

## **The Morning After**

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With a bucket of popcorn to share, my wife and I streamed *The Poseidon Adventure* last night. It was much more entertaining than watching the election coverage, and – unlike the election coverage – it had a clear denouement. The movie also seemed curiously appropriate for the occasion, as the country turns the corner toward a new Washington political environment. If you're not familiar with the movie, *The Poseidon Adventure* was one of the first great mid-1970s disaster flicks, telling the story of a motley group of cruise ship passengers as they try to save themselves after the ship is capsized by a tsunami.<sup>1</sup>

This year we have all been buffeted by wave upon wave of disaster crashing upon our economy, our culture, and our lives. The Covid-19 pandemic and the deep recession were two cataclysms that affected all of us. Some of us may differ on whether yesterday marked the *end* or the *beginning* of yet another monster wave: Did we all just survive a third tsunami and find ourselves on the inverted hull, about to be rescued? Or did the ship just last night flip over and leave us to drown unless we can navigate the next four years against dire odds?

I won't try to answer that question; it's inherently political, and we are a divided nation. But I will endeavor here to pick up some of the pieces, as Maureen McGovern so beautifully sang in her Oscar-winning theme to *The Poseidon Adventure*:

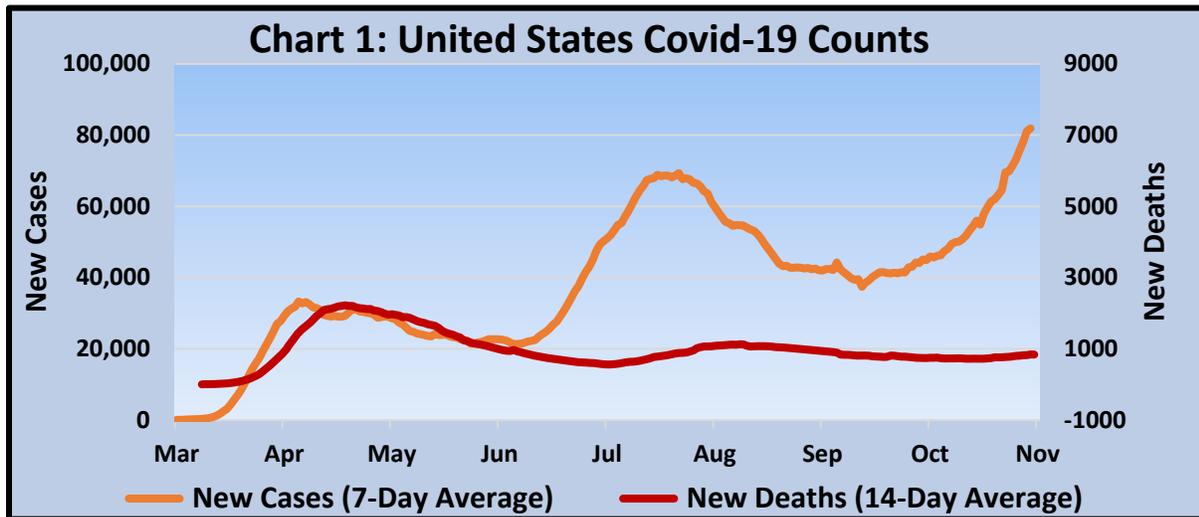
*There's got to be a morning after  
If we can hold on through the night  
We have a chance to find the sunshine  
Let's keep on looking for the light.*

In the spirit of looking for the light, perhaps we should start with a very brief summary of last night's results. We still don't know who won the Presidency, nor do we know which party will control the Senate. But it does seem that the so-called blue wave didn't crest; as I tuned in briefly to the television news after *The Poseidon Adventure* ended, it became clear that Mr. Biden failed to deliver a knockout blow. Even if Mr. Biden wins the election, he may have a very difficult time finding the Senate votes he would need to enact his legislative agenda – regardless of which party ultimately wins the upper chamber. Without that blue wave, his tax proposals may well be dead on arrival in Congress. The lack of a blue wave also suggests that the presidential election may be contested in the courts, causing greater uncertainty and delays before a result is known.

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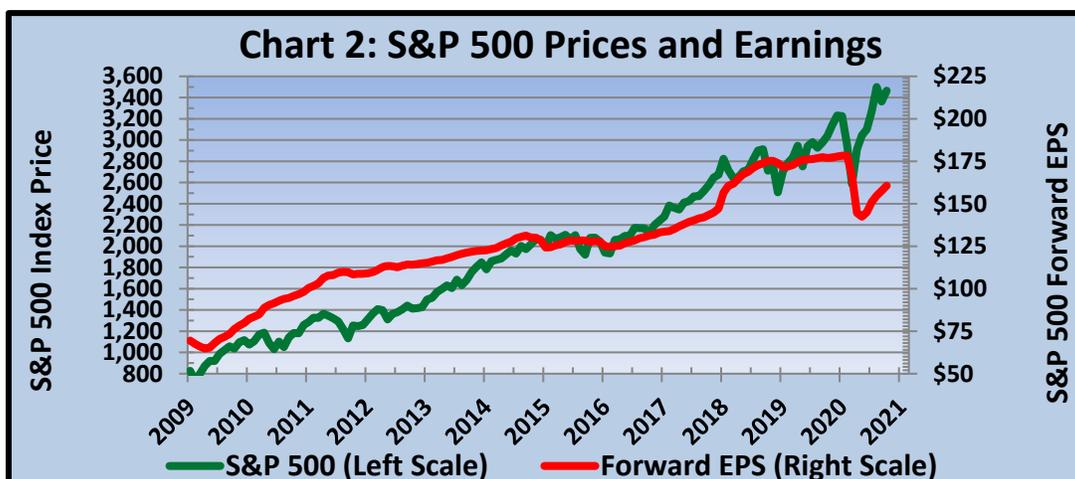
<sup>1</sup> Spoiler alert: Not everyone makes it out alive. Perhaps there's a lesson in that for our pandemic times, perhaps not. You decide.

Beyond the election results, we also know that Covid-19 infections are still spiraling upward. Chart 1 shows case counts (which are somewhat open to interpretation) and death counts (which are somewhat more reliable) as of last Sunday. It's worth noting that mortality rates have dropped sharply, most likely because of better treatments, younger victims, more testing, and perhaps genetic degradation of the virus itself. But still: Nearly 10 million victims and a quarter-million fatalities already, and no sign of abatement.



Source: Worldometers.info

So that's the world that greets us this morning. Leading up to the election, equity markets nosedived last week and rebounded earlier this week; even so, as Chart 2 shows, prices (in green) remain well ahead of earnings expectations (in red). Investors appear to be guessing that the economy will improve rapidly through the next two years, driving earnings growth even more robustly than the recovery hinted in the chart. This is entirely plausible: As Covid-19 treatments improve outcomes and as vaccination becomes widespread, government restrictions and personal preferences are likely to shift toward more economic engagement. People are likely to spend more money when they get vaccinated and when they get their jobs back. Whether this happens quickly enough to justify current stock valuations is an open question.



Source: FactSet

American stocks oscillated sharply last night in futures markets around the world, as the hours ticked by without resolution to the election.<sup>2</sup> Volatility has risen sharply in recent days, as shown in Chart 3. Wall Street now appears headed for a sharply higher opening, as the prospect of big tax hikes (especially Mr. Biden’s proposal to raise the corporate income tax rate from 21% to 28%) is fading rapidly. Yet investors’ hopes for a quick resolution and for major stimulus legislation early next year are also fading fast. The results so far suggest that the country is headed toward a legislative status quo, with neither party having firm control of Congress.



Source: StockCharts.com

The bond markets, like the stock markets, were deeply nervous heading into the election. Bond prices sold off last week amid fears that a prospective Biden presidency would usher in multi-trillion dollar stimulus spending, and inflation along with it. The yield curve steepened, as shown in Chart 4; the chart shows the difference between 10-year and 2-year Treasury yields. The steeper curve, represented by the rising spread, suggests that investors have been assuming a Biden victory and effective control of Congress as well; that may have been a mistaken assumption. Yields fell overnight and bond prices rose, as the lingering ballot uncertainty led investors to the safety of Treasury debt.



Source: FactSet

<sup>2</sup> The overnight response to the election in 2016 was deeply pessimistic, with stock market futures falling very sharply. But by the time the sun rose over the New York Stock Exchange the next day, this gloom had disappeared and the stock market began a two year march upward. One might be wise to recognize that first impressions can be deeply misguided.

On the morning after the election, then, it's still too soon to know how the next four years – or even the next four months, or four days – will shape up. The news last night may have taken the “blue wave” scenario off the table, but most other outcomes remain possible. Indeed, the investment community's worst fear – that of a contested election – seems more plausible today than it did last weekend.

It's also worth remembering that perhaps the most important job in Washington, for the investment community, wasn't even on yesterday's ballot. Federal Reserve Chair Jerome Powell is secure in his job for another two years, and his steady hand has greatly comforted investors throughout this extraordinary year. His clarity of purpose and creative monetary policies have ensured smooth functioning of the banking and capital markets systems, providing ready access to capital and operating funds for businesses and individuals. This clarity will presumably continue for as long as the economy is burdened by the pandemic; we'll get an early sense of Mr. Powell's post-election views after the Fed's meeting tomorrow afternoon.

There are still many ballots to be counted. Now is a time for patience as we await final results and a better understanding of the political climate that will take shape in the coming year. As we evaluate the emerging new market environment, we can perhaps take inspiration from *The Poseidon Adventure*'s plucky passengers as they navigated an upside-down world:

*There's got to be a morning after  
We're moving closer to the shore  
I know we'll be there by tomorrow<sup>3</sup>  
And we'll escape the darkness  
We won't be searching anymore.*

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<sup>3</sup> The word “tomorrow” might best be understood figuratively, in my opinion.