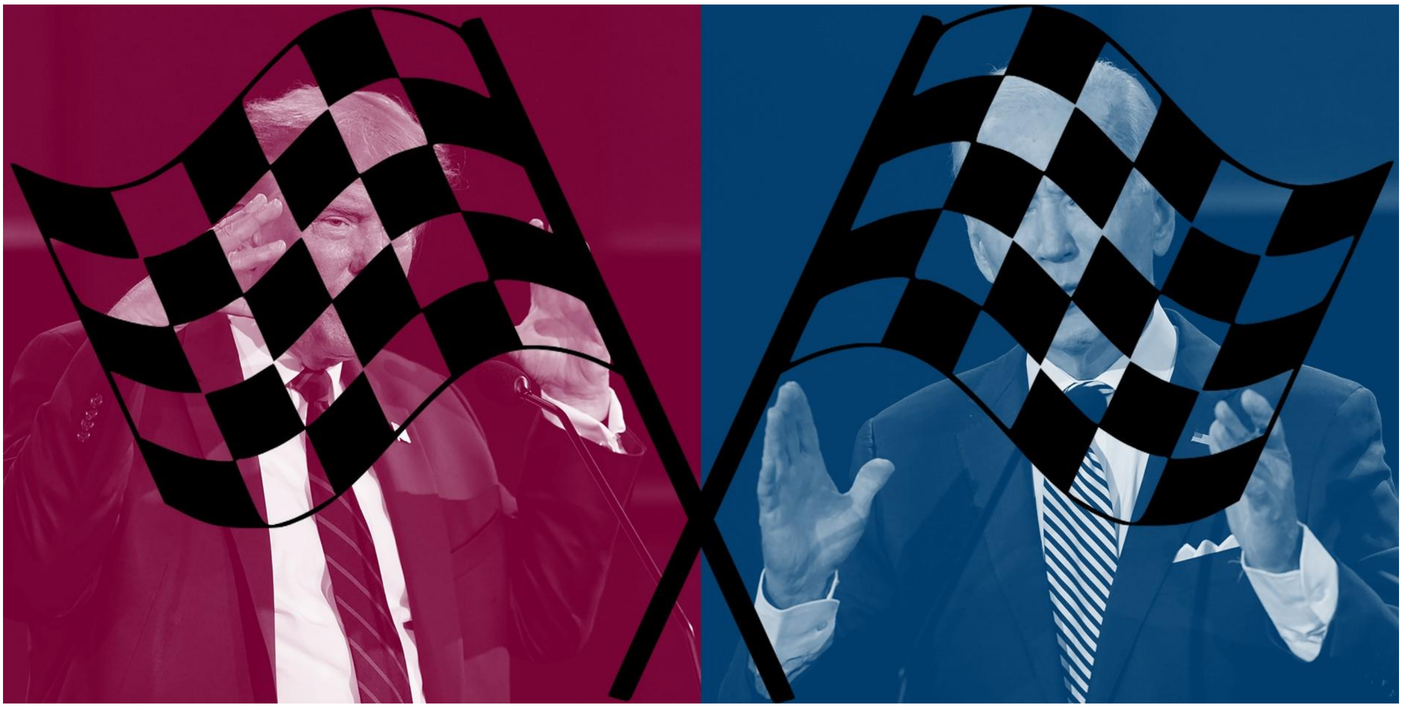
TriLake Partners
Wealth managers

The viewpoint

November 2020

And down the stretch they come

by TriLake Partners' resident electoral college dropout



This edition of our newsletter is much more serious than normal, reflecting perhaps the state of anxiety over geopolitical affairs as well as uncertainty in the capital markets. But with only a couple of days before Election Day in the US, the chances of yet another October surprise have greatly diminished and I now feel safer about writing about markets and investments again.

I have never put great stock in articles that try to divine the fortunes of capital markets from election results. Concluding whether Democrat or Republican or various combinations of control of the White House, the Senate and/or the House of Representatives are more beneficial to investors based on history seems more like a parlour game than a scientific exercise. Each election happens in its own time and circumstance. What clues can we really draw from LBJ's 1968 victory or Reagan's landslide victory over Mondale or the 2010 victories of Tea Party candidates that could inform us of the future of markets?

But I can no longer conclude like I used to back in the 1980s that party control of the executive branch ultimately is not all that great. After all, the president does not write legislation or control the purse. Sure, Carter appointed Paul Volcker whose Fed's actions have far-reaching implications to this day, but Ford could have done the same. Reagan/Bush did not tear down the Berlin Wall. And after the quadrennial November dust settled, the US capital markets just brushed the dust off its mighty shoulders and went back to business. No. This year's elections are indeed more consequential and Wall Street can no longer ignore politics.

I do not profess to know the probable results up and down the ballot. Trump pulling an inside straight in 2016 has chastened many long-time election observers and, despite the even narrower path Trump has four years hence to 270 electoral votes, nobody can count him out. Both sides have been "lawyering up" in every state in anticipation to the incumbent's legal challenges. All but a resounding Biden victory early next week points to the results getting contested as far as it can go.

As stewards of wealth, we must try to discern signal from noise and keep our focus on actionable developments. Let's take stock (pun intended) of where we are on oft-discussed matters:

The pandemic

China shows that recovery is possible. Yes, the ruling party can implement draconian policies without lengthy democratic debate but democracies like Taiwan, New Zealand and South Korea have also exhibited success. We've long been warned by scientists that the winter months will bring a spike in cases and deaths and we are now bracing for localised lockdowns in Europe to spread wider in coverage. Borders may close again. But we know more about Covid-19 than we did in during the initial wave and death rates are reduced as a result. We will likely see the first vaccine candidates submitted for approval before the year is over but public health experts warn us that mass vaccinations might start only in the second half of 2021.The politicisation of measures like mask-wearing, social distancing, even vaccination are great hindrances to controlling the virus.

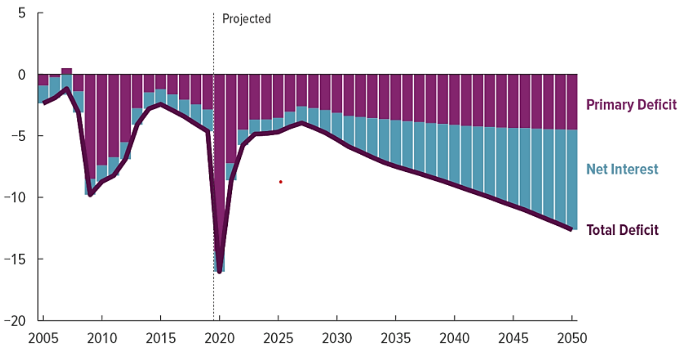
Prudence tells us not to try to ride the recovery trade in the travel and leisure sector. Airlines will recover and so will hotels and local tourism but be mindful of what the months of inactivity have done to asset quality and debt ratios, let alone future capex. We must revisit old growth assumptions and incorporate a new fragility for the sector. Healthcare systems and medical supplies may be the safer recovery play as hospitals eventually address their backlog of less urgent (but more profitable) procedures. As for biopharma, I think it's uncompensated volatility. If I told you during the market bottom in late March that Gilead Sciences' remdesivir would be a widely-used prophylaxis for Covid yet be one of the worst stocks in the S&P 500, would you have believed me? Neither would I.

US government spending

Regardless of White House control, infrastructure spending should finally get its long-delayed impetus. It's always been the kind of spending that both parties could get behind. Buthe old deficit hawks (remember them?) prevented it during the Obama years and the insistence on a border wall doomed cooperation during Trump's first term. How to pay for it with the ballooning budget deficit caused by the tax cuts and the pandemic-related spending is another matter and another newsletter (or two).

Spending priorities of a second Trump term are hard to figure since neither he nor the party elucidated any policy platform. A Trump reelection would yield a smaller fiscal aid package but strangely enough could actually mean adoption of public health safety measures(?)! Unfettered by the urgency of reelection, what would stop Trump from greater cooperation with public health authorities and supporting common-sense approaches to control the virus as vaccines are rolled out? The divisive theatre would already have served its purpose of keeping him the White House; let's now control the virus and be the hero. He's not THAT prideful, is he? Is he? Don't answer that.

Fig 1: US federal deficit as percentage of GDP



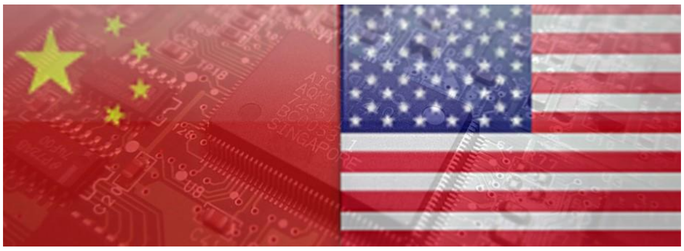
Source: US Congressional Budget Office

The fear of tax cut rollbacks by a Biden administration has subsided a little. Nobody thinks this would be a 2021 priority and a split Congress wouldn't make it easy. A Democrat-led Senate increases the likelihood of fiscal aid that includes assistance to state and local governments. The recent selloff appears to have been triggered not just by the spike in Covid cases but in the US also by the Senate Majority Leader's unwillingness to consider any discussion or compromise with the House.

A Biden victory would mean a revival of plans for the Trans-Pacific Partnership, a return to the Paris accords leading to an energy transition plan and repair of relationships with traditional allies. World perceptions of a return to "normalcy" would also benefit world trade and export-oriented countries as the Dollar Index weakens. (I hope for—but dare not dream of—a more enlightened liberal world order that is more aware of the great societal disparities wrought by Version 1. So "normalcy" is a good near-term goal.) Working with allies would be concomitant to confronting the Dilemma of the New Age: China's expanding role in world affairs.

Trade/China

The lack of a party platform other than "whatever Trump wants" means trying to predict an unpredictable second term. Certainly, Trump would continue to eschew multilateral actions in favour of bilateral negotiations where he believes he could extract maximum concessions. And as he would now have an eye on perpetuating his grip on his influence past 2024… sorry but my brain just went catatonic there. Anyway, Mexico would continue to benefit (as it has ironically during most of Trump's first term) from the cold trade war. Biden would confront the threat to its hegemony with perhaps less belligerence but with more allies in a united front.



The bifurcation of technology is a possibility. China already has its own internet; will 5G also split in two? Will China's control of rare earths like cobalt lead battery technology down different paths for supply security reasons? Will China make concessions in exchange for access to semiconductors that run, well, everything?

We may have already witnessed the peak of Pax Americana but so long as the US maintains its advantages in higher education, technological innovation, strategic alliances, the world's reserve currency and—dare I say it—a vibrant democracy, then Warren Buffett's admonition to never bet against America sounds like good advice.

Supply, demand and the central bank put

Funny how we all speak of central banks' direct and indirect support of asset prices like it's a God-given axiom. Nobody knows how and when markets could be eventually be weaned from monetary policy support but it would be the irresponsible asset manager that doesn't recognise it and invest accordingly. The Fed's explicit focus on employment doesn't mean a return to the 4-5% range over the next four years. This could mean another long period of wage stagnation. The record levels of liquidity, negative real interest rates and stock market highs are happening alongside low money velocity and spotty global recovery. Large injections of liquidity are often followed by increases in commodity prices which we've seen in precious and industrial metals. Oil however would still be stuck in the drums if it weren't for China sopping up the cheap oil in mid-2020.

Even with a safe effective vaccine that is manufactured and distributed quickly, it's hard to see inflation returning anytime soon. Consumer spending will take a few quarters to return to 2019 levels. We will also adopt other behaviours learned during the pandemic that could mean depressed demand for things like cinemas, business travel, retail, urban real estate. And technology and demographics are inexorable deflationary forces.

Of course, technology could also spur demand over time: Witness the change in household spending over the last twenty years due in large part to technological change. The continuing emergence of the middle class in China, India and the underperforming ASEAN countries could also be another bright spot of demand.

Much of this has nothing to do with US politics and that may be the point of greatest comfort. The dysfunctional discourse in America is riveting, ghastly theatre and yet the capital markets learn and adapt. As investors, we must also adapt. It took a while for many of us to finally admit that we cannot separate politics and portfolios as we used to do for years. So long as we recognise our biases and surround ourselves with different points of view, we can allocate capital to optimise our portfolios' risk/return profiles without getting lost in the political noise.