Focal Point

US election: known and unkown uncertainties

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- Less than four weeks before the US election day (November 3), uncertainty is unprecedented. Polls give Democratic contender Joe Biden a lead over president Trump, while the race about the majority in the Senate looks even more open.
- Surging postal votes may delay the proclamation with the risk of a prolonged legal dispute on a contested election result.
- Our base scenario, Biden as president checked by a Republican majority in Senate,would prevent the implementation of higher taxation and tighter regulation proposed by the Democrats, but could open the door to infrastructure spending.
- This scenario may have a mild but overall positive impact on risky assets, as abrupt policy changes would be avoided and Treasury yields would remain low. A full Democratic win would be temporarily harmful for equity and credit and have a more pesitent negative effect on the dollar, while increased deficit spending would lead to a bear steepening of the curve.
- Markets are pricing the possible volatility triggered by a delayed and contested outcome of the election. Such a scenario could paradoxically favour short term the US dollar on its persistent safe haven status.

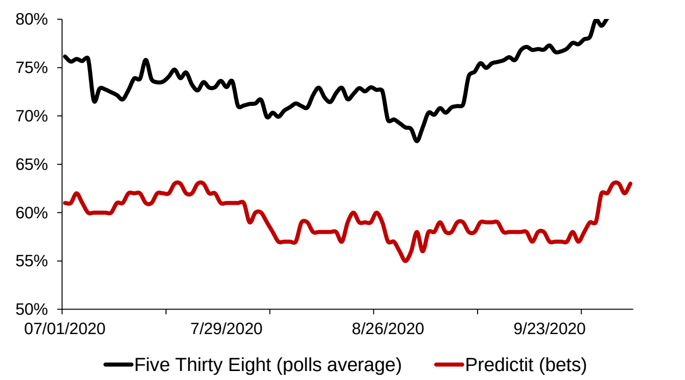
The outcome of the November presidential election was already very uncertain before the news of President Trump's positive Covid-19 diagnosis. Now his health will take central stage making the evolution of the campaign in its final weeks even more unpredictable. Yet, we assume that the election may still take place in an orderly manner. If the Democrats gain both the presidency and the control of the Congress, the implementation of their radical electoral platform would imply a major shift in taxation and regulation as well as a boost to government spending. The probability of such a scenario is increasing fast (around 65% according to the average polls taken over the last week), but we still see a high chance of Biden being elected accompanied by a split Congress (or too narrow a Democratic majority). This would result in the preservation of the status quo on several policy topics but with a substantial reduction of political uncertainty.

However, the official final outcome of the presidential election may take weeks before being announced, and markets are bracing for the risk of a prolonged and bitter legal battle. In this piece, we sketch the current state of the polls, the possible scenarios following the release of the final results and what they mean for financial markets.

Polls point to Biden, bets are less sure…

Senator Joe Biden, has maintained since the Covid-19 eruption a 6 to 10 percentage point lead over President Trump in terms of overall preferences, according to polls. Such an advantage has not moved much in reaction to the news flows, but it is still too early to assess whether and how the latest news on President Trump's health will affect voters' opinions.

Biden: probability of being elected

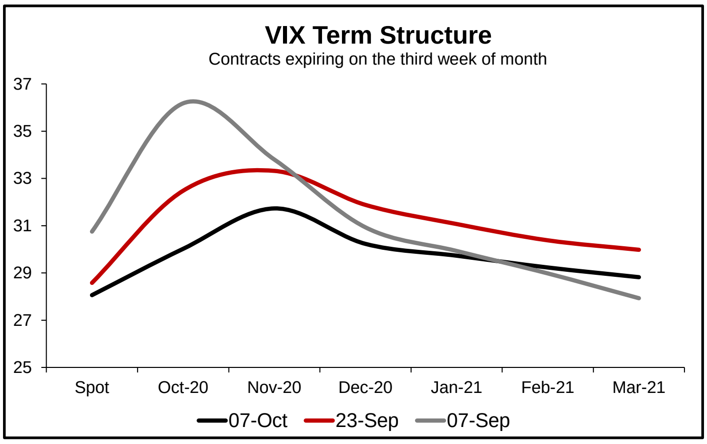


However, it is worth reminding that what matters is the number of electoral votes, which are attributed at the state level and overall give more weight to small states. In 2016, Senator Hillary Clinton was given a 3 to 5 pp nationwide lead in the polls in the week ahead of the election. In the end she won by 2 percentage points nationally but Trump prevailed as he gained more delegates thanks to a narrow win by 78,000 votes (out of 137 million in total) in three swing states. Therefore, the aggregation of state level polls provides a more reliable picture. According to Fivethirtyeight, a news outlet with a good track record on electoral polls, Senator Biden has a slightly above 75% probability of being elected. But polls can move quickly. At the end of September 2016, Fivethirtyeight gave Senator Clinton a 67% probability of success, which peaked at 87% after the televised debates and slid to 71% by the day before the election. Political bets, another popular gauge of voters' sentiment, point to a more uncertain outcome, with Biden assigned a roughly 60% chance of winning.

…and markets fear a muddled outcome

Covid-19 emergency and a sharp increase in turnout will lead much more people to vote by mail, adding to. According to some estimates, nearly 80 million voters will send theire vote by mail, nearly twice as much as in 2016. Biden's supporters are, looking at surveys, twice more likely than Trump's to vote by mail. Therefore, the results of the election night, when only votes cast in person are counted, may be overturned in the following days as ballots delivered by mail are added.

Moreover, mail votes suffer from a higher rejection rate and this may lead to a surge in litigation if the Democrats do not win in a landslide (not our base assumption) and the results in swing states are very close. The risk is a repeat of 2000, when George Bush *jr*. was declared President more than one month after the election after several recounts. The US political environment is now much more polarized than 20 years ago, and a stalemate would likely result in a much more bitter and messy confrontation. Market nervousness have abated in recent weeks, but contracts on the S&P (and to some extent the other main equity indexes) continue to price a peak in volatility in November, i.e. after rather than before the election, consistent with a prolonged period of turmoil. Moreover, it is worth remembering that even he looses the election, Trump would stay in power until mid-January.



The possible scenarios

At some point, nevertheless, the new President and the partially renewed Congress will be sworn in. In terms of economic policy and impact on the economy and markets it is key whether the President can count on a supporting majority in both houses, the Senate as well as the House of Representatives (House). Otherwise, a split government would make fundamental changes nearly impossible to implement. While a continued Democratic majority in the House is almost certain, the race for the Senate appears quite tight, with the Democrats enjoying a small, but increasing lead in polls. If they prove accurate, and Democrats gain a solid majority in the Senate (a "blue wave"), they could put into law their rather radical economic platform. It includes higher taxes for the wealthiest individuals and corporations (to kick in only after the economy has stabilised) and a noticeably tighter regulation for oil companies, banks and possibly tech firms. On the spending side, on top of infrastructure projects and education, the extension of Obamacare would increase outlays on health. Expenditure should increase by around 7.5 US$ billions according to the party's program. Only 60% of it will be , with a strong frontloading of the stimulus; only 60% of it is planned to be financed by higher taxes. The large impact on domestic demand may bring forward the first Fed rate hike, which we currently expect no earlier than in H2 2024.

Trade tensions with China would not disappear overnight but would be dealt with under a multilateral framework, involving the World Trade Organisation. The partnership with the EU would likely be strengthened, with the possibility of a comprehensive trade deal including digital services. The US may also re-join the Trans Pacific Partnership.

Split government: no radical changes

On the contrary, a split government would ensure a sort of *status quo*. No sweeping changes on taxation would be feasible, while a compromise may be found on infrastructures investment and some form of control on spiralling drug prices. Who becomes President will matter a lot for regulation and foreign policy. Trump would use his mandate to push forward deregulation on sectors like financials and energy, while Biden would seek to increase control on the non-financial industry, as banking regulation needs a backing by the Senate. On trade, Trump would step up the confrontation with China and possibly with the EU; the risk of another wave of tariffs and sanctions (on, for example, auto imports from the EU) would increase. President Biden would not make a complete U-turn on protectionism: a tough stance with China is popular across the political spectrum. More predictable policies and the return to a multilateral approach would nevertheless ease significantly political uncertainty. Finally, the push toward a tighter environmental regulation could bring about new tariffs related to carbon emission by trade partners.

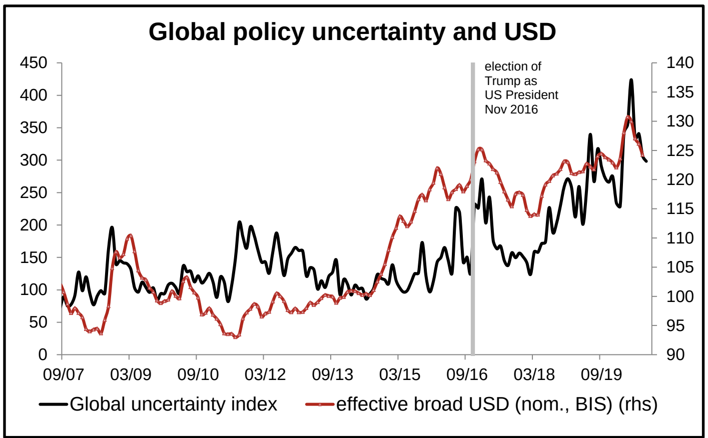
	"Blue Wave"	**Split Government**
Taxes	Higher marginal top income rate and corporate tax after 2022	No action. Current cuts to expire in 2020 under Biden
Spending	Higher spending on education, infrastructure and healthcare	Infrastructure plan likely under either President. Healthcare boosted under Biden
(De)regulation	Big tightening for energy and financials. FAANGS targeted (antitrust and data protection). Participation to the Paris accord confirmed.	Trump to push for further deregulation (environment and banks), Biden would tighten nonfinancial regulation (Senate approval needed for banks)
Trade	Tough with China, but return to multilateralism. Trans Pacific Partnership may be revived.	With Trump spat with China to escalate and frictions with EU likely. Biden also tough with China, but more predictable.

Financial market implications

Needless to say, the biggest fallout on financial markets will be in case of a "blue wave", but the status quo under a split govern would not be neutral either. Below, we sketch the main implications by asset class:

FX: A "blue wave" outcome would undermine the USD on concerns about tax hikes and tighter regulation. A soaring fiscal deficit amid yields capped by the Fed will also require a further discount on the dear USD to attract foreign capital inflows. EM FX may benefit in particular on hopes of more predictable trade policy. A split government under Trump may be mildly USD supportive (pro business regulation maintained) and broadly neutral under Biden (with more predictable trade policies reversing safe-haven flows into the USD, but a split Congress easing concerns about taxes and regulation).

Paradoxically, a contested US election outcome would underpin the USD as the country is perceived as a safe asset amid rising uncertainties, notably vs. EMs (note that the USD was a prime beneficiary of rising US/China trade tensions). Concerns about the US-specific impact, however, would limit the gains, keeping the EUR/USD muted. The JPY may benefit more clearly as a safe haven.



Sovereign bonds: US elections can noticeably influence bond markets – in both directions. The scenario most supporting US Treasuries is a contested election outcome. This also includes a case in which the mail votes trigger a swing of the original election result. As the 2000 election has shown, the uncertainty would likely drive down yields across the curve (tenors up to 10 years fell by around 90 bps until the end of December 2000). However, in contrast to 2000 the extent is likely to be much more limited this time amid the current low level – particularly at the short end of the curve. Hence, the resulting flight to quality is seen to lead to a bull flattening of the curve.

In case of a blue wave uncertainty is removed fast and expectations of a large fiscal stimulus will drive up yields. The expected shift of income from high- to low-savings cohorts is seen to boost consumption and growth. Hence, an increased Treasury supply will meet a lower demand. As the Fed will aim to keep real yields at a very low level the bulk of the increase is likely to occur via higher inflation expectations. Ultimately, the US yield curve is expected to bear steepen in this scenario.

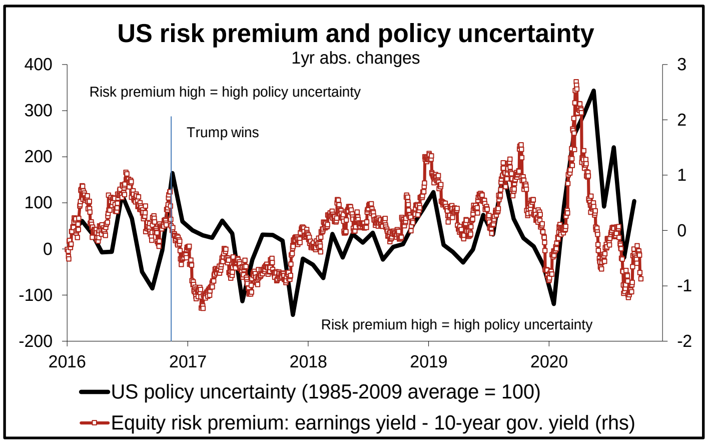
A split government would have the least impact on government bond markets. As Congress and President would struggle to agree on major policy changes, yield increases would remain capped for the time being.

Credit: Implications vary widely across sectors. A blue wave" would likely harm less profitable banks Banks, Tech, Health and Oil but would favour Real Estate & Building Mats, Infrastructure and Clean Energy. The hike in corporate taxes would not impact EBITDA, therefore limiting the fallout on leverage. A President Biden constrained by a split Congress would be a sweet spot for the credit market as trade tension would be reduced, tax breaks would remain in place, at least until their expiration in 2025, and Democrats could step up regulation only using less powerful regulatory tools. Finally, a Trump victory with split government would be positive for Oil but negative for European exporters as trade hostilities would resurface.

Equity: A "blue wave" would be a threat for IT, Tobacco, Energy, auto suppliers, and big banks (tighter regulation), Pharma (price reductions) and Defence. It would induce a rotation towards renewable Energy, Infrastructure and Cyber Security. Finally, an Obamacare expansion would favour healthcare providers. Concerning Pharma, the threat from drug price reductions seems quite discounted: their cyclically adjusted PE is lower than the S&P 500 one by 7% relative to history and, when compared to the relative earnings momentum, the price performance of Pharma is at 25% discount vs the same index. As for Tech, the threat could be only partial as, with the Covid-19 crisis, the push towards the digital economy can compensate in part. Year-to-date, the sector has already enjoyed a +4% earnings revisions (12-month forward earnings) vs a -12% of the broader index and -25% of the EMU index.

A higher taxation in the "blue wave" regime could have an overall negative impact of maximum 6-10% on total earnings, in part offset by further GDP stimulus, lingering low yields, weaker USD and dovish Fed.

Based on past experience, we see both policy uncertainty and risk premium to increase till November, with higher market volatility, which may decline rapidly after a clear outcome, but persist in case of a contested result. On a 1-year horizon, we remain constructive on equities, even in a "blue-wave" scenario. We expect a 5% total return for the S&P 500 which would be only slightly lower than in a divided Congress scenario or in case of a Trump victory. As for the latter outcome, we should probably expect the continuation of the good equity momentum but also a trade friction-induced volatility, with temporary spikes in the risk premium. That said, the timing of the vaccine and the recovery momentum would become more relevant for investors. Of course, for the short term, a contested result would induce a market setback and probably also an occasion to buy in.



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