ClearBridge Investments

Biden Holds On, Moderate Agenda Likely

November 6, 2020

Key Takeaways

- Joe Biden emerged victorious, although a Democratic "blue wave" failed to materialize. Investors have initially cheered this more moderate outcome, with equities rallying and the VIX falling. A shift in leadership is emerging relative to pre-election trends, with value and small caps lagging growth and large caps.
- With his victory, Biden continues a pattern of presidential challengers benefiting from economic weakness during the watch of the prior administration. However, the economy appears to have turned the corner and the ClearBridge Recovery Dashboard remains green with no changes this month.
- An additional round of stimulus will be one of the new administration's first priorities, particularly with expanded unemployment coverage expiring at year end for millions. The size of any bill will depend on the composition of Congress, which remains too close to call.

Recession, Job Losses Derail Trump's Second Term Bid

Joe Biden regained control of the White House for Democrats, and while his victory was anticipated prior to Election Day, the results were closer than anticipated. Since securing the nomination, Biden has polled ahead of Trump according to political polling aggregators such as FiveThirtyEight.

History was also on Biden's side, given a pattern of presidential challengers taking advantage of economic weakness on the watch of the incumbent. By winning the electoral college and popular vote, he adds Donald Trump to the list of post-World War II presidents (along with Ford, Carter and George H.W. Bush) who failed to secure a second term after experiencing a recession within two years of Election Day and a material rise in the unemployment rate the year of the election – from 3.5% in February to 7.9% in September.

Exhibit 1: When it Comes to Re-Election, It's All About the Economy

No Recession in Two Years Before Election					
Year	**President**	**Change in Election Year Unemployment Rate**	**Recession?**	**Re-election?**	**Margin of Victory (Popular Vote)**
2012	Obama	-1.6%	No	**Yes**	3.9%
2004	Bush 43	-0.2%	No	**Yes**	2.5%
1996	Clinton	-0.6%	No	**Yes**	8.5%
1984	Reagan	-3.0%	No	**Yes**	18.2%
1972	Nixon	0.1%	No	**Yes**	23.2%
1964	Johnson	-0.3%	No	**Yes**	22.6%
1956	Eisenhower	-1.8%	No	**Yes**	15.4%

Recession in Two Years Before Election					
Year	**President**	**Change in Election Year Unemployment Rate**	**Recession?**	**Re-election?**	**Margin of Victory (Popular Vote)**
1992	Bush 41	1.4%	Yes	**No**	-5.6%
1980	Carter	1.7%	Yes	**No**	-9.7%
1976	Ford	1.7%	Yes	**No**	-2.1%

Source: National Bureau of Economic Research, Bureau of Labor Statistics and Wikipedia.

With the Democratic nominee the favorite over the past several months, investors have had ample time to consider the potential impacts of a Biden administration. However, the consensus narrative before the election centered around the potential for a "blue wave" where Democrats would take the White House, control a solid majority in the Senate, and expand their margin in the House of Representatives. This could have led to the implementation of an ambitious agenda. While votes are still being counted, this scenario did not play out. Control of the Senate could remain unknown for some time, with runoff races for the two Georgia seats looking increasingly likely but appears to favor continued Republican control at this juncture. Further, the margin in the House of Representatives looks set to narrow, although Democrats appear poised to maintain a slim majority. Regardless of the final outcomes, the Senate (and narrower House majority) should serve as a moderating force on policy and legislation relative to the "blue wave" scenario.

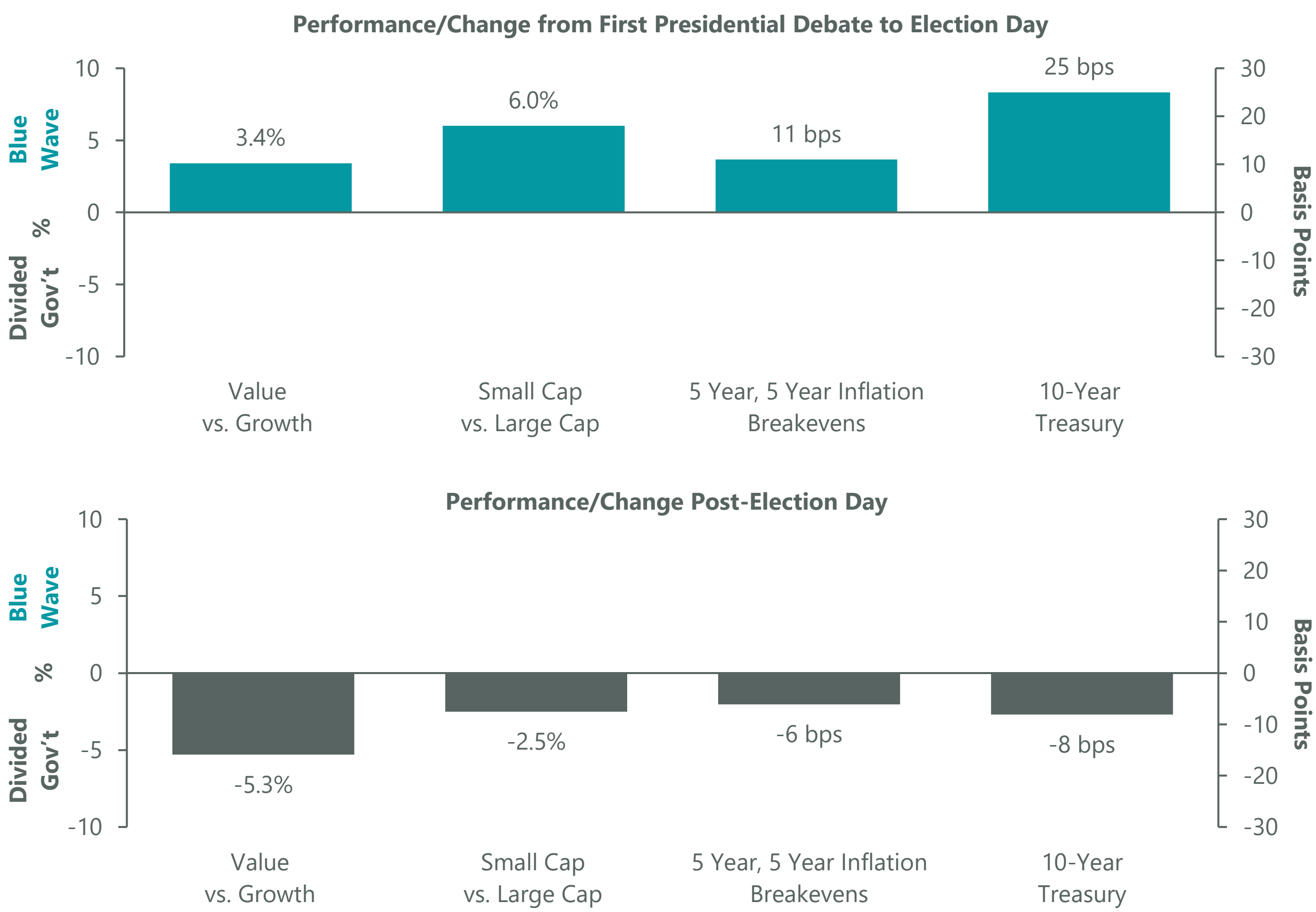
As a result of these developments, the size and scope of fiscal stimulus is likely to be more limited. A bill in the $1 trillion range, representing a compromise between previous Republican and Democrat proposals, seems possible. Senate Majority Leader Mitch McConnell stated his support for a stimulus bill on the day after the election, and going forward his longstanding relationship with Biden could help set the backdrop for more bipartisan cooperation relative to the last several years. Further, several swing-state senators on both sides of the aisle are up for re-election in 2022 and several more are set to retire. The balance of them are Republicans, however, which could further help provide an incentive to get stimulus (and possibly other legislation) passed.

Senator McConnell also spoke about working with the Biden administration to confirm more moderate Cabinet nominees, while suggesting that more progressive picks might not make it through a Republican-held Senate. This should help temper the regulatory agenda, if more moderate candidates end up in key administrative posts. Further, given the expectation of continued Republican control of the Senate, some of the policy initiatives more concerning to investors, such as higher corporate and individual taxes, are unlikely to be enacted.

Even if Democrats do ultimately take back the Senate, the final margin and where the 51st vote lies will be an important consideration. The scope of what Democrats can hope to enact will likely be fairly limited given an extremely shallow majority if they do win control of the Senate. This will likely force them to utilize the budget reconciliation process to a greater extent, as it requires only 50 votes (as opposed to a 60-vote filibuster-proof majority) for passage. However, bills passed this way can only impact taxes, spending, and deficits for a period of 10 years. Put differently, their lasting impacts are designed to be zero, and the process cannot be used to address larger policy changes. As a result, Democratic priorities like social security, minimum wages, and environmental regulations would need to be passed with a broader coalition that include multiple Republican votes, meaning any substantive shifts would likely need to be more centrist in order to draw bi-partisan support.

As a result, regardless of what happens in the Senate, the outcome is favorable for equity investors with fewer changes and a more balanced agenda. As a result, market leadership has shifted in the immediate aftermath of the election. In the period following the first presidential debate, when Biden's margin in the polls over Trump began to widen, small cap and value stocks had outperformed while interest rates and inflation expectations rose on the anticipation of greater fiscal spending (Exhibit 2). With the scale of fiscal spending now smaller, leadership since the election has shifted back in favor of large caps and growth stocks while interest rates and inflation expectations have declined.

Exhibit 2: Market Now Pricing in Divided Government



Pre-election data covers the period from Sept. 29, 2020 to Nov. 3, 2020. Post-election data includes Nov. 4 through Nov. 6, as of 5:00pm on Nov. 6, 2020. Source: Russell Investments, Bloomberg. Small Cap: Russell 2000 Index. Large Cap: Russell 1000 Index. Value: Russell 1000 Value Index. Growth: Russell 1000 Growth Index. 5 Year, 5 Year Inflation Breakevens are a measure of expected inflation (on average) over the five-year period that begins five years from today.

Importantly, we believe investors should be somewhat cautious in focusing too much on these short-term performance swings. Financials were the best-performing sector on the day after the 2016 election, and that group along with energy were the top two over the ensuing month. While these groups continued to show strength into early 2017, they have been two of the three worst-performing sectors since.

While the results from the election appear to be market-friendly, the health of the economy remains a concern for many. Investors should take some solace in the notion that Biden will be in somewhat familiar waters as he begins his Presidency. As Vice President, Biden took office in the midst of the global financial crisis and helped steer the economy back into an expansion characterized by steady but slow economic growth. This time, Biden will inherit an already-improving economy. In fact, we believe the U.S. economy has already exited the COVID-19 recession, a view supported by the ClearBridge Recovery Dashboard, which turned green/expansionary in the second quarter, with no underlying signal changes this month. The initial release of third quarter GDP came in at +33.1% last week, further reaffirming this message.

Exhibit 3: ClearBridge Recovery Dashboard

		October 30, 2020	September 30, 2020	August 31, 2020
Confidence	Consumer Confidence	⬆	⬆	⬆
	Business Confidence (ISM)	⬆	⬆	⬆
	Investor Sentiment	✖	✖	✖
Economics	Housing Starts	⬆	⬆	⬆
	Initial Jobless Claims	●	●	●
	Philly Fed	⬆	⬆	⬆
Financial	Credit Spreads	⬆	⬆	⬆
	Fed Policy	⬆	⬆	⬆
	Financial Conditions	⬆	⬆	⬆
	Overall Signal	⬆	⬆	⬆

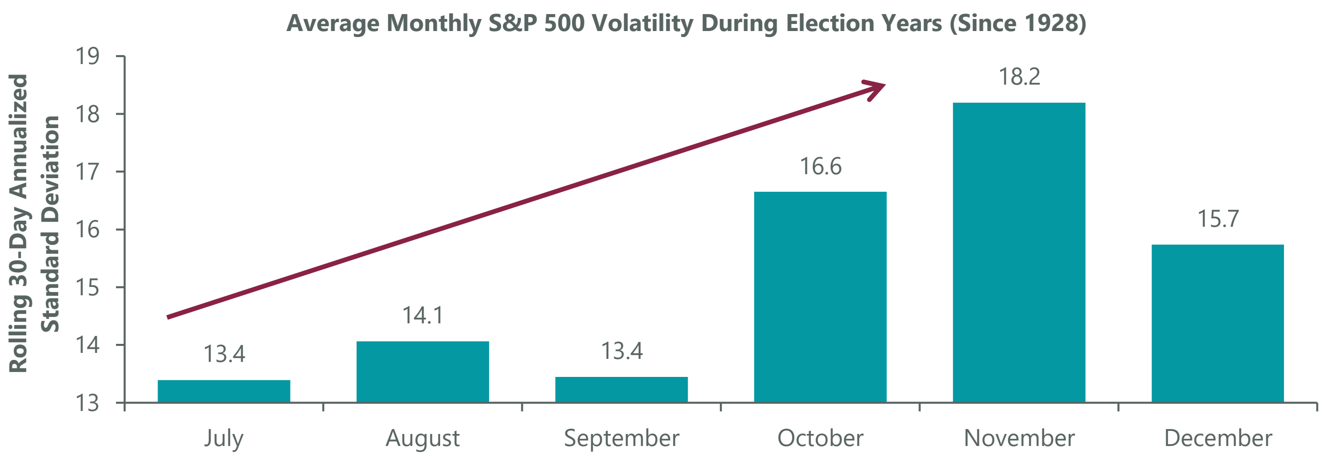
⬆ Expansion ● Improvement ✖ Recession

Data as of Oct. 30, 2020. Source: FactSet, Bloomberg, Conference Board, Census Bureau, Federal Reserve, FRBPA, Chicago Fed, ISM, Dept. of Labor, Bloomberg/Barclays, AAII, Investors Intelligence, and Moody's.

While the economy appears to have turned the corner earlier this year, conditions remain precarious. There are over 21.5 million Americans receiving unemployment benefits under the various programs and business bankruptcy filings continue to creep higher. Among those receiving unemployment benefits, over 13 million are on two special programs created as a part of the CARES Act to expand unemployment benefits to a wider pool and for a longer period of time. These programs, called Pandemic Unemployment Assistance and Pandemic Emergency Unemployment Compensation, both expire at year end meaning 62% of those currently receiving benefits could lose them. This dynamic makes the passage of a stimulus bill particularly important, and a potential source of short-term volatility as we move closer to year end.

Many market participants were prepared for election-related volatility, and historically the VIX has risen heading into a Presidential election. As investors reposition following the resolution of a major point of uncertainty and unwind hedges, the VIX typically falls and equities rise (Exhibit 4). Longer term, the backdrop appears favorable as well, as the ongoing economic recovery should continue to drive corporate earnings in the years ahead. While the path forward could see bouts of choppiness, particularly given COVID-19 fears, we believe the U.S. economy has reached escape velocity, making any meaningful drawdown an attractive entry point for long-term equity investors.

Exhibit 4: The Runup to Elections Spark Higher Volatility



Source: FactSet.

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