



Thinking out loud: market implications of US elections

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The political priorities and policies of the government of the world's largest economy and superpower evidently matters for international investors. The checks and balances in the US Constitution limit the room for radical changes in policy direction and typically market volatility around US presidential and congressional elections is moderate and short-lived. But these are extraordinary times with a pandemic, a global economy still recovering from the deepest recession in modern history, political polarisation and the fear of a delayed and contested election outcome.

This note considers the possible implications for financial market assets of US election outcomes based on our assessment of the policy agenda of the presidential candidates and their respective political parties. Inevitably it is a speculative exercise – unexpected events can dramatically change the course of the election campaign.

The news that President Trump and the First Lady tested positive for coronavirus underscores the extraordinary backdrop to the 2020 elections. Nonetheless, this note is an effort to provide investors with some background and thoughts on how the elections could impact financial markets.

Background and current polling

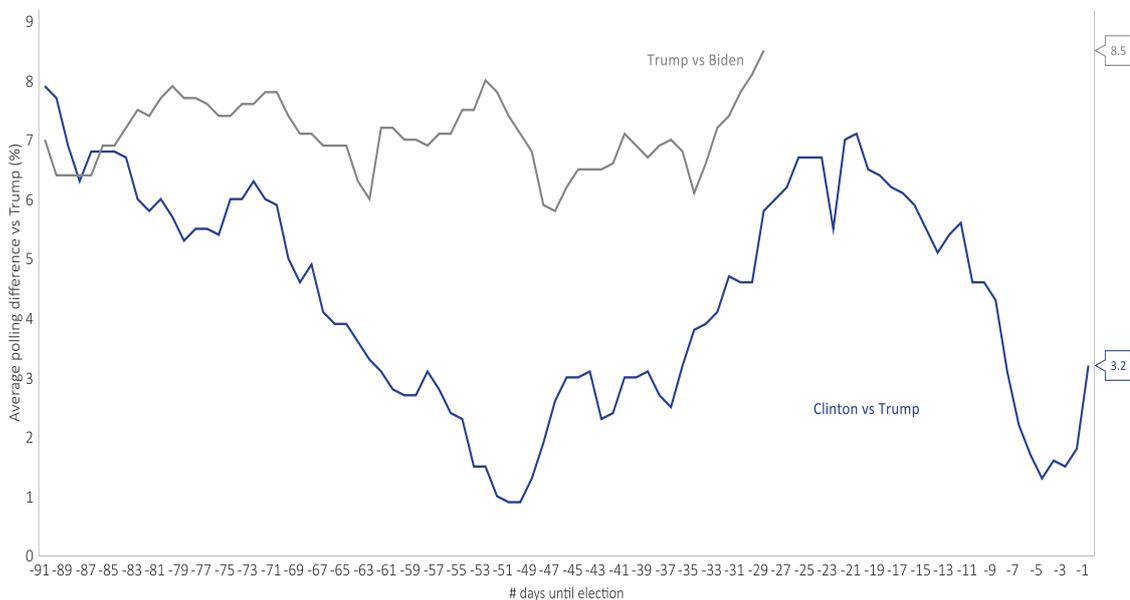
Incumbents usually win a second presidential term and until the coronavirus outbreak and recession, President Trump was well-placed to win a second term on 3 November on the back of record low unemployment. But incumbents often lose in a year of economic recession and high unemployment.

The Democratic Party presidential candidate Joe Biden currently enjoys an eight-percentage point average lead in national polls, a bigger lead than

Hilary Clinton had at this point in the campaign (see Fig. 1). But the presidency is not determined by popular vote, but by a college of 538 electors selected from each state (with the number of electors from each state broadly matching its relative population size) and nearly all are mandated to vote on a winner-takes-all basis. The candidate that secures at least 270 votes in the electoral college wins. Although the election takes place on 3 November, the electoral college does not formally cast their votes for the president and vice-president until 14 December.

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FIG. 1: US NATIONAL AVERAGE OPINION POLL GAP BETWEEN PRESIDENT TRUMP & DEMOCRATIC PARTY CANDIDATES IN 2016 AND 2020



Source: RealClearPolitics and Bloomberg; latest data at 5 October 2020

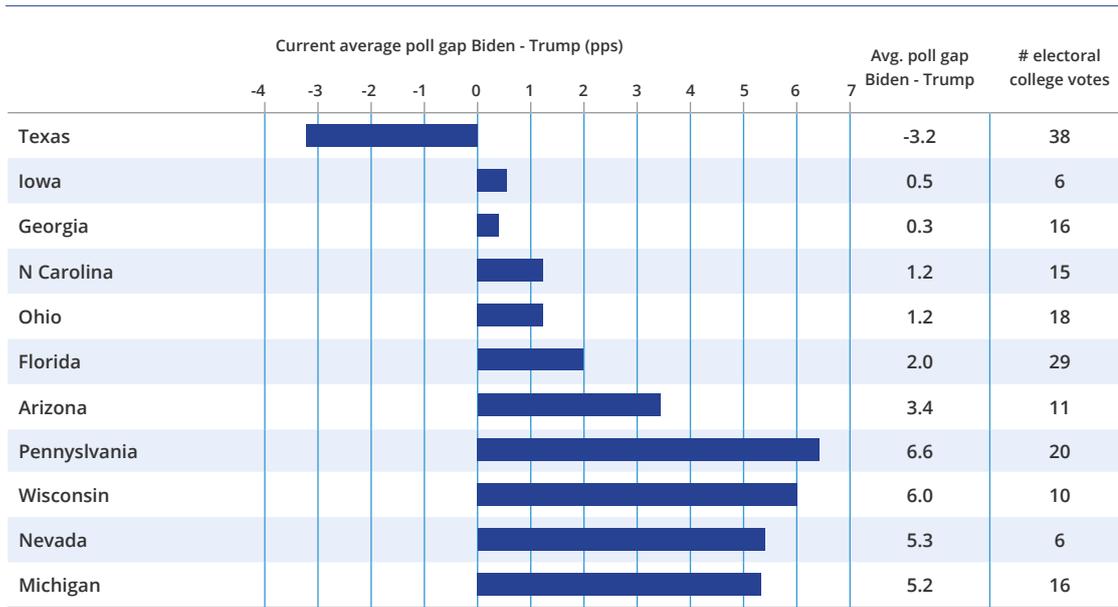
Most states are not competitive, and the outcome of the presidential election is decided by a relatively small number of 'swing states'.

The Democratic Party benefits from 190 electoral college votes from solid Democrat states such as California and New York. The core Republican Party (GOP) electoral college vote of 77 mostly comes from southern states such as Tennessee and Alabama. But despite a greater core electoral college vote, Republican presidential candidates have often been successful in winning in Democratic leaning states. In 2016, President Trump won traditionally Democrat leaning states in the north west, notably Michigan, Ohio and Pennsylvania as well as Florida and secured 306 electoral college votes despite

having a little over one percent of a lower popular vote than Hilary Clinton.

The current poll gap between Biden and Trump in key swing 'battleground states' that President Trump won in 2016 is shown in Fig 2. For President Trump to win re-election he will need to at least secure the votes of the states running from Texas to Arizona while Biden must win all the subsequent states in Fig. 2. Florida and Pennsylvania are the must-win states for President Trump and candidate Biden respectively. It is possible for both to secure 270 electoral college votes without either state, but it would require a huge upset in other large states.

FIG 2: BATTLEGROUND STATES IN THE PRESIDENTIAL ELECTION



Source: RealClearPolitics; latest data at 5 October 2020

In our view, the three most plausible election scenarios based on current polling is a Democratic Party 'clean sweep'; Biden wins the Presidency, but the GOP retains control of the Senate; and the 'status quo' of a Trump Presidency and split Congress.

Congressional elections

At least as important for US domestic policy is the outcome of the Congressional elections. Congress sets government spending and tax policies and approves key appointments such as to the Supreme Court and Federal Reserve (Fed). The failure to reach agreement on further fiscal support in recent months is in large part due to the even greater partisanship in Washington in the run-up to the elections on 3 November.

The election of a new President is often accompanied by a 'clean sweep' of Congress as it was for the GOP when Donald Trump won the November 2016 presidential election, although the Democratic Party won back the House of Representatives in the 2018 mid-term elections.

The Democratic Party currently has 232 seats in the House of Representatives compared to 198 for the Republican Party. All 435 seats in the House of Representatives are up for election on 3 November, but current polling suggests it is unlikely that the Republicans will secure a 19-seat swing required to gain a majority (PredictIt prediction market implies just 15% chance of Republicans gaining control).

Control of the 100-seat Senate is much more uncertain where the GOP currently has a three-seat majority with Republicans defending 23 of

the 35 seats up for election. Current state polls suggest most Democrat Senators will hold their seats, but four GOP incumbents (for Iowa, Maine, North Carolina, and Arizona) are currently trailing in the polls, albeit by a small margin.

Election scenarios

In our view, the three most plausible election scenarios based on current polling is a Democratic Party 'clean sweep'; Biden wins the Presidency, but the GOP retains control of the Senate; and the 'status quo' of a Trump Presidency and split Congress. A 'Red clean sweep' cannot be wholly discounted but requires a big shift in popular support in favour of President Trump and Republican congressional candidates over the next four weeks.

A scenario that is of rising concern for markets is the possibility of a delayed and contested election result. An unprecedented number of Americans are expected to vote by mail because of coronavirus concerns that take longer to count and could be subject to dispute over their validity.¹ But even if the full count is delayed for several days, markets will only not know the outcome of the elections if the vote is very close and contested in one or more key states. If President Trump does not secure the electoral college votes of Florida, he has almost certainly lost and similarly if candidate Biden does not win Pennsylvania it is difficult to see a path for him to the White House.

¹ The rules around mail-in voting varies across states. For example, whether mail-in votes must be received by or postmarked before or by election day.

The only recent precedent for a prolonged delay finalizing the outcome of a presidential election was in the very close presidential race between Al Gore and George W. Bush in 2000 that rested on a contested count in Florida. Only on the 12 December was the Bush victory confirmed when the Supreme Court ruled in his favour over the disputed vote count in Florida. In the intervening period, US equities dropped by almost 10% as did the US dollar and after an initial rise, the dollar was weaker, and market volatility stayed elevated. In the circumstances of a pandemic, high unemployment and the need for further policy support for the economic recovery, markets at the very least will be turbulent even if political and legal strife does not spill-over into social unrest.

Policy implications

It is likely that a Democratic 'clean sweep' would imply a meaningfully larger fiscal stimulus in early 2021 than under a Republican clean sweep or divided Congress (under either a Trump or Biden presidency). The initial Democratic proposal for extending further fiscal support was in the order of \$3.4 trillion compared to around \$1 trillion from Republicans. And while President Trump is sympathetic to a bigger infrastructure-led stimulus, Republican senators are more fiscally conservative.

The Democratic policy agenda also envisages a reversal of the Trump cuts in the corporate tax rate and higher taxes on high-income households as well as more regulation of banks and the energy sector (climate-related). The sector implications of a Democratic 'clean sweep' are meaningful

considering the 180-degree change it would imply for environmental, health and regulatory policies.

A divided Congress will act as a significant barrier to the implementation of a Trump or Biden domestic policy agenda. It would be very difficult for a President Biden to push a big fiscal stimulus and tax increases through a Republican-controlled Senate. Similarly, a re-elected Donald Trump would face a Democratic-controlled House of Representatives hostile to further tax cuts and healthcare reform.

Even with a divided Congress, a Biden presidency would however imply a change in approach to international trade and foreign affairs. There is cross-party consensus in the US that China is a strategic rival and must be 'contained'. But Biden is less likely than President Trump to impose further tariffs to manage bilateral trade with China (and other developed as well as emerging economies) and focus more on building international alliances that contain China's economic and political influence around the world. A Biden administration would also be less hostile to multilateral institutions such as the IMF and World Bank.

Election outcomes and market implications

PredictIt prediction market implies a 55% chance of a Democratic party 'Blue clean sweep' and one-third chance of a split Congress. We would not place too much weight on current polling and betting odds with still four weeks until election day. Rather than assign probabilities to outcomes in

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A Blue clean sweep would imply a more substantive fiscal stimulus than under the other election outcomes and bring forward expectations for Fed 'lift-off' and bear steepening of the Treasury curve. It would also likely be associated with a weaker US dollar as the Trump trade policy uncertainty is priced-out and the medium-term outlook for dollar fundamentals worsen on the prospect of widening twin fiscal and current account deficits.

our view a more interesting exercise is to consider the market implications associated with each of the plausible election outcomes and stress-test portfolios accordingly.

Blue clean sweep

Democratic Party candidate Joe Biden wins the presidency, the Democratic Party retains a majority in the House of Representatives and wrestles control of the Senate with a narrow majority.

In such a scenario, the initial reaction of US equities and corporate credit markets may be negative on concerns of higher corporate taxes and regulation. That said, if an incoming administration clearly signals that its priority is a major fiscal stimulus package, the positive boost to growth & corporate earnings could witness a quick reversal of any knee-jerk sell-off.

A more substantive fiscal stimulus than in other election scenarios would bring forward expectations for Fed 'lift-off' from 2024 to 2023 and even 2022 and bear steepening of the Treasury curve as longer-end yields move higher. A Blue clean sweep would also likely be associated with a weaker US dollar as the Trump trade policy uncertainty premium is priced-out and medium-term outlook for dollar fundamentals worsen on the prospect of widening twin fiscal and current account deficits.

A Blue clean sweep, if associated with an upward revision to US and global growth expectations,

reduced trade policy risk and a weaker dollar would be very positive for emerging market assets despite higher Treasury yields.

Status quo

Donald Trump retains the presidency and the GOP control of the Senate while the Democrats hang onto the House of Representatives

S&P500 and credit get a modest boost as concerns around higher corporate taxes & regulation under a Democratic administration are priced-out. It is also a scenario with some moderate fiscal easing but not so much as to shift expectations around Fed lift-off. There could still be some mild bear steepening of the Treasury curve as 'risk-off' positioning prior to election is closed-out.

The US dollar would likely get a lift on renewed concerns that President Trump could renew the 'trade war' with China and threaten tariffs on other trading partners.

Biden win, GOP hold Senate

Biden wins the presidency, but the GOP retain a majority in the Senate and the Democratic Party control the House.

A Biden victory but split Congress implies little chance of a fiscal stimulus with GOP opposition in the Senate to increased federal spending. Consequently, there would be greater onus on the Federal Reserve to sustain recovery with further

monetary easing that along with weaker growth outlook, implies bull flattening of the Treasury curve, is negative for US risk assets and renewed weakness in the US dollar.

Red clean sweep

A Republican Party 'Red clean sweep' that captures the House of Representatives as well as the Senate and presidency is the least likely outcome based on current polling but is a scenario that should not be discounted.

The administration would likely propose a fiscal stimulus package in the order of that recently proposed by Treasury Secretary Mnuchin of c\$1.5 trillion, including possible tax cuts. The deregulation push would resume which would be viewed by investors as positive for oil and the financial sectors. A Red wave would affirm President Trump's 'America First' foreign and trade policies.

Moderate fiscal stimulus, possible tax cuts and deregulation would likely be viewed as positive for US risk assets and the dollar as well as somewhat higher Treasury yields. But along with greater trade and foreign policy uncertainty, a Red wave would probably be perceived as negative for the rest of the world and emerging markets.

Delayed and contested election outcome

It is likely that a final vote count from the elections will not be completed until several days after 3 November. Even with delay, markets may effectively know the outcome based on the results from key states. But if the elections are very close

and it is not possible to determine the outcome until all the votes are in and legal disputes settled, financial markets will be roiled by potentially weeks of political and policy uncertainty.

Prolonged uncertainty as to the outcome and the likelihood of a divided government would be negative for risk assets and associated with a bull flattening of Treasury curve as investors favour safe-haven assets. The Federal Reserve, that meets on 4 November, may provide further liquidity to limit market disruption. The US dollar may modestly gain from broader 'risk-off' sentiment in global markets.

The overriding characteristic of a delayed and contested outcome to the US elections would be market volatility, some of which is already reflected in VIX futures contracts for November and December. Volatility would only subside once the outcome of the elections is settled, after which the market converges to the election scenarios previously outlined.

Summary

Box 1 summarises the possible short-term market reaction to the outcome of the elections expressed on a '-3' to '+3' scale for the S&P500, 10-year US Treasury yield (with '+' score indicating lower yield/higher bond price); US investment grade and high yield credit ('+' indicates lower credit spreads); Euro/dollar ('+' implies stronger euro versus US dollar); emerging market currencies (EMFX, '+' indicates weaker dollar against basket of EM currencies); and VIX ('+' indicates higher implied volatility).

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| Scenario | SPX | UST 10yr | €/\$ | EMFX | IG credit | HY credit | VIX | Rationale |
|---------------------------|-----|----------|------|------|-----------|-----------|-----|--|
| Blue clean sweep | -1 | -3 | +2 | +2 | -1 | -1 | 2 | Modest initial decline in S&P500 and corporate credit spread widening led by energy/banks/tech due to prospect of higher corporate taxes and regulation, partially offset by prospects of fiscal stimulus boosting growth & corporate earnings. Meaningfully greater fiscal stimulus than in other scenarios would bring forward expectations for Fed 'lift-off' from 2024 to 2023 and bear steepening of Treasury curve. Weaker US dollar as Trump trade policy premium priced-out and weaker dollar fundamentals on likelihood of widening twin fiscal and current account deficits. |
| Status quo | +1 | -1 | -1 | -1 | +1 | +1 | -1 | S&P500 and credit spreads get a modest boost as risk of higher corporate taxes & regulation priced-out. It is also a scenario with some moderate fiscal easing but not so much as to shift expectations around Fed lift-off although still get some bear steepening as 'risk-off' positioning prior to election is closed-out. US dollar gets a lift with the prospect that Trump would likely result in wider imposition of tariffs on China and other trading partners. |
| Biden win, GOP Senate | 2 | +1 | +1 | +2 | +1 | +1 | 0 | A Biden victory but split Congress implies little chance of a fiscal stimulus with GOP opposition in the Senate to increased federal spending. Consequently, greater onus on Fed to sustain recovery with further monetary easing that along with weaker growth outlook, implies bull flattening of Treasury curve, negative for US risk assets and weaker US dollar. |
| Red clean sweep | +3 | -2 | -1 | -2 | +2 | +2 | 0 | Moderate fiscal stimulus combining tax cuts and infrastructure spend; further deregulation (positive for energy & financial sectors); and more 'America First' foreign and trade policies. The former are positive for risk assets and some modest bear steepening of the Treasury curve while the latter is US dollar positive and negative for EM assets. |
| Delayed/contested outcome | -3 | +3 | -1 | -2 | -2 | -2 | +3 | A prolonged delay in determining the result of the presidential and quite possibly the congressional elections due to counting 'mail-in' votes (perhaps because of legal challenges). Prolonged uncertainty as to the outcome and likelihood of a split government leads to a spike in implied & realised volatility and 'risk-off'. Investment grade credit out-performs high yield with Fed credit backstop facilities. US dollar gains on broader 'risk-off' move especially against EMFX. Once election outcome is clear, market converges to election outcome scenarios. |

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