NLP Financial Management Ltd

The US Elections and Their Impact on Macro and Markets

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Summary

This note covers the impact of the US elections on the economy, financial markets and our portfolios. As we are just a few days away from the three elections in the USA, the presidential elections and the elections to the House and the Senate we analyse the different outcomes (a shift from the current Republican ("red") President Trump and Republican Senate to a potential "blue sweep", i.e. the Democrats winning the presidential elections and both the House and the Senate). We discuss the potential impact that such political change can have on the markets. It is always difficult to predict the outcome of elections and even more difficult to predict its impact on the financial markets. We look at different scenarios and show that our portfolios, which are diversified in asset classes, investment strategy, geography, sector, currency and style factors, should be less impacted by any major swings to the downside which are possible. The US economy has rebounded sharply from the lows of the second quarter but there is a serious risk of second dip. In our current asset allocation, our portfolios are well spread, have built in hedges and still carry enough cash to benefit from buying opportunities.

Politics

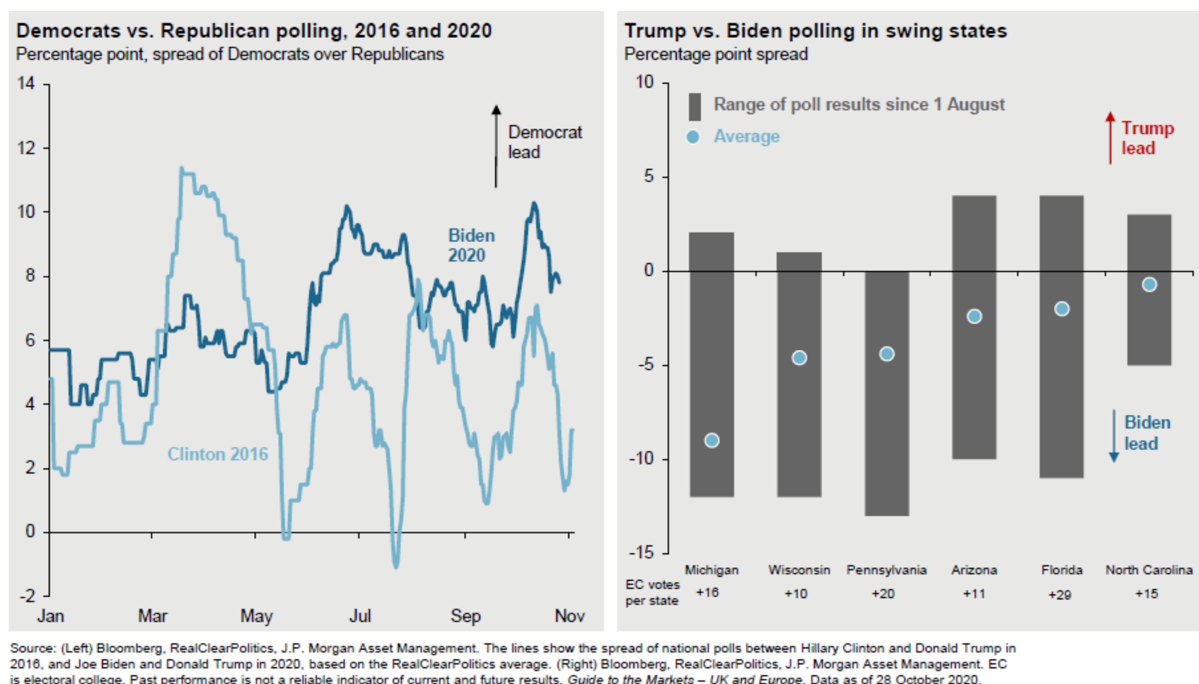
At the elections on 3 November 2020 voters will decide on the next president (White House), but also on the president's ability to achieve policy goals, i.e. the control of Congress, the House of Representatives and the Senate. If Congress remains divided between the Democrats and the Republicans as it is at the moment, the next president will have to rely heavily on unilateral executive orders, rulemakings through the federal government via the department and agencies that have significant power. That will limit any larger policy proposals which require the approval by Congress. What are the numbers needed to win each race?

In the US, the presidential candidate doesn't have to win the "popular vote" (majority of votes) but the "electoral college" (a system which allocates the number of electoral votes in each state determined by population size). The winner needs to get at least 270 of the 538 electoral votes in order to win the presidency.

The Senate has 100 seats and the US senators serve six-year terms whereby a third are elected at each federal or mid-term election. At the moment the Republicans control the Senate and 35 seats are up for election this year. 23 are currently held by Republicans and 12 by Democrats. The Democrats need to win three additional seats to win control of the Senate if they win the presidency as the vice president casts tie-breaking votes. Otherwise the Democrats would need four additional seats.

In the House of Representatives all 435 seats are up for election in November. All congressmen and congresswomen serve a two-year term. As the Democrats are currently controlling the House, the Republicans would need to win 21 additional seats to change the majority. The members of both the House and the Senate serve on the committees. The control of the Senate is important as it has the authority to approve presidential nominations such as the recent Supreme Court judge Amy Coney Barrett or members of the Federal Reserve Board. The polls suggest that Biden will win the presidency, the Democrats retain the House and perhaps even win the Senate (dubbed "blue sweep").

Figure 1: Polls favour the Democrats, but we caution against predicting the outcome



Source: (Left) Bloomberg, RealClearPolitics, J.P. Morgan Asset Management. The lines show the spread of national polls between Hillary Clinton and Donald Trump in 2016, and Joe Biden and Donald Trump in 2020, based on the RealClearPolitics average. (Right) Bloomberg, RealClearPolitics, J.P. Morgan Asset Management. EC is electoral college. Past performance is not a reliable indicator of current and future results. *Guide to the Markets – UK and Europe*. Data as of 28 October 2020.

Source: JP Morgan MI-GTM, Webcast 28 October 2020

According to betting websites, bookmakers and academics such as data science professor Thomas Miller of Northwestern University, Trump has a very low chance of winning. But we must not forget that in 2016 the financial markets, political experts and statisticians got it wrong, mainly due to an underappreciation of the importance of the electoral college system.

What are the main differences in the economic and political programs? The Democrats stand for potential tax hikes, the break-up of the large tech companies and a green program (favouring renewables over fossil). The Republicans would continue with lower taxes and a confrontational stance on China. The following table shows the different policy implications of the different political constellation. A democratic president with a split Congress would be considered negative from a fiscal point of view and more negative from a risk asset point of view (making risky assets, i.e. equities less attractive).

Figure 2: US Election Outcomes and Policy Implications

Republican President **Republican Senate** **Risk-Asset Impact:** Short-Term Positive Medium-Term Positive **Fiscal Policy:** More Spending **Fed Policy:** Easy	**Democratic President** **Republican Senate** **Risk-Asset Impact:** Short-Term Negative Medium-Term Negative **Fiscal Policy:** Rediscovered Austerity **Fed Policy:** Easy
Republican President **Democratic Senate** **Risk-Asset Impact:** Short-Term Neutral Medium-Term Negative **Fiscal Policy:** Status Quo **Fed Policy:** Easy	**Democratic President** **Democratic Senate** **Risk-Asset Impact:** Short-Term Negative Medium-Term Positive **Fiscal Policy:** More Taxes & Spending **Fed Policy:** Easy

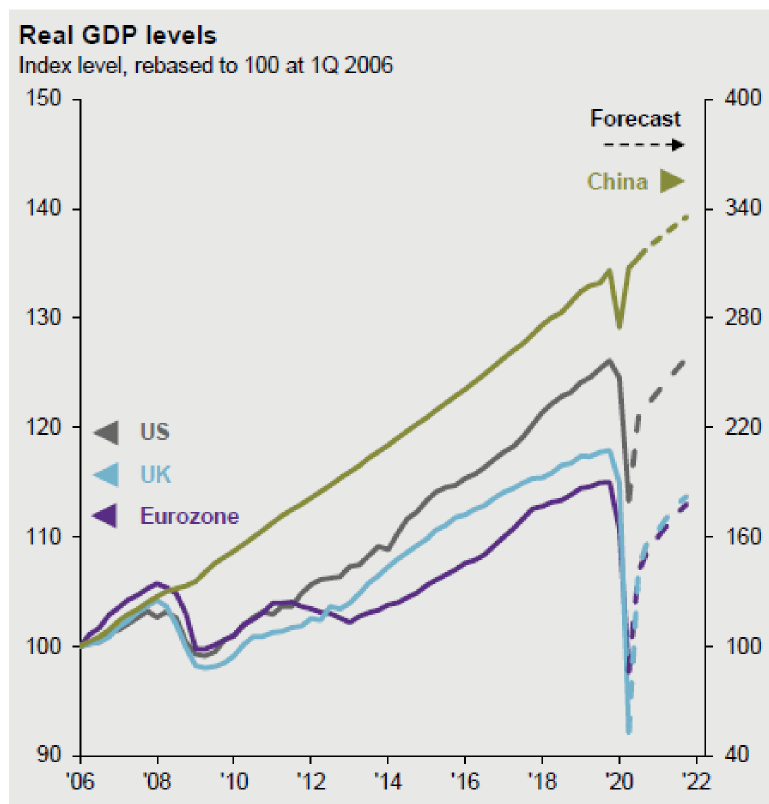
Source: Alliance Bernstein, https://www.alliancebernstein.com/gb/en-gb/financial-intermediary/insights/economic-perspectives/2020-us-election-what-the-polls-could-mean-for-policy-and-markets.htl accessed 29 October 2020

Macro

Analysing the nine main US indicators (confidence indicators: consumer and business confidence, investor sentiment; economic indicators: housing starts, initial jobless claims and Philly Fed; financial indicators: credit spreads, Fed policy and financial conditions) seven indicators predict now an "expansion" and only investor sentiment is still in "recession" mode and initial jobless claims now on "improvement". This is an improvement from 3 and 6 months ago when several indicators were in recession and improvement mode.

Much has been written and discussed about the length of the recession and the shape of the recovery. The letters U, V and W are used to describe the most likely outcomes. While the US economy looks like being in a V shape recovery (speedy), there is still the risk of a W shape recovery (second dip into a recession after an initial recovery). The UK is probably more in a U (longer, lower recovery) with the risk of a W-shaped scenario. Policy mistakes by the Fed or the US Treasury are the main risk factors which could derail the recovery.

Figure 3: Real GDP Levels – 2006 – now



Source: JP Morgan MI-GTM, Webcast 28 October 2020

Markets

When it comes to re-election, voters are influenced by the money in their pockets. Before the turn of the year the US economy was booming, with unemployment levels near historic lows, markets at all-time highs and disposable income on the up. If the election had been this time last year, Trump would have considered his chances to be far greater than they are now. COVID-19 has significantly altered the economic and, ultimately, the political landscape in the US. Presidents facing re-election tend to perform well when the economy is strong, but struggle if the memories of a recession are fresh in the minds of voters. George Bush Senior, Jimmy Carter and Gerald Ford all failed to be re-elected after suffering from a recession in the 2 years before election. Conversely, Obama, Bush Jr., Clinton, Reagan, Nixon, Johnson and Eisenhower were all re-elected as the US economy had not entered a recent recession. The data suggests it would be difficult for Trump to win in November, however this recession differs from most in the past. During most recessions disposable incomes typically fall. This time around the disposable incomes of those in the US are actually up 34% from the previous year.[1] This is in part due to the raft of stimulus packages agreed throughout the crisis, including direct stimulus cheques sent to every US citizen earlier in the year. Whether this alone would be enough to convince voters to stick with Trump remains to be seen, especially with his handling of the pandemic considered by most to be inadequate.

As an investment team the key question we seek to answer when analysing all of the above factors is what impact will this have on financial markets? One inevitability is that uncertainty, of any form, will lead to wider share price swings on the up and downside. The build up to any election is dynamic in nature, with the outcome

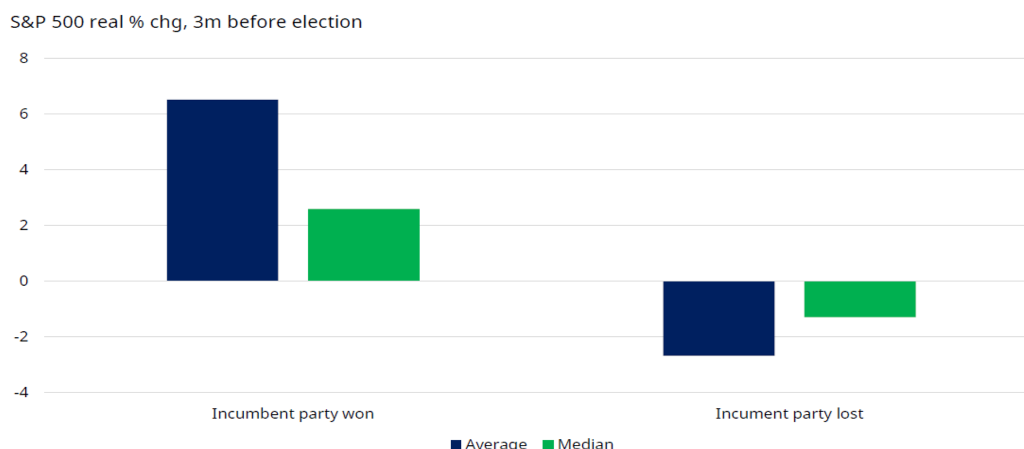
[1] Disposable income per capita, annualised growth. Correct as of 30 June 2020.

not usually known until the final few hours of a campaign. Market participants will attempt to anticipate that outcome as early as possible in order to take advantage of any mispricing opportunities, but an election is a moveable feast and the closer we get to knowing the result, the more volatility displayed in markets. Historically, volatility increases in the months leading up to an election as participants price the potential impact of a new administration, with an average monthly volatility in October and November of 16.6 and 18.2 respectively, versus only 14.1 in August and 13.4 in September[2]. Our view is that this election year has been no different, although it should be noted that volatility looks low relative to the spikes seen in the middle of the market correction of February and March. We should expect enhanced market sensitivity in the final week of the election and following the result, depending on the outcome.

So, we know that markets typically display larger price movements in the build up to an election, but what direction do they usually head in before the early November date? As alluded to earlier, market participants have a penchant for certainty. There is no greater certainty than a maintaining of the status quo, and thus markets typically rise if the incumbent party is expected to be re-elected. Conversely, if the expectation is of a regime shift, then markets on average fall, as can be seen in the below graphic. Based on historical data, an expected Biden victory should send the US market south, however this has not been the case. To date, the S&P 500 is up 12.45% in dollar terms[3]. To put it into context, the market has correctly "predicted" the result of every election since 1984 and 86% of results since 1936. Either the polls have got it wrong yet again, or investors believe a Biden presidency to be favourable for the economy and markets.

Figure 4. How have markets performed ahead of an election?

US share prices have on average fallen whenever the incumbent party lost



Past performance is not a guide to future performance and may not be repeated
Source: Datastream Refinitiv, Robert Shiller dataset and Schroders. Data from 1932 to 2016. Notes = real (adjusted for inflation) price change from 31st July to 31st October of every election year. Period covers 22 presidential elections, 13 in which incumbent party won and 9 in which they lost.

Source: Schroders, 22 October 2020

Considering all of the aforementioned, does the market really care which party is in power? Looking at the data suggests that it does not make a great difference whether the White House is blue or red. As can be seen on the right-hand side of the below chart, the Dow Jones averages 9.2% annualised under a Democratic president and 9.1% under a Republican. The wider S&P 500 index has a slightly larger divergence in favour of Democrats,

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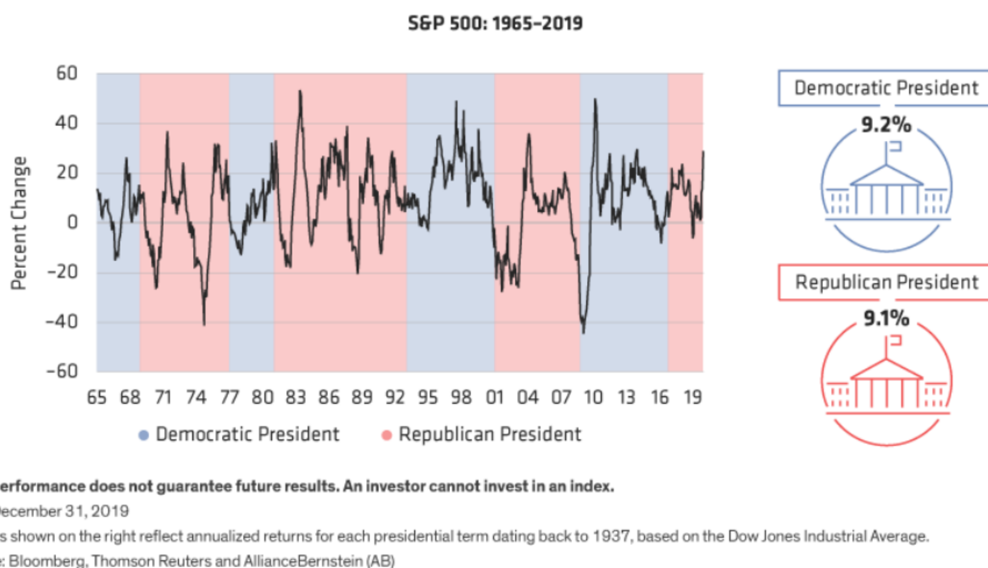
[2] Average monthly volatility of the S&P 500 during election years since 1928. Calculated by taking the rolling 30-day annualised standard deviation.
[3] Not adjusted for inflation, as of 23 October 2020

but both sides have experienced periods of strong growth in share prices, and also falls. Donald Trump's first term has seen a substantial expansion of the equity indices, considerably above both averages, which has seen them reach record highs even accounting for the retracement in March. As we previously highlighted, a Trump re-election would likely see a positive reaction from markets initially, but the longer-term direction will depend on each candidate's policy making and their ability to get it through the houses.

Figure 5. Does the Market Care Who is in the White House?



Source: Alliance Bernstein, 19 October 2020

Assuming the House of Representatives remains under Democrat control, there are essentially four possible outcomes:

- Democrats take control of the White House and Senate (blue sweep)
- Democrats take the White House but Republicans gain the Senate
- Trump remains president whilst the Senate remains Democrat
- Trump's Republicans keep the White House and take the Senate (red sweep).

As far as the US economy and markets are concerned, the middle two outcomes are the least desired, as either candidate would be hamstrung in their attempts to push vital fiscal stimulus packages through. Under a blue sweep, we would most likely see corporate tax hikes (which would weigh on markets in the near-term) but would help fund an extremely ambitious fiscal package with an expected net spending of $3tn, equating to 15% of GDP. If the Republicans take the Senate however, we would expect a far more muted fiscal move under Biden. If the outcome sees a continuation of the current arrangement, then we should expect the purse strings to remain loose, but the finer details scrutinised over by the Democrats in the Senate which could lead to further delays of important measures. Focus should be on the individual sectors within the US market though, as different election outcomes could mean very different things for some industries in particular.

The next President will be responsible for the direction of travel for the world's largest economy. Trump intends to finally remove the US as a signatory of the Paris Climate Accord, whilst Biden has already outlined plans to see the US remain a signatory, in addition to pursuing zero carbon emissions by 2050. Biden also has an

ambitious climate plan involving spending over $2tn over four years on clean energy, transportation and infrastructure, whilst simultaneously moving away from fossil fuels and particularly fracking for shale gas. As could be expected from these plans, the sector most likely to be affected is energy, with traditional forms of oil & gas suffering whilst renewables should expect to be the beneficiaries. Healthcare is another sector which will be impacted by the election outcome, with Biden proposing to refund policies such as "Obamacare", whilst Trump has declared a willingness to bring down drug pricing to international levels. As was the case in the 2016 election, healthcare stocks could see some short-term volatility but with Biden a far less radical candidate, the real threat to the sector has abated somewhat.

Biden and the Democrats have promised to go after the big technology companies in the US, with higher corporate and individual taxes likely to fall heaviest on the tech sector in particular. Although Biden's tone is far gentler than that of the candidates he saw off, we should expect legislation against the tech giants to come to the fore under a blue sweep, with the likes of Facebook, Amazon and Google Parent Alphabet to come under the most pressure in the markets.

View

We believe that it is too simplistic to view a Democratic sweep as negative for the market whilst a maintaining of the status quo as market friendly. Whilst Joe Biden is promising increased taxes on corporations and high net worth individuals, the net impact of his proposed fiscal package will be expansionary, particularly for the renewables and green infrastructure sectors. A blue sweep could see long-term rates pushed higher, whilst the mega-caps in the tech sector could see some short-term price swings. Due to the weakness in the economy, a tax increase seems also unlikely at this point.

However, it would be inadvisable to build an investment strategy based on a potential election outcome, not only because this is notoriously difficult to do, but because markets don't necessarily behave in the manner you would expect. In 2016, the few market participants who predicted a Trump victory expected markets to suffer, but stocks continued to rise.

In a risk-off scenario where the US and other equity markets sell off sharply, our equity holdings would be negatively affected, but hedged to some extent due to our exposure to the US dollar (typically viewed as a safe-haven) and due to our dynamic global macro managers who can quickly adjust their portfolios and take advantage of trading opportunities.

The approach adopted at NLP Financial Management has always been to focus on a diversification of managers, styles and sectors across all geographies. Markets can often fluctuate in the short-term depending on the election outcome, but we will always take a long-term view when managing our portfolios. We have confidence in our active managers to take advantage of any pricing opportunities in those names which have quality characteristics that leaves them well placed to benefit from those long-term trends, regardless of who sits in the White House.

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NOTE: This material has been written for information purposes only and must not be considered as financial advice. Past performance is not a guide to the future performance. Changes in rates of exchange may also cause the value of investments to go up or down.