SKY HARBOR
CAPITAL MANAGEMENT

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Weekly Briefing

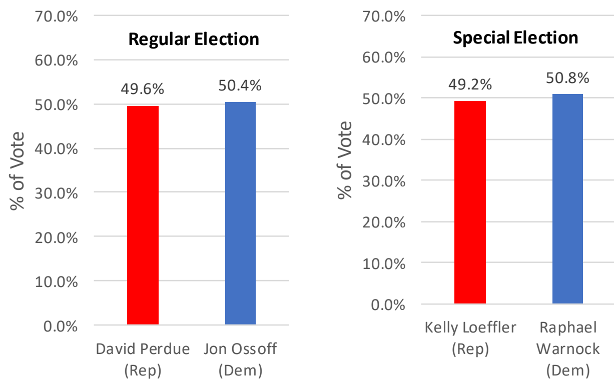
SKYView: Georgia Goes Blue

With nearly all votes now counted, what had been thought unlikely in early November – Democrats winning both Senate seats up for grabs in Georgia's run-off elections – has come to fruition. By only the narrowest of margins, control of the upper chamber of Congress now resides with the Democrats, and with it follows a range of new US fiscal policy implications. In this *Weekly Briefing*, we examine the consequences of a "blue wave" with a focus on the impact to risk assets as we begin 2021.

At the time of publication (98% of votes counted), major news outlets had called both Georgia run-off elections in favor of the Democrats. As a result, the US Senate is now split 50/50 between Republicans and Democrats, the latter group including two Independent Senators (Bernie Sanders of Vermont and Angus King of Maine) who caucus with the Democratic Party. As a tie-breaking vote will go to Vice-President-Elect Kamala Harris, Democrats now add a small majority in the Senate to the majority they already held within the House of Representatives.

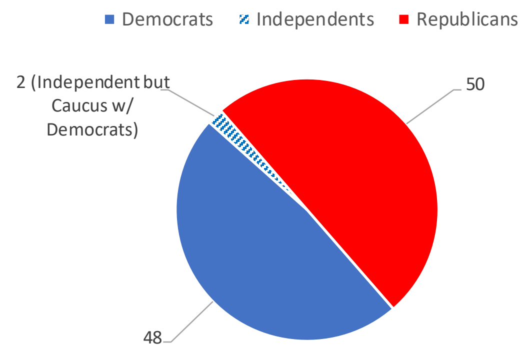
Democrats Sweep Georgia Run-Off Elections

data as of Jan 7, 98% reporting



Senate Split 50/50; VP-Elect Will Act As Tie-Breaker

Vice-President-Elect Kamala Harris gives Democrats slim control of Senate

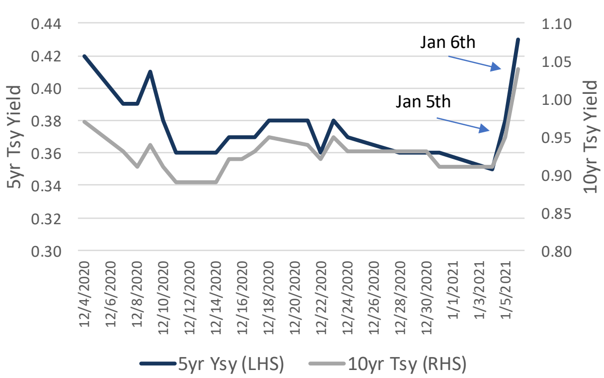


Source: SKY Harbor, The Associated Press

Risk assets in general rallied on the back of election results, as investors have become increasingly optimistic that growth can surprise to the upside through additional stimulus measures now likely to be pushed through by Congressional Democrats. Consistent with these heightened growth expectations and the associated upward pressure on inflation (both a result of optimism for a new $500bn to $1.5tn fiscal stimulus package), US Treasury yields have been on the rise (10yr Tsy yields increased 9 bps on Wednesday alone). In a piece published by JP Morgan[1], analysts found that 10-year yields tend to rise by 15-20 bps for each 1% increase in consensus growth expectations, leaving open the possibility of even higher rates in the near to intermediate term as economists re-set expectations.

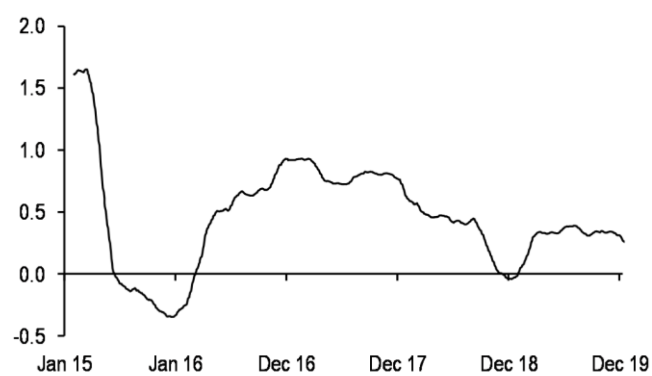
Treasury Yields Jumped on Election Outcome

daily data



Treasury Yields Sensitive to Growth Expectations

rolling 2yr beta of 10yr Tsy yields with respect to 1yr ahead growth forecasts*



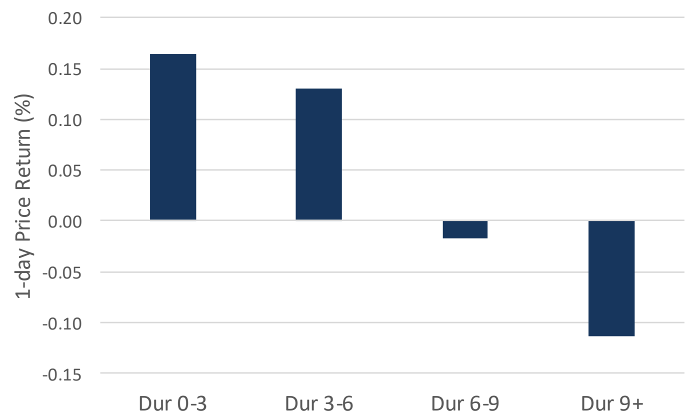
* after adjusting for 3m3m OIS rates (%), 5yX5y inflation swap rates (%) and Fed forward guidance (months)
Source: SKY Harbor, JP Morgan, BlueChip, Bloomberg, ICE Data Indices

The rapid move in rates only partially offset an otherwise upbeat tone in high yield markets, particularly as the notion that additional stimulus spending might be directed toward smaller businesses increasingly gained traction. Nevertheless, rate risk had an impact on performance, with higher duration

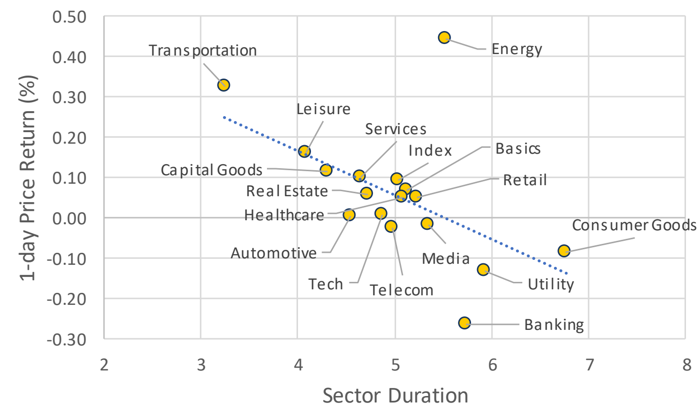
[1] https://markets.jpmorgan.com/#research.article_page&action=open&doc=GPS-3567936-0

buckets lagging from a price return perspective. The pattern was also noticeable on a sector basis, as those with above-average duration (Banking, Utility, Consumer Goods) had weaker price returns than their below-average cohorts (Transportation, Leisure, Capital Goods).

Treasury Moves Led to Long Duration Underperformance
January 6, 2020



Duration Appears to Have Impacted Sector Performance As Well
January 6, 2020

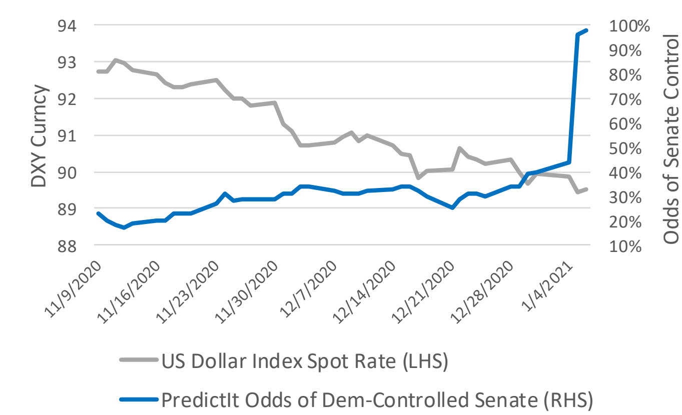


Source: SKY Harbor, ICE Data Indices

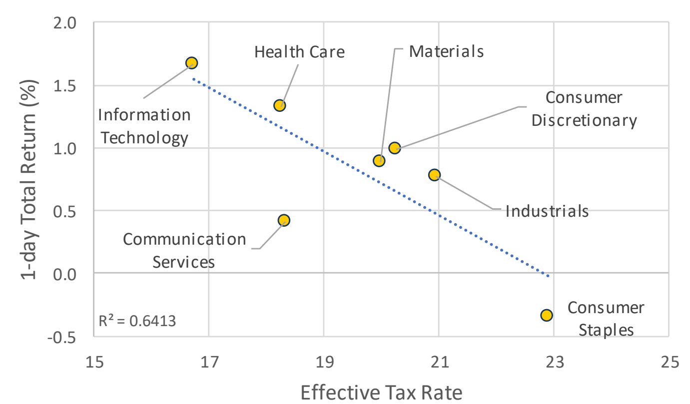
Within the Senate, most legislation requires 60 votes for passage, necessitating bipartisan support given only the slimmest majority held by Democrats. Therefore, Democrats will likely need to focus on agenda items that moderate Republicans are likely to back (such as infrastructure spending), while others (minimum wage hikes, overhauling immigration laws, etc.) appear unlikely before the next round of midterm elections. Importantly for the Biden Administration, key powers requiring a simple majority (such as confirming federal judges) are now in play, and Democrats may be able to pass additional economic relief (including the recently defeated plan for $2,000 stimulus checks for Americans, or expansion of Obamacare) through the reconciliation process. Ultimately, Georgia's run-off results have opened several new avenues by which fiscal policy can be expanded in 2021. Such expansion, however, needs to be funded.

While campaigning in 2020, Biden outlined several tax policies that external groups estimated would generate in excess of $3tn of revenue for the US government over the next decade. A 50/50 Senate, however, likely means such proposals will need to be scaled back to gain traction. Even so, taxes on corporations and high-earning Americans will almost certainly have to rise in order to at least partially finance additional stimulus measures, even if by less than Biden originally proposed. Based on market reactions thus far, investors appear to believe higher taxes for enhanced economic growth is a valid trade, at least for now, as both equity and high yield indices have generated strong total returns since the special elections. Meanwhile, the US dollar has continued to depreciate given the likelihood of rising budget deficits (good for many exporters and those with top line growth driven by commodity prices quoted in USD), and higher tax paying sectors have demonstrated less robust equity returns given the risk of Trump-era tax cut reversals.

US Dollar Has Weakened As Dem Victory Got More Likely
daily data since November '20



S&P 500 Sector Returns* (ex Energy & Financials) vs. Tax Rates
January 6, 2020



*average tax rates and total returns calculated on an equal-weighted basis after excluding outliers
Source: SKY Harbor, Bloomberg, Predict It.org, Capital IQ

In conclusion, a Democratic Sweep has increased the likelihood of further fiscal stimulus in the US, which in turn is likely to drive economic growth higher than initially anticipated under a divided government. This additional growth, however, is likely to put upward pressure on rates, and will likely be paid for with higher taxes or increased deficit spending (perhaps both). Despite the sweep, concerns stemming from a major overhaul of tax and regulatory policy may be misplaced, as some level of bipartisan support will likely be necessary given only the slimmest Democratic majority in the Senate. On balance, the Georgia election results have not materially altered our view on high yield markets over the intermediate term, though on the margin we anticipate some sector and risk positioning changes. In the very near term, however, somewhat diminished are the underlying risks of a slow / delayed recovery via implicit fiscal support.

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