What Will the Election Mean for Fixed Income?

Insight from sub-adviser Wellington Management

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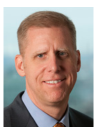

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Key Points

- A Trump victory in November would prompt expectations for a stronger US dollar, which could translate to lower inflation expectations.
- A Biden victory combined with Democrats winning control of the Senate would raise expectations for a substantial boost in US fiscal spending and a potentially weakened US dollar.
- If Biden wins and Republicans retain the Senate, credit markets would likely respond favorably, as they tend to prefer split government over single-party domination.

BASEBALL LEGEND YOGI BERRA FAMOUSLY REMARKED THAT "IT'S TOUGH TO MAKE PREDICTIONS, ESPECIALLY ABOUT THE FUTURE." Political elections are no exception, of course. But as difficult as forecasting an election can be, predicting market reactions is arguably even more challenging. That being said, with the 2020 US elections only a few weeks away, now seems an opportune time to think through the various potential outcomes and their implications for fixed-income and currency markets.

While most market participants are focused on the presidential election, the contest to determine which party controls the Senate is of equal importance in the event of a victory by former vice president Joe Biden; it matters less if President Trump is re-elected given that Democrats control the House of Representatives, with little chance of a flip there. Thus, the three possible outcomes to consider are:

1. Trump presidency, Democrat or split Congress
2. Biden presidency, Democrat Senate
3. Biden presidency, split Congress

1. Trump Presidency, Democrat or Split Congress

In the event of a Trump victory in November, we believe the market reaction would be markedly different than in 2016. At that time, Republicans controlled both houses in Congress as well as the presidency, so markets were quick to price in the reflation[1] that would presumably result from lower corporate taxes and deregulation. This time around, we think the market reaction would be disinflationary, as a Trump presidency would likely yield the smallest fiscal stimulus of the three options above.

- **Currencies:** Less fiscal stimulus is likely to be supportive of the US dollar (USD) broadly. However, in 2016, the USD performed particularly well against emerging markets (EMs).[2] This time may be different as the North American Free Trade Agreement has already been renegotiated and there is also a trade deal with China, so renewed trade wars might be focused more on Europe, with potentially negative consequences for the euro.
- **Nominal and real interest rates:**[3] A stronger USD could translate to lower inflation expectations going forward, which in turn could move nominal US Treasury yields lower (a so-called "bull flattener"[4]). At the same time, real rates could rise due to lower future fiscal spending.
- **Credit:** While a Trump presidency would keep corporate tax rates at current levels, credit markets might weaken on less fiscal stimulus, which the market deems very important as we recover from the COVID-19 recession. In this scenario, we would expect investment-grade (IG) debt[5] to outperform high-yield bonds,[6] as a strong USD could continue to support foreign inflows into IG, whereas high-yield spreads[7] are more susceptible to a less stimulative environment.

2. Biden Presidency, Democrat Senate

This is the most reflationary outcome, as spending would likely be highest under such a scenario.

- **Currencies:** The USD would likely trade weaker in this scenario, given the expected increase in government debt. EM currencies, which tend to outperform against a weak USD backdrop, would be among the biggest beneficiaries.
- **Nominal and real interest rates:** Inflation expectations are likely to rise as the market prices in substantial fiscal stimulus, a weaker USD, and potentially higher oil prices. While we would expect nominal rates to rise, we'd anticipate a so-called "bear flattener"[8] (i.e., 10-year rates rise more than 30-year rates), as the market might price in a lower structural growth rate from higher taxes and potentially unproductive government spending. This would mean real rates would likely stay low as well.
- **Credit:** In the short term, credit should fare well because it would price in a stimulatory environment; high yield and bank loans should outperform IG, as reflation disproportionately benefits companies with high debt levels. Longer term, it's less clear how equity and credit markets would respond to higher corporate tax rates and less business-friendly policies. As our colleague Connor Fitzgerald has observed, the US equity market has become more "bond-like" over the years. As such, we have found a strong correlation between US equity performance and changes in long corporate real yields. Following a Democrat sweep, real yields might rise and credit spreads might widen, which has historically coincided with negative equity performance.

3. Biden Presidency, Split Congress

A Biden victory with a split Congress would likely mean higher spending than under Trump, but somewhat constrained by a Republican Senate. Stimulus would largely be focused on areas where the two parties could find common ground (i.e., infrastructure).

- **Currencies:** We would not expect much of a reaction from the USD under this "middle-ground" scenario.
- **Nominal and real interest rates:** Nominal rates could rise and yield curves[9] could steepen on higher inflation expectations and the removal of election-related uncertainty. Real rates might also rise (although less than nominal rates), as infrastructure spending tends to be the most productive form of government spending.
- **Credit:** Credit markets would likely respond favorably to this outcome, as they tend to prefer split government over single-party domination.

Stay Tuned

We will follow up before the end of the year with our post-election thoughts, including updated market views if necessary. Until then, hold onto your hats—the final countdown to the election (and perhaps its aftermath as well) should be interesting, to say the least!

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[1] Reflation: Fiscal or monetary policy designed to expand output, stimulate spending, and curb the effects of deflation, which usually occurs after a period of economic uncertainty or a recession.

[2] An emerging market economy is the economy of a developing nation that is becoming more engaged with global markets as it grows. Countries classified as emerging market economies are those with some, but not all, of the characteristics of a developed market.

[3] Real versus nominal interest rates: A real interest rate has been adjusted to remove the effects of inflation to reflect the real cost of funds to the borrower and the real yield to the lender or investor. Nominal interest rates refer to rates before accounting for inflation.

[4] A bull flattener is a yield-rate environment in which long-term rates are decreasing more quickly than short-term rates.

[5] Investment grade is a bond classification used to denote bonds that carry a relatively low credit risk compared to other bonds.

[6] High-yield bonds (sometimes called "junk bonds") carry a higher risk of default than most bonds issued by corporations and governments.

[7] A high-yield bond spread is the percentage difference in current yields of various classes of high-yield bonds compared against investment-grade corporate bonds, Treasury bonds, or another benchmark bond measure.

[8] A bear flattener is a yield-rate environment in which short-term rates rise faster than long-term rates and is seen as a harbinger of an economic contraction.

[9] A yield curve is a line that plots yields (interst rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest-rate changes and economic activity. While normal curves point to economic expansion, downward sloping curves point to economic recession.

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