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US Election Implications: What it means for Emerging Markets

The main event over the past few weeks is obviously the result of the US Presidential Election. The Democrat nominee, Joe Biden, defeating Donald Trump (only the 5th time in the past 100 years that a sitting US president has lost the election). Below we provide some initial thoughts on what this outcome means for Emerging Markets.

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This article has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

With the election (effectively a referendum on the divisive Trump presidency) voter engagement has been extremely high. In fact, turnout in the 2020 presidential election hit a 50-year high, exceeding the record set by the 2008 presidential election of Barack Obama. The tallied votes five days after the election accounted for 62% of the eligible voting-age population in the US a 0.4 percentage point increase so far over the rate hit in 2008.

The sheer number of votes also set records, although that is a less remarkable milestone given the country's growing population. So far 148 million votes have been tallied, with Democrat Joe Biden winning more than 75 million — the highest number for a presidential candidate in history. Trump received more than 70 million — the highest total for a losing candidate as well.

Despite Trump losing the election the expected "blue wave" of democratic voters did not materialise. The consensus of major national polls tracked by the political analyst FiveThirtyEight gave Biden a national 8.4 percentage point leading into the election. Whereas Biden won the national popular vote by a far smaller 3.5 percentage points (with some votes yet to be counted this will end up being slightly higher). The 2020 election polls were as misleading as they were in 2016.

A significant issue for pollsters appears to be voters growing unwillingness to take unsolicited calls on their mobile phones. The Pew Research Centre reports that its polling response rates have plummeted from 36 per cent two decades ago to just 6 per cent now. With such a small response rate it is no surprise that the polls missed the large swing to Trump by Latinos in Florida, and heavily overestimated how many white voters with no college degrees had reconsidered their vote for Donald Trump.

The end result being far closer than expected, Republican losses in both the US House of Representatives and the US Senate have been much lower than feared.

Whilst the Democrats have retained control of the House of Representatives, Republicans will retain control of the US Senate, subject to the outcome of two run-off elections in Georgia on January 5th.

The Democrats need to win both of these runoffs in Georgia to take control of both houses of Congress. This looks unlikely given the relatively strong showing by the Republican Georgian senate candidates on November 5t, but is still possible.

Given this political landscape in the US we can make some broad observations on what we see as the likely impact this will have on EM countries.

Multilateral Foreign Policy to Replace Trump's "America First" Approach

Donald Trump's "America First" foreign policy is likely to see a quick reversal as Joe Biden looks to re-engage with many international multilateral institutions. For example, Biden has announced he will re-join the Paris Agreement and the World Health Organisation on the first day of his presidency as well as re-engage with NATO.

Biden has also signalled that he will look to strengthen the US State Department to allow a more diplomatic approach to international relations as opposed to the transactional approach of Trump (i.e. "contribute more to defence or I will remove US troops from Europe"). This more stable, forward looking approach is likely to see the US engage in areas of the world where its influence has been in retreat over the past 4 years.

This power vacuum has often been filled by China through its "Belt and Road" development program in many emerging and frontier countries. For countries in Latam, Africa and Asia this is likely to be a positive as they benefit from the increased competition between the US and China to gain their favour. This may imply a lift in financial, trade and investment support in some form by the US, especially relative to what it would be under a Trump presidency.

Specifically, in the domain of trade, the US president has significant power to enact policy without the need for Congressional approval. Biden's stated trade policy is not actually that different from what we saw from Trump.

However, it is highly likely a Biden administration will be more predictable and look to work in conjunction with European and Asian allies on trade after Trump's abrupt shifts and tariff threats to both friends and foes alike. This more stable environment could lead to a significant boost for investment in tradable goods.

Biden's key focus in trade will be the relationship with China. Key agenda items include curbing China's massive subsidies to state-controlled firms, ending policies that force U.S. companies to transfer technology to Chinese counterparts, and opening its digital services markets to US tech firms (another big Biden donor constituency). The US trade relationship with China is likely to be further complicated by a greater focus on human rights by the Biden Administration highlighted by Joe Biden stating on the campaign trail, "this is a guy who is a thug," when asked about President Xi. US concerns over human rights issues such as the treatment of the Uighur population in Western China is likely to sour relations with China further.

Joe Biden has not stated whether he will roll back his predecessor's tariffs on imported steel, aluminium, and Chinese goods. All in all, Joe Biden presidency is likely to accelerate the move of global manufacturing out of China and into other countries benefiting EMs such as Mexico, Malaysia and even potentially India.

The US economic recovery is likely to be slow over the next 12 months. COVID-19 has left the US economy in a depressed state, consensus forecasts have the US economy contracting -3.9% in 2020, before growing +3.8% in 2021. This 2021 forecast was, however, generated prior to the recent acceleration in COVID-19 cases seen during October and November. Meanwhile, around 13 million US consumers reach a financial cliff in December when federal pandemic unemployment benefits expire, further dampening consumer spending. The next few months therefore looks bleak for the US economy, with little policymakers can do before the inauguration of Joe Biden on the 20th of January 2021.

If however, as we suspect they will, Republicans are able to take control of the US Senate (by winning at least one of the runoff elections in Georgia) this will have a major impact on Biden's ability to enact his stated policy agenda, as well as the ability of congress to pass a COVID stimulus bill early in the new year.

The difficulty the US Congress will have in negotiating a meaningful stimulus package is well demonstrated by the negotiations between the Treasury Secretary Steve Mnuchin and the Democrat leadership (Nancy Pelosi) prior to the Presidential election. These negotiations broke down when a group of "small government" Republican Senators balked at the proposed US$1.8 trillion White House stimulus.

Without the consent of these Republican Senators (who would be required to pass any bill), Pelosi walked away from negotiations as the Democrats had already shaved $1.2 trillion from their original $3.4 trillion stimulus bill.

The political situation is now potentially worse than it was prior to the election, making a stimulus package harder to pass. With a Democrat President, Republicans are likely to take an even harder stance in negotiations over a potential stimulus package. Congressional Democrats will also come under increasing pressure to do a deal. Biden is likely to be blamed for the failure of government to enact any stimulus at all. The most likely outcome is therefore a stimulus not large enough to make a significant dent in the economic fallout of the COVID-19 pandemic in 2021. Remember we have 13m Americans about to lose their government support in December!

With the US reaching 130,000 COVID-19 cases per day up 64% in the past 2 weeks, our view US is consumers are more likely to bunker down given the risks of contracting COVID-19 as we enter 2021. The dampening effect this will have on the economy and consumer spending over the next 12 months may well be underestimated. In this environment without a significant stimulus the US economy is likely to stay very recessed until a vaccine is widely available. As we have written in previous newsletters, we do not see this until late 2021 at the earliest.

Long Term Reforms Unlikely to Pass

Striking a stimulus deal was only one part of Biden's pandemic recovery plan. Of bigger importance was his massive infrastructure plan called Build Back Better which planned to spend over $7 trillion (nearly 35% of US GDP!) on initiatives such as the creation of 10 million clean-energy jobs, and on housing, education, economic fairness and health care. If the Republicans win in Georgia this proposal could be dead in the water, unless some Republican senators cross the floor. This is not impossible as we note (at the time of writing) seven high profile Republican senators have already publicly endorsed Biden as the winner – breaking ranks from rest of Senate majority.

The other major reform Biden was proposing was tax reform, winding back Trump's tax cuts and going further. Biden was proposing to increase the corporate rate from 21% to 28% and well as increase taxes on individuals earning $400,000 or more, estate tax exemptions would also be reduced. Biden planned to use this additional tax revenue to pay for student loan relief, increase tax credits for dependent children as well as first home buyers.

Again, these proposals are unlikely to be implemented if the Republicans retain a tight voting control the Senate – with virtually no defections.

The impact of these reforms would have been to redistribute money to people with a greater propensity to spend (students, low-income parents and first homeowners) as well as to stimulate the housing market. These measures had long term implications for spending.

Without the spending on infrastructure and the proposed tax reform the US risks being stuck with an economy over the medium term with high savings, anemic consumer spending, insufficient investment opportunities and low growth (notwithstanding an initial economic recovery post-Covid). This is the definition of secular stagnation. As a large driver of global growth such a situation in the US would impact the growth outlook for all regions including Emerging Markets. Countries reliant on US growth and trade would be particularly impacted.

What the Election Means for the Warakirri Global Emerging Markets Fund

How does the outcome of the US election impact the way we think about the current positioning in our portfolio? We think there are three key takeaways from the US election.

First, the election result has reconfirmed our view that being underweight China remains an appropriate position. China's continued development requires it to redirect its centralised investment led economy to more of a consumer and technology led economy.

Observing the Biden campaign, we see no reason to expect a reversal in the current trend towards America making it harder for China to access US technology and markets. This will make China's economic transition harder. We think Chinese growth going forward is likely to slow, for us the US election doesn't change this dynamic.

Second, given the muted outlook for growth in the US (and China) investing in companies with their own structural growth drivers, not reliant on underlying economic conditions, we believe, continues to make sense.

We continue to believe that our investment process which identifies such stocks with long term growth prospects at reasonable prices will add value for our clients' wealth. The likely ongoing political paralysis in Washington over the next two years only strengthens our view that this is the correct strategy.

Third, the runoff elections for the two Georgian Senate seats remain hugely important for the US growth outlook over the next few years. We continue to believe that the Republican's remain in the box seat to win at least one of these seats, but if we are wrong and the Democrats take control of the US senate the US economy could experience significant stimulus over the next few years.

As previously highlighted a proposed US$7 trillion infrastructure plan is hinging on the outcome of these runoff elections, as well as a significant short-term pandemic stimulus plan. If both of these are enacted it could fundamentally change the outlook for US growth, long term rates and corporate tax rates in the US. This in turn would have a material impact on equity markets, including the relative attractiveness of different sectors and countries. We are therefore keeping a close eye on the result of these Senate runoff elections on January 5th.

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