Market Optimism May Be Justified—But I Urge Caution

Weak growth and a fiscally hamstrung U.S. signal trouble ahead.

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While the U.S. elections grind toward the finish line, risk markets—after a bumpy ride—are hovering close to all-time highs. In light of surprisingly close elections that will likely lead to a split Congress, legislative gridlock, and inadequate fiscal support, this may seem surprising. The surprise grows when one considers the coronavirus wave that is breaking across Europe and the U.S., leaving a swath of lockdowns in its wake. How did the markets get here? Where do we go next?

The U.S. elections are likely to lead to a Democratic president accompanied by a Democratic House and a Republican Senate—and based on previous experience of divided governments over the past decade, we should expect very little legislative progress during the term of President-elect Joe Biden. The good news for risk investors is that Biden's planned corporate tax increases are unlikely to come to fruition; the not-so-good news is that coronavirus-related stimulus is likely to be significantly smaller and the tax-financed infrastructure package has been canceled altogether.

Looming Lockdowns and Positive Sentiment Make an Odd Combination

The markets decided to take their cue from the good news about tax increases—well, that and the assumption that we are in the early stage of the next business cycle expansion (a view that was reinforced when Pfizer, a couple of days later, announced that its prospective coronavirus vaccine delivers an immunity effectiveness of 94%). Consequently, risk markets staged a spectacular rally.

As things stand, investors seem willing to look past the data volatility and sweeping lockdowns that have arisen on the back of the second coronavirus outbreak. Whether they are right to do so remains to be seen, but for now—the argument runs—the policy response is already in place, and the second wave outbreak is unlikely to lead to a run on the financial system akin to what we experienced earlier in the year. Furthermore, given developments on the vaccine front, the current outbreak will likely be the swan song of the coronavirus. Good riddance.

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While these arguments make sense, the combination of a second coronavirus outbreak and market optimism gives me reason to pause. Economists have substantially reduced their growth expectations for the eurozone for the fourth quarter of 2020, and I harbor no optimism that the U.S. will fare any better as the authorities there continue to express overly optimistic views that leave no doubt that they are far behind the virus curve. I am skeptical of the view that lockdowns will be short-lived and followed by sharp rebounds: It is a very different proposition to remove lockdowns during peak flu season than during warm-weather months. Moreover, in the absence of a strong fiscal response, it is not clear to me that household balance sheets will weather mobility restrictions as well as they did during the previous lockdown.

Biden's Likely Inability to Raise Taxes Is Not a Net Positive

I believe that the combination of a rapid growth deceleration, monetary policies that are running on empty, a backloaded and timid U.S. fiscal response, and companies that have been struggling for a year to keep their heads above water warrants some caution—which is not what the markets have exhibited since the U.S. elections. As an economist, I am more concerned about what I believe to be the failing fiscal agenda in the U.S. than I am encouraged by the fact that Biden is unlikely to be able to raise taxes. The inability to raise the corporate tax rate is not a windfall gain for the economy as the lack of tax revenues is offset in more than unit measure in near-term fiscal spending. Net, this is *not* positive for growth. Most likely, everything will be fine, but the risk of a double-dip recession has undoubtedly increased over the past month.

On the other hand, the likely change at the helm of the White House should lead to a more orthodox and predictable foreign policy. The frictions between China and the U.S. are unlikely to wither under Biden, but soon the trade war should be reduced to a small dot in the rearview mirror—undoubtedly a positive development.

Encouragingly, the third-largest economy, China, seems to keep ticking along. The country's recovery from the virus-induced growth slowdown and ability to manage subsequent virus outbreaks has been nothing but spectacular. Consequently, while the authorities in China are unlikely to pull the rug from under the economy, they are clearly steering it away from the government support measures—a development that has yet to show up in the data but that, in my view, is likely to appear over the coming quarters.

Altogether, while the passage of the U.S. elections has prompted investors to shift attention to the business cycle expansion, immense challenges loom over the next few quarters. Preserving some dry investment powder may be a wise decision.

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