



U.S. Elections Appear to Have Been Market-Friendly

Divided government likely would produce moderate policies.

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KEY INSIGHTS

- Initial market reactions to the U.S. elections have been favorable, but the potential remains for near-term volatility.
- If Republicans keep control of the Senate after two runoff elections in Georgia, divided government could impede the Biden administration's legislative agenda.
- GOP Senate control almost certainly would rule out any significant tax increases. The Biden presidency is likely to focus more on regulation and foreign policy.

After an initial period of uncertainty, recent steps by the Trump administration to cooperate in the transition seem to guarantee the inauguration of Joe Biden as president on January 20, 2021. Two runoff elections in Georgia on January 5 will determine the balance of power in the Senate. Currently, a continuation of divided government appears most likely, with Democrats having narrowly retained control of the House.

While capital markets appear to have reacted positively to the elections, the postelection transition, while formally underway, creates a potential for market volatility. However, T. Rowe Price investment professionals believe that other issues, such as the potential rollout of coronavirus vaccines, are likely to be more critical in the months ahead.

"I think eyes will remain more on the response to COVID than on politics," says John Linehan, CIO, Equity.

Election and Policy Issues

With Congress entering the "lame duck" period before President-elect Biden's inauguration, markets will focus on the prospect for additional fiscal relief. Negotiations on such a package broke down shortly before the election.

Katie Deal, the Equity Division's Washington analyst, sees only a "slim chance" of significant fiscal legislation before the end of 2020, with negotiations beginning in earnest for a 2021 stimulus package. Given the slim majority either party may hold in the upcoming Senate, Democrats will struggle to match their previous USD 2.2 trillion package, which failed to move beyond the House.

Divided government likely will dominate the fiscal picture in 2021—assuming Republicans hold at least one of two Georgia Senate seats headed for runoff elections. "In a GOP Senate, a proposed tax rate increase of any magnitude would be dead on arrival," Linehan predicts.



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With Congress entering the 'lame duck' period before President-elect Biden's inauguration, markets will focus on the prospect for additional fiscal relief.

In a divided government, the fiscal debate eventually could return to the question of what to do about exploding federal deficits, suggests Mark Vaselkiv, CIO, Fixed Income. For now, however, both parties appear to recognize the need to support the economic recovery. Failure to pass additional fiscal stimulus early next year could increase the risk of a double-dip recession, Vaselkiv warns.

Outlook for Monetary Policy

One significant factor that the election almost certainly will not change is the Fed's massive liquidity support for the economy and the capital markets, which has pushed credit spreads down and enabled a surge in both investment-grade and high yield corporate debt. "What the Fed has done has been extraordinary," Vaselkiv notes.

Yet, despite surging liquidity, short-term and long-term Treasury yields have remained relatively low and stable—a sign that inflation expectations are still muted. This could allow the Fed to avoid raising rates through 2024 and perhaps even into 2025, Vaselkiv adds.

Regulatory and Trade Policy

With major fiscal initiatives less likely in a divided government scenario, the Biden administration might look to regulatory policy to advance its agenda. This could include efforts to shift the U.S. energy base away from fossil fuels and toward renewables. While new energy regulation could deter capital spending in the sector, it might reduce supply and boost energy prices, Linehan says.

Major changes in health care policy appear unlikely, Deal says. And while both parties have expressed interest in regulating the big technology platform companies, their proposals are very different, making quick action doubtful.

Trade policy is another area where the new administration might try to differentiate itself, Deal says. Biden

has expressed a desire for normalized relationships with traditional U.S. trading partners, such as the European Union, Japan, and South Korea. However, China may prove a different case. Biden may find it politically difficult to roll back Trump's tariff regime without first making demonstrable progress with Beijing, Deal argues.

Capital Market Implications

For equity investors, the election is unlikely to change the wide variation in returns—especially between growth and value—that has grown over the past year. However, much depends on the course of the pandemic. Further vaccine progress and stronger economic growth could benefit cyclical sectors such as energy, Linehan says.

In U.S. credit markets, low interest rates, declining default rates, and Fed support are likely to remain positive factors. However, longer-term Treasury yields could drift higher in early 2021 if the economic recovery accelerates. This could produce capital losses on longer-term maturities, Vaselkiv says. He suggests that investors may want to consider high yield bonds and floating rate bank loans, which have prices that are less sensitive to changes in interest rates.

Tax-exempt state and local municipal bonds also appear to offer attractive opportunities for individual investors, especially those in the top federal tax bracket. Most issuers remain in good fiscal shape despite the pandemic, Vaselkiv notes. Meanwhile, the hunt for higher yields has drawn nontraditional investors into the market, boosting demand for taxable muni securities, such as those issued by local municipalities.

Conclusions

Although continuing political uncertainty raises short-term issues for U.S. and global capital markets, we believe that most investors would be best off focusing on their long-term investment strategies.



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— Mark Vaselkiv
CIO, Fixed Income

Historically, U.S. equity market performance has been relatively consistent across presidents from both parties, Linehan notes, suggesting a long-term perspective is most appropriate. The potential costs of shifting in and out of asset classes in response to

shorter-term political events can be steep, Vaselkiv notes.

"It's easy to get consumed by elections," Linehan says. "But we think having a balanced approach to investing, and being thoughtful and careful, could be critical to long-term investment success."

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