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US ELECTION SPECIAL: Interview with Jeffrey Sherman, Deputy CIO at DoubleLine Capital LP, and Steven Friedman, Senior Macro Economist at MacKay Shields LLC

Please note the conference call occurred on the 14th of October 2020. All market commentary and information refer to the period before then.

Key takeaways

- A 'blue wave' victory for the Democrats could result in more coordinated policies. Should Trump win, the Republicans are unlikely to control both houses of Congress, so a continuation of the current standoff is likely.
- Irrespective of the election victor, there is going to be more fiscal spending. The trillion-dollar question is whether it will create inflation and lead to higher interest rates.
- There is significant coordination currently between fiscal and monetary authorities – which means less of the debt burden is being borne by the public.
- While the election is of great interest and will tell us a lot about fiscal policy in the years ahead, it is always a risky game to try and position portfolios in expectation of a certain result.

What are your views on the current economic policies of President Donald Trump and the challenger Joe Biden?

Jeff: While we have seen a number of fiscal policies discussed, what we really need is increased cooperation within the two chambers of Congress. There needs to be agreement between the Republicans and Democrats, which was what we saw around the $2.2trn worth of fiscal spending with the CARES Act back in March. If we see a 'blue wave', with the Democrats dominating all three chambers – the Presidency, the Senate and the House – there could be a more coordinated effort to push through policy. A landslide victory in either direction is what the market is looking for, just so we do not have further massive uncertainty in the coming months.

Steven: I agree. If Trump makes a comeback and wins the election, it is unlikely the Republicans would control both houses of Congress – so we could see a continuation of the current standoff we have in DC. Therefore, I would be less confident in having enough fiscal support for the economy as it tries to recover from the Covid-19 crisis. If Biden wins and there is the 'blue wave', this would open the door to near-term support for the economy. Biden also has some fairly expansionary fiscal plans in mind, which could provide a longer-term boost to the economy.

You mentioned the Democrat clean sweep, which is being referred to as the 'blue wave' – what would this mean for investors?

Jeff: A 'blue wave' would likely result in corporate profitability being impaired a little, simply due to the tax hike. However, both parties are spenders. The notion Democrats are the spending party and Republicans are ultra-fiscal conservatives was blown out of the water by the Tax Cuts and Jobs Act a couple years ago. There is going to be more spending, irrespective of the leadership. The Trump administration has been free flowing with money and stimulus is all the talk in town – so I do not see anything changing there if he is re-elected. The trillion-dollar question is whether this would create some form of inflation leading to higher interest rates. But that is to be seen, as we are in a deflationary shock right now. Ultimately, regardless of the winner, we are going to see significantly higher burdens of debt.

Steven: Again, I agree with Jeff – both of the candidates are spenders. We saw higher deficits under Trump, and we would likely see higher deficits under Biden. Biden has big spending initiatives, which will not be offset by tax increases, so deficits would have to go up. He does have some decent ideas around infrastructure and education, which can boost growth over time. Trump may be a fan of expansionary fiscal policy, but if he wins and does not have control of Congress, I see limited prospects for significant spending legislation over the next two years. He would probably focus on areas like immigration and trade policy – where he has some independence from Congress.

Speaking of infrastructure, is this likely to be a key beneficiary of the spending?

Jeff: Infrastructure has been the talk of the town since the 2016 election. Both parties heavily participated in discussions, but we never saw any action from President Trump – most of the spending was focused on corporate tax cuts. I think we would see more public infrastructure plans under the Democrats, but it is way too early to tell.

You both mentioned escalating deficits, should this growing mountain of debt worry investors?

Jeff: We are seeing how far the limits can be pushed. US debt has finally exceeded 100% of GDP and spending is going to continue, but there must be a pressure valve. Typically, this comes through inflation or currency. If we are going to undertake spending, it needs to be focused on the people who are currently displaced – through job creation, education or skills training. Infrastructure seems obvious – as it is capital intensive and will utilise quality labour – as well as typically providing a strong money multiplier.


Source: Flickr – The White House

Steven: The Federal Reserve has essentially absorbed the debt necessary to finance the CARES Act, and it will also absorb what is necessary for a similarly sized follow-up. We are in an environment where there is significant coordination between fiscal and monetary authorities – which means less of the debt burden is being borne by the public. It remains to be seen how this impacts markets, but as mentioned, the currency markets could be the eventual release valve, as well as higher rates.

Jeff: Steven nailed it there. Chair Powell keeps saying it is 'fiscal, fiscal, fiscal'. He is essentially saying, 'you print the money and I will buy it'. So, debt monetisation looks very likely.

Trump has been vocal about the Fed; would a Biden win change the current dynamic?

Steven: Despite Trump's criticism of the Fed, the Fed did a remarkable job maintaining its independence. The increased fiscal and monetary coordination, which Jeff and I have spoken about, was the Fed's choice – not the result of pressure from the Trump administration. The Fed acted aggressively in response to the crisis, so this would limit the amount of criticism from a Biden administration. In addition, the Fed framework change to encourage inflation above 2%, in exchange for stronger labour market outcomes, is the right thing to do in this environment. It is also politically savvy, as it is this type of strategy Democrats can get behind.

Finally, do you have any portfolio positioning advice in relation to the election?

Jeff: You should not position your portfolio for one election direction – given the surprise of the last outcome. Looking forward, the challenges for the bond market do not stem from the election but from the amount of yields on offer today. There are some pockets of the market that simply do not offer a lot of value for current levels of risk. If we have a supply of bonds in excess of what the Fed can buy, this could easily put pressure on interest rates – from a supply-demand perspective. Secondly, if you get weakness in the dollar, this could discourage some investment in the US. There are a lot of scenarios I can paint – irrespective of the election – where interest rates go higher from here. As Steven pointed out, the Fed is willing to let inflation run a little bit hotter than normal. The bond market has noticed this and the curve is steep. Therefore, you want to focus on areas the Fed is not directly affecting – so not treasuries or investment grade corporate bonds. There are opportunities in the leveraged finance sector, but you have to be careful. There are also opportunities forthcoming within the mortgage market, due to forbearance. Some impaired credits will ultimately lead to opportunities in the next year or so.


Source: Flickr – Biden for President

Steven: This is right. While the election is of great interest and will tell us a lot about fiscal policy in the years ahead, at the end of the day, we continue to have an extremely supportive monetary policy stance. At the very least, we do not have to worry about fiscal contraction, and this support for the economy will be sufficient moving forward. As for the virus, hopefully by this time next year we will be talking about a widely distributed and effective vaccine. So, this is an environment where we see expansion taking hold, in which you need to be adding risk back into portfolios. To Jeff's point, we also need to distinguish between the assets the Fed is essentially adopting and those it has orphaned. The opportunities are in the orphaned areas – such as high yield, subordinated ABS and emerging market debt.