Uncommon truths
Is gridlock good for stocks?

US election outcomes remains unclear but it looks as though a Biden presidency will face a divided Congress. Market reaction suggests this will get the best out of Joe Biden, while avoiding the worst. We agree but worry about volatility (both short term and due to occasional gridlock issues).

At the time of writing, it looks as though Joe Biden will be the next president of the US, that the House of Representatives will be Democrat and that the Senate will be Republican. Amazingly, after four full days of counting, we cannot be 100% certain about any of those predictions (especially given the legal challenges mounted by President Trump).

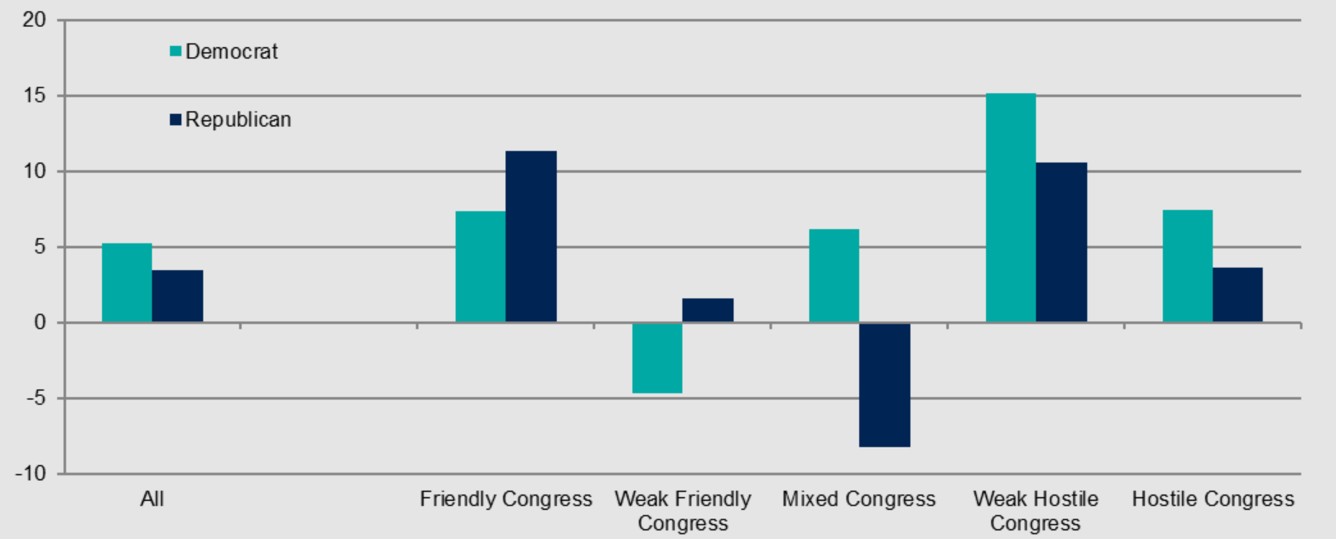
However, equity markets have opined on this outcome and they like it. The S&P 500 has gained 4.2% since it closed on election day and is very close to its all-time high. The NASDAQ Composite index has done even better, with a gain of 6.6% since election day, again bringing it close to an all-time high. Who would have guessed Joe Biden would be so popular?

Of course, the real positive for equity markets is not so much that Biden will be president (though we believe there are some positive elements to that, as explained later). Rather, it is the belief that most of his potentially market damaging initiatives will be blocked by a Republican Senate. For now, markets are viewing the previously dreaded “gridlock” through a Panglossian “checks and balances” prism.

That may not always be the case, especially when it comes to matters fiscal. We expect a return to debt ceiling battles, which could be problematic if a Covid-weakened economy needs support. See, for example, the recent stalemate in which the $2.2 trillion fiscal package proposed by the Democrat House was blocked for being too generous by the White House and the Republican Senate. This is even more problematic in a world where central banks appear able to prevent financial market meltdown but struggle to engineer a positive economic stimulus (by the way, the Fed made no changes to its policy stance at its scheduled post-election meeting).

What does history tell us about stock markets and the balance of power? **Figure 1** shows that Democrat presidents have been associated with better US stock gains than Republicans (since 1853). However, the analysis is more complicated when we consider the type of Congress facing a president. Returns have tended to be positive for both Democrat and Republican presidents when confronted by either a friendly or a hostile Congress (defined as both houses of Congress being either aligned with or against the president). Matters become less clear when we look at complex arrangements (i.e. when Congress is neither wholly supportive nor wholly hostile). It almost seems that when Congress is mixed, the greater the level of hostility confronting a Democrat president, the better the stock market performance (though beware small sample sizes for the sub-groups).

Figure 1 – US equity gains during US presidencies since 1853 by type of Congress (% ann.)*



*Based on the S&P 500 index since 1957 and comparable indices as derived by Robert Shiller prior to that (see details in Appendix). The analysis starts at the beginning of the presidency of Franklin Pierce on 04 March 1853 and ends on 05 November 2020. “Friendly Congress” is when both houses are of the same party as the president; “Weak Friendly Congress” is when both houses support the President for most of his full term; “Mixed Congress” is when both parties have an equal stake in Congress; Weak Hostile Congress” is when both houses are predominantly against the president and “Hostile Congress” is when both houses are against the president throughout his term. Past performance is no guarantee of future results.
Source: 270towin, Robert Shiller, Global Financial Data, Bloomberg, Refinitiv Datastream, Wikipedia and Invesco

Surprisingly, to find an exact historical template for the predicted balance of power (Democrat president, Democrat House and Republican Senate) we need to go all the way back to the presidency of Grover Cleveland from 1885 to 1889 (see this for a visual guide to the balance of power since 1855). The gain in stock prices during Cleveland's presidency was an annualised 4.9% versus 4.0% over the full period since 1853 (up to 5 November 2020).

There have been more examples of a Democrat president faced by a Republican House and a Democrat Senate: James Buchanan (1859-61), Woodrow Wilson (1917-19) and Barrack Obama (2011-15). The annualised gain in stock prices over those three periods taken together was 6.2%, though each period was different (7.2% for Buchanan, -5.6% for Wilson and 12.1% for Obama).

Those limited historical precedents raise no red flags for stocks about the predicted balance of power. So, perhaps markets are right to be relaxed, since there may be little in the way of legislation that could disrupt the natural path of the economy. We have always argued that the cycle is more important than politics and that, for the markets, the actions of the Fed matter more than those of the government.

There is now less chance of initiatives such as: raising corporate and capital gains taxes; doubling the minimum wage to $15 (ironically Florida, which voted for President Trump, also voted to raise the minimum wage to $15 by 2026); lowering US drug prices; restricting the oil & gas industry; taming "big tech"; boosting infrastructure & defence spending and expanding the Affordable Care Act.

So, if those elements are now unlikely, what can we expect from a Biden presidency? We imagine he will focus on the traditional areas of presidential influence: defence and foreign policy. First and foremost, we anticipate a more traditional approach to relations with other countries, which should render the US more stable and predictable. We believe that could lower geo-political risk premia, which could be negative for so-called "safe havens" such as gold.

Second, it could result in the US filling the vacuum it created in recent years in some critical international arenas such as the Middle East (Syria, for example) and climate change (Biden has said he would immediately re-join the Paris Agreement, which may explain why oil & gas stocks have lagged the US market rally in recent days, though he may struggle to get related legislation through the Senate). As nature abhors vacuums, others have filled the space left by the US, with Russia, China and Iran now more influential in key Middle Eastern hotspots (by the way, the US started to abdicate that responsibility during the Obama/Biden era).

Third, we expect relations with the EU to improve and agree with the notion that Germany is more likely than the UK to be the trusted partner in Europe (though Angela Merkel's Chancellorship ends during the Autumn of 2021).

Fourth, though relations with China are likely to remain tense, given the struggle for dominance in key strategic areas, they will hopefully be more cordial and structured. This does not mean that China is off the hook: Biden may have more success dealing with China by using coalitions of like-minded countries.

Fifth, and critical for the global economy, Joe Biden does not like tariffs. A de-escalation of global trade tensions, including the removal of tariffs, could remove hurdles to trade.

Finally, on the domestic front, we assume that Joe Biden would be more likely to push for increased federal spending (Covid relief package, infrastructure spending and investment in "green" initiatives). How successful he will be in the face of a fiscally conservative Senate is not clear but at least he would try. Any successes could lead to higher spending and a marginal boost to the economy.

Given the above (including the limitations), it is possible a Biden presidency may be marginally better for US and global growth and may bring about a lowering of risk premia. This could be to the benefit of risk assets over the long term and perhaps to the detriment of so-called "safe havens", though periods of policy gridlock may cause volatility. However, we also believe these effects will be marginal and we put more emphasis on broader cyclical issues.

Finally, the above is speculative to the extent that we do not know the full set of election outcomes. But whoever becomes president will be faced by several realities: first, financial markets may remain volatile until the election results are clear and accepted by all (that could take weeks); second, Congress is likely to be divided, which will limit policy initiatives; third, US Covid infections are rising and deaths are likely to follow, providing an economic and policy challenge and, finally, the fiscal situation has worsened dramatically this year, which could reduce the scope for fiscal action in the short term and will likely require fiscal consolidation over the medium term (implying tax hikes and spending cuts).

Unless stated otherwise, all data as of 6 November 2020

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Figure 2 – Asset class total returns

Data as at 06/11/2020	Index	Current Level/RY	Total Return (USD, %) 1w	1m	QTD	YTD	12m	Total Return (Local Currency, %) 1w	1m	QTD	YTD	12m
Equities												
World	MSCI	593	7.6	4.2	5.0	6.9	11.9	6.9	3.6	4.3	6.0	10.3
Emerging Markets	MSCI	1176	6.6	6.8	8.8	7.9	12.9	5.7	5.8	7.3	10.4	14.7
US	MSCI	3408	7.6	4.7	4.8	12.5	18.6	7.6	4.7	4.8	12.5	18.6
Europe	MSCI	1640	9.0	0.9	2.9	-5.8	-2.0	6.9	-0.2	1.2	-9.8	-8.0
Europe ex-UK	MSCI	2075	9.4	1.1	3.0	-0.2	3.3	7.2	0.0	1.4	-6.0	-4.3
UK	MSCI	905	7.7	0.4	2.2	-21.7	-17.5	5.9	-0.9	0.5	-21.1	-19.2
Japan	MSCI	3506	6.4	3.4	4.7	4.4	6.3	5.1	1.2	2.5	-0.8	0.7
Government Bonds												
World	BofA-ML	0.22	1.2	1.1	1.0	7.8	8.0	0.2	0.2	0.0	4.8	4.2
Emerging Markets	BBloom	4.23	3.1	1.8	2.3	2.6	5.6	3.1	1.8	2.3	2.6	5.6
US (10y)	Datastream	0.82	0.4	-0.7	-1.3	13.3	12.5	0.4	-0.7	-1.3	13.3	12.5
Europe	Bofa-ML	-0.22	2.1	1.7	2.4	11.0	11.6	0.2	1.0	1.1	5.0	4.0
Europe ex-UK (EMU, 10y)	Datastream	-0.62	1.9	1.8	2.2	10.6	10.6	-0.1	1.0	0.9	4.5	3.1
UK (10y)	Datastream	0.31	1.6	1.6	1.3	5.0	7.3	-0.1	0.2	-0.4	5.9	5.1
Japan (10y)	Datastream	0.02	1.4	2.4	2.2	5.1	4.8	0.2	0.2	0.1	-0.1	-0.7
IG Corporate Bonds												
Global	BofA-ML	1.59	1.5	1.2	1.5	7.4	8.7	0.9	0.9	1.0	6.0	6.7
Emerging Markets	BBloom	4.27	1.3	1.1	1.8	7.3	9.7	1.3	1.1	1.8	7.3	9.7
US	BofA-ML	2.02	1.2	0.9	1.0	7.7	8.8	1.2	0.9	1.0	7.7	8.8
Europe	BofA-ML	0.42	2.4	1.6	2.5	7.8	9.0	0.4	0.9	1.2	1.9	1.7
UK	BofA-ML	1.76	2.1	2.2	2.2	4.4	7.9	0.4	0.8	0.5	5.2	5.7
Japan	BofA-ML	0.47	1.3	2.4	2.3	5.3	5.5	0.1	0.2	0.1	0.1	0.0
HY Corporate Bonds												
Global	BofA-ML	5.56	2.3	1.6	2.6	3.1	5.5	1.9	1.4	2.3	2.1	4.1
US	BofA-ML	5.63	2.1	1.7	2.6	2.3	4.5	2.1	1.7	2.6	2.3	4.5
Europe	BofA-ML	3.86	3.6	1.8	3.1	5.0	8.1	1.6	1.1	1.8	-0.8	0.8
Cash (Overnight LIBOR)												
US		0.08	0.0	0.0	0.0	0.4	0.6	0.0	0.0	0.0	0.4	0.6
Euro Area		-0.59	1.9	1.1	1.3	5.4	6.7	0.0	-0.1	-0.1	-0.5	-0.6
UK		0.05	1.7	2.2	1.9	-0.6	2.7	0.0	0.0	0.0	0.2	0.3
Japan		-0.12	1.3	2.2	2.0	5.0	5.3	0.0	0.0	0.0	-0.1	-0.1
Real Estate (REITs)												
Global	FTSE	1620	5.6	-1.2	2.2	-17.7	-16.5	3.6	-1.9	1.0	-22.2	-22.2
Emerging Markets	FTSE	1944	8.5	3.6	5.6	-18.2	-11.9	6.5	2.8	4.2	-22.7	-17.9
US	FTSE	2532	3.6	-3.5	1.1	-19.2	-19.7	3.6	-3.5	1.1	-19.2	-19.7
Europe ex-UK	FTSE	3299	8.4	-0.8	1.7	-9.9	-5.2	6.3	-1.5	0.4	-14.9	-11.6
UK	FTSE	1184	5.9	0.1	5.0	-24.3	-15.8	4.2	-1.2	3.3	-23.7	-17.5
Japan	FTSE	2457	5.4	-0.5	1.2	-15.9	-17.8	4.1	-2.7	-1.0	-20.1	-22.2
Commodities												
All	GSCI	1705	2.4	-2.3	-1.3	-34.2	-31.3	-	-	-	-	-
Energy	GSCI	213	2.4	-8.2	-6.8	-57.2	-54.4	-	-	-	-	-
Industrial Metals	GSCI	1298	2.8	7.0	5.6	6.6	5.2	-	-	-	-	-
Precious Metals	GSCI	2259	4.3	2.8	3.6	26.3	28.5	-	-	-	-	-
Agricultural Goods	GSCI	356	2.3	4.2	6.2	2.4	7.1	-	-	-	-	-
Currencies (vs USD)*												
EUR		1.19	1.9	1.2	1.3	5.9	7.3	-	-	-	-	-
JPY		103.36	1.3	2.2	2.0	5.1	5.4	-	-	-	-	-
GBP		1.31	1.7	1.3	1.7	-0.8	2.1	-	-	-	-	-
CHF		1.11	1.8	1.9	2.3	7.5	10.2	-	-	-	-	-
CNY		6.61	1.2	2.7	2.7	5.3	5.9	-	-	-	-	-

Notes: *The currency section is organised so that in all cases the numbers show the movement in the mentioned currency versus USD (+ve indicates appreciation, -ve indicates depreciation). Past performance is no guarantee of future results. Please see appendix for definitions, methodology and disclaimers.
Source: Refinitiv Datastream and Invesco

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Figure 3 – World equity sector total returns relative to market (%)

Data as at 06/11/2020	Global				
	1w	**1m**	**QTD**	**YTD**	**12m**
Energy	**-3.3**	**-5.3**	**-5.8**	**-36.0**	**-34.7**
Basic Materials	**0.6**	**0.8**	**0.9**	**2.4**	**4.5**
Basic Resources	0.8	2.1	2.1	3.6	8.0
Chemicals	0.3	-0.7	-0.5	1.0	0.6
Industrials	**0.6**	**-0.6**	**-0.2**	**-2.5**	**-4.1**
Construction & Materials	0.4	0.2	1.6	-3.1	-3.3
Industrial Goods & Services	0.7	-0.8	-0.5	-2.4	-4.2
Consumer Discretionary	**0.3**	**1.1**	**0.8**	**11.1**	**10.3**
Automobiles & Parts	1.0	1.5	1.6	16.4	14.9
Media	0.8	0.3	0.4	-3.2	-5.5
Retailers	-0.7	1.1	-0.2	29.9	28.6
Travel & Leisure	-0.1	-1.7	-0.8	-19.1	-18.9
Consumer Products & Services	1.7	2.4	2.9	11.3	11.1
Consumer Staples	**-1.8**	**-3.0**	**-3.5**	**-5.3**	**-6.6**
Food, Beverage & Tobacco	-2.2	-3.7	-4.0	-9.6	-10.3
Personal Care, Drug & Grocery Stores	-1.0	-1.8	-2.5	3.1	0.6
Healthcare	**1.0**	**-0.3**	**-1.2**	**8.1**	**7.9**
Financials	**-0.9**	**-0.6**	**0.7**	**-20.5**	**-20.2**
Banks	-1.5	0.4	2.3	-27.7	-26.9
Financial Services	-0.1	-0.3	0.5	-10.2	-10.2
Insurance	-0.8	-2.9	-2.0	-17.4	-18.0
Real Estate	**-1.0**	**-3.7**	**-2.2**	**-14.7**	**-15.2**
Technology	**1.7**	**3.8**	**3.1**	**32.7**	**34.6**
Telecommunications	**-1.9**	**-1.9**	**-1.9**	**-4.1**	**-5.2**
Utilities	**-1.3**	**0.1**	**2.0**	**-3.1**	**-2.6**

Notes: Returns shown are for Datastream sector indices versus the total market index. Past performance is no guarantee of future results.
Source: Refinitiv Datastream and Invesco

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Figure 4 – Model asset allocation

	Neutral	Policy Range		Allocation	Position vs Neutral	Hedged	Currency
Cash	**5%**	**0-10%**		**10%**			
Cash	2.5%			10%			
Gold	2.5%			0%			
Bonds	**45%**	**10-80%**	↓	**45%**			
Government	30%	10-50%	↓	15%			
US	10%		↓	4%			
Europe ex-UK (Eurozone)	8%		↑	2%			
UK	2%		↓	0%			
Japan	8%			5%			
Emerging Markets	2%			4%			
Corporate IG	10%	0-20%		20%			
US Dollar	5%		↓	5%			
Euro	2%		↑	3%			
Sterling	1%			4%			
Japanese Yen	1%		↑	4%			
Emerging Markets	1%		↑	4%			
Corporate HY	5%	0-10%	↑	10%			
US Dollar	4%		↑	8%			
Euro	1%		↑	2%			
Equities	**40%**	**20-60%**	↑	**30%**			
US	24%			14%			
Europe ex-UK	6%		↑	5%			
UK	3%			3%			
Japan	3%		↑	6%			
Emerging Markets	4%		↓	2%			
Real Estate	**8%**	**0-16%**	↑	**15%**			
US	2%			2%			
Europe ex-UK	2%		↑	4%			
UK	1%		↑	3%			
Japan	2%		↓	4%			
Emerging Markets	1%		↓	2%			
Commodities	**2%**	**0-4%**	↓	**0%**			
Energy	1%		↓	0%			
Industrial Metals	0.3%			0%			
Precious Metals	0.3%			0%			
Agriculture	0.3%		↓	0%			
Total	**100%**			**100%**			
Currency Exposure (including effect of hedging)							
USD	49%		↓	38%			
EUR	20%		↑	18%			
GBP	7%		↓	11%			
JPY	15%		↑	21%			
EM	8%		↓	12%			
Total	**100%**			**100%**			

Notes: This is a theoretical portfolio and is for illustrative purposes only. See the latest The Big Picture document for more details. It does not represent an actual portfolio and is not a recommendation of any investment or trading strategy. Arrows indicate the direction of the most recent changes.
Source: Invesco

Figure 5 – Model allocation for global sectors

	Neutral	Invesco	Preferred Region
Energy	**6.0%**	**Neutral**	**US**
Basic Materials	**4.1%**	**Neutral**	**Europe**
Basic Resources	2.2%	Underweight	Europe
Chemicals	1.9%	Overweight	US
Industrials	**12.6%**	**Underweight**	**US**
Construction & Materials	1.6%	Neutral ↑	Europe
Industrial Goods & Services	11.1%	Overweight ↑	US
Consumer Discretionary	**16.3%**	**Underweight**	**Japan**
Automobiles & Parts	2.3%	Underweight	Japan
Media	1.3%	Underweight	US
Retailers	6.9%	Neutral	EM
Travel & Leisure	2.0%	Underweight	Japan
Consumer Products & Services	3.9%	Neutral	Japan
Consumer Staples	**7.0%**	**Overweight**	**Europe**
Food, Beverage & Tobacco	4.5%	Overweight	Europe
Personal Care, Drug & Grocery Stores	2.5%	Underweight ↓	US
Healthcare	**10.9%**	**Neutral**	**Europe**
Financials	**12.8%**	**Neutral**	**EM**
Banks	5.8%	Neutral ↓	EM
Financial Services	3.8%	Overweight ↑	US
Insurance	3.2%	Underweight	Japan
Real Estate	**3.7%**	**Overweight**	**Europe**
Technology	**18.9%**	**Overweight**	**US**
Telecommunications	**4.2%**	**Neutral**	**US**
Utilities	**3.5%**	**Neutral**	**Europe**

Notes: These are theoretical allocations which are for illustrative purposes only. They do not represent an actual portfolio and are not a recommendation of any investment or trading strategy. See the latest Strategic Sector Selector for more details.
Source: Refinitiv Datastream and Invesco

Appendix

Methodology for asset allocation, expected returns and optimal portfolios

Portfolio construction process

The optimal portfolios are theoretical and not real. We use optimisation processes to guide our allocations around "neutral" and within prescribed policy ranges based on our estimations of expected returns and using historical covariance information. This guides the allocation to global asset groups (equities, government bonds etc.), which is the most important level of decision. For the purposes of this document the optimal portfolios are constructed with a one-year horizon.

Which asset classes?

We look for investibility, size and liquidity. We have chosen to include: equities, bonds (government, corporate investment grade and corporate high-yield), REITs to represent real estate, commodities and cash (all across a range of geographies). We use cross-asset correlations to determine which decisions are the most important.

Neutral allocations and policy ranges

We use market capitalisation in USD for major benchmark indices to calculate neutral allocations. For commodities, we use industry estimates for total ETP market cap + assets under management in hedge funds + direct investments. We use an arbitrary 5% for the combination of cash and gold. We impose diversification by using policy ranges for each asset category (the range is usually symmetric around neutral).

Expected/projected returns

The process for estimating expected returns is based upon yield (except commodities, of course). After analysing how yields vary with the economic cycle, and where they are situated within historical ranges, we forecast the direction and amplitude of moves over the next year. Cash returns are calculated assuming a straight-line move in short term rates towards our targets (with, of course, no capital gain or loss). Bond returns assume a straight-line progression in yields, with capital gains/losses predicated upon constant maturity (effectively supposing constant turnover to achieve that). Forecasts of corporate investment-grade and high-yield spreads are based upon our view of the economic cycle (as are forecasts of credit losses). Coupon payments are added to give total returns. Equity and REIT returns are based on dividend growth assumptions. We calculate total returns by applying those growth assumptions and adding the forecast dividend yield. No such metrics exist for commodities; therefore, we base our projections on US CPI-adjusted real prices relative to their long-term averages and views on the economic cycle. All expected returns are first calculated in local currency and then, where necessary, converted into other currency bases using our exchange rate forecasts.

Optimising the portfolio

Using a covariance matrix based on monthly local currency total returns for the last 5 years and we run an optimisation process that maximises the Sharpe Ratio. Another version maximises Return subject to volatility not exceeding that of our Neutral Portfolio. The optimiser is based on the Markowitz model.

Currency hedging

We adopt a cautious approach when it comes to currency hedging as currency movements are notoriously difficult to accurately predict and sometimes hedging can be costly. Also, some of our asset allocation choices are based on currency forecasts. We use an amalgam of central bank rate forecasts, policy expectations and real exchange rates relative to their historical averages to predict the direction and amplitude of currency moves.

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Definitions of data and benchmarks for Figure 2

Sources: we source data from Datastream unless otherwise indicated.

Cash: returns are based on a proprietary index calculated using the Intercontinental Exchange Benchmark Administration overnight LIBOR (London Interbank Offer Rate). The global rate is the average of the euro, British pound, US dollar and Japanese yen rates. The series started on 1st January 2001 with a value of 100.

Gold: London bullion market spot price in USD/troy ounce.

Government bonds: Current levels, yields and total returns use Datastream benchmark 10-year yields for the US, Eurozone, Japan and the UK, and the Bank of America Merrill Lynch government bond total return index for the World and Europe. The emerging markets yields and returns are based on the Barclays Bloomberg emerging markets sovereign US dollar bond index.

Corporate investment grade (IG) bonds: Bank of America Merrill Lynch investment grade corporate bond total return indices, except for in emerging markets where we use the Barclays Bloomberg emerging markets corporate US dollar bond index.

Corporate high yield (HY) bonds: Bank of America Merrill Lynch high yield total return indices

Equities: We use MSCI benchmark gross total return indices for all regions.

Commodities: Goldman Sachs Commodity total return indices

Real estate: FTSE EPRA/NAREIT total return indices

Currencies: Global Trade Information Services spot rates

US equity indices used in Figure 1

The stock market performance data is based on broad US stock indices from US academic Robert Shiller and Datastream. The index prior to 1926 is Robert Shiller's recalculation of data from Common Stock Indexes by Cowles & Associates (see here). From 1926 to 1957, the Shiller data is based on the S&P Composite Index and thereafter is based on the S&P 500 as we know it today.

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