FLASH MARKET COMMENTARY:
2020 Election Results, What it Means, and Where We Go From Here


BILL ANDRAKAKOS, CFA, FRM
Chief Investment Officer


TOBY STANNARD
Director of Investments

RECAP OF ELECTION OUTCOMES

After a grueling, multi-year election cycle, it appears that there is finally some clarity around the political landscape, at least for the next two years. Assuming that a Republican candidate wins one of two upcoming U.S. Senate run-off elections in Georgia on January 5th, the federal government will consist of a Democratic White House and a split Congress. Republicans gained seats in the House, won seats against incumbents in the Democratic strongholds of Minnesota, California, and New York, and increased control of state governments across the country. The latter will prove important during the 2022 mid-term elections as redistricting maps will be drawn following the 2020 Census. In Barack Obama's first term, Democrats lost 63 House seats in the mid-term elections. During Bill Clinton's, they shed 54. As Mark Twain said, "History doesn't repeat itself, but it often rhymes." Now with only a slim Democratic majority in the House, this potentially portends Republican control of Congress in 2022.

Voter turnout was the highest in recorded history, polling estimates forecasting a "Blue Wave" were proved largely inaccurate, political divisiveness continues to deepen and intensify, and the American people have delivered a clear mandate: neither party is entrusted with a majority to govern. From an investment standpoint, the divided government elected and sent to Washington, D.C. looks promising over the near term. The fringe policy proposals of both the left and right have been repudiated and carry almost no possibility of being turned into legislation. Our hope is that the expressed mandate of voters will lead to moderation and incentivize bipartisan collaboration for policies that can help the country recover from a global pandemic.

While President Trump refuses to concede the election, his campaign's hope that lawsuits in key states and continued claims of fraud will successfully reverse the outcome fades more with each passing day. States will certify their results in the coming week, and we anticipate that the Electoral College vote will happen as planned on December 14th with electors adhering to the will of the people. The only thing being stopped by the president's last-ditch efforts for a second term is the traditional resources and services afforded to the transitioning administration of the president-elect. Despite all this and given the current circumstances surrounding the pandemic, the election ran smoothly. It is a testament to the adaptability and durability of our democracy. The worst-case scenario of a long, drawn out process full of uncertainty and fraud fortunately never came to be. For that, we can all be thankful.

WHAT THESE RESULTS MEAN FOR INVESTORS

With a split Congress and narrow majorities, a broad swath of the policy proposals that posed the greatest risks from an investment standpoint will be nearly impossible to pass. The tax agenda that President-Elect Biden put forth on the campaign trail – to increase rates on income, capital gains, businesses, etc. – now looks to be highly unlikely, assuming Republicans maintain control of the Senate. The same is true for high-cost spending plans on key Democratic platform planks like Medicare for All and the Green New Deal. Potentially posing a headwind for segments of the Municipal Bond market, this also likely means that a large federal stimulus package to state governments – which was expected in the event of a Democratic sweep – will be scrapped. Yet to be determined is Republicans' willingness to support such aid, and at what levels, absent the influence of a Trump administration.

Traditionally, one could expect the new government to work together to craft bipartisan policies that have a far greater chance of successfully being enacted, especially those which spur job/wage growth and benefit all constituencies. During Mr. Biden's tenure in Congress, he did just that as he was known for his willingness to reach across the aisle, compromise, and moderate his goals to get things done. However, with Washington being more politically polarized than ever and the progressive flank of Biden's party pulling him further to the left, it may be too optimistic to expect such a well-functioning government.

At the state level, several referendums were voted down that justify highlighting. In our home state of Illinois, the referendum to change the state constitution – known as the Fair Tax Amendment – and allow for a progressive income tax system was voted down. As such, Illinois residents will see tax rates stay where they are, at least for now, though this outcome will result in greater uncertainty about how the state will navigate its increasing budgetary challenges. In California, Prop 22 to reclassify gig economy workers from independent contractors to employees did not pass. Had it passed, this would have fundamentally changed Uber's business model (as an example) and significantly increased costs to consumers. With almost 10% of all rides on Uber's platform coming from California, this was a material event and demonstrates why it was fought so vigorously. By failing to pass in California, we expect this policy risk to fade away for the time being, especially at the federal level.

On balance, this appears to be all positive news for the markets and the economy, though the future of political developments is always difficult to forecast accurately. Of greatest concern around the election were tax and spending proposals that, in our opinion, would be highly detrimental to an economy in a fledgling recovery from an historically destructive pandemic. Whether Washington grinds to a halt or begins to work together is of little significance now. It's widely known that markets love political gridlock. And, in this case, we agree. Both parties will have to pull themselves to the center and soften the harder edges of their ideals to get anything done. With such risks now off the table, we can move forward a bit more confidently without the concern of a potential policy landmine lurking around the corner.

WHERE WE GO FROM HERE

In stark contrast to recent equity market returns – the S&P 500 has rallied almost 8% from November 2nd through November 18th – coronavirus cases are surging across the globe, U.S. hospitalizations have hit a new high straining the health care system, and states across the country are reinstituting lockdown measures to mitigate the spread. There is reason to be optimistic though (which may be the catalyst for the ebullient market sentiment we're currently experiencing) as two vaccines have proven highly effective in late-stage trials. However, manufacturing, distribution, and vaccination for the majority of the global population could take years. In addition, there is no strong evidence to suggest that most of the U.S. population will be eager to get vaccinated. This implies that the novel coronavirus – as well as the economic costs associated with containing it – will be around much longer than markets seem to expect.

With the recent spike in Covid-19 cases – daily case counts are now at record highs – schools, restaurants, bars, gyms, and more have once again closed their doors in many states, either voluntarily or due to state requirements. As experienced last spring, these measures will undoubtedly have negative impacts on the economy. To illustrate, we reference a recent research report by Ross Hammond, senior fellow at the Brookings Institution, and his co-authors that estimate the economic cost of school closures.[1] When schools close to in-person instruction, parents are forced to juggle their work and childcare responsibilities. As a result, productivity (in the economic sense of the word) suffers and falls. Hammond estimates that one month of school closures across the country costs the U.S. economy $56 billion. Extrapolating this figure over a 9-month school year equates to $504 billion or 2.3% of U.S. GDP. These estimates only account for the immediate consequences, however. What about the long-term costs? A McKinsey & Co. report found that closing schools to in-person instruction through January of 2021 would cost the average K-12 student in the U.S. $61,000 - $82,000 in lifetime earnings. A similar study by George Psacharopoulos of Georgetown University estimated that a four-month shutdown of all U.S. schools would result in $2.5 trillion in lost future earnings. The service industry and small businesses in the U.S. are both the largest employer of American workers and the biggest driver of economic activity. They have also been the sectors hit hardest by the pandemic. The U.S. labor market has only recovered approximately 50% of jobs lost during the recession earlier this year. In addition, underlying positive employment data of the past couple months is concerning news that the service industry and small businesses are once again shedding jobs.

The longer that strict containment measures remain in place, the greater the economic damage that will result. In addition to reopening rollbacks, the winter months will further cripple the service sector, particularly restaurants and bars, as the weather will be too cold across much of the country to offer outdoor dining. The knock-on effects must be accounted for as well – unemployment rises, income decreases, consumer spending drops – all of which hurt the broader economy and business earnings (and therefore should negatively impact stock prices). It is not often fully appreciated that consumer spending comprises 70% of U.S. GDP. With all this being said, it is hard to imagine the V-shaped, rapid recovery currently being priced in by equity markets, especially considering that another round of massive fiscal stimulus is unlikely given the outcome of this election.

Back in January, equity markets sold off significantly on two occasions as the coronavirus became a material concern. However, they rebounded just as quickly and established new all-time highs in February. It wasn't until February 19th that the sustained and dramatic sell-off took place. Despite the long-held belief that the market incorporates all available information accurately, the preceding example of January demonstrates that sometimes the market gets it wrong. With valuations continuing to stretch further into overbought territory while ignoring these very real risks, we would argue that the market might be getting it wrong again now.

So, what can and should we be doing? We appreciate that the market can stay irrational long enough to erode the value of us being correct. But prudent risk management requires just that, to manage risk prudently. We remain conservatively positioned relative to strategic allocations with sufficient cash levels that can be redeployed quickly in the event of a market correction. As things stand today, there are limited attractive opportunities in the public markets – both equity and fixed income – worthy of investment. In our opinion, it is difficult to justify adding risk to portfolios by investing excess cash positions when the upside prospects appear quite small and the downside risk appears rather large. As such, we believe the best course of action is to find better use of that risk budget, potentially in the private markets. With a market landscape that is currently quite fluid and sensitive to evolving circumstances, it is important to note that this defensive cash position is not a long-term, strategic holding. We would look to allocate these funds as risks dissipate, opportunities arise, or conditions change. As always, we continue to diligently, but patiently, source and evaluate solutions that adequately compensate investors for the risks assumed.

Please do not hesitate to contact us should you have any questions or concerns. We would be happy to provide additional context and detail specific to your portfolio.

[1]Source: Economic Cost and Health Care Workforce Effects of School Closures in the U.S. Howard Lempel, Joshua M. Epstein, and Ross A. Hammond. Link to research article

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