

Global market implications of the US elections

Uncertain results continue to weigh on sentiment but we see a Biden presidency and a divided Congress, our central scenario, as a constructive outcome for risk markets. Chances of more fiscal support have ebbed, as has the risk of a sharp adjustment higher in rates. The threat to rate-sensitive sectors has, therefore, diminished



A trader at the German stock exchange on Wednesday

US election upshot: Gridlock in Washington

With votes still being counted (and potentially recounted) in a number of states, the result of the US presidential election is still undecided. Our expectation is that Biden has a solid chance of winning more electoral college votes than Trump, but official results might still have to wait until tomorrow, or potentially longer due to the increasing risk of recounts and legal challenges. Meanwhile, Republicans look set to keep control of the Senate, and Democrats of the house (with a smaller majority than previously). In short, Congress will in all likelihood remain divided for another two years. This amounts to a major upset to hopes of substantial near term fiscal support.

This amounts to a major upset to hopes of substantial near term

fiscal support

Even if or when a Biden victory is confirmed, this amounts to a major upset to hopes of a Democrat sweep, and to hopes of substantial near term fiscal support. We expect there is still room for a fiscal deal of around \$1tn at the beginning of 2021, a far cry from House Democrats' \$3.4tn proposal, but protracted legal battles over the election result will chip away at already meagre bi-partisan goodwill. If this scenario unfolds then other pieces of the Democrat agenda are up in the air. We suspect the bar is high to implement tax hikes with a republican senate, so is the risk is for a structurally wider fiscal deficit.

Rates view: Goodbye blue wave

We believe that the election is easier to interpret for rates than for other markets. Yes a Biden or Trump presidency would have different implications for trade and other policy areas but the receding odds of substantial fiscal support far outweighs other factors. In short, the pre-election reflation trade appears to be dead. We had seen flows into government bonds in recent weeks that had broadly gone unnoticed as yields pushed higher. More such inflows are probable should uncertainty build in the weeks ahead.

In the near-term, we expect legal manoeuvres around the election result to further depress stimulus hopes. We believe that a test of 0.50% would be excessive given the resilience of the US economy and the prospect of a vaccine in 2021 but 10Y yields around 0.75% look elevated to us. The 60-65bp area for the 10Y has been a natural place to settle during times of reflection in recent months. This should put further flattening pressure on USD 2s10s, a clear reflation trade indicator. 10s30s on the other hand should remain steep.

0.55-0.75% 10Y US treasuries

Back to the pre-election range

Beyond that, we maintain a view that a 1-handle for the 10Y US is on the cards for 2021 but, clearly, the upside risks have greatly diminished after this week's election. In the absence of a step-change in fiscal policy, we see no reason for markets to question the current path of Fed policy, pricing only muted chances of a hike in 2023. With the front end of the US curve static and the eurozone going nowhere fast, this translates into tactical flattening and a tighter Treasury-Bund spread, but the bigger structural move will be the other way, in 2021.

FX: Weak USD outlook unchanged

Looking through the short-term uncertainty associated with the contested outcome (though markets now appear to consider an eventual Biden victory as a likely outcome), the scenario of a Biden presidency and republican senate still points to a weaker USD outlook and a constructive view on cyclical FX, mainly for 2021 once we're through the tough winter months.

This is because

- the US fiscal stimulus, albeit smaller, should be nonetheless delivered;
- the low likelihood for material tax hikes (vs the "blue wave") should be positive for US equities (and thus, by extension, support risk currencies);
- there is likely to be an end to unpredictable trade wars and a return to a rules-based system for international relations, being more beneficial for higher beta FX vs safe havens; and
- the Fed should remain behind the curve (given its new average-inflation targeting framework) leading to low or lower US real rates

Granted, the scope for gains in cyclical FX and a more pronounced USD sell-off is now more limited than in any "blue wave" scenario, given the anticipated less aggressive US fiscal stimulus. But the scope for gains is there nonetheless, and in fact, points to a more balanced outlook across various asset classes.

For EM investors, the lower upside potential in EM currencies (vs the "blue wave") is likely to be in part offset by the lower downside potential to local bonds, with local currency bonds (mainly long-end) likely to do better now vs the "blue wave" scenario, given the more limited scope for higher long-end UST yields. This should be particularly the case for low yielders, be it CEE or EM Asia.

Timing-wise, the upside to cyclical FX (in both the G10 and EM worlds) should be more pronounced next year rather than in coming months, particularly given uncertainty about the global economic outlook over the winter months (including the wave of restrictions in the eurozone, rising Covid cases in the US and lower odds of larger frontloaded US fiscal stimulus).

EUR/USD should head towards 1.25 next year

The soft USD outlook for 2021 is therefore unchanged - EUR/USD should head towards 1.25 next year and weaker dollar dynamics should lift beta currencies in the G10 space and help EM FX. GBP (mainly vs EUR) should remain more insulated from global factors and the US election outcome, with the outcome of UK-EU trade negotiations being the key driver for sterling over the coming weeks

Credit: Tighter spreads on the back of potential election outcomes likely to be short-lived

Spread tightening was seen in both Euro and USD yesterday. Euro corporates pencilled in a 1bp tightening and financials a 2bp tightening. USD outperformed with a 3-4bp tightening across the board. Of course, it may still take some time to finalise the election results, whereby we might see a continuation of performing but volatile spread developments.

However, in the long run, USD spread underperformance vs Euro will remain the dominant trend, on lower stimulus and later on possible detrimental effects from a constrained presidency.

At the same time, we expect Euro spreads to tighten from here for the rest of the year. USD credit spread curves should see further steepening, which will open more cost-saving advantages for US

companies issuing in Euro, namely in longer-dated issues.

EM sovereign credit: A supportive middle ground with more upside for higher yielding credits

Among the possible scenarios, a Biden win and a divided Congress are shaping up as a supportive middle-ground for EM sovereign credit. This has the potential to cement the strong performance we have seen in 2020 despite the pandemic (+1.0% YTD for JPM EMBI Global Diversified).

On the one hand, the prospects of lower fiscal stimulus and a Fed that remains open to more easing if needed will keep a lid on underlying core rates and should contain any Treasury curve steepening. From a total returns perspective, this means that a more damaging "blue wave" reflation scenario can be avoided for EM investment-grade sovereigns, given their higher rates sensitivity (OAS+136bp, with a modified duration of 10 years based on Bloomberg Barclays indices).

Credit selection remains key

On the other hand, this scenario could mean an end to erratic trade policies going forward which favours EM risk assets. The modest optimism (on a combination of some fiscal stimulus and a return to a rules-based trading system) should favour higher-yielding EM risk assets, given their large credit component (OAS+653bp with a modified duration of 7.1 years). Notwithstanding, credit selection will remain key as the pandemic has seen fiscal balance sheets being stretched and debt sustainability to remain a key concern in years to come.

In the aftermath of the US elections, EM credit has seen a strong rally across the board as many investors had remained on the sidelines ahead of the US elections and with hopes of a clearer election result rising. In line with the thinking above, higher-yielding credits have performed better (-13bp and -10bp for 5yr CDS of South Africa and Brazil, respectively). Volatility might persist in the near-term should there be a legal battle.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.