US Election Preview: Strong fundamentals suggest any sell-off is a buying opportunity

Fullerton Market Updates

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Executive summary

- US election uncertainties are high because policy outcomes are difficult to call
    - Democrats are likely to offer greater fiscal stimulus;
    - Republicans could prove more hawkish on foreign policy
- Regardless who wins, additional fiscal stimulus is likely if the US economy continues to struggle.
- **More importantly, US fiscal austerity is a long-way off, and so any pull-backs in markets could be buying opportunities.**
- With the re-election of President Trump, US equities are likely to continue to perform well, while the pressure would remain for bonds to slowly sell-off over time. Under Biden, US equities could perform stronger than otherwise given the significance of his fiscal stimulus plans, and his more dovish approach to US foreign policy (which can benefit the performance of US multinationals).
- The US dollar could be stronger than otherwise if global risk aversion increases with the re-election of President Trump. In addition, confidence in strong performing Asian equities could also be tested over time as US foreign-policy settings would likely remain hawkish, especially relations with China.

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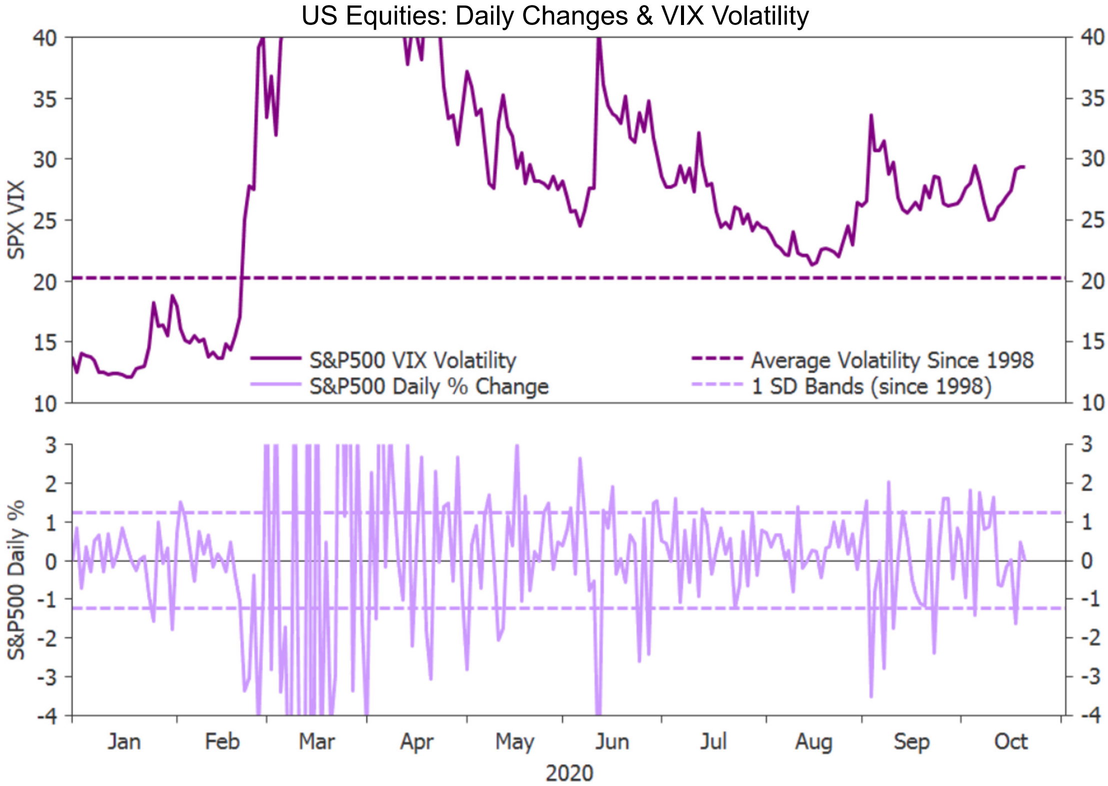
Positive news has been dominated by US election uncertainties

Despite the positive news (on 20 October 2020) that President Trump and the Democrats are moving closer to passing another large COVID-19 stimulus package (at around $1.8-2.2tn or 9-11% of GDP)[1] investors remain very cautious.

For example, US equity market uncertainty, as measured by VIX volatility, has increased over October and remains 1.5 times more volatile than usual with less than two weeks before the US elections (on 3 November).

[1] Source: Thomson Reuters

Figure 1: US equity volatility

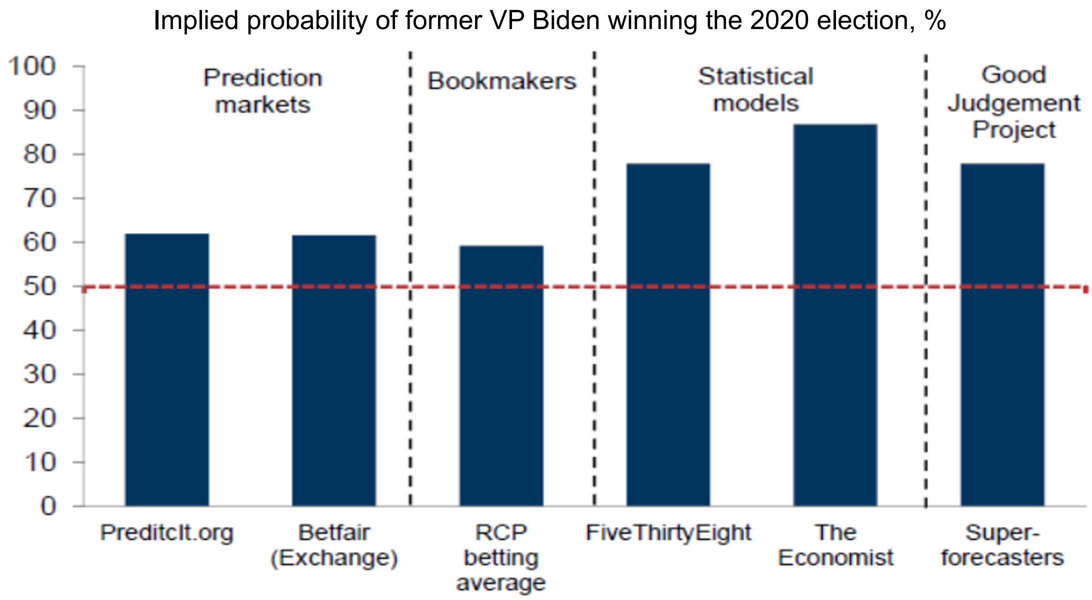


Source: Refinitiv Datastream, 21 Oct 2020

Markets are likely to be shocked by a re-election of President Trump

A variety of polls and models have been signalling a positive election outcome for the Democrats for quite a while now. Therefore, markets would likely be shocked the most by either the re-election of President Trump, or by a contested result.

Figure 2: Probabilities of Biden winning the election



Source: PredictIt, RealClearPolitics, FiveThirtyEight, The Economist, Good Judgement Project, Goldman Sachs Global Investment Research. As at 1 Oct 2020

Placing those events aside, the main driver of greater risk-aversion for investors seems to be trying to understand how supportive (or otherwise) US policy can be with the Democrats in control.

Below we outline our investment views against possible US election outcomes:

The status quo outcome - Trump legislative gridlock (Trump wins presidential re-election, Democrats hold the House, and the Republicans retain the Senate): A continuation of current policies, with a modest bias toward more fiscal policy stimulus over time. President Trump is likely to spend more which should be positive for US risk-assets. For example, he has talked about additional tax cuts for the middle class and a large infrastructure spending plan.

- US equities would likely continue to perform well, while the pressure would remain for bonds to slowly sell-off over time.
- The US dollar could be stronger than otherwise if global risk aversion increases with the re-election of President Trump.
- Confidence in strong performing Asian equities could be tested over time as US foreign-policy settings would likely remain hawkish, especially relations with China.

Outcomes would likely be similar (but even more surprising given current polling) if the Republicans also won the House in a clean sweep.

Democrat clean sweep (Biden wins the presidential race, Democrats retain the House, and win the Senate majority): Even if Republicans hold their Senate majority, fiscal policy is still likely to be more expansionary than under President Trump.

- The Democrats plan to increase government spending by $0.5tn p.a. (2.4% of GDP) for 4 years, with investments in infrastructure (especially utilities, rail networks, and broadband), education, health care, and housing.[2]
- Probably not until 2022, Biden plans to increase corporate, personal, and capital-gains tax rates, generating an extra $0.4tn p.a. (1.9% of GDP) in revenue on average.[3]
- Historically, a Democratic clean-sweep has been the least bullish for US equity market performance. However, this could change under Biden given the significance of his fiscal stimulus plans and his more dovish approach to US foreign policy (which can benefit the performance of US multinationals).

- On a net basis it is quite likely that Biden will create significant fiscal stimulus, which can be supportive of US equities, especially industrials.
  - The extra fiscal policy stimulus could also act as a catalyst for some rotation away from growth stocks towards cyclical stocks, which could be further enhanced when a COVID-19 vaccine is unveiled.
  - In the past, sharp economic accelerations that help to broaden equity rallies have often motivated investors to rotate from expensive growth stocks to low valuation cyclicals (especially those that experience significant improvements in earnings outlooks and are highly levered to economic growth).
- If the US fiscal deficit deteriorates by more than otherwise under the Democrats then that can lead to stronger than otherwise US growth, a larger than otherwise current account deficit, and a weaker USD. On the other hand, it is possible that if the positive growth effects are strong enough then the US dollar can be supported.
- Because Biden's foreign and global trade policies are likely to be more dovish than the Republicans outcomes can be bullish for global risk appetite and global equities.

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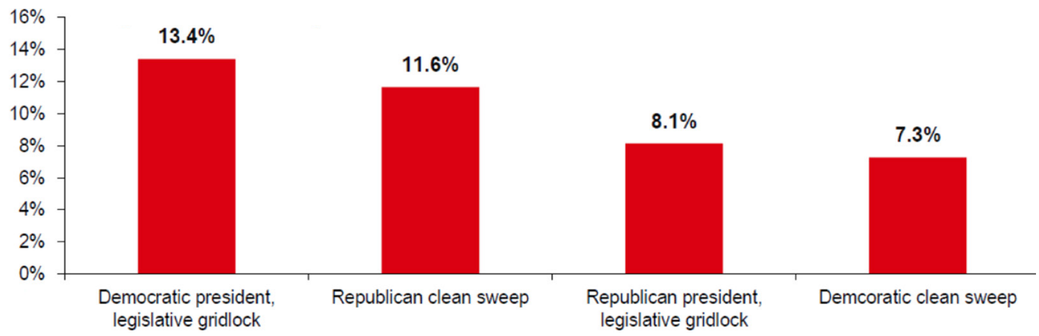
[2] Source: Goldman Sachs Top of Mind, 1 October 2020

[3] Source: The Tax Policy Center, Goldman Sachs Top of Mind, 1 October 2020

Biden legislative gridlock (Biden wins the presidential race, but Democrats lose the House, and the Republicans retain the Senate): This scenario would likely imply a broad continuation of current policies, but with less US foreign-policy tension, which could support global risk sentiment. Historically, a Democrat president with a split Congress has seen the strongest returns for the S&P 500 – however, that may not hold in a scenario where fiscal stimulus is less than Biden hopes for.

Figure 3: Historical US equity returns (% p.a) based on White House and Congressional control

S&P 500 annual returns based on party in White House and control of Congress (data since 1932)



Source: Bloomberg, HSBC, As at 7 October 2020

Delayed outcome (In the event no finalised election result is available on polling day or shortly thereafter): This could stem from delays in counting postal votes, recounts in tightly fought states, or a contested outcome. In this scenario, investors would likely suffer significant losses until the election was resolved and markets rebounded.

- The odds of a contested election may be higher than usual, given the surge in postal voting and its greater likelihood of being challenged. A drawn-out disputed election would create significant uncertainty and possibly drive a meaningful fall in US equities. Flight-to-safety could see currencies like the USD and the yen appreciate. Gold prices could also jump.
- Contested US elections are rare, having occurred only twice before (e.g. in 1876 between Democrat Tilden and Republican Hayes, and in 2000 between Democrat Gore and Republican Bush).
  - During the Gore-Bush saga, which required a month to resolve, US equities dropped about 7% from their pre-election level (while the USD and gold prices were firm).