SKY HARBOR
CAPITAL MANAGEMENT

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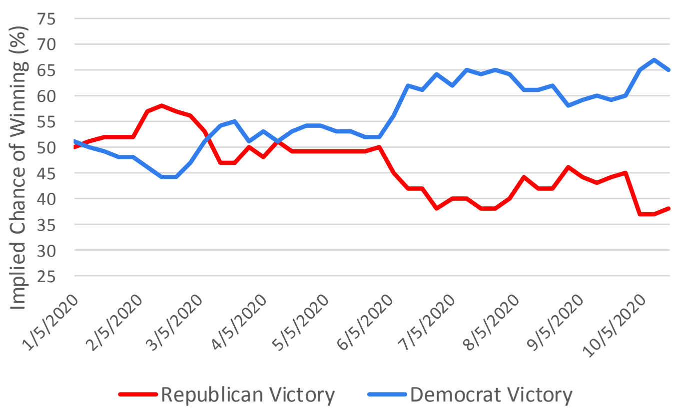
Weekly Briefing

SKYView: Implications of a Democrat Sweep

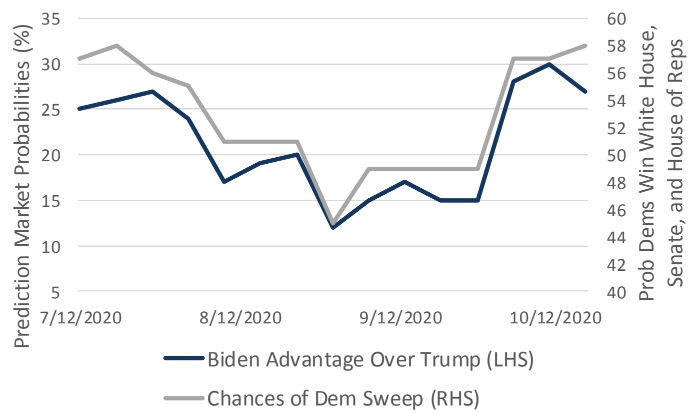
With just over a week to go before US elections, investors have focused on what various outcomes may mean for risk assets. While the Presidential race between Trump and Biden has garnered the most attention, control of Congress may actually be most meaningful when it comes to policy-making in the coming years. In this *Weekly Briefing*, we examine the implications of the Presidential race, and contemplate what a Democratic sweep (Biden winning the Presidency and the Democrats gaining a majority in the Senate while maintaining their position in the House of Representatives) may mean for stimulus spending, taxes, and sector risk premiums.

According to data from PredictIt.org, betting market odds of Biden winning the Presidency stand at ~ 65% at the time of writing, his lead over Trump having expanded since near parity in early June. At the same time, chances of Democrats taking control of the White House and Senate (and keeping control of the House) have also been on the rise, an outcome (Democrat Sweep) that could make the passage of legislation considerably easier across a multitude of party priorities. Whereas some sort of follow-on stimulus program is likely to materialize in the coming months regardless of the outcome of the election, a Democrat Sweep – particularly if it results in a more significant majority in the Senate – could bring about a larger package as well as increased infrastructure spending, in our view.

Biden Probability of Victory Has Increased
weekly data, since January '20



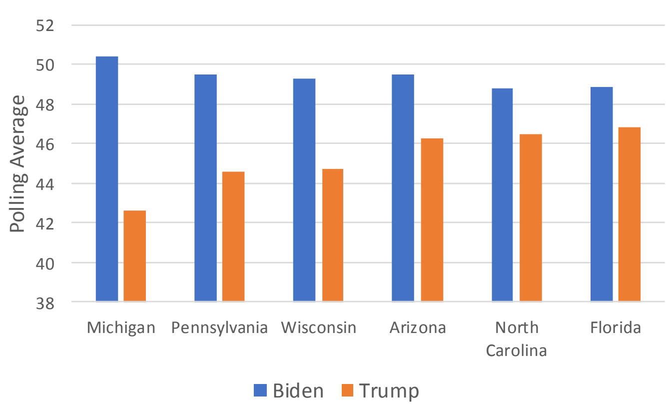
Chances of Democrat Sweep Also Rising
weekly data, since July '20



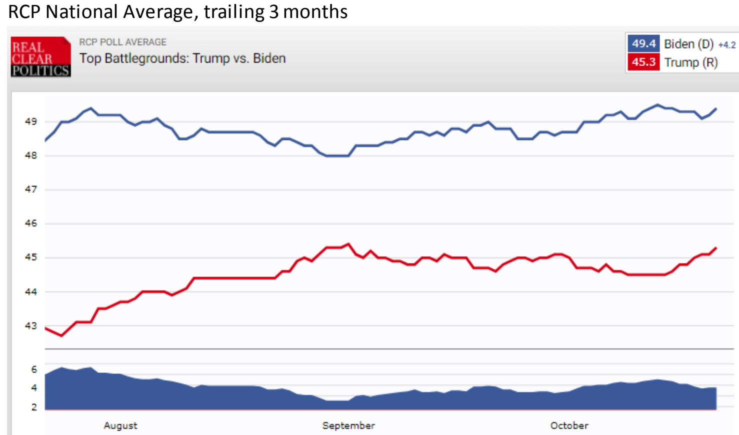
Source: SKY Harbor, PredictIt, Bloomberg

By virtue of the electoral college system, the outcome of the Presidential election may ultimately come down to results in a handful of "battleground" states. Similar to the trajectory of nation-wide prediction markets, polling in most of these contested states (presented below) have also moved in favor of the Democratic nominee. With an estimated advantage of between +2.1% (Florida) and +7.8% (Michigan), Biden's average "battleground" lead over Trump of +4.2% compares favorably to Clinton's advantage over Trump (+3.8%) in the same states during the lead-up to the 2016 election. Statistical models, though presumably improved upon since 2016, still imply a reasonably competitive race given past margin of error.

Biden Leading in All 6 Battleground States
RCP National Average



Battleground State Average
RCP National Average, trailing 3 months



Source: SKY Harbor, Real Clear Politics

To understand election implications for US high yield, we compared Biden's chance of victory and the implied probability of a Democratic Sweep (via prediction markets) to both sector and industry performance relative to the ICE BofA US High Yield Index (ticker H0A0), with sector and industry cohorts adjusted for differences in underlying credit quality and historical beta. The resulting correlations, presented in the tables below, appear very much in line with candidate policies. In particular, investors appear to be increasingly pricing in the benefits of a (likely) larger stimulus package (and perhaps even an infrastructure bill) under a Dem Sweep scenario, with Autos, Building Materials, Chemicals, and Steel among the likely industry winners. The potential for reduced defense spending, green energy initiatives, greater power to the EPA, increased healthcare coverage, and perhaps a preference for a slower virus-related re-opening of the economy under Democrats could harm Aerospace, Energy, Gaming, and Healthcare segments of the market.

Biden Victory / Dem Sweep: Total Return Correlations

based on weekly data, presented alphabetically

Positive Correlations	Rationale
Autos & Auto Parts	Stimulus / boost to demand
Building Materials	Stimulus / boost to demand
Capital Goods	Stimulus / boost to demand; Infrastructure spending
Chemicals	Stimulus / boost to demand; Infrastructure spending
Steel	Stimulus / boost to demand; Infrastructure spending
Technology	Greater risk of second lockdown

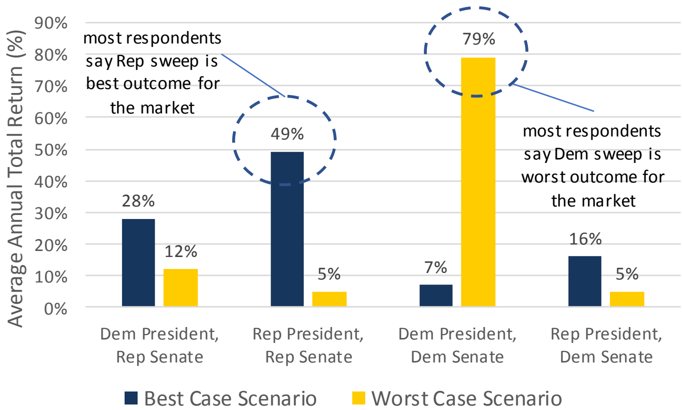
Negative Correlations	Rationale
Aerospace	Reduced defense spending; tighter regulations
Air Transportation	Loss of potential industry bail-out money
Energy	Ban of public land fracking; Green energy initiatives
Gaming	Greater risk of second lockdown
Healthcare	Increase the scope of ACA
Hotels	Greater risk of second lockdown

Source: SKY Harbor, ICE BofA Indices

While there will certainly be winners and losers from a sector perspective, the election outcome best suited for high yield market total returns remains vague. In a recent survey conducted by JP Morgan, respondents were asked to identify which election scenario would be best and worst for credit spreads. The results, which we present below (left side), identified a Republican Sweep as being most advantageous for the market, and a Democratic Sweep as the worst case scenario (79% of respondents). At first glance, results appear concerning for the market, as a Democratic Sweep registers as the most likely outcome based on both polls and prediction markets. Cause for concern, however, may be overblown. Below (right side), we calculated average annual high yield returns (H0A0) under each type of political regime. Excluding the six years dominated by recessions since 1987, we found that high yield returns have been strongest under a unified government, with full Democratic control modestly beating full Republican control. In our view, the market may not be fully appreciating the extent to which larger stimulus spending may offset the negative impact of higher corporate and individual tax rates that Democrats are likely to seek.

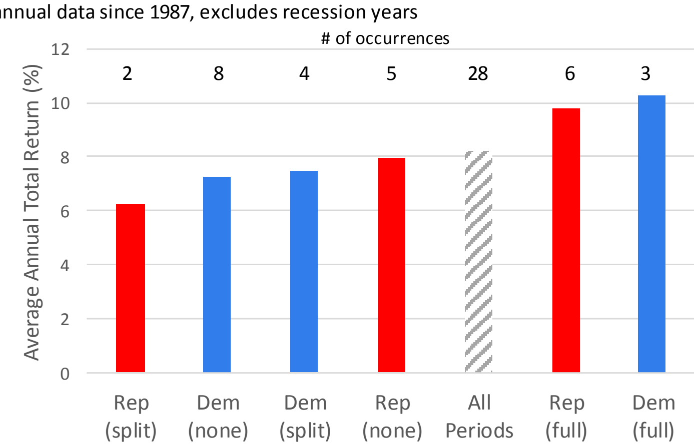
JP Morgan Survey of Investor Preferences

annual data since 1987, excludes recession years



Average US High Yield Returns by Party Control

annual data since 1987, excludes recession years



Note: Rep (full) denotes a Republican President and Republican control of both chambers Congress; Rep (split) denotes Republican President and split Congress; Rep (none) denotes a Republican President and no majority in either chamber of Congress; same logic for Dem (full), Dem (split), and Dem (none)

Source: SKY Harbor, JP Morgan, BofA Indices

Polling data and prediction markets imply a rising likelihood of a Democratic Sweep as US elections draw near, with swing state data now firmly in favor of Biden. Our analysis of these trends imply that issuers poised to benefit from stimulus spending – the potential of which is assumed to be larger under Democratic control – may outperform the broader market should election results fail to surprise. Despite investor apprehension toward Democratic control of the White House, Senate, and House of Representatives, history would imply that high yield market returns have been most favorable under such a scenario.

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