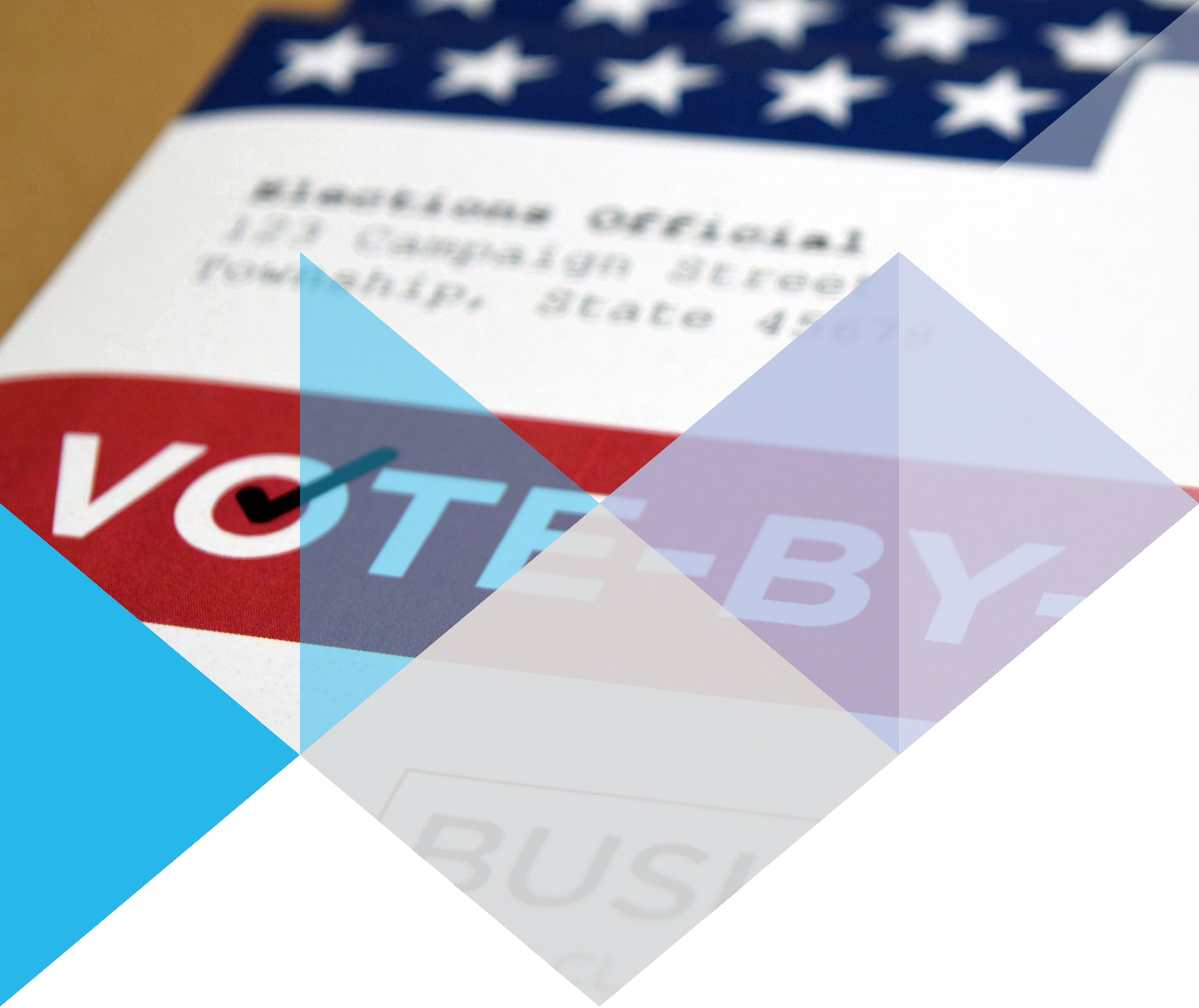

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Election Matters

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Elections matter. Every fall in the United States during a year divisible by four, everyone frets over the national election and prognosticates about its consequences. The two political parties position themselves to make the outcome close, a possibility made more likely in the presidential contest by the peculiar arithmetic of the Electoral College. Because the primary process typically drives candidates to the wings of their parties, prospective policies offer dramatically distinct choices. And power in Washington depends on control over both the White House and Capitol Hill, making multiple down-ticket races important. The combination of small differences in odds, big differences in professed programs, and potential amplification effects from Congressional races complicates framing an economic outlook and investment strategy.

This note lays out a framework for understanding the policy consequences of election results, stressing both yawning differences and surprising similarities across the potential outcomes. The framework helps to understand why the decibel volume is, for now, much louder on the political than the business news channels.

As of this writing, President Trump trails badly in the polls, with an aggregator placing his expected share of the vote at 43 percent. Similarly, an electronic market puts heavy weight on a "Blue Wave" in which the Democrats retain the House and take back the Senate. However, bettors appear to have improved their opinion that Trump wins the election to almost even money. Another obvious caution is that four years ago candidate Trump was faring even more poorly in the polls, and there was widespread talk of an ascendant Democratic majority. Polls and pundits fared similarly poorly in the UK's referendum on membership in the European Union just five months earlier.

2020 Election: Donald Trump's Polling Share

Average of Polls

Source: Real Clear Politics, accessed via Bloomberg, 8/30/2020.

Looking Back to 2016

2016 offers a string of lessons.

First, elections are sometimes better described as being lost by one side rather than won by the other. The "Remain" campaign in the UK referendum framed the issue of the European Union's role poorly, and Hillary Clinton failed to connect with the Democratic base.

Second, reading the mood of the public, a fraught business at the best of times, is particularly hazardous now. Social media magnifies messages, polarizes views, and undercuts the role of traditional opinion leaders. For instance, rest assured that a preponderance of US newspapers will endorse Joe Biden. Rest equally assured that this will not matter to Trump supporters.

Third, polls are of declining usefulness, hence our twin surprises about UK and US elections.

The fourth lesson from 2016 is about its aftermath: predicting post-election governance is as important as predicting the election results. Prime Minister Theresa May failed to make use of a Brexit mandate, and a solidly Republican government had few legislative achievements during Trump's first two years in office.

All this boils down to the advice that it is difficult to predict who wins a national election and even more difficult to predict how the winner fares. The latter property probably explains why investors are mostly unperturbed by the approaching election. They view dysfunction as a feature, not a bug, of the US political system.

Looking Forward to 2021 and Beyond

Potential scenarios for action during the next president's administration should be weighed by their content and ease of execution. The table below sketches out the possibilities, with the columns exploring the plausible alternatives for the ballot box (ease of execution) and rows considering content (the substance of things hoped for).

The left and right wings consider wave elections in which one party holds the reins of power. This makes legislative initiatives (items in the upper portion of the table mostly) more attainable, as compromise is needed within one caucus. That said, the first two years of the Trump Administration showed that bridging gaps within a party is sometimes as difficult as between parties. After a "Blue Wave," Speaker Pelosi might find progressives in her party as problematic to corral as Speaker Ryan did with his Tea Party colleagues.

If the Congress is split, it likely means that the election was close and that the current control of the chambers will not flip. This implies either President Biden confronts a Republican Senate or President Trump faces off with a Democratic House.

Potential Policy Scenarios of Various Electoral Outcomes

	President Biden		President Trump	
	All Democratic Hill	Divided Government		All Republican Hill
		Republican Senate	Democratic House	
Infrastructure spending	▲	–	–	▲
Defense spending	▼	◄•►	▲	▲
Corporate taxes	▲	–	–	▼
Personal taxes	▲	–	–	▼
Wealth tax	▲	–	–	–
Climate change	▲▲	▲	–	▼
Federal Reserve slant	◄	◄	◄	◄
Judiciary slant	◄◄	◄	►►	►►
Financial regulation	▲▲	▲	▼	▼
Tech regulation	▲	▲	▲	▲
Mergers and acquisitions	▼	▼	◄•►	▲
Trade relations	▼	▼	▼	▼

Source: Mellon.

The obvious implications are that:

- Major legislative initiatives are unlikely for either president because one party can always block the other.
- President Biden would be relatively more hobbled by a split government because all nominations (the middle portion of the table) will have to pass in a hostile Senate. This will pull the choice of candidates to the center. In contrast, President Trump will continue to have a freer rein to remake the Judiciary.

Either president would resort to executive action (items in the lower portion of the table mostly) to further their aims, especially so if legislative compromise eludes him. Recognize that the rows are broad categories. While both parties can agree more spending is necessary to shore up the nation's crumbling infrastructure, Democrats would more likely focus on the coasts and give it a green tint. Moreover, a fiscal package would presumably combine rows. Massive spending plans in a Biden administration, for instance, would be paired with increases in marginal tax rates for higher-income households, netting to a larger deficit.

The difference in the visions of how the federal government should be run in a Biden or Trump administration is vast. The ability of either to execute those visions is suspect.

Some Similarities

Equally informative are their four similarities.

First, the US economy will take time to heal from its wrenching contraction during the first half of 2020. In our forecast, US real GDP does not retain the level it posted at the end of 2019 until 2023. Along the way, many households and businesses will likely be in distress. In that environment, politicians, particularly newly elected

ones, will likely not want to throttle back fiscal stimulus. This macroeconomic constraint implies that tax hikes on upper incomes by the Democrats may be phased in or be swamped by reductions for lower-income households, sweeteners in exemptions (such as raising the cap on the tax deductibility of state and local income taxes), and spending initiatives.

Second, the tide has gone out on the Volcker-Greenspan era of low inflation, a small Federal Reserve (Fed) balance sheet, and exclusive reliance on an interest rate as the monetary policy operating instrument. Both presidents would welcome Chair Powell recently becoming one directional—viewing unemployment as never too low and inflation hopes to go above goal. Whether Chair Powell is in charge after February 2022 will be an open question. He has strengthened bonds with Capitol Hill, to be sure, reinforcing his tenure prospects in the middle columns of the table. On the wings of the table above, either president might want someone more aligned with their self-interests.

Third, President Trump opened the box on US-China trade and out came concerns about the protection of intellectual property, national security, and market access. President-for-life Xi, for his part, has stirred up bipartisan discontent on human rights issues, control of the South China Sea, and the status of Hong Kong. These concerns cannot be put back in the box next year by either leader. Style, however, matters. President Biden is a traditional multi-lateralist. In office, his Administration will work to rebuild partnerships to deal with these issues and to roll back trade restrictions that stretch the interpretation of the rules of the World Trade Organization.

Fourth, neither executive would worry about the size of the federal debt, enabling them to act on their considerable spending and taxation ambitions. The Fed is in their corner, and despite the manifest dislocations in our fiscal management, US Treasury securities are still viewed as safe-haven assets. As a result, expectations for a secularly low interest rate would keep the fiscal burden of the debt from skyrocketing. Nonetheless, the gross public debt will scale new heights relative to nominal GDP. Much of that will be held by foreign investors and official institutions. Such a profile poses myriad risks and vulnerabilities in the long run but will not worry the political caste in the short run. At some point, a succession of those short runs will cumulate to a tipping point, but probably on someone else's watch.

Conclusion

The already-heated political rhetoric is sure to get hotter as the election nears. But that is a shouted conversation about the wings of the table. Investors do not appear rattled. Equity markets are buoyant, credit risk spreads narrow, and implied volatilities of financial prices not especially high. Why? They must believe that Washington DC will remain dysfunctional and will find common ground if pressed by macroeconomic circumstances. And Fed Chair Powell has everybody's back.

The caution is that these circumstances would change if events piled the consensus probability from the middle columns to one of the wings of the table.

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Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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