

Global Equity Strategy

The Senate changes control: what does it mean

Investment Strategy | Strategy

At the time of writing, it looks highly likely that the two Georgian seats have turned Democrat and the Democrats are now controlling the Senate.

Implications: still lots of compromise will be needed. The majority is only there by the casting vote of the Vice President. There are four independently minded Senators who regularly break party lines (the Democratic Senator Manchin voted with Donald Trump 52% of the time and is against a change in filibuster rule and voiced opposition to Green New Deal and Medicare for all). The filibuster is likely to remain in place (all bills apart from budget reconciliation need a majority of 60 to block a filibuster) and the Supreme Court is likely to remain conservative (with a 6:3 Republican appointees). A key change is that the Democrats can decide which bills are voted on and thus set the legislative agenda.

GDP impacts: this makes it more likely that we get more short term stimulus (\$350bn in an optimistic scenario via one off payments adding 1.5% to GDP) and some long term fiscal stimulus (which in an optimistic scenario adds 0.5% a year to GDP). Under a central scenario the short term boost would be c1% of GDP and the long term 0.3%p.a. Critically, it means into a growth shock the fiscal response will be much quicker and hence there is much more of a safety net for global GDP and equities, with a reduced risk of a fiscal gridlock.

EPS impacts: under the central scenario the GDP boost almost exactly offsets the EPS hit (of 5.4%) from higher corporate taxes. Higher statutory corporate taxes (21% to 28% taking 5.4% off EPS) would likely be passed but other taxes hikes that would be problematic (e.g. GILTI tax etc.) and Biden's attempt to raise minimum wages would be filibustered, we believe. In optimistic scenario on fiscal stimulus, EPS is c4% higher. Clearly there will be a pickup in regulatory scrutiny for tech but we remain reasonably relaxed on this given the need for compromise.

Bond yields may test 1.3% but we believe that the Fed would have some form of YCC (though not explicitly) to cap the rise. Since May the Fed have bought just 43% of net issuance.

Inflation expectations continue to rise. We continue to believe by end 22 inflation expectations will be close to 3%, having just broken 2% pushing down the TIPS yield.

Regions: the US underperforms, in our view. It is the least operationally leveraged market and is the region that suffers the most from a sector overexposure to industries under more regulatory pressure (parts of tech & healthcare). Our biggest overweight remains GEM.

Cyclicals have already priced in a PMI in the high 60s hence we remain benchmark of cyclicals (having downgraded on Dec 17th). We have seen the second largest cyclical rally on record.

Sectors: Big cap pharma has to be cheaper for longer (branded drugs prices can't remain 52% above those of Europe). This might be bad for energy (renegotiation of Iranian nuclear deal is made easier, accelerating move to EV and tighter emission standards) and luxury (80% of tax hikes fall on top 1%). The relative winners remain renewable utilities, construction especially green related (e.g. insulation).

Research Analysts

Andrew Garthwaite

44 20 7883 6477
andrew.garthwaite@credit-suisse.com

Robert Griffiths

44 20 7883 8885
robert.griffiths@credit-suisse.com

Nicolas Wylenzek

44 20 7883 6480
nicolas.wylenzek@credit-suisse.com

Mengyuan Yuan

44 20 7888 0368
mengyuan.yuan@credit-suisse.com

Asim Ali

44 20 7883 2480
asim.ali@credit-suisse.com

Timothy O'Sullivan

44 20 7888 9803
timothy.osullivan@credit-suisse.com

The Democrats look highly likely to take control of the Senate

At the time of writing, 98% of votes are counted and both Democratic candidates are leading the Republican incumbents. While major media organizations have started to declare Raphael Warnock (D) as the winner (e.g. CNN, Fox News), most continue to consider the race between Jon Ossoff (D) and David Perdue (R) as too close to call. However, with the remaining votes likely to favor Democrats it is very likely that Democrats will end up flipping both seats (NYT).

What does this mean? Effectively with the Vice President having the casting vote, the Democrats win control of the Senate, and therefore control the executive and legislative branches of the US government. Nevertheless, the margins in the Senate are clearly slim and therefore there will still be the need for compromise, limiting the scope for policy to take a radical turn from here. In that sense, this is a particularly marginal sweep for the following reasons:

- **The need to build coalitions of Senators:** The slim nature of the Democrat majority increases significantly the power and importance of the more centrist Senators. There are two Senators who are formally independents (Angus King and Bernie Sanders), though who tend to vote with the Democrats, and then a group of independent minded Senators from both parties: the New York Times identifies the Democrat Joe Manchin of West Virginia and the Republicans Lisa Murkowski of Alaska, Susan Collins of Maine and Mitt Romney of Utah as among the Senators with the most independent voting record.

Senator Manchin, for example, was a Democrat who voted with Donald Trump 52% of the time, including backing his judicial appointments to the Supreme Court. He is, in effect the marginal member of the majority, and all policy will have to go through him if no Republicans can be relied upon. Significantly, he is against any change to the filibuster rule in the Senate, as well as voicing opposition to the Green New Deal and Medicare for All.

- **The filibuster to remain in place:** President-elect Biden suggested in an interview with the editorial board of the New York Times in January 2020 that he was opposed to changing the filibuster rule, which permits a Senator, or a series of Senators, to speak for as long as they wish, on any topic they choose, unless 60 senators vote to bring the debate to a close by invoking cloture under Senate Rule XXII. As noted above, some of the key centrist Senators are similarly opposed, so even though the rule could be changed with a simple majority vote, it seems unlikely it will be, despite the challenges to Biden's agenda it poses. We would note that judicial appointments are already protected from a filibuster and budget reconciliation can be used to pass one spending/revenue bill per year with a simple majority.

- **Significant judicial changes appear unlikely:** The other powerful branch of government in the US, which also presents a hurdle Biden's legislation will have to clear, is the Supreme Court. Republican appointees outnumber Democrat appointees by 6 to 3, which has led to calls for reform or 'packing' of the court (raising the number of judges to dilute the sway of the current bench). The President-elect has said he would not commit to such a path, but would convene a bi-partisan commission to study how to reform the court system, to report back in 180 days.

- **...but Democrats would appoint the Senate Leader.** The Senate Majority Leader decides which bills are voted on, and thus plays a significant role in setting the legislative agenda. A Democrat in this role could therefore see the number of bills being passed by both houses and being signed into law rise significantly versus an outcome where the Republicans continue to control the Senate. Bipartisanship would still be required for the reasons above, but it would create scope for common ground to be found on areas like infrastructure.

Assessing the EPS impact

We think that this has a small positive net impact on US EPS. There are three angles to assessing the impact on earnings: the benefit of higher GDP growth; the hit from higher taxation; other factors, such as regulation.

Impact on GDP

i. Short term fiscal stimulus

It seems much more probable that there would be a larger one-off payment. Under the deal agreed over the Christmas break (the so called No Surprises Act) each individual earning up to \$75K a year receives a \$600 one off payment. This could potentially rise to a \$2000 per person one off payment, a measure which passed in the House and which has the support of President Trump. An increase of \$1600 in the size of the stimulus checks would equate to a fiscal boost of c\$350bn (1.5% of GDP).

ii. The long term fiscal stimulus

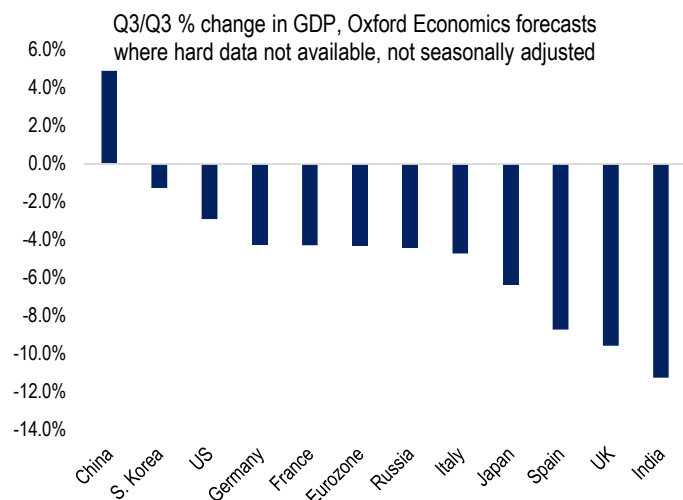
Biden has proposed a \$2trn investment programme (9.3% of GDP) deployed over four years. The aim of the programme is to significantly escalate the use of clean energy in the transportation, electricity and building sectors. This is part of a suite of proposals designed to create economic opportunities and strengthen infrastructure while also tackling climate change (we discuss some of these plans in detail in our note [US election outlook](#)). Biden has also pledged \$775bn to make childcare and nursing more affordable and \$700bn on 'Made in America' government procurement (though it is unclear if there is crossover between plans within the headline spending numbers).

Biden plans to pay for this with a rise in corporate and personal taxation (Moody's estimate about \$1.4trn of tax rises under Biden proposals). However, he has committed not to raise personal tax rates for those earning less than \$400k a year and thus the tax hikes would fall on those who have a very low marginal propensity to spend. Consequently, we think the growth hit from the tax hike would be relatively small compared to the growth boost coming from the green fiscal programme.

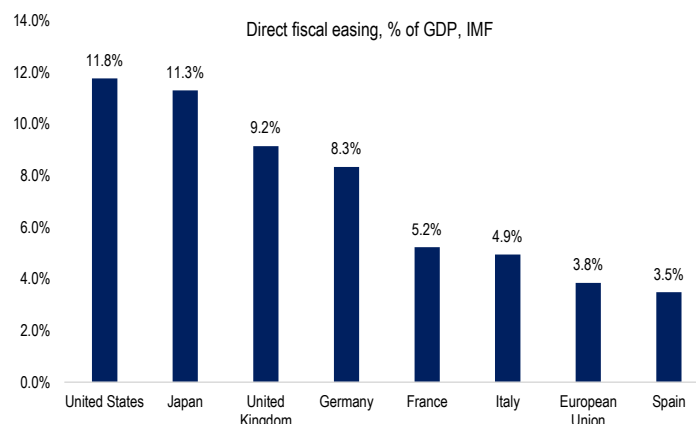
For the market, we believe that the short-term stimulus is more important than the long-term stimulus. Nevertheless, this longer term fiscal package if passed could easily end up boosting GDP by c1% a year. More likely there is compromise but even then GDP growth could be c30bps higher a year than would have been the case.

The big picture was that the US in 2020 has the biggest fiscal boost and thus was of the least impacted regions (outside of Asia) by the virus.

This victory means that in our mind should US economic growth disappoint, there will continue to be a large fiscal safety net. This underpins the US and global recovery.

Figure 1: Year-on-year GDP across countries

Source: Company data, Credit Suisse estimates

Figure 2: The US fiscal response has been the most aggressive of major countries

Source: Company data, Credit Suisse estimates

Impact of taxation

Biden plans to increase the statutory corporate tax rate from 21% to 28%. Our US Strategy team argues that this 50% reversal of the Trump tax cuts, using the 2017-18 experience as a guide, would increase the effective rate by 4-5%, shaving \$9 off 2021 EPS (i.e. -5.4%). In December 2017, the passage of the Tax Cuts and Jobs Act (TCJA) lowered the statutory corporate tax rate from 35% to 21% but the effective rate (the amount actually paid) declined from 28% to 19%, adding \$18 to 2018 EPS.

Our US Strategy team note that the sectors likely to be least affected include energy, health care, materials and tech, owing to the international footprint of their businesses. More domestic sectors – e.g. utilities, staples and communications – were the most heavily impacted. See [US Equity Strategy - Unwinding Trump Tax Cuts](#).

There are additional measures could take at least another 2% off US earnings, but many of these other measures may be hard to pass with a just 50 Democrat Senators. These other proposals include:

- i. Biden plans to impose a minimum 15% tax on book income above \$100m and doubling the global intangible low taxed income (GILTI) tax rate to 21% (from 10.5%).
- ii. Biden plans to subject wages above \$400,000 to a 12.4% payroll tax, half of which is paid by employers and half by employees.
- iii. Biden has proposed an additional 10% 'offshoring penalty surtax' on profits for manufactured goods and for services such as call centers, if American companies produce them overseas and then sell them back to the US market. According to a briefing paper from the Biden campaign, "companies will pay a 30.8% tax rate on any such profits".

Thus we assume the net hit to EPS from higher corporate taxes is around 5%.

What about tech regulation?

Tech regulation seems likely to be stepped up, but that was happening anyway with the DoJ investigation for example into Apple and Google as well as the FTC and 48 states investigation into Facebook. President-elect Joe Biden has spoken assertively about tech regulation, suggesting "some of the things that are going on are simply wrong and require government

regulation” (to the New York Times on 17 January 2020). He, along with President Trump, has also suggested revoking Section 230 of the Communications Decency Act, which holds that online platforms are not liable for what their users post on them. The Republicans had refused to sign the 449-page Congressional investigation into tech (though they back the antitrust enforcement mechanism). Hence, Democrat control of the Senate may change this.

We tend to be relatively relaxed on regulation because:

- Regulation covers about half of the Tech+ universe (Apple, Google, Facebook and Amazon). Software, semis, gaming and telecom equipment are largely outside of this debate.
- The FTC has tended to judge monopolies on the basis of price, quality and choice and for the most part, tech companies lead to lower prices, increased quality and greater choice for consumers. Moreover, tech companies are by their nature highly innovative and have the capex to pour into growth areas (such as Alphabet’s WayMo, for example).
- It is often hard to call them monopolies in the classic sense of the word, as they are not sole providers but instead popular providers. (Apple is the third-largest provider of smartphones, for example).
- In a break-up scenario, it could be that the large tech companies could actually increase their value (this was the case for Standard Oil and AT&T).
- The problem for tech might be that transformative deals become harder, but often when deals have been done, the regulators have viewed them favourably or the deals have been regulated by a regulator from a different sector (e.g. Facebook’s purchase of Instagram and then WhatsApp).
- Any investigation typically takes a very long time to complete, as we saw in the case of Google in Europe.
- We think the example of MSFT two decades ago was to sell only on the completion of the antitrust investigation.

Net impact on earnings is very small:

Our central scenario would be a near term fiscal boost of about 1% of GDP and a long term fiscal boost of 0.3% pa. Hence for 2021, GDP is c1.3% higher than it would otherwise be potentially (though it is always hard to deal with counterfactuals). Each 1% on GDP adds about 5% to EPS. Hence this adds 6.5% to EPS. Higher corporate tax rates takes about 5.4% off EPS so in net terms EPS is up about 1%.

Under the optimistic scenario, the boost to GDP would be worth about 4.6% more than the hit to earnings from higher corporate tax rates.

Clearly this does not account for the EPS hit from tougher regulation and thus overstates the EPS boost.

Figure 3: Scenario analysis

Scenario analysis	Optimistic scenario	Central scenario
Fiscal boost, % of GDP		
Short-term	1.5%	1.0%
Long term	0.5% p.a.	0.3% p.a.
Similar EPS impact		
Corporate tax increase (Probability high)	-5.4%	
Other tax increases (Probability low)	0.0%	
Minimum wage legislation (Probability low)	0.0%	
EPS impact from tax reform and minimum wage increase	-5.4%	
EPS impact from fiscal stimulus	10.0%	6.5%
EPS impact (adj. for fiscal stimulus)	4.6%	1.1%

Source: Company data, Credit Suisse estimates

Impact on bonds

We can see the 10 year yield in the US rising to 1.3%-1.5% but we believe that the Fed would come in to cap the rise in 10 year bond yields because as we highlighted in our outlook (see [2021 Research Outlook: Equities, Regions and Macro](#), 20 Nov), the Fed have made it very clear that they see much less risk in allowing policy to be too stimulatory rather than too loose. Moreover, with the average maturity of mortgage debt being more than 10 years and investment grade debt being 8 years, the long end of the bond market is economically very important. Since May, the Fed have funded only 43% of net issuance.

We think inflation expectations continue to rise (they are currently 2%) and our view has been that by end 2022 they will be 3% (see [2021 Research Outlook: Equities, Regions and Macro](#), 20 Nov).

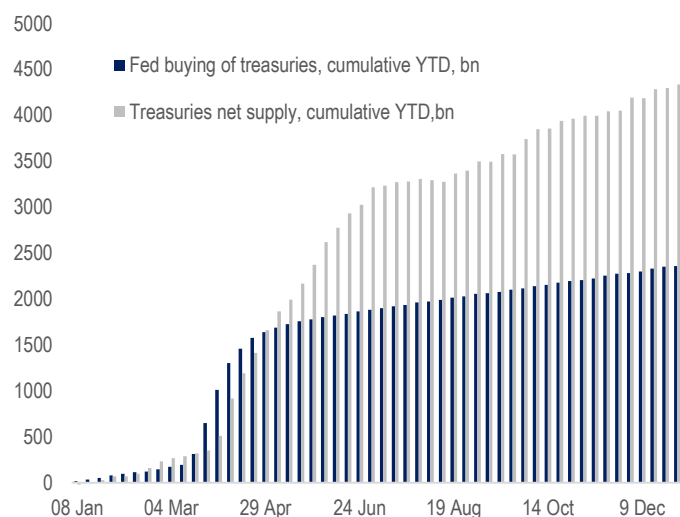
Impact on global equities

There is a small net impact positive on US EPS, potentially. Importantly should US GDP disappoint then we think a Democrat clean sweep allows a much more immediate fiscal response and thus provides a safety net.

We think that the Fed would cap bond yields and hence investors would need to focus on the ERP and this potentially pushes markets up to the S&P 500 up to 4,100 by year-end (see [2021 Research Outlook: Equities, Regions and Macro](#), 20 Nov for details).

With only 50 seats, there will be compromise on many of the regulatory proposals (as highlighted on page 2).

We continue to believe that the three key supports for our overweight of equities are: policy, ERP and the start of a bond for equity switch. Meanwhile, excess liquidity, earnings revisions and funds flow (corporate and retail buying) are supportive.

Figure 4: Since April the Fed has bought only about 43% of net issuance

Source: Company data, Credit Suisse estimates

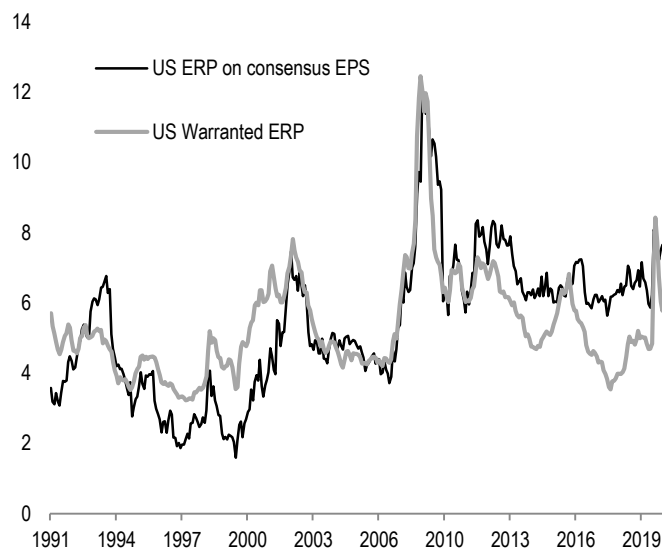
This result is a small net boost to global equities (the GDP benefit being greater than the tax or regulatory hit). We continue with our strong overweight of GEM equities (see [2021 Outlook: Equities, Regions and Macro](#), 20 November 2020).

Regions

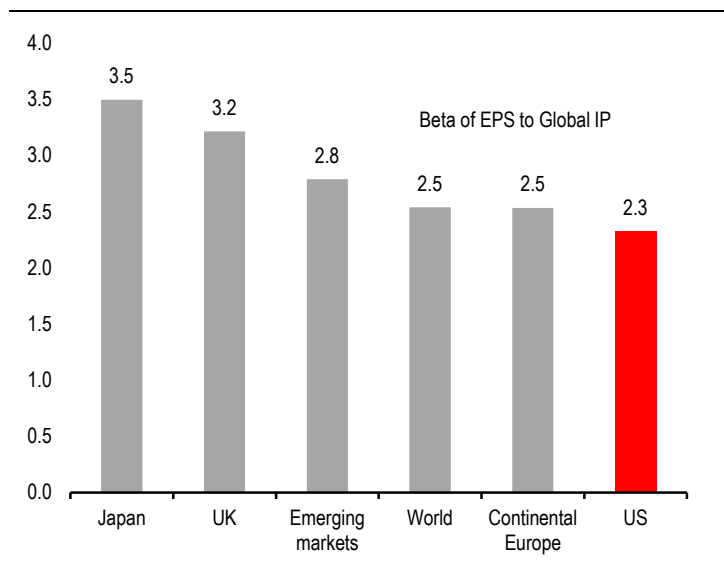
We would expect the US to underperform because:

- Boost to global growth helps the operationally leveraged non-US markets

We see the US as the most defensive market, as it has the lowest operational leverage and the most flexible labour market. As a result, the US's relative performance has been inversely correlated with non-US IP. The US outperforms if non-US IP growth is less than 3%.

Figure 5: Actual ERP vs warranted ERP

Source: Company data, Credit Suisse estimates

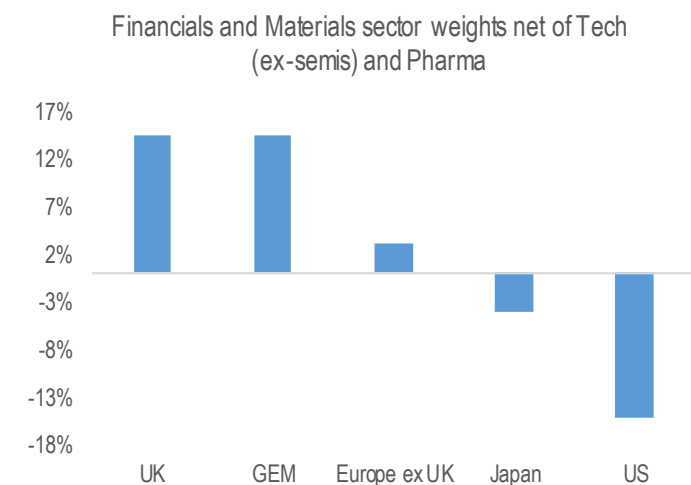
Figure 6: US has low operational leverage

Source: Company data, Credit Suisse estimates

■ Higher corporate tax rate, more regulation is relatively bad for the US

The higher tax rate and the tougher the regulatory environment for US tech as well as healthcare reform, is relatively bad for US markets.

If financials and materials are the relative 'winners', and tech (ex-semis) and pharma are the relative 'losers', then as implied by the first chart below, this would be to the benefit of GEM, the UK and Europe and to the relative detriment of the US.

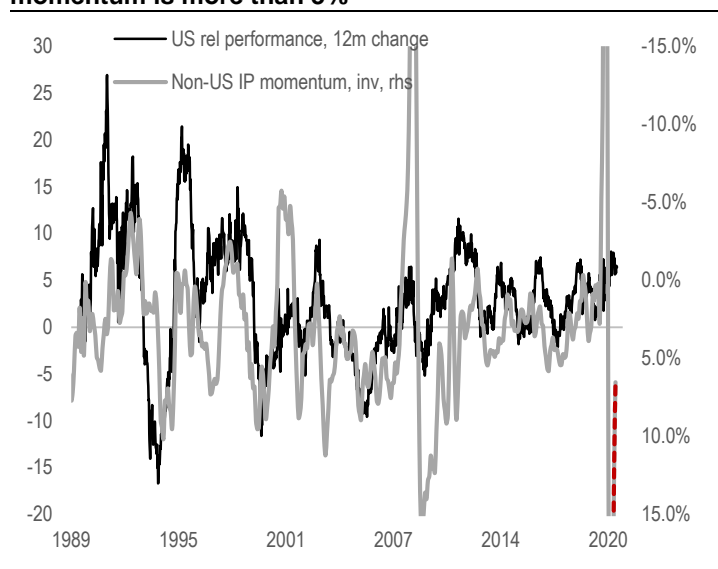
Figure 8: Financials and materials sector weight minus tech (ex-semis) and pharma

Source: Company data, Credit Suisse estimates

Cyclicals

Clearly a Democratic victory is a pro-cyclical trade (as it is pro-growth). Historically, 83% of the time the bond yield rises cyclicals outperform.

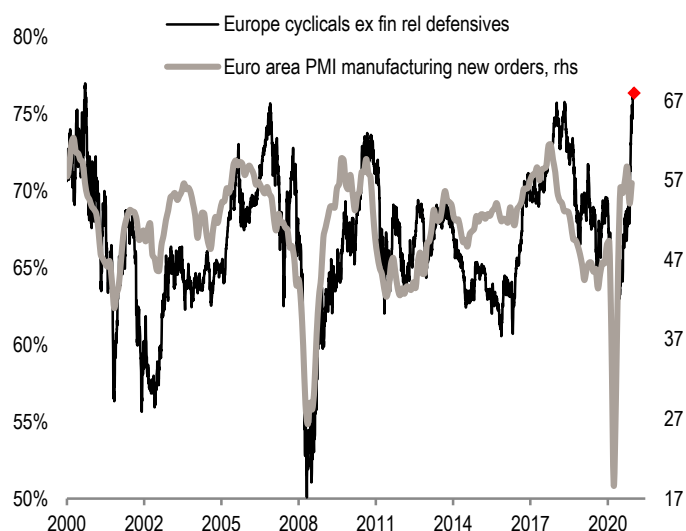
Nevertheless, we refrain from adding to conventional cyclicals as a whole (we downgraded from overweight to benchmark in December, see [2021 Research Outlook: Themes, Sectors and Styles](#), 16 Dec).

Figure 7: US typically underperforms if non-US IP momentum is more than 3%

Source: Company data, Credit Suisse estimates

This is because conventional cyclicals are already discounting a PMI in the high 60s consistent with nearly 4.5% GDP growth (in line with both IMF and CS forecasts). Moreover, cyclicals have from their low outperformed defensives by nearly 40% - only on one occasions (Dec 08 to Jan 11) was the cyclical rally greater (at 47%).

Figure 9: The cyclicals-to-defensives ratio is discounting PMIs at c68



Source: Company data, Credit Suisse estimates

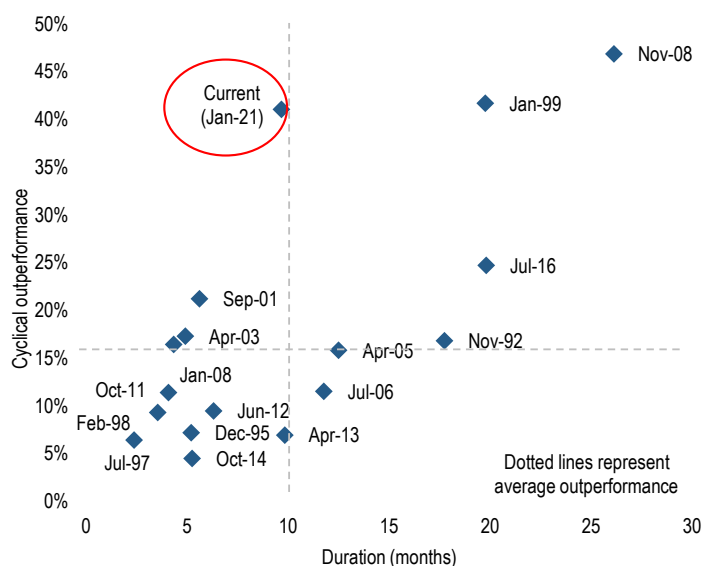
We choose to play the cyclical rally via banks (which we increased to overweight in our 2021 outlook) from benchmark and by focusing on industrial cyclicals (see our sector outlook for details). We focused on banks because they are the most sensitive sector to bond yields, Euro and PMIs and on our end 21 projections, banks are some 35% cheap (we project a PMI of 55, a Euro/\$ of 1.25 and a Bund yield of minus 30bp at the end of 2021). We also have a strong overweight of non-disrupted industrial cyclicals (given the IP catch up required) of mining, packaging and construction materials. We also like sectors that are likely to have a super cycle because of capital discipline such as EU budget airlines, shipping and DRAMs

Relative 'losers'

Pharma

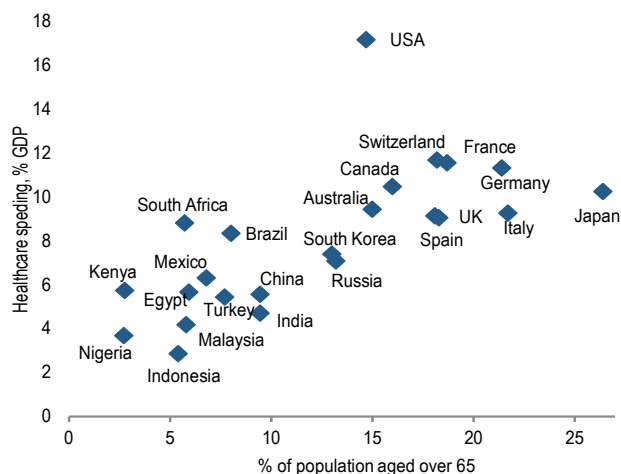
It seems that the US overspends on healthcare as we can see below at a time when the US government now accounts for c42% of total healthcare spend (up from 20% in 2009) and against a backdrop of a record budget deficits. US branded drug price are 52% above those in Europe and this seems highly unlikely to be able to persist.

Figure 10: Cyclicals have already outperformed by twice what is 'normal'



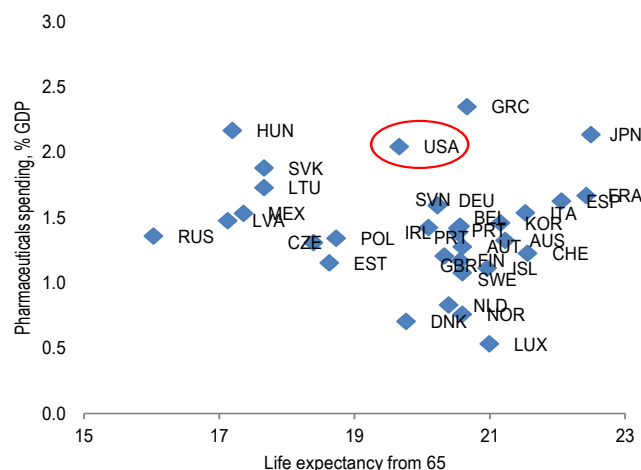
Source: Company data, Credit Suisse estimates

Figure 11: US healthcare spending as a proportion of GDP is much higher than in any other major country



Source: Refinitiv, Credit Suisse research

Figure 12: Drug spending as a share of GDP versus life expectancy for the US is very high



Source: Refinitiv, Credit Suisse research

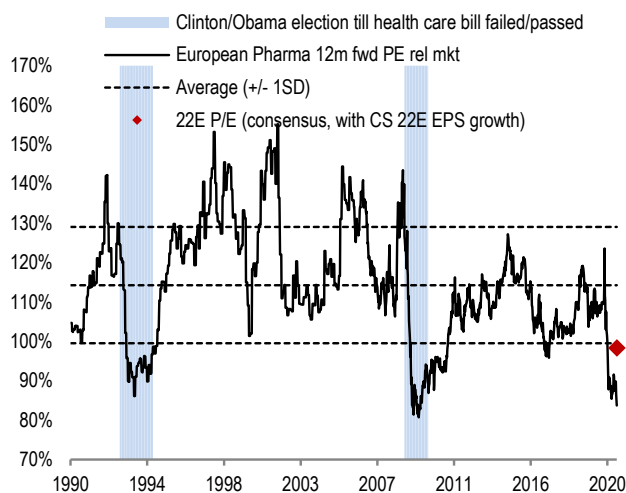
President-elect Biden has argued for expanding the Affordable Care Act, including providing an additional public option for insurance. Prior to the election, he proposed a German-style data-driven drug pricing system to negotiate ceiling prices for all payers; although the net impact on pricing is still unclear at this stage, this will be incrementally negative for pricing, albeit softer than President Trump's international pricing model. He also supports importing drugs more cheaply and imposing tax penalties on price hikes above general inflation. Our pharma team has assessed the impact of the Biden presidency on global biopharma (see [Decision 2020: A Biden win and an unknown Senate- implications for Biopharma](#), 9 November).

While the filibuster and need for compromise with centrist Democrats do limit the ability of Biden to reform healthcare, we would not rule out the possibility of President-elect Biden taking the same route as President Trump. He could use presidential executive action via MFN and HHS to reduce drug prices de facto that Medicare pays, which would then spread throughout the system.

This is one of the reasons why we have kept to an underweight of pharma. The sector needs to be cheaper for longer when there is a political fight against it (i.e. after a Democratic clean sweep). The last two occasions there was a concerted attack on pharma it stayed cheap for 20 and 10 months, respectively, and traded on discounts of up to 20%.

The sector might appear very cheap on 12m forward P/E but this is because non pharma earnings are very depressed. If we value the sector off 2022 earnings, then pharma is on a market multiple as oppose to discounts of 20%.

Figure 13: The sector is very sensitive to political risk and stays cheap for a long time (it is not as cheap if we adjust for 2022 earnings)



Source: Refinitiv, Credit Suisse research

Figure 14: Historically, it stays cheap for 10 to 20 months

Start of derating	Start of rerating	Magnitude of derating, % change in rel PE	Length of time (in mth)	Rel PE at trough
Nov-92	Jul-94	-31%	20	86.1%
Dec-08	Oct-09	-33%	10	83.5%
Start of current derating		Magnitude of current derating		Rel PE
Apr-20		-19%		86%

Source: Refinitiv, Credit Suisse research

Energy

Under Democratic control of the Senate, it might be easier to change the terms of the Iran nuclear deal, which could add 2MMBbl/d of supply. There will also be a clear move to renewables obviously with Biden wanting to be zero carbon by 2050 (Biden has proposed to have all new American-built buses to be zero-emissions by 2030). He also proposed imposing restrictions on fossil fuel development on federal lands and recommitted to ending fossil fuel subsidies. Much of these can be implemented by EPA and SEC and allowing states to impose their own fuel standards. Biden has indicated he would reinstate California's long-held authority to set its own emissions standards and could also grant waivers to other states that take similar actions. This could encourage other states to follow California and implement programmes similar to LCFS (20% reduction in carbon intensity by 2030).

Luxury

Biden has proposed higher income taxes for those earning more than \$400,000 per year. Indeed, he has said explicitly that it is only this group that will face tax rises. This group is also likely to be the main burden bearer for the rising corporate tax rate, capital gains tax, and payroll taxes. The Penn Wharton Budget Model (PWBM) estimates that 80% of the increased tax burden under a unified Democrat government would fall on the top 1%.

Relative 'winners' under a Biden clean sweep

Utilities: focus on green energy/renewables

Under Biden's plan to achieve a 100% clean energy standard by 2035, our US utilities analysts estimate that a 70% zero-carbon target by 2035 would increase annualised solar/wind/storage capacity MW demand by 26%/34%/48%, while a 100% zero-carbon target would increase it by 116%/129%/169%, respectively, and require ~\$4-28bn/year in incremental renewable and storage investments. Currently, only 17% of market cap of US utilities (weighted by generation capacity) is renewables and 62% are still fossil fuels.

Building and construction

Joe Biden's campaign website suggested he would aim for \$1.3trn of infrastructure spending over the next 10 years. There is also some bi-partisan support in this areas.

Reducing carbon emissions from buildings is a big part of Biden plans. Residential and commercial buildings and are responsible for nearly 40% of US greenhouse emissions, with heating, ventilation and air conditioning (HVAC) accounting for 30% of the 40% (i.e. 12% of total emissions).

Biden plans to upgrade 4 million buildings and weatherise (adding double glazing, etc.) 2 million homes over four years with the aim of reducing the carbon footprint of the US building stocks by 50% by 2035, creating at least 1 million jobs. He seeks to "spur the construction" of 1.5 million sustainable homes – see [2021 Outlook: Themes, Sectors and Styles](#), December 16, 2020.

The recent fall in the 10 year TIPS yield is consistent with a c.20% year on year rise in housing sales.

Disclosure Appendix

Analyst Certification

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Outperform (O) : The stock's total return is expected to outperform the relevant benchmark* over the next 12 months.

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Global Ratings Distribution

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Underperform/Sell*	11%	(21% banking clients)
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This research report is authored by:

Credit Suisse International Andrew Garthwaite ; Robert Griffiths ; Nicolas Wylenzek ; Mengyuan Yuan ; Asim Ali ; Timothy O'Sullivan

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