AMERICA AT A CROSSROADS:

The 2020 US Election

The lead-up to the US election has been a dream come true for cable news channels and pundits, but perhaps not so much for investors trying to make sense of all the possible outcomes and what they might mean for financial markets still reeling from a global pandemic.

We asked seven Lazard Asset Management (Lazard) thought leaders to share their views of the upcoming contest. All of these investment professionals currently believe there are two likely election outcomes: Continued divided government in some form, or a “blue wave” where the Democratic party wins the presidency and control of both houses of Congress. Our experts also are thinking about the post-election investment implications for fiscal stimulus, tax policy, trade relations, and many other areas, all of which will be affected by who wins and loses on 3 November.

Our professionals manage investment strategies as part of their respective teams, each of which develops their own views and makes independent decisions for their client portfolios. This diversity of thought is a defining characteristic of Lazard’s culture. We invite you to consider their broad array of perspectives as you contemplate what lies ahead for world markets.

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Q: Elections get a lot of news coverage and attention. But just how important are they to markets in general? How important is the outcome of this particular election for markets, and in what ways?

Ron Temple (Head of US Equities, Co-Head of Multi-Asset): Gauging the short-term reaction to any election is very difficult, and ultimately not that important. What really matters is: What are the longer-term prospects for companies to generate profits? Elevated policy uncertainty is not good for growth. I think there's a misperception in the market that politicians can only do harm, so you're better off with gridlock, which is what we would likely have under any divided government scenario. I think that's completely untrue and that less uncertainty is the most positive outcome for the market and for growth. In the midst of a pandemic, you probably want one party to be in control of the White House and the two legislative chambers. That way, one party would "own" the problem, rather than be in a position to point fingers at the opposition.

The most important scenario to consider is a "blue wave" in which Democrats win control of the House, Senate, and White House. Based on his campaign, I would rank a Biden Administration's policies as being: 1) climate change, 2) infrastructure investment with a heavy emphasis on climate, 3) increasing tax rates on corporations and very high-income households that earn more than $400,000 a year, 4) expanding access to healthcare, and 5) re-establishing the role of the US in multilateral institutions.

More importantly, however, I believe a blue wave could be the beginning of a major structural shift in markets. The groundwork for this shift is already partially in place. The Fed's announcement of its new monetary policy framework of a flexible form of average inflation targeting means that the Federal Open Market Committee is highly unlikely to raise rates until inflation is sustained above 2%. The second building block is the passage of the European Union Recovery Fund, which allocates €750 billion of stimulus to be invested over the next 2.5 years. This EU Recovery Fund comes on top of large national-level fiscal stimulus packages that are also under way. If the Democrats prioritize a US$2–3 trillion infrastructure and climate investment initiative early on, we could see a fiscal impetus that is unparalleled in the post-World War II era. In this scenario, growth and inflation expectations are likely to increase, leading to a steepening of the US yield curve. As growth accelerates, the recovery will broaden through more sectors of the economy, offering investors more choices of stocks that can grow revenue and earnings. At the same time, higher long-term interest rates imply higher discount rates on future cash flows, which could depress the valuation of companies whose shares are driven by cash flows expected far in the future relative to those with near-term cash flows. This could lead to a major rotation out of growth and momentum stocks that might possibly generate high returns in the future into shares of companies that are already generating high returns.

This scenario is not a done deal. It requires the Democrats to channel significant political capital into a major investment program. If that happens, it could represent a seismic shift in markets that should compensate for higher tax rates.

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Q: The US budget deficit in fiscal 2020 was $3.13 trillion, triple that of 2019. From a fixed income investor's point of view, what are the ramifications of another very large stimulus package?

John Senesac (Portfolio Manager/Analyst, US Fixed Income): The effect of fiscal expansion on growth is crucial for rates. The Fed is on hold at zero interest rates and being very accommodative with their balance sheet programs, so we could certainly see rates and inflation expectations rise if we see some large growth numbers as a result of fiscal stimulus, especially if it is not accompanied by productivity growth. In that case, I would expect the Treasury curve to steepen, with longer rates moving significantly higher. Municipal rates would most likely follow Treasuries; however, my expectation is that municipals would outperform Treasuries.

Annual nominal GDP growth is negative right now, so we have a long way to go before this type of nominal growth-led inflation becomes a concern. However, we've been in a declining rate environment with benign inflation for over two decades. Many market participants might find this environment characterized by a higher trend in inflation that actually has legs—that is, higher than "moderately above 2%" and longer than "for some time"—challenging.

As far as fiscal ramifications, I don't think higher deficit spending will necessarily be a negative so long as growth is high enough and sustained, even if tax increases are enacted as promised. But if growth lacks follow through and struggles in a higher tax regime, then I would expect corporate profits to struggle, and that obviously translates back into financial asset prices. The federal government would have to issue a lot more debt, and that probably means the US dollar would be relatively weaker.

Q: Does a Democratic sweep have any other implications for fixed income assets?

Yvette Klevan (Portfolio Manager/Analyst, Global Fixed Income): If Democrats control the presidency and Congress, I think investors will start to anticipate and factor in potential tax changes. US equity markets have come back very strongly, as have other risk assets, so I'm a little concerned that in the short run you could see some investors taking profits to make sure they get the capital gains tax rate of 2020 as opposed to a higher rate in future years. The expectation of higher corporate tax rates, which could be a blow to earnings, could be another reason for taking profits on equities.

What we've seen over the past year or two is that when equity markets sell off, credit spreads sometimes widen. My team has taken some exposure off the table lately, especially for longer maturities. Similar to the way some say recent equity market gains are disconnected from the real economy, credit spreads have retraced quite a bit as well. Investment grade spreads have almost retightened to pre-COVID levels, where the riskier parts of the credit spectrum, like high yield and emerging markets, have retraced, but not fully to pre-pandemic levels. We would expect some volatility there.

Longer-term, someone will have to pay for a large fiscal stimulus if Democrats win full control, or even to finance the recent stimulus, so I agree that there would theoretically be a situation in which yield curves may steepen. However, I think steepening would be related more to the larger supply of Treasuries and other bonds at auction than to inflationary pressures.

Q: The US has just gone through a major growth shock, and one of the key components of the Democratic platform is raising taxes. Beyond the potential for a rapid sell-off, just how much impact would a higher-tax regime have on financial assets and growth in the United States?

Nick Bratt (Portfolio Manager/Analyst, Global Thematic Equity): To his credit, Biden has not hedged his bets about taxes: He has said that he will increase taxes. I think the market reaction will depend on how aggressive the increases are. He's already been clear that corporate taxes will revert to 28%, which is where they were before Trump, and the US economy did perfectly well. Biden has also made clear that he would raise the federal income tax on individuals, and I do not think restoring the maximum individual tax rate to the previous level would be overly disruptive here, either. I think there's also a reasonable chance that Biden could say in his acceptance speech that, in view of the pandemic, tax increases will be postponed until the economy is in better shape.

Q: Looking at the markets in a global context, US equities have been dominant for more than a decade. What would the election mean for markets outside the United States?

John Reinsberg (Deputy Chairman of Lazard Asset Management and Head of International and Global Strategies): A Trump re-election would be more favorable to US markets with a continuation of existing stimulus and tax policies. European and Japanese equity markets would likely follow a US equity rally with a devil-you-know sympathy rally. I believe a Trump victory would accelerate both a US trade deal with the United Kingdom and the prospect of trade disputes with Europe. A Trump victory may not necessarily be more favorable for emerging markets, with continued rhetoric on protectionist foreign policy, but should not be any worse than what we already know. An all-out trade war with China would likely heat up again, leading domestically oriented Chinese companies to likely outperform export-oriented ones. I would expect relief for Russia, Turkey, and India, and little change in the US dollar.

I think a Biden victory may provide a more favorable outlook for non-US markets. Japanese markets likely will adopt a wait-and-see attitude, and equities would trade in sympathy with the US. In Europe, a Biden win may be seen as better news, with a return to Obama-era policies, and would likely bring relief about a potential trade war between the US and Europe. Despite having been vice president for eight years, Biden remains a lesser-known political actor in the UK, so I don't believe a trade deal would be imminent, although the two countries will remain close allies. Emerging markets might be the big winner if Biden's victory means dollar weakness and lower geopolitical risk in emerging economies, especially with a potential for re-establishing relations with China and Mexico. However, I think a Biden win could be negative for Russia, Turkey, and Brazil.

Q: Is there anything else we should think about with regard to emerging markets?

Arif Joshi (Portfolio Manager/Analyst on Emerging Markets Debt): The consensus, which I agree with, is that the immediate reaction to a Trump victory is a positive one for US equity prices, driven by the anticipation of higher growth due to continued deregulation, a continuation of the tax cuts, and additional stimulus. In a Biden victory, it's the exact opposite. I would expect US stocks to go lower on the expectation of higher taxes, increased regulation, and lower corporate profitability. But that's just the immediate reaction. We expect US growth next year to increase significantly, somewhere between 4%–5%, led by monetary and fiscal stimulus, both of which would likely occur under either candidate. So, we would expect US risk assets to go up under either a Biden or a Trump administration over the next 3–6 months.

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>
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The situation is more bifurcated for emerging markets assets: A Biden administration is categorically good for them, while a Trump administration is categorically poor. That's largely due to currency trends, which tend to drive emerging markets assets. In the short term, a Trump victory would likely be positive for the dollar, reversing the weakness of the last couple of months. The view of the market would be that we are back to an America First economy and foreign policy, as well as continued disengagement from global trade partners, all of which tends to result in dollar strength. Under a Biden administration, you would likely see a double-digit decline in the value of the US dollar, which could push emerging markets assets to outperform their US counterparts for the first time in a decade. That's partly because the market would likely revise growth estimates a little lower, but more importantly because it would expect a Biden administration to reintegrate into the global trade structure.

However, it's important to note that Biden is not Bernie Sanders or Alexandria Ocasio-Cortez. This is not the extreme left versus the extreme right; this is the most moderate Democrat around versus a right-leaning president. The markets know that the betting sites and quantitative models show a significant probability of Biden winning, and yet the S&P isn't crashing. The 10-year isn't soaring. That's the market telling you it's generally comfortable with both sides.

Q: There has been a great deal of discussion about the fact that, due to an increase in mail-in voting and other concerns, the winner of the election won't be immediately clear. Can you put those concerns in context for us?

Tom McManus (Managing Director and Portfolio Manager/Analyst on the Lazard Multi-Asset Investment Team): State polling and pundit forecasts suggest a wide enough margin to allow for a relatively quick resolution of the outcome of the election, but the sheer number of absentee ballots requested—85 million, which represents 62% of the total votes cast four years ago—raises questions about how fast these votes can be accurately processed. In battleground states, absentee ballots could suggest a different result from in-person voting, triggering disputes over the identity of the winner. While the probability of a prolonged dispute over the ultimate outcome is low, the impact of such an event could be meaningful. Some are concerned about an outcome like 2000, when there was five weeks of legal wrangling until the US Supreme Court made a decision to halt the recount. Using the market reaction in 2000 as a guide isn't so relevant because a bear market had already set in, and it didn't seem as though there was nearly as much hyper-partisanship then as now. Any post-election violence would obviously be seen as negative for markets. But overall, I suspect there is a 90%–95% probability that reasonable people will conclude that one or the other candidate secured a victory in the Electoral College within 24 hours of polls closing in California.

Some are worrying that disputes regarding the results of the election may continue beyond the Electoral College vote on 14 December until the Congress counts those votes on 6 January, or even until Inauguration Day on 20 January, ultimately challenging the notion of a peaceful transfer of power. I see the probability of this occurring as very low. I expect many investors would become progressively more unnerved if these key dates are reached without a concession and commitment to work together for the common good. In this scenario, I would expect investors to become less comfortable with risky assets and more likely to boost exposure to highly liquid, safe assets such as Treasury securities.

Q: None of the investment managers we polled believe that prolonged uncertainty over the election results is a likely outcome on 3 November, but they do all believe investors should plan for it. What are the potential investment implications of a delay in deciding the election or a dispute about the legitimacy of the vote?

John Reinsberg: As investors dislike uncertainty, a prolonged dispute would be negative for risk assets, and I believe investors should consider the following potential consequences: 1) a shift to a more risk-off posture, 2) increased volatility, 3) a potential global market correction led by the US, 4) asset allocation shifts toward foreign stocks, 5) a greater interest in gold and cryptocurrencies, 6) a sell-off in credit-sensitive assets, including high yield bonds, 7) lower business and consumer confidence, and 8) a weakening in the US dollar and US bond yields in favor of the Swiss franc, the yen, and maybe even the euro.

Q: Once the dust over the election has settled, the next president will have to get down to the business of governing. Which issues are likely to be handled significantly differently under a Trump or Biden administration?

Yvette Klevan: The differences between Trump and Biden are likely going to be more on the domestic front than the foreign front, but Europe is an important exception. Trump has seemed to some to be surprisingly negative on the EU and certain issues, such as who is paying for NATO. I think Biden would be much more friendly toward Europe on trade issues and regulations.

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>
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I'm also very excited about the potential for some of the infrastructure spending being proposed, particularly some of the green infrastructure programs promoted by the Democrats. With so much money being spent and zero interest rates, there has never been a better time to push toward developing inexpensive renewable energy capacity and addressing environmental concerns in other ways, such as making buildings more efficient. With all the layoffs the country has experienced, it's a huge opportunity to build out new job sectors, shape a new domestic industry focused on renewable energy, retrain a lot of people, and bring back jobs to the US.

Q: It seems that investors in nearly every asset class are keenly awaiting the next stimulus. However, it's difficult to think of another asset class in which security issuers stand to benefit more directly and profoundly than public finance, or the municipal bond sector. How would the most dramatic scenario, a Democratic sweep, affect munis?

John Senesac: I think there are two key areas to focus on within public finance: infrastructure and healthcare. We are over a decade behind the eight-ball on funding infrastructure, and that's something that has to be addressed in one way or another. Infrastructure spending under this scenario, I believe, will be guided by environmental concerns and therefore driven by sustainability. Federal infrastructure aid likely will funnel through state and local governments, which are already responsible for financing the majority of current infrastructure spending. Therefore, I anticipate that green bond issuance at the state and local level will rise meaningfully as a result.

Healthcare is the second area to watch, and although difficult to forecast, one could make an argument that a Democratic sweep may help certain hospitals at the margin. The US spends a lot of money on health care at the state level—healthcare consumes about 29% of state expenditures. Democrats want to offer a public option similar to Medicare, as well as expand coverage in the states that elected not to expand Medicaid under the Affordable Care Act by offering the public option premium-free. This expansion, in addition to increasing subsidies for health insurance costs to low- and middle-income Americans could be a net positive for some hospitals. Given the challenges hospitals have had, we have historically focused on larger hospital systems, but these changes may create an opportunity to expand our investment universe within the sector.

Finally, as a muni bond investor, I'm also watching tax policy. When taxes go up under Biden, as promised, one would assume higher overall demand for municipal bonds, which generate tax-exempt income.

Q: Let's turn to foreign policy, particularly the relationship between the US and China. That relationship has changed significantly over the past four years, with the US becoming much more adversarial and China often responding in kind. What are the stakes for that relationship in this election?

Nick Bratt: In my opinion, China's place in the world is the single most important existential question the developed world faces in the next 50 years. I think that we are already in a new Cold War, and one of the few areas where we do have bipartisan agreement is on the threat China poses to the liberal democratic world--not just to the US, but to Japan, India, Australia, and other capitalist liberal democracies.

China has 1.4 billion people and a very proud history, and the country is driven by the dream of national rejuvenation. For about 2,000 years, China accounted for some 20%–30% of the global economy, but by the early 1960s, its share was as low as 4%. Seen from the perspective of a fervent Chinese nationalist, this was deeply shameful, so the Chinese are driven understandably by a desire to reassert their status on the global stage. Now the Chinese economy is back to about 16% of global GDP. China has reached a high level of economic development and has a high-quality educational system, rising living standards, and a determination to become world leaders in many different areas of technology. They have also acknowledged the pressing nature of climate change and are committed to reducing pollution. Given all of this, there are very strong grounds for believing that China will continue to put economic and political pressure on the rest of the world over the next 20–30 years.

Both Republicans and Democrats have decided that China's behavior needs to change, particularly with regard to intellectual property rights, observing rules and regulations, and adhering to accepted international business norms. There seems to be a broad agreement that the Chinese have exploited the easygoing way of the Western world and that we need to do something about that. But what's the next step forward? My sense is that a Biden administration will seek to negotiate peaceful arrangements—making treaties with other nations on one hand and recognizing where we can work out a reasonable modus operandi to resolve disputes on the other. If Trump is re-elected, we will have a continuation of his aggressive approach.

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> *– Nicholas Bratt*

Q: Finally, the role the US does or should play in the world has been the subject of intense debate over the past four years. What might change as a result of this election about the way the US participates in multilateral institutions, and does it matter to investors?

Ron Temple: Under Biden, the US would likely re-engage with allies to participate more closely in multilateral institutions such as NATO, the Paris Climate Accord, the World Health Organization, and the World Trade Organization. The issue of multilateral engagement is a difficult thing for investors to factor in, however. If the WTO didn't exist tomorrow, can I tell you how much earnings would go down for any given company? No. What I can tell you is that the range of global multilateral institutions have been very important to creating a global trade framework, for maintaining peace for generations, and in helping to address global healthcare and climate challenges. These institutions have created a more stable, predictable backdrop against which companies and consumers can make important economic decisions. Without question, they have played a role in lowering the cost of capital and discount rates in the United States and abroad. Reaffirming the importance of, and in some cases reforming, these institutions could be meaningfully positive for growth and investors if handled properly.

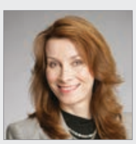
Going Forward

Every investment team at Lazard is actively engaged in understanding the different potential election scenarios and evaluating risk and reward, while also actively discussing these views with colleagues. If you have further questions about the market implications of this major risk event, please contact your Lazard representative for a more in-depth discussion.

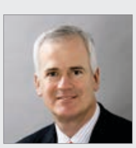
Bios

Nicholas Bratt is a Portfolio Manager/Analyst on the Global Thematic Equity team. He began working in the investment field in 1973. Prior to joining Lazard in 2003, Nick was a Director of Global Products, Head of International Portfolio Management, Head of the Global Equity Group and Global Chief Investment Officer with Scudder/Deutsche Asset Management. He has an MIA from Columbia University (Fulbright Scholarship) and a BA in Politics, Philosophy and Economics from St. John's College, Oxford University. Nick is a Director of the Korea Society and a member of the Council on Foreign Relations.

Arif Joshi, CFA, is a Portfolio Manager/Analyst on Lazard's Emerging Markets Debt team. He began working in the investment field in 1998. Prior to joining Lazard in 2010, Arif was with HSBC Asset Management (formerly Halbis) where he served as Senior Vice President and Portfolio Manager. At HSBC, Arif was responsible for global emerging markets, focusing on corporate and sovereign credit analysis, risk management and quantitative modeling. He began this role at The Atlantic Advisors LLC (acquired by HSBC in 2005). Prior to HSBC, he was an associate at Strategic Management Group where he advised Fortune 500 companies on finance and corporate strategy. Arif has an MBA in Finance from Columbia Business School and a BS in Economics from the Wharton School at the University of Pennsylvania. Arif is a CFA® charterholder.



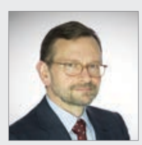
Yvette Klevan is a Portfolio Manager/Analyst on the Global Fixed Income team. She began working in the investment field in 1982. Prior to joining Lazard in 2002, Yvette was a Senior Portfolio Manager with Offitbank. Previously she worked at Bank of America, Chase Manhattan Bank, and Aramco Services Company. Yvette has an MBA in Finance and Management Information Systems from the University of Houston and a BBA in Mechanical Engineering Route to Business from the University of Texas. As of February 2018, she serves as a signatory representative to the Fixed Income Advisory Committee for the Principles for Responsible Investment (PRI).



Tom McManus is a Managing Director and Portfolio Manager/Analyst on the Lazard Multi-Asset investment team, specializing in macroeconomic forecasting and asset allocation. He began working in the investment field in 1980. Prior to joining Lazard in 2010, Tom was Managing Director and Chief Investment Officer of Wells Fargo Advisors. Previously, Tom was Managing Director and Chief Investment Strategist at Bank of America Securities LLC. Tom started his career at Morgan Stanley in 1980 in strategic planning and equity derivatives. From 1983 to 1991, he was a member of the Global Equity Derivatives department at Goldman Sachs. Tom has a BS in Operations Research from Columbia School of Engineering and Applied Science, where he is a member of the alumni association Board of Managers and VP of student relations.

John Reinsberg is Deputy Chairman of Lazard Asset Management LLC and Head of International and Global Strategies. He is also a Portfolio Manager/Analyst on the Global Equity and International Equity portfolio teams. He began working in the investment field in 1981. Prior to joining Lazard in 1992, John was Executive Vice President with General Electric Investment Corporation and Trustee of the General Electric Pension Trust. He was also previously with Jardine Matheson (Hong Kong) and Hill & Knowlton, Inc. John has an MBA from Columbia University and a BA from the University of Pennsylvania. He is an Overseer of the University of Pennsylvania School of Arts and Sciences, Chairman of the University of Pennsylvania Huntsman Program Advisory Board, a Trustee of the NPR Foundation (National Public Radio), and Vice Chairman of the NPR Foundation Investment Committee.

John Senesac is a Portfolio Manager/Analyst on the US Fixed Income team. John primarily focuses on investment opportunities in the US Fixed Income markets, specializing in Sovereign and Municipal credits. He began working in the investment field in 1992. Prior to joining Lazard in 2000, John was associated with Alliance Capital/Regent Investor Services and Trenwick America Reinsurance Corporation. John has a BS degree from Central Connecticut State University and an AAS from Briarwood College. John is a CFA® charterholder and a member of the New York Society of Security Analysts (NYSSA).



Ronald Temple, CFA, is a Managing Director and Co-Head of Multi-Asset and Head of US Equity. In this role, Ron is responsible for overseeing the firm's multi-asset and US equity strategies as well as several global equity strategies. He is also a Portfolio Manager/Analyst on various US and global equity teams. He joined Lazard in 2001 with ten years of global experience including fixed-income derivative trading, risk management, corporate finance and corporate strategy in roles at Deutsche Bank AG, Bank of America NT & SA, and Fleet Financial Group in London, New York, Singapore, San Francisco, and Boston. Ron has an MPP from Harvard University and graduated magna cum laude with a BA in Economics & Public Policy from Duke University. He is a member of the Council on Foreign Relations, the Economic Club of New York, the CFA Society New York, is the chair of Duke University's Graduate School Board of Visitors and is Co-Chair of the Duke University Talent Identification Program Advisory Board. He also served as a trustee of the Link Community School in Newark, New Jersey, from 2006–2014, as a member of the Trinity Board of Visitors at Duke University from 2006–2012 and a member of the Financial Accounting Standards Advisory Council from 2013 to 2015.

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Notes

1 Responses have been edited for clarity and length.

Important Information

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