Market Bulletin

7 January 2021

US election: Democrats take control of the Senate

Several major news outlets are now projecting that the Democrats will win the two remaining Senate races following Tuesday's run-offs in Georgia. This creates a 50:50 tie in Senate seats and thus hands the Democrats control, with Vice President-elect Kamala Harris having the deciding vote. Following Joe Biden's victory in November's presidential election and with the Democrats retaining the House, control of the Senate had been up in the air with no candidate in either Georgia Senate race surpassing the required 50% hurdle rate in the first round.

This outcome significantly boosts the prospects of further near-term stimulus for the US economy. Following the passage of a $900 billion stimulus package at the end of December, the Democrats will likely view a further spending bill as an early priority. This could include a third round of stimulus cheques targeted at lower and middle-income households, as well as much needed support for state and local governments. Over the medium term, bipartisan support for an infrastructure bill may have been found regardless of Senate composition, but it is now possible that the Democrats will be able to pass a larger infrastructure package via the budget reconciliation process.

The result will also benefit President-elect Biden's ambitions on climate change. Significant action was already anticipated regardless of Senate control, with re-joining the Paris accord highlighted as a day one priority and stricter fuel emissions standards anticipated. It may now be possible to push through more subsidies for renewable energy production, transmission and transportation, while there is also the potential for energy tax hikes. Senate confirmation of key Cabinet appointments may also be more easily achieved.

A blue ripple, but not a blue wave

Other parts of the Democrat agenda will still face significant obstacles given the delicate balance of power. Tax policy has been a key market focus given Biden's campaign commitments to raise corporate tax rates from 21% to 28%, reversing half of the corporate tax rate cut that President Trump implemented at the end of 2017. While we see potential for some tax increases later in Biden's term, major changes are unlikely to be a near-term priority given the fragile health of the US economy. It is however less likely that we will see extensions to provisions within the 2017 Tax Cuts and Jobs act as a result of the Georgia results.

The "filibuster rule" – which essentially requires the agreement of 60 senators to pass non-budget related legislation – may stifle attempts for broader policy reform. A major shake-up to the healthcare system appears unlikely, although controls on drug prices may find support from both sides of the aisle. For "big tech", the direction of travel remains towards a tougher regulatory environment, but it is not clear that major regulatory overhaul would receive unilateral support among Democrats, and Republican opposition would be expected given differing views across the parties on the focus for technology regulation.

AUTHORS

Karen Ward
Chief Market Strategist for EMEA

Hugh Gimber
Global Market Strategist

Market implications

The US economy was already set to benefit from significant policy stimulus in 2021, but the outcome of the Georgia races will impact the channel through which that support is delivered. Aggressive fiscal stimulus now looks likely to shoulder more of the burden, alleviating some of the pressure on the Federal Reserve.

For bond markets, increased expectations of government spending are putting upward pressure on long-dated US Treasury yields with higher inflation expectations the primary driver behind the move. We see further room for yields to move higher and yield curves to steepen as the recovery takes hold, although the path of the pandemic will remain a key influence. The Federal Reserve's shift to an average inflation targeting framework is also an important factor. While on balance further monetary policy easing is now less likely given the composition of the Senate, the bar for the Federal Reserve to remove policy support is extremely high. This will likely limit both how far, and how quickly, yields can rise, which emphasises the need for investors to hunt for income outside of core government bonds.

For equities, an environment of moderately higher government bond yields and improving near-term growth prospects should provide support for value sectors and small caps on a relative basis. Higher interest rates not only benefit financial stocks within value, but may also help to narrow the valuation gap between growth and value sectors, after declining interest rates turbocharged growth stock valuations in 2020. On a regional basis, a rally in value sectors could benefit the more cyclically-oriented markets such as Europe.

The implications for the US dollar are less clear. Higher bond yields and stronger growth prospects relative to the rest of the world should in theory provide support for the greenback, although this may be counteracted by the impact of higher government spending on the US deficit.

For emerging markets, the outcome of the Senate races is not as significant. US-China relations will remain a key factor, but the US administration has significant scope to set the tone of these discussions without requiring Senate support.

0903c02a82ad20b0