Deep purple?

67 – 9 November 2020

Key points

- If after the January 5th run-offs in Georgia the Democrats still don't control the Senate, President-elect Biden will have to try to follow a "purple pathway" on economic policy to address "secular stagnation". We think such strategy – combining public investment, tough competition policies and market-based approaches to decarbonization – exists but collides with the polarization of both parties.

Joe Biden's conciliatory victory speech has probably comforted equity investors in their positive reaction to the Democrats' failure (for now) to take control of the Senate, thus keeping in check the most radical aspects of the Democrats' platform on regulation and tax. The market is focusing now on the chances of a quick fiscal push. Some encouraging signals came from the Republican majority leader in the Senate on a stimulus by year end, but the package would likely be much smaller than what the Democrats expected, and a lack of cooperation from the White House – as we are writing these lines Donald Trump still has not conceded – would not help to get anything during the transition.

The situation may change on January 5th with the two run-off Senate elections in Georgia. The Democrats still have one shot at snatching a majority in the upper house, but we note that Joe Biden has been able to win Republican-leaning voters who did not extend their rejection of Donald Trump's personality to supporting liberals in Congressional races. Mobilisation may be an issue for the Democrats in January with the incumbent President on his way out. We would retain a divided Congress as our baseline.

Beyond the immediate fiscal issue, we think that the capacity to fight "secular stagnation", which implies reviving productivity and innovation, should ultimately be the right gauge to the success of Joe Biden's presidency in the economic realm. In principle, a "purple pathway" should be possible, blending the Democrats' fondness for infrastructure investment with tough competition policies and market-based approaches to the decarbonization of the economy which would appeal to moderate Republicans. There is probably no Democrat better equipped than Joe Biden to deal with a divided Congress and cut deals along those lines. Still, this is a narrow path, given the polarization of the base of each party. If the centrist avenue is blocked, the result may well be policy paralysis.

We also look at the first ripples Biden's victory is creating in the rest of the world. Times are likely to be hard for foreign leaders who cozied a bit too much with the Trump administration. In some cases – e.g. Boris Johnson – the new pressure may reduce the probability of accidents, in others – e.g. Recep Erdogan – the looming change in the US foreign policy stance may fan the flames on an already volatile situation.

And now for the hard part

The US elections brought Joe Biden to the White House, but without reflecting any mass conversion to his party's policy agenda. For now, the equity market is welcoming the outcome, expecting the usual "checks and balances" in the US institutional system to take the edge out of the most profit-damaging aspects of the Democrats' economic agenda – namely reversing Trump's deregulation push and tax cuts. From this point of view, investors can take comfort in the fact that, in his victory speech, President-elect Biden insisted on cross-party cooperation and the need to unify the country.

Looking ahead, the issue at stake is whether there is political space for a centrist approach addressing the underlying economic issues which have contributed to the rise in populism in the first place, or if Biden's victory will act as a mere stop-gap, "lowering the temperature" for a while in the US political discourse but essentially masking policy paralysis. Market focus is for now on the chances of a swift additional fiscal push, and indeed this is crucial for the short-term economic outlook, but more fundamentally, we think that the capacity to fight "secular stagnation", which implies reviving productivity and innovation, should ultimately be the right gauge to the success of Joe Biden's presidency in the economic realm.

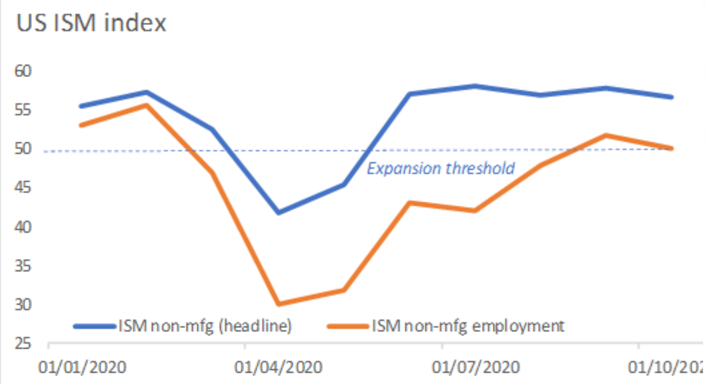
Immediate challenges

As we are writing these lines, the Democrats have lost 5 seats in the House of Representatives in net terms. There is no doubt they will maintain their majority. They have already secured 216 seats and need to win only 2 of the remaining 23 races. But the electoral map is interesting. Democrats lost seats in some of the Great Lakes states which Biden managed to re-build as a "blue wall". Democratic Senator Peters was re-elected in Michigan, but by a much smaller margin than in 2014 (1.5% against a whopping 13%), in a State Biden won by a 3% margin. This points to a very simple fact: Biden managed to mobilise beyond the Democratic base to reach out to Republican-leaning voters put off by Donald Trump's personality, who did not extend their rejection of the incumbent President to supporting Democratic candidates to Congress.

The Democrats might still secure a majority in the Senate. For now, the two parties control 48 seats each, with 4 races still to conclude. It would take a major upset in late counting for the Republican candidate to lose his edge in North Carolina. Results in Alaska take time (only 56% of the votes have been processed so far) but the Republican incumbent is a clear favourite there. So, taking on board Kamala Harris' tie-breaking vote, it seems that the Democrats absolutely need to win the two run-offs in Georgia on January 5th. The "Biden effect" is plain to see there as well. In one of the races, Democratic candidate Raphael Warnock together with the other democrats (Georgia conflates primaries with the final election) got 48.4% of the votes, and in the other Jon Osoff secured 47.9%, both below Biden's score in this state he won by a razor thin margin (49.5% to 49.3% for Donald Trump). Both parties will pour massive resources into the January race there and flipping 1 or 2% of the votes is of course possible. Still, most commentators are circumspect on the Democrats' chances to win both seats. They will have trouble generating the same level of mobilisation in these run-offs now that Donald Trump has lost, while Republican voters will have a strong incentive to go to the polls (avoiding a Democratic "trifecta").

This is why **in our baseline Congress would remain divided, reducing the room for manoeuvre for Biden on delivering a large fiscal push quickly**. True, the US dataflow has been more than decent lately, which would suggest there is no emergency on this front. The manufacturing ISM index hit in October its highest level since the summer of 2018. The more significant non-manufacturing ISM edged down, but at 56.6 remained well into expansion territory. This comes in sharp contrast with the Euro area where the composite PMI index for October, at 50.0, stood right on the line between expansion and contraction. Yet, we still believe there is some underlying softness in the US when looking at the labour market, even without factoring in the ongoing deterioration on the Covid front. The "employment" component of the non-manufacturing ISM is now barely in expansion territory (see Exhibit 1). The market took comfort last week in a better-than-expected payroll report, but the improvement remains very small when measured against the massive loss of the first wave (see Exhibit 2). There is still some "acquired speed" in the US recovery, but it could do with another push.

Exhibit 1 – Headline still good -but look at the details



Source: ISM, AXA IM Research, November 2020

Exhibit 2 – Labour market is soft

Source: Macrobond, BLS, AXA IM Research, November 2020

Upon being re-elected in Kentucky, Republican Senate majority leader Mitch McConnell sounded quite open to finding a deal with the Democrats on a quick stimulus package – calling this the number one item on the Senate's to-do list when reconvening for a "lame duck session" – but this came with strong qualifiers. He seized on the positive surprise from the payroll batch to state that *"it reinforces the argument that I've been making for the last few months, that something smaller – rather than throwing another USD 3trn at this issue is more appropriate"*. Earlier in the year the Senate had proposed a USD 500bn package, while the House is now targeting USD 2.2trn, down from an original plan at USD 3trn. Nancy Pelosi the same day last week stated that a narrow bill *"doesn't appeal to me at all"*. **There may well be a deal – which may be tagged to the resolution which Congress needs to pass anyway by December 11th to avoid another shutdown – but it's unlikely it will be as large as what the Democrats want.**

Then **we also must factor in potential disruption from the White House**. Donald Trump is President until January 19th. Negotiations on an immediate relief bill would have to involve the Treasury department and the White House. Secretary Mnuchin and Nancy Pelosi were apparently close to a compromise before the elections, but it is unclear how cooperative the executive branch of government is going to be during the transition phase, while the Democrats may be reluctant to sit with the Senate Republicans if most of them align with the incumbent President in refusing to accept the legitimacy of the election results. This is one of the channels through which a persistent refusal by Donald Trump to concede could create some market movements ahead.

US 10-year yields have corrected from their pre-election high at 0.92% on November 3rd, when the "blue wave" was the market's central scenario (ours as well for that matter), but equally rebounded from their relapse at 0.72% on November 5th to settle slightly above 0.80% on the 6th. This probably reflects some "wait-and-see" attitude while the dust settles (which may take until the Jan 5th elections in Georgia). The equity market halted its rally on Friday, probably taking time to ascertain whether a fiscal push could prolong it by supporting cyclicals.

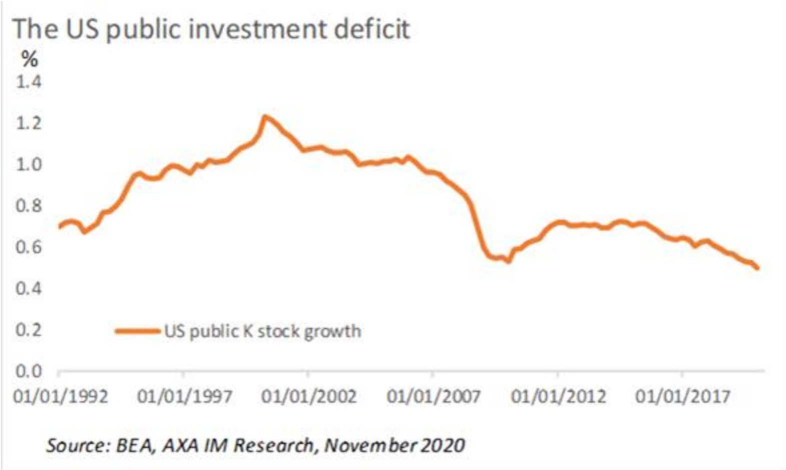
In need of an encompassing macro strategy

While investors are understandably focusing on these immediate consequences of the elections, we think there should be some bandwidth left to discussing the US long-term growth strategy, and whether the new political configuration makes it easier to emerge.

The received wisdom is that before Covid hit, Donald Trump would have been re-elected easily given the strong performance of the US economy. GDP growth was decent, that much is true, but this was made possible by an already accommodative fiscal stance. **In the three years to the end of 2019, US GDP grew by 2.4% per annum on average, in the same ballpark as during the last three years of the Obama administration** (2.5%). Still, in the meantime, the US federal deficit literally exploded from USD587bn to USD 998bn in 2019, essentially because of the sweeping tax cuts enacted at the beginning of Trump's mandate. This is growth "on steroids", which does not reflect the real state of the economy. The US remains in a better position than Europe in terms of growth performance, but its underlying path, after controlling for short-term policy props, has significantly slowed down.

The most cogent analysis we have encountered so far on this is Larry Summers' secular stagnation. In his narrative, at the root of the economic morass is a slowdown in technological innovation which is impairing productivity growth. Summers' recommendation is to lift public investment – infrastructures – in the hope it can kickstart a rebound in productivity. It may sound distant now, **but Donald Trump's own electoral platform in 2016 was steeped into the "secular stagnation" approach**, as a massive infrastructure spending plan – which did not come to fruition, largely because of the opposition of Republicans in Congress - was one of his key proposals then. The decelerating trend in public investment, which started in the early 2000s and intensified during the Great Recession of 2008/2009 (partly under a Democratic administration) has not been reversed (see Exhibit 3).

Exhibit 3 – A downward trend in public investment in the US



The "Summers approach" was adopted by Biden with a twist: the green transition, to be heavily funded by the government, is intended to be one of the key vectors of innovation. If the Democrats fail to snatch a majority in the Senate with the run-offs in Georgia, it is unclear how Joe Biden's own USD1.5trn infrastructure plan skewed towards renewable energy could come about. True, the President-elect's bi-partisan credentials can help him to secure deals with some moderate Republicans in the Senate. They are an endangered species, but a few are remaining (e.g. Mitt Romney, Lisa Murkowski, Susan Collins). Still, they tend to be run-of-the-mill fiscal conservatives.

Yet, macro strategies don't have to be one-sided. **Summers focused on the deterioration of US infrastructures, which unsurprisingly appeals to the "big government" left, but one could equally attribute some of the slowdown in productivity in the US to an "ossification" of the US economy due to a lack of competition**. Thomas Philippon (in his book "the Great Reversal", published in 2019) has been instrumental in pushing this thesis, highlighting the fact that in some key sectors – telecommunications for instance – the level of competition is now higher in Europe than in the US. Some of the countries which successfully reformed in the 1990s and 2000s pursued dual strategies. Canada for instance responded to its deep crisis in the early 1990s by liberalising its economy while raising its public investment effort once they had restored their public finances.

In principle, there would be space for a cross-party macro strategy in the US, a "purple pathway", with the Democrats' fondness for public investment complemented, or partly offset, by tougher competition policies which would appeal to free markets Republicans. Moreover, although the Republican party under Trump has been dominated by its climate-sceptic wing (note that Mitch McConnell's state is the fifth biggest coal producer in the US), some of its Senators – including Lindsey Graham, otherwise a staunch support of Donald Trump - acknowledged that global warming is man-made and agree with the need to cap carbon emission. However, they would rather achieve this through market mechanisms, with government "nudge", while the Democrats are on the whole more supportive of direct intervention.

The room for manoeuvre for Biden will be narrow though. Even moderate Republican Senators may have to compose with a still Trumpian base, allergic to any cooperation with the other side. Utah Senator Mitt Romney – who supports a market-based greening of the economy – stated this weekend that Donald Trump will *"be the 900 pounds gorilla when it comes to the Republican party"* and will continue to influence its stance. Romney may have summarised the view of the Republican establishment quite well by saying that *"[Americans] don't want the Green New Deal, Medicare for all, don't want higher taxes, don't want to get rid of oil and gas and coal".* This sets clear limits to the extent of cooperation. At least at this stage. The Democrats themselves may have some trouble keeping their own radicals in check. There is probably no Democrat better equipped than Joe Biden to deal with a divided Congress. Still, if the centrist avenue is blocked, the result may well be policy paralysis.

Meanwhile, in the rest of the world…

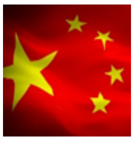
Times are likely to be hard for foreign leaders who cozied a bit too much with the Trump administration to the taste of Joe Biden. In some cases – e.g. Boris Johnson – the new pressure may actually reduce the probability of accidents, in others – e.g. Recep Erdogan – the change in the US foreign policy stance may fan the flames on an already volatile situation.

We have already mentioned in Macrocast the role the Irish issue plays in the US approach to the UK. Beyond Biden's own strong Irish roots, the American-Irish vote remains a key constituency for the Democratic party. A study by the Clinton Foundation in 2017 suggested that Irish Americans voted at 47% for Hilary Clinton in 2016 against 27% for Donald Trump, and 33 million people identified as Irish in the 2017 American Community Survey by the Census Bureau. A no-deal Brexit which would jeopardize the "Good Friday" agreement in Ireland would be unfavourably received in Washington DC to say the least and would make it impossible for the UK to negotiate a Free Trade Agreement with the US. We note that Boris Johnson was unusually bullish about the chances of a deal with the EU in a TV interview this Sunday morning.

Boris Johnson already had to deal with unfavourable polls – all major pollsters now have Labour above the Tories in voting intentions, and the opposition leader ahead in favourability indices. Keir Starmer has stopped fighting on the principle of Brexit, choosing instead to criticise the government on its actual handling of the negotiations, building an incompetence case against the Prime Minister, already in a complicated position with his Covid strategy. No deal would hardly help Johnson there, while it would further boost the chances of the Nationalists in the Scottish elections next year to win an absolute majority, which would make it difficult to reject a second independence referendum. If on top of everything a "no deal" Brexit is a source of complete isolation on the world stage, it is probably time for the British Prime Minister to cut his losses and sign a deal. Quickly.

The Turkish leader has been benefitting from quite a lot of goodwill from Donald Trump although his alignment with the US strategic interests was getting increasingly questionable, namely through his planned purchase of Russian military hardware. **This is very unlikely to continue under a Biden administration, making the implementation of sanctions against Turkey more likely**. This would add to the pressure on the country. The 200-basis points policy rate hike in September, complemented by "tightening by stealth" measures, did not stop the slide in the currency. We thought breaking the symbolic level of 8 TRY per USD would trigger a more muscular response, but nothing of note has come and the currency slid further to 8.5.

The sense of crisis was exacerbated last week by the dismissal of the head of the central bank, followed during the weekend by the resignation of the finance minister (Recep Erdogan's own son-in-law). The market's suspicion that Erdogan would not accept a tightening in monetary policy – he argued that higher rates actually fuel inflation instead of curbing it – has been vindicated one again. What's unclear of course is the end game. There are few chances of a spontaneous stabilisation since inflation is accelerating fast, erasing much of the competitiveness gains triggered by the currency depreciation, while foreign exchange reserves continue to diminish. The banks' solvency gets under pressure via the currency-denominated loans. If the new governor of the central bank does not have more freedom of action than his predecessor, a (politically tricky) IMF intervention will be unavoidable, an outcome a lot of sell-side firms have been expecting for a while.

Country/Region	What we focused on last week	What we will focus on this week
	• US election, President Trump did better than expected leaving outcome inconclusive • Biden has led in Electoral Vote. Legal challenges underway. Senate race will not be decided until January • FOMC left policy on hold. Fed Chair warned of COVID rise and suggested bias to add stimulus via QE	• US election developments – prolonged legal challenge or an outcome • COVID cases on the rise again in US, watch for reaction from states or mobility • CPI inflation (Oct) expected steady around last month's 1.4%yoy • PPI inflation (Oct) also due
	• Italian government announced a three-regional tiers system: stringency measures will depend on the epidemiological situation • German IP disappointed at 1.6% mom, still 11% below its pre-Covid level • Final PMIs confirmed sectors divergence, with manufacturing at a 27-month high and services at the lowest since May 2020	• Banque de France business climate to help gauging the impact of the restrictions • EA IP data to post another monthly rise • BOJ to hold its annual Forum on Central Banking: could provide some hints on the December recalibration and progress on strategy review
	• UK enters 'time limited' lockdown • MPC boost QE by £150bn, exceeding our £100bn forecast as reduces GDP growth outlook, but still sees inflation at 2% in 2021 • Chancellor Sunak announces an extension of the furlough scheme until March 2021 • Final PMIs (Oct) confirm retracement	• Covid growth rates have started to fall, but will need to continue to end lockdown • Breakthrough needed on Brexit trade talks • Q3 GDP (prelim estimate) expect +16% q/q, full breakdown of output by sector for Sept. • Labour market (Sept) watched for signs of unemployment rising as furlough curtailed
	• Oct manufacturing and services PMI improve respectively to 48.7 and 47.7 from 48 and 46.9 but remain in contraction territory • Monetary base reaches +16.2% yoy in November, up for the 6th month above 3%, stimulated by the BoJ accommodative policy	• November Reuters Tankan Manufacturing index should continue to improve but at lower path • Oct bank lending should remain dynamic • September machinery orders to gauge manufacturing recovery
	• Steady to rising PMIs show ongoing solid expansion in manufacturing and services activities • Beijing vows to double GDP size by 2035 implying an annual average growth of 4.7% in the next 15 years • Xi pledges further market opening by targeting $22trn of imports over the coming decade	• Trade data to show steady growth in exports and imports • CPI inflation to drop further due to waning food price growth
	• PMIs improved across EM, with India, Korea, Thailand and Brazil remaining Strong /expansion territory. Russia, Mexico, Indonesia, Malaysia and the Philippines however, printed below the waterline • Asia export monitor shows continued recovery • Q3 GDP for Indonesia (-3.5%yoy after -5.3% in Q2) came out worse than expectation • IP Brazil +2.6% (Sep.) recovers past losses	• Central bank meeting: Mexico – expect policy rates unchanged (4.25%). • Inflation rate in Mexico to stay close to the upper range of the central bank (Oct) • Current account balance in Turkey (Sep.) • Industrial production in Mexico and India (Sep.) • Flash Q3 GDP in Russia, Poland

Upcoming events	**US :**	Tue: JOLT's Job Openings (Sep), Thu: CPI inflation (Oct), jobless claims, ; Fri: PPI inflation (Oct)
	Euro Area:	Mon: Sentix Investor Confidence; Tue: ZEW Economic Sentiment; Thu: ECB Economic bulletin, Eurogroup meeting, IP; Fri: Employ change, GDP, Trade Balance
	UK:	Mon: RICS house price balance; Tue: Labour market report (Sep/Oct); Thu: GDP (Q3), IP, mfg production (Sep), Business investment, construction output
	China:	Mon: Current account, bank lending; Tue: M2 money stock, M3 money supply; Wed: Machine tool orders, PPI, Tertiary Industry Activity Index; Fri: Reuters IPSOS PCSI
	Japan:	Mon: CPI, PPI; Tue: M2 money stock, New loan; Thu: Reuters IPSOS PCSI

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