as opposed to the US backdrop or a change in our top-down view.

Investment Risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Important information

This marketing document is exclusively for use by Professional Clients and Financial Advisers in Continental Europe (as defined below), Qualified Investors in Switzerland and Professional Clients in Guernsey, Isle of Man, Jersey, and UK. By accepting this document, you consent to communicate with us in English, unless you inform us otherwise. This document is not for consumer use, please do not redistribute. Data as at 6 November 2020, unless otherwise stated.

Where individuals or the business have expressed opinions, they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice.

This document is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. The information provided is for illustrative purposes only, it should not be relied upon as recommendations to buy or sell securities.

For the distribution of this document, Continental Europe is defined as Austria, Belgium, Denmark, Finland, France, Germany, Italy, Liechtenstein, Luxembourg, Netherlands, Norway, Spain.

Issued by Invesco Management S.A., President Building, 37A Avenue JF Kennedy, L-1855 Luxembourg, regulated by the Commission de Surveillance du Secteur Financier, Luxembourg.

Issued in Austria and Germany by Invesco Asset Management Deutschland GmbH, An der Welle 5, 60322 Frankfurt am Main, Germany. Issued in Switzerland and Liechtenstein by Invesco Asset Management (Schweiz) AG, Talacker 34, 8001 Zurich, Switzerland.

Issued in Guernsey, Jersey, Isle of Man and the UK by Invesco Asset Management Limited, Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire RG9 1HH, UK. Authorised and regulated by the Financial Conduct Authority.

EMEA8947/111120