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How will US poll verdict impact rupee and interest rate in India

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The much awaited event of 2020, the US presidential election is finally behind us. Even as at the time of writing, while the vote tally has finally crossed decisively in favour of Joe Biden, the potential re-counts and legal challenges are likely to keep us busy ; and the markets a little muddy in the coming weeks. The market has now clearly priced in a Joe Biden administration with a divided US Congress, as the Senate continues to be with the Republicans. The month before the elections the markets were pricing in a blue wave with the expectations of a Senate also being taken over by the Democrats. The day of the election the market realised that it was nowhere near a blue wave but a possible red wave. But in the end, both these colors did not matter with the trading screens witnessing a splash of green. Why is this result being construed as the most constructive outcome for risk assets and as the “best of both worlds” for EM asset classes? This article attempts to decode this paradox and analyses the significance of this new paradigm on FX and rates market.

To being with, the US electoral outcome provides the balance of power that is sometimes liked by the markets - it ensure continuity on broad policies while providing checks and balance on major policy changes.

Heading into the election, the expected “Blue wave” was expected to drive aggressive reflationary fiscal policies, partly funded by higher corporate and personal taxation along with higher capital gain taxes. However, the balanced outcome which led to weakness in Dollar had a positive impact on bonds and equities. The S&P is up 6% over the last week, the VIX back to the recent lows and interest rate volatility has declined sharply!

The initial market reaction has led to flattening in UST curve as aggressive reflationary fiscal stimulus is less likely given that GOP will still control the US Senate. The US equities have reacted positively on the assumption that this outcome diminishes the prospect of major corporation tax hikes while regulations surrounding financial services, healthcare, big tech and real estate may end up being less onerous than feared. At the same time, a Biden presidency would likely mean a more predictable global trade backdrop, which is good news for businesses with international supply chains and corporate profitability.

Implication for FX market

Looking through the short-term uncertainty associated with the contested outcome, the scenario of a Biden presidency and republican senate points to a weaker USD outlook and a constructive view on cyclical FX. This is primarily on account of:

- the US fiscal stimulus, albeit smaller, should be nonetheless delivered;
- the restrictive US fiscal policies will ensure that Fed continues to take up the slack of overall accommodation by being more aggressive in QE and lower US real rates for long term
- the low likelihood for significant tax hikes (vs the "blue wave") should be positive for US equities (thus, by extension support risk currencies); and
- there is likely to a return to rule based multilateral trading practices and end to unpredictable trade and tariff war, being more beneficial for higher yielding FX vs safe havens;

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

However, given the limited scope of aggressive US fiscal stimulus, the fear of sharp Dollar devaluation will be put to rest. 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 likely to do better now vs the "blue wave" scenario, given the limited scope for higher long-end UST yields. Moreover, a combination of benign monetary/fiscal policy outlook in DM and less confrontational US trade policies means a low rate volatility environment which will be supportive for carry trades including EM currencies.

Implication for Bond market

The election outcome has significantly reduced the odds of expansionary US fiscal policies and risk of sharp adjustment higher in USTs yield. On the contrary, a divided Congress outcome would place more pressure on the US Fed to support the economy over time. With less fiscal support in the near future, it may take longer for inflation to reach desired levels. Also the potential medium-term risk for inflation from the legislative action on taxes, energy reform, environmental policies and labor friendly initiatives (doubling of minimal wages etc.) in the event of a Democrat sweep is now weathered away due to the divided Congress.

As far as Fed is concerned, the newly adopted flexible average inflation target (FAIT) means

Fed stays on hold for longer, with rates pinned at the zero bound. Moreover, on the balance sheet side the Fed President Powell has recently indicated that "there are a number of parameters where Fed can shift the composition, the duration, the size, and the lifecycle (of the program)" to indicate more flexibility for accommodation. Overall, with the front end of the US curve staying static and other systemic central banks going nowhere fast, the outcome of election will translate into tactical flattening of the UST curve.

So in summary, a split congress, a smaller fiscal stimulus, a lower US tax increase, lower rates and a weaker dollar is likely to keep the sentiment positive for global risk appetite. A less confrontational approach to trade policy is likely to bolster the export dependent economies which in turn will mean more flows to the region. India may not be the best bet in the beneficiary space but is definitely expected to get a more than fair share of the spoils.

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