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How might the US election result affect markets?

25 June 2020

The US presidential election will take place on 3rd November. Such has been the impact of the Covid-19 virus this year that investors' attention has, understandably, very much been centred elsewhere. But as the date comes nearer, markets are likely to focus more closely on the potential repercussions of the election outcome on the economy and corporate America. Given the clear differences in the two party's policies and perspectives we believe that the impact on financial markets could be quite significant.

Coming into this year President Trump's position looked strong with the economy recovering, equity markets nudging all-time highs and some potential progress in Chinese relations in the shape of a phase one trade deal. History was also on his side as incumbent presidents tend to be re-elected in the US unless they face recession in their tenure, amazingly a trend that has held since the American Revolution. Clearly much has changed since the Covid-19 outbreak with the US now in recession, unemployment at historic highs and with US/China relations once again looking more strained and doubts now looming over the trade deal. Recent social protests seem to be further damaging President Trump's popularity and his approval rating is currently notably low (41%).

As a result, the odds of (presumptive) Democratic candidate Joe Biden taking office have risen from 40% to 60% since March, an undeniably significant swing even if we have been reminded on numerous occasions in recent years to treat opinion polls with some caution.

So, what do we think will be the key issues for voters? The strength (or weakness) of the economy is always key when running into an election. Given events so far this year, this will perhaps be even more important than usual, as will the perceived ability of each party to stimulate a recovery.

The electorate's perception of how the Republicans have managed the pandemic will also be crucial – President Trump is not faring well in this respect and currently 55% of Americans disapprove of how the president has managed the crisis.

Looking still from a Republican perspective, we are thin on specific policy details elsewhere at this stage, but the assumption is that President Trump will continue with his 'America First', tough on China, tough on trade stance that proved popular with his core supporters first time around. He has already intimated a willingness to make further tax cuts if required to aid the economic recovery, as well as providing a potential boost from substantial infrastructure spending. There appears to be no change in the perception that the Republican administration is 'business friendly' in its policies, particularly in relation to taxation and regulation. If he were to stay in office, many also expect Trump to find a more dovish replacement for Jerome Powell when his tenure as Chair of the Federal Reserve ends in 2022 to try to ensure his desire for stimulatory, ultra-loose monetary policy remains fulfilled.

All this means that equity markets would doubtless respond well to a Trump victory.

Turning to the Democrats, Joe Biden is seen as a less progressive candidate than Bernie Sanders or Elizabeth Warren, however he is still likely to implement a number of policies that could have a major bearing on markets. The most significant and measurable change would be a likely raise in corporation tax (from 21% to 28%) and a closure of various existing tax loopholes.

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It is estimated that Trump's massive cut in corporation tax from 35% to 21% in 2017 led to an increase in S&P 500 Index earnings of around 10% and has been a key driver in the outperformance of the US market since then. A partial reversal in this tax rate policy would doubtless weigh heavily on the market. Less significant, but still potentially negative for equities, would be Biden's proposal to raise capital gains tax and limit companies' ability to deduct interest expenses from their tax liability.

Again from a corporate perspective, a new Democratic government could present further potential headwinds. Biden has spoken about introducing tougher antitrust (competition) policies that could impact heavily on, for example, the giant technology companies that have been such a key driver of the US market in recent years. Also proposed is a major reform of healthcare. This could involve making a 'public option' available as an alternative to private health insurance, which might undermine the business models of insurance providers. It could also involve limiting prices that healthcare firms can charge, potentially impacting profits of healthcare providers and pharmaceutical firms. Given that the healthcare sector represents about 15% of the S&P 500 Index, the effect of these proposals could also be significant.

Add to all this a proposal for a higher minimum wage and tighter regulation of the energy sector and it is perhaps inevitable that a victory for the Democrats would not be well received by the market. Of course, how badly it would be received depends on whether the Democrats secured a 'clean sweep' of the House and the Senate (current betting odds suggest they might). We have seen over the years that when control is divided, as it is currently, the ability of a president to implement their policies can be significantly reduced. It would, for example, be quite unlikely that a Republican controlled Senate would agree to these proposed corporation tax hikes.

It is also important to add that, while a Republican victory would be seen as favourable for equities, a policy that saw additional tax cuts and yet further federal spending could well lead to a spike in inflation down the line and in turn put significant upward pressure on bond yields.

Current expectations are that the result may be close, and the outcome may well come down to a handful of swing states. Trump's narrow and surprise victories in states such as Michigan, Pennsylvania and Wisconsin proved crucial four years ago and these states will be watched intently this time around. The spike in the pricing of volatility ('VIX') futures contracts around the election date points to a high level of uncertainty and suggests that financial markets have become more concerned about the prospect of a Democrat victory.

The outbreak of Covid-19 has also thrown up a number of interesting sub-plots around the election process and, as President Trump has already intimated, could conceivably add a level of controversy to the result. The campaigning season is being shortened and there have already been delays to the primary season as well as the date for the Democratic National Convention. The restrictions around organised gatherings is putting a greater onus on media-led campaigns, especially for the Democrats, and with it a much greater financial burden. Voter turnout could well be affected and there will be a greater reliance on alternative voting methods, the expansion of which is being proposed by the Democrats and strongly opposed by the Republicans.

We will be watching events over the next few months closely and focusing on potential opportunities and risks in markets. We do believe that a Democrat victory would hold the US market back in the shorter term. We should, however, perhaps be reassured by the fact that history shows that the US market is dynamic, driven in the longer term more by economic factors than politics, and can perform well under a variety of administrations.

We will, of course, continue to keep you updated on our thoughts as things progress.

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CL5943/20200625/1.01