Pricing a Blue Wave

Weekly - Regional View US

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Nobel prize-winning economist Robert Shiller first gained fame among investors when, in 2000, he published his book *Irrational Exuberance*. The timing couldn't have been better, coming out right when the dotcom bubble was bursting, offering a behavioral-based explanation for why these episodes repeatedly happen in financial markets. The book may seem like appropriate reading in a year in which tech stocks are once again reaching lofty levels.

Yet it's another book that Shiller published just last year titled *Narrative Economics* that seems more apropos for understanding recent market developments. The idea is that people learn through stories and when they go viral they can become economic and market-moving events. It's fair to say that there's no bigger story right now than the US election as it enters the home stretch.

A prevailing market narrative a few months ago was that a Blue Wave election outcome—former Vice President Joe Biden wins the presidency and the Democrats sweep Congress—would be negative for equities because it would result in higher corporate taxes and more regulation. But in the past two weeks this narrative has completely flipped, to the point where investors now view a Blue Wave as being a catalyst for a reflation trade: cyclicals and value stocks higher, a steeper yield curve, and a weaker US dollar.

What changed to cause this narrative twist fairly late in the election story? First, the inability to pass a major fiscal package prior to the election means that it's increasingly likely to be the Democrats' top priority after a Blue Wave outcome, with higher taxes being a 2022 problem for investors. Second, Biden's widening lead in the polls and prediction markets, and along with it the likelihood of a Blue Wave, is reducing election uncertainty. Investors may have initially feared a Blue Wave, but a delayed or contested election outcome is even more unsettling.

All of this helps to explain what's been happening in financial markets this month, after the probabilities of a Blue Wave (up) and a preelection fiscal deal (down) moved in opposite directions. Small-cap stocks (8%) and large-cap value (4%) are outpacing large-cap growth (1.8%), the Treasury yield curve (30y/5y) has steepened 11 basis points in two weeks, while

commodities are up 2.3% and the US dollar index is down 1.2% over that time. In short, it's the reflation trade.

These trends may not continue over the next four weeks, but they should over the next six to nine months. Equity volatility remains elevated, even as the indexes move higher on stimulus hopes. Three weeks until the election is practically an eternity in 2020 time, so additional narrative shifts are definitely possible, both before and after. Too much optimism being priced in too soon could also lead to a potentially perverse situation in which investors are disappointed if a Blue Wave doesn't happen.

Near term volatility aside, the reflation trade has more room to run, in our view. For starters, since a Blue Wave is far from certain—conservative estimates put the probability above 50%—the upside potential of more stimulus is not fully priced. But the most important catalyst for the trade has nothing to do with the election, because it's a vaccine. The good news is that data from the Phase 3 trials for three vaccines should start to arrive by early to mid-November and early indications are fairly promising. It may take until at least mid-2021 to reach herd immunity levels in the US, but financial markets will price in the economic benefits far sooner.

Appendix

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