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## US Election Brief | North America

## Three Early Lessons from a Late Night

1) 'Election week' is playing out and investors should focus on policy paths from 'divided' government; 2) Fiscal stimulus to be smaller or 'reactive'; and 3) Tax changes are unlikely. This is consistent with the divided government market paths we laid out, and shifts market focus to COVID issues.



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## 1) Amid 'Election Week', Focus on Divided Government Policy Paths

In brief:

- White House control is likely take at least another couple of days, even if Biden crosses 270 on the electoral vote count;
- Vote counts could substantiate Republicans holding Senate control as early as this week, taking a 'Blue Wave' formally off the table;
- Hence, investors should narrow their focus to policy impacts from divided government scenarios.

**A longer path to the White House:** The Democratic path to the White House appears viable, but as of this writing appears to rely on slim margins across several key states. Hence, a scenario where Former Vice President Biden (or President Trump for that matter) crosses 270 electoral votes as full counts are processed in the coming days could still be accompanied by recounts. This scenario, of course, would further extend the timeline for knowing a clear result. However, we note that it may not necessarily be the case that Biden requires Pennsylvania – one of the states where we see the most scope for litigation and legal challenges – to secure an electoral college majority.

**But amid this Presidential election uncertainty, a constructive approach for investors is to focus on the policy impacts of divided government scenarios. That's because the chances of a 'Blue Wave' appear to be waning:** While Democrats maintain a path to the White House, the path to Senate control could close this week. Current vote counts in the Maine Senate race favor Republican Susan Collins. If she continues to hold above 50% of the vote, she would avoid a subsequent count under the state's rank-choice voting system. If this occurred, the path for Democratic Senate control would be very narrow, effectively relying on winning a race in NC they are behind in as well as a runoff race in GA.

**Exhibit 1:** Current betting market odds place a divided outcome with Joe Biden as President (Blue Tide) as the most likely outcome

President Outcome		Congress Outcome	
Joe Biden	86%	D House & R Senate	85%
Donald Trump	16%	D House & D Senate	15%

Source: Bloomberg, PredictIt.org, Morgan Stanley Research; Note: Betting market probabilities for President do not sum to 100 based on the conversion of odds into implied probabilities, and reflect current markets as of 11/4 10:30AM EST.

## 2) Fiscal Policy Paths Are Smaller or More 'Reactive'

We've [frequently stated](#) that the macro impacts of the election are more about unified versus divided government composition than whether a Democrat or Republican wins the White House. **The close race for Senate control makes the plausible policy path uncertain, given that the final outcome can lead to divergent scenarios:**

**A 'Blue Wave' would have been most conducive to a large fiscal expansion:** In our view, one or both of the following would have played out: (1) Material spending initiatives (healthcare, climate, and/or infrastructure) paired with insufficient tax increases (i.e., net 10-year deficit expansion of \$1T+), and/or (2) A substantial proactive COVID-related stimulus package (i.e., \$2T+). Recall from our [framework](#) that one reliable election prior is that the laws that can be enacted are limited to those favored by consensus within the controlling party, which effectively allows legislative power to accrue to the more moderate members of the caucus. Hence, we would have expected the use of deficits to bridge the gap between these more moderate members and the progressive policy ambitions.

**But in divided government, fiscal expansion is either smaller or more 'reactive':**

- **The status quo (RRD) could clear a path to proactive stimulus, but to a lesser level than the 'Blue Wave':** If it becomes evident that Republicans will maintain control of the Senate, a stimulus package during the lame duck period is on the table. If the GOP holds the White House, Senate Republicans could de-emphasize their deficit concerns in order to support the President's demands for fiscal stimulus. Having just demonstrated his electoral power, the President may be in a position to persuade Senate Republicans in this way. That said, a fiscal package here could land more in the \$1.5T range.
- **In a 'Blue Tide' (DRD) outcome, we would not expect fiscal stimulus before challenging economic or markets data demonstrate the need for it:** We expect that Senate Republicans would hold to their concerns about further expanding spending within a recovery that they view to be self-sustaining. Hence, more stimulus would likely require demonstration of further market or economic weakness in order to deliver stimulus in 2021. Hence, fiscal stimulus becomes reactive rather than proactive, as we expect it would have been in the 'Blue Wave' or 'Thin Red Line' scenarios.

### 3) Tax Changes Are Becoming Less Likely

This is perhaps the simplest observation. Republicans firmly oppose increasing taxes. The Tax Cuts and Jobs Act (TCJA) was lauded by the party as a key achievement. It stands to reason that defending the policy would be a priority.

Hence, Democrats controlling the White House, Senate, and House of Representatives is likely a necessary condition for tax increases.

## Investment Implications

Andrew Sheets, Serena Tang

For markets, our key initial observations are as follows:

- This is one of the most *uncertain political* scenarios (uncertainty over a winner, a wait to count all the votes, potential court challenges). But it is one of the **calmest in terms of market shifts**. Scenarios with less fiscal stimulus are more likely than 24 hours ago, and that reduces the probability of larger, more extreme market rotations, rotations that we do not believe investors were positioned for.
- Indeed, our initial read is that **this uncertainty drives range-bound markets** for US equities, US yields and USD, as markets wait for greater clarity. We think that cross-asset volatility should decline modestly, as 'game-changing' policy outcomes appear off the table.
- **These results also make the COVID-19 dynamic more important:** A 'sweep' (by either party) would have raised the probability of large further stimulus, a narrative that would have made it easier for the market to look through negative near-term developments on cases or a vaccine. With these scenarios now unlikely, the negative developments in new cases, or positive developments for a vaccine, carry more importance.
- **Foreign > fiscal policy:** With a Biden win, divided congressional power could mean far more leeway to enact foreign policy than fiscal policy. Catalysts for currencies (i.e., GBP) and oil could be more significant than other asset classes.

**Exhibit 2:** Morgan Stanley price targets for end-2020 across election outcome scenarios versus latest levels – Treasuries, breakevens, US stocks and credit all see divergent outcomes depending on Senate control

	Scenarios (YE20)		Current	Exp Chg (YE20)	
	D	R		D	R
President	D/R	D/R	D/R	D/R	D/R
Fiscal Impulse	-	+		-	+
Corp Tax Rate	21%	21%	21%	21%	21%
<b>EQUITIES</b>	<b>Scenarios (YE20)</b>			<b>Exp Chg (YE20)</b>	
S&P 500	3375	3450	3,369	0%	2%
MSCI Europe	1475	1515	1,442	2%	5%
TOPIX	1500	1550	1,627	-8%	-5%
MSCI EM	950	1000	1,121	-15%	-11%
MSCI Russia	610	660	529	15%	25%
<b>GOVERNMENT BONDS</b>	<b>Scenarios (YE20)</b>			<b>Exp Chg (YE20)</b>	
UST 10yr	0.6	0.75	0.76	-16	-1
UST 30yr	1.3	1.6	1.51	-21	9
10yr B/E	1.55	1.7	1.66	-11	4
<b>FX</b>	<b>Scenarios (YE20)</b>			<b>Exp Chg (YE20)</b>	
CAD	1.32	1.33	1.32	0%	1%
EUR	1.18	1.16	1.17	1%	-1%
GBP	1.35	1.25	1.30	4%	-4%
JPY	105	106	105	0%	1%
MXN	20.5	21.75	21.1	-3%	3%
CNH	6.65	6.95	6.66	0%	4%
<b>CREDIT</b>	<b>Scenarios (YE20)</b>			<b>Exp Chg (YE20)</b>	
Agency MBS OAS	20	20	20	0	0
CDX IG	70	65	55	15	10
CDX HY	450	425	391	59	34
EM Sov Credit	425	415	413	12	2
<b>COMMODITIES</b>	<b>Scenarios (YE20)</b>			<b>Exp Chg (YE20)</b>	
WTI	40	42.5	38.6	4%	10%

Source: Bloomberg, Yield Book, Morgan Stanley Research forecasts

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	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MSC
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<b>Equal-weight/Hold</b>	<b>1462</b>	<b>43%</b>	<b>357</b>	<b>44%</b>	<b>24%</b>	<b>681</b>	<b>45%</b>
<b>Not-Rated/Hold</b>	<b>4</b>	<b>0%</b>	<b>1</b>	<b>0%</b>	<b>25%</b>	<b>3</b>	<b>0%</b>
<b>Underweight/Sell</b>	<b>539</b>	<b>16%</b>	<b>85</b>	<b>11%</b>	<b>16%</b>	<b>220</b>	<b>15%</b>
<b>TOTAL</b>	<b>3,363</b>		<b>804</b>			<b>1501</b>	

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