MARKET INSIGHTS

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Mackenzie Fixed Income Team — October 16, 2020

Global Macroeconomic Update

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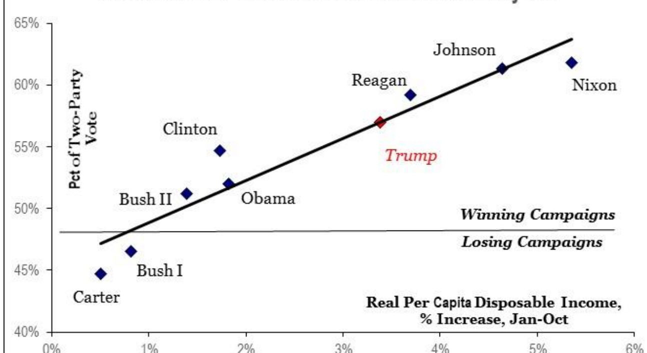
Key Themes:

- Polls continue to suggest the US Presidential race Biden's to lose, but market and economic data suggest Trump has the edge
- The outlook for US fiscal policy likely runs through the results of the Senate election outcome – a race that is too close to call
- We continue to believe there is a decent probability of not knowing the full election outcome on Nov 3 or 4 and like long JPY structures over the dates of the election

The Road to Victory Likely Runs Through Scranton

Dunder Mifflin would be proud. As we go to print just over two weeks before the US election it has been a wild one to say the least. With little time remaining we wanted to update you on what we are seeing, hearing, thinking and what the election results could mean for fixed income markets going forward.

Chart 1: Real Per Capita Disposable Income Growth & President's Re-Election Share Of The Two-Party Vote



Sources: Strategas' LLC; Mackenzie Investments

Overall, we believe the race for the White House is closer than most headlines would have you think. The polls are suggesting Biden has it while the economic and market data would suggest the race is Trump's (please see Chart 1). While most national polls have Biden ahead by 8 to 11 percentage points (ppts) those surveys are generally getting significantly skewed by large Democrat voter blocks in California and New York. In the key seven or so swing states – Wisconsin (WI) Michigan (MI), Pennsylvania (PA), Florida (FL), Arizona (AZ), North Carolina (NC), and Minnesota (MN) – Biden is up by an average of 4 or 5 ppts, probably at the top end or just above the margin of error. Recall in 2016, almost every poll had Clinton ahead in WI, MI and PA and Trump ended up winning all three states by the razor thin margin of 77,000 votes – combined. We continue to believe the keys to the White House likely rest with the results in PA, MI and WI, with PA likely acting as the most crucial of the swing states.

The Senate also remains too close to call with one or two races likely to make the difference, in our view. In particular the Senate race in Michigan which has the Republican James going up against the incumbent Democrat Peters is proving very interesting with James having narrowed his gap with Peters to as little as 1 ppt in the last few weeks according to some polls – which is even tighter than the presidential race in the state. Usually it is the Presidential "down ticket" vote influencing the choice for Senate, House and other nominees, but in Michigan it could end up that the James' vote actually influences Trump's results. This is no small nuance: one rust belt state (MI, PA or WI) could be the difference between winning the electoral college or not. Also of interest to us is the NC Senate race between the incumbent Republican Tillis versus the Democrat nominee Cunningham as well as the AZ race between Republican incumbent McSally and Democrat nominee Kelly where both incumbent Republicans are trailing their Democrat nominees moderately in the polls. With both AZ and NC likely to be very close for the Presidential vote, we continue to wonder how much the "down ticket" ideal is in play and what it means for the outcome in the Senate.

We believe the Senate outcome is very important for the direction of US policy - particularly fiscal policy and therefore markets - for at least the next two years. A Biden White House with a Republican Senate is very different than a Biden White House with a Democrat-majority Senate in terms of the ability to get legislation passed. For all of the hype and euphoria over the "Trump" tax cuts, taxation and spending policy is generally very much born in Congress with the House and Senate often hashing it out before it gets to the Executive Branch / White House. The fact that Treasury Secretary Mnuchin and Speaker Pelosi have been predominantly hashing out the so-called "Phase 4" Covid relief package over recent weeks is more the exception to the rule on how things usually get done in Washington. We continue to believe a Biden White House and Democrat Senate will likely lead to additional fiscal Covid-related stimulus packages, a higher probability of a large infrastructure package (or packages) and increased fixed income issuance by the Treasury. All other things being equal, in our view this would probably mean higher longer-end rates and a steeper curve whether measured in 2s-10s or 5s-30s. But as we have previously noted, we do not believe it produces an environment where longer-end rates run away higher because the Fed is likely to “cap” rates via extending its weighted average maturity for its current QE program purchases closer to 10 years from the current five years in an effort to:

1) signal it will do whatever it takes to get the economy back to pre-Covid nominal levels;
2) make the credit transmission mechanism for SME investments and borrowing as low as possible a bit further out the curve than it has done so traditionally; and
3) spur inflation as much as possible to help satisfy its new average inflation targeting (AIT) framework.

Finally, we remain concerned about an undecided election the night of November 3rd / morning of November 4th. Not that it is our base case, but it is far from zero. Recently we have seen equity and FX volatility around election dates sell off (albeit from elevated levels) probably due to both Biden’s lead widening in the National Polls as well as some of the disconnect between fundamentals and asset prices. We would remain on guard for a few reasons. The first two are laid out earlier in this piece: The Presidential race insofar as the electoral college could be a lot closer than people are expecting with one state possibly tipping the balance. Second, for markets the Senate is a big deal and an undecided Senate outcome will also have an impact. But beyond those reasons we would also flag the record number of absentee and mail-in ballots that are going through the system this year. Some states that have longer-established infrastructure to handle mail-in ballots such as Florida should be fine, but other states, particularly the rust belt swing states like PA and MI are not equipped to handle this much mail volume and it could be days or longer before we know the outcome. This isn’t just fear mongering or paranoia: there is a 17:1 ratio between Democrat and Republican requests for mail-in and absentee ballots in PA. So could Trump win the state on election night and then Democrat votes trickle in for the three days after the election giving the state to Biden? You bet. And with 20 electoral college votes at stake for PA with 270 needed to win it is not insignificant. Similarly in MI, more than 2.3 million people – or a third of the state’s electorate – requested absentee or mail-in ballots. With MI not beginning to count ballots until election day and having 14 days to complete the count there is a not an insignificant probability of also experiencing a delay there for results. And this says nothing about either Trump or Biden “contesting” the election results outright. We continue to like expressing any concerns regarding delays, contesting the election or “unknows” via short USDJPY structures. This is a classic risk-off strategy that is in-line with our long-held proposition of selling the USD on rallies as the era of US exceptionalism comes (or is coming) to an end and Fed actions continue to debase the USD (purposely or not) no matter who wins the White House in 2020.
