U.S. Presidential Election: the Final Stretch

The U.S. election is entering into the final stretch with less than two weeks to go before November 3rd. In this issue of the Thinking Man, we discuss some of the most relevant issues that are likely to determine the winner, not only for the presidency, but also for the Senate. We also compare and contrast the different policies from each candidate, and anticipate what we believe are the potential consequences from a victory by Donald Trump or Joe Biden, in terms of the economy, financial markets and clients' portfolios.

1. What are the expected main policy differences between a Trump and a Biden presidency, and the potential impact on financial markets?

Both candidates do not present large contrasts in their monetary and trade policy proposals. They do however, offer stark divergences in their regulatory and trade policy proposals. The table below shows how positive or negative each candidate's policy stance is predicted to be for both stocks and bonds (a 1 is positive, -1 is negative, and 0 is neutral).[1]

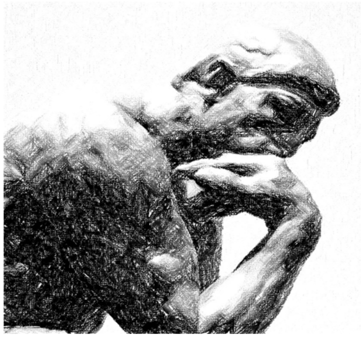
Proposed Policy Prescription and Asset Prices				
	Trump		Biden	
	Stocks	Bonds	Stocks	Bonds
Monetary	1	-1	1	-1
Fiscal	1	-1	-1	1
Regulatory	1	-1	-1	1
Trade	-1	-1	1	0
Total	2	-4	0	1

Source: Strategas Research Partners with numbers from BigSur Partners

Regarding monetary policy, the Fed's "whatever it takes approach" has funneled $7T of liquidity into the economy. A change in government will probably not alter this ongoing trend. As the table illustrates, this "Fed Put" will continue to be positive for stocks regardless of who wins the election.

[1] Ratings shown herein are proprietary and have not been endorsed by any bona fide third party rating agency.

The Thinking Man's Approach



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- The U.S. presidential race is entering the last stretch with less than two weeks until November 3.
- The differences in monetary, fiscal, regulatory and trade policies between the two candidates would mean that a reelection of President Trump could be better for the stock market, while an election of Joe Biden should be neutral, being slightly positive for bond markets.
- Although the margin has been shrinking lately, Polls and betting markets are pointing to a "Blue Wave" where Joe Biden wins the election and Democrats regain the Senate majority.
- Nevertheless, financial and economic data, such as the recent performance of the stock market and better economic growth, seem to be pointing to a reelection of President Trump.
- Because of this divergence, we actually believe that the election will be much closer than is currently anticipated. This uncertainty could lead to a higher risk of a contested election, with a temporary spike in volatility.

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

On the trade side, we believe Biden would be more bullish for equities given his pro-globalization stance, and probably more friendly approach to trade with China. Trump on the other hand, would probably exacerbate the trade war with China, and continue alienating many of the country's main trade partners, which is negative for globalization and for stocks in general.

The first real important difference is in the regulatory environment. Stocks would benefit from a continuation of deregulation under a Trump presidency, especially in the energy and financial sectors. Biden, on the other hand, would likely push for more regulation on businesses - mainly to control large tech companies – resulting in an environment that is negative for corporations but positive for bondholders.

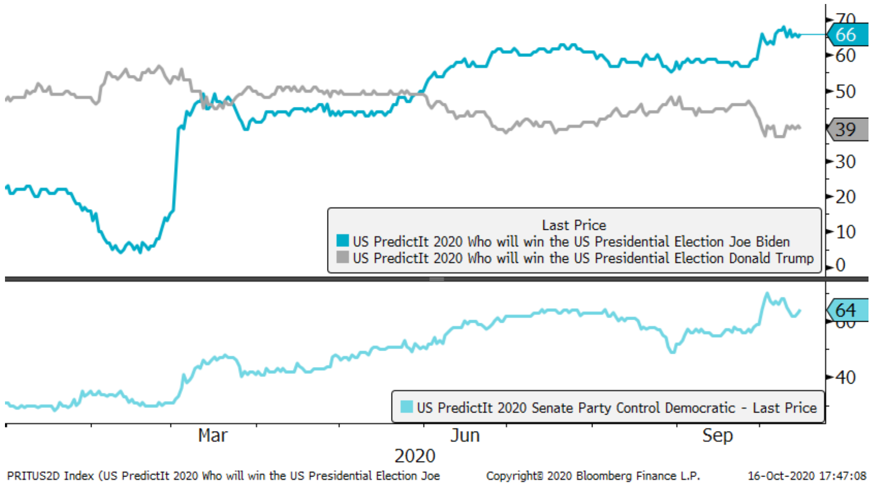
The last important contrast is in fiscal policy. Some analysts believe that Biden would be positive for stocks from a fiscal standpoint, given the enormous stimulus bill he has proposed, which would add to the monetary stimulus and continue fueling the rally we have seen recently in equities. However, his proposed fiscal agenda, which includes taxing corporations, income, small businesses, capital gains, dividends, and estate at a much higher rate than Trump, will hamper not only earnings but could also end up being detrimental to the economic recovery in the long-term. For example, according to Goldman Sachs, approximately 12% of S&P 500 earnings would be cut because of taxes on corporate profits. Since the economy is still in the middle of recovering from the pandemic, it is likely that Biden would not implement these policies until a solid recovery is underway in 2021. However, recent economic data is starting to reveal a slowdown in the recovery, which could delay a significant improvement beyond 2021. With this in mind, a Biden presidency could actually end up being negative for stocks.

One of the most insightful conclusions shown from the table is that in general, a Biden presidency would be more bullish for fixed income securities than Trump. This is because a "blue wave", which would mean the Democrats taking both the presidency and the Senate, would facilitate a large fiscal stimulus with appropriations for state and local governments, aiding the municipal bond market, amongst others. On the other hand, Trump would be more bullish for stocks in general, which we also attribute to the fact that he would probably not implement any additional lockdown measures, thereby hampering the economic recovery.

2. Polls are currently favoring the Biden campaign by an ample margin, while markets and the economy point towards a reelection of President Trump. Which is correct?

In the average of national polls, Joe Biden is leading Donald Trump by a comfortable margin of around 8%. Even as the gap has been closing in recent days, it is still large enough to signal that Biden should comfortably win the election if it was held today, as shown in the graph below. However, it is important to remember the 2016 election, where polls indicated a victory for Hillary Clinton, but a different outcome ensued. A repeat of the last election is the nightmare scenario for Democrats and the reason of hope for Republicans.

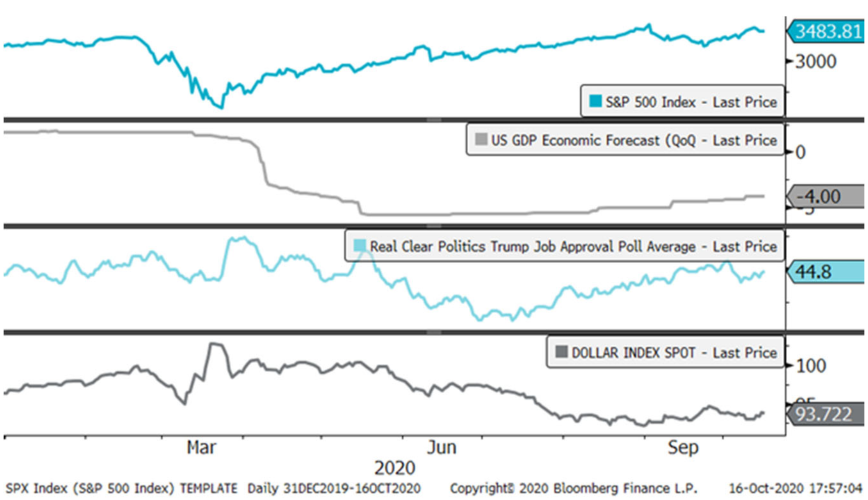
Four years ago, polls were actually correct at the national vote level. President Trump lost the popular vote by approximately 3 million votes. However, pollsters misrepresented the result in key swing states



and failed to adjust polls for white voters without college education who were heavily leaning towards Trump. Currently, polls appear to have adapted from four years ago in order to better represent the result. Nevertheless, polls may be missing some other necessary adjustments and could ultimately be underrepresenting President Trump's real chances at reelection.

A widely discussed possibility is that Trump supporters are becoming less prone to sharing their support for the President. However, many argue that if this were the case, we would see an increase in the percentage of undecided voters rather than an increase in Biden supporters. Unless voters are purposefully trying to skew the polls, which seems an unlikely scenario but not unfathomable.

However, the difference in the polls today between Biden and Trump is almost double the difference that Clinton commanded over Trump two weeks prior to the 2016 election[2]. Even if polls were wrong by the same margin as in 2016, Biden should still win the election.



Regardless of the expected winner from polling, some economic and market data is actually pointing to a different conclusion. For example, since 1984, the incumbent party has always been reelected as long as the S&P 500 had a positive return in the 3 months prior to the election.[3] In 2016, this held true as the market had a negative return in the three months prior to the election and the incumbent party lost. Today, the S&P 500 is up in the last 3 months, essentially pricing in a Trump

[2] https://www.bbc.com/news/election-us-2016-37450661
[3] www.strategas.com

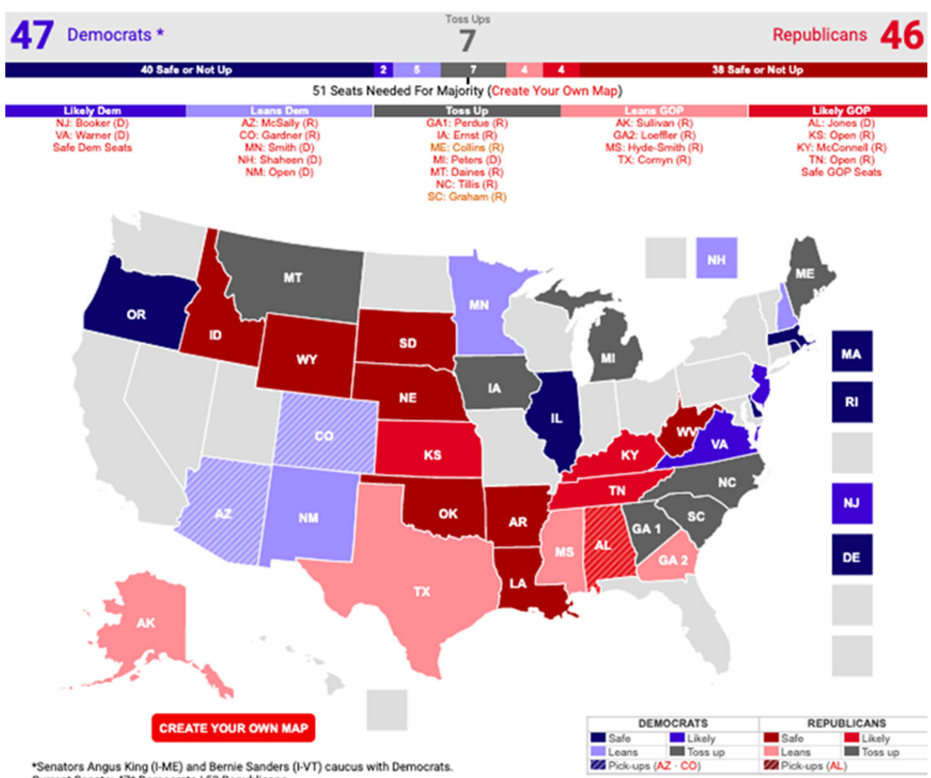
win. In general, the improving economic outlook – GDP forecast and job approval numbers, and a strengthening dollar – are showing an incumbent party victory, as illustrated in the graph above.

Even so, these indicators can be suffering from a "base effect" distortion, in which they are coming off such low levels because of the pandemic that they can only improve. A distorted economy in an atypical environment could mean that better economic data does not necessarily equate to a Trump victory. In fact, the Strategas Biden portfolio is outperforming the Trump portfolio. In 2016, this indicator accurately predicted the election results.

However, Strategas also conducts a survey of investment professionals, where the majority, albeit by a small margin, believe that President Trump will be reelected. RealClear Politics' average of presidential betting odds also shows a marked narrowing of the lead of Biden over President Trump in the past week and a half, 61.9% to 38.6%, a spread of 23.3%. On October 11, their respective odds were 67.5% to 32.8%, a spread half again as wide at 34.7%[4]. Because of this latest trend and the divergences explained previously we actually believe, that the election could be closer than polls and betting markets are currently suggesting.

3. Is a Blue Wave certain, as polls seem to indicate, and is this potential scenario currently priced in?

As can be seen in the first graph from the previous point, polls are predicting that the election will result in a "blue wave". This means that Biden is expected to win the presidency, while Democrats are expected to maintain control of the House of Representatives, and regain control of the Senate. It is almost certain that Democrats will retain the House, which they won over in the mid-term elections in 2018. As for the presidential election, as



[4] https://www.realclearpolitics.com/

explained in detail in the previous point, Biden's chances appear to be slightly better than Trump's, as we believe that the election is much closer than suggested by polls and betting markets.

Concerning the Senate, polls are currently also pointing to Democrats regaining control. However, this race is much tighter and difficult to predict than the other two. From the total 100 Senator seats, 35 are up for election, with 23 being currently held by Republicans and 12 by Democrats. Based purely on numbers, Republicans seem more vulnerable as they have almost double the seats open for election when compared to Democrats. For example, Democrats are expected to retain eleven seats, losing only in Alabama, where they had won special election in 2017. On the other hand, Republicans are expected to lose seats in Arizona and Colorado, with several other Republican states tied.

As can be seen in the RealClear Politics map above, the race for control of the Senate is extremely close. Based on the average of state polls, they predict that seven races are virtually tied (toss ups), with the outcome of these elections deciding which party will control the Senate over the next couple of years. Without these seven races, Democrats should have 47 seats and Republicans 46. Hence, for a "blue wave" to materialize, Democrats would need to win at least three of the seven toss up races[5].

Even as Democrats have centered their efforts in these states, such as registering people to vote and outspending Republicans in political advertisements, it is important to acknowledge that most of the races are in places that have traditionally voted Republican, such as Georgia and the Carolina's. Democrats would need a major upset to win in traditional Republican states. Some analysts have suggested that for Democrats to pick up three or more seats, Biden would need to win by more than 5%, which is less than what polls are currently anticipating. In our view, this argument is flawed, as it would suggest that a person would vote for one party in the presidential race while voting for the other party in the Senate election, which is actually what some recent reports seem to believe. Therefore, we strongly believe that a Democrat "blue wave" is far from certain.

Historically, markets have usually performed better when there is a divided government. The recent performance of equities would seem to suggest that market has not priced in the prospect of a Democratic sweep, where Mr. Biden would be free to implement his agenda, without any pushback from Republicans. As mentioned in the first point, a reelection of President Trump would seem better for the equity market, taking into consideration the likelihood of tax hikes proposed by Biden. If a "blue wave" were to materialize, we would naturally expect a correction of the equity market that prices in the reduction in corporate earnings. Nonetheless, it would also enable Democrats to implement an aggressive fiscal package, similar to the HEROES act approved by the House earlier in the year, which would put a floor to any potential correction. Finally, some analysts believe that Biden could delay any proposed tax hikes until the economy has recovered from the current recession. As a result, it is more likely that the market is in a wait and see mode, expecting not only the result of the election, but also the underlying message in case of a "blue wave".

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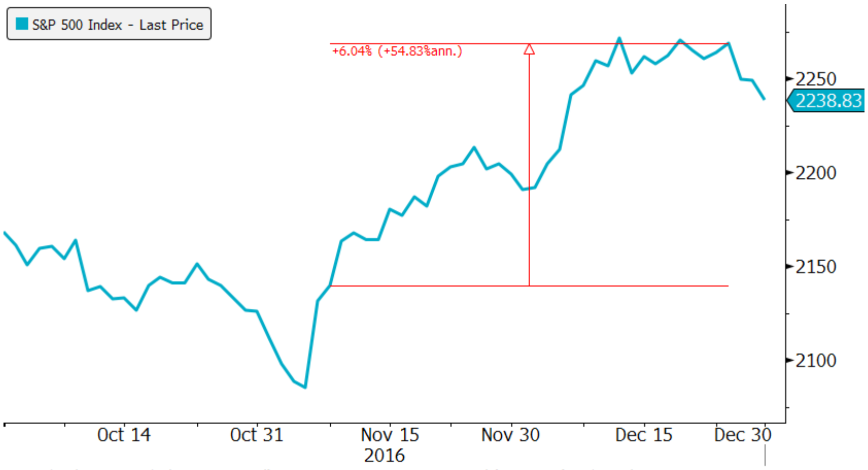
[5] Assuming Biden wins the presidency, Democrats would only need 50 seats to have the majority as the Vice President would have the deciding vote in any tie.

4. What is the possible market reaction in the case of a Trump reelection?

Thus far, we have centered most of our analysis on the implications of a Biden presidency and a democratic sweep. However, four years ago President Trump staged a huge upset by defeating Hillary Clinton, who was expected to win the election based on poll numbers and betting markets. The story is quite similar four years later, the Democratic nominee is ahead in the polls and President Trump is battling for another major upset. In the second point, we have already discussed why the economy and the stock market, amongst others, are sending a different message from what polls are showing, and the main reasons we believe that the election is much closer than expected.

Several months ago, the market was uneasy about a Biden presidency, as the main point in his agenda was repealing the tax cuts from the Trump administration. However, the market grew much more nervous with the prospects of a contested election that would potentially drag the result to the Supreme Court, for weeks or months, similar to what happened in the 2000 election of Bush v. Gore. The widening in the polls in favor of Biden appears to be welcomed by the market, as the fears of a contested election seem to have dissipated. Furthermore, a huge fiscal stimulus bill in case of a "blue wave" could offset some of the damage of a potential increase in the tax rate.



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If history repeats itself, and President Trump stages a second major upset, the market would quickly need to readjust its expectations. Four years ago, the market rallied significantly following the election as the prospects of less regulation and a decrease in taxes came into light. From the beginning of November 2016 to the peak of December 2016, the market rallied by approximately 6% as illustrated in the graph above. We believe that a similar performance could be in store in case of a win by Trump, as there would not only be an increase in taxes, but also discussion of further tax reductions. There would also be a continuation of corporate deregulation, which has been at the front of the Trump administration, and would lead to additional gains in corporate earnings.

5. How should investors position their portfolios in anticipation of the election?

Regardless of what polls are showing, we believe that there is still a high degree of uncertainty regarding the U.S. election. With this in mind, we believe that this is not the time to be implementing radical tactical changes to the portfolio based on expected election results. This is no different to what we have been suggesting over the last few months. We remain constructive on the equity market, as we believe that monetary and fiscal stimulus will continue to support the economic recovery going forward, despite the recent slowdown. Even as stocks seem expensive and valuations looked stretched, they are relatively attractive when compared to fixed income markets. For comparison purposes, the 10-year Treasury bond is currently yielding 77 bps, while the implied equity risk premium has remained at around 4.75%.

In equities, we think that the rotation theme will continue to develop in the fourth quarter of 2020 and 2021. As the economic recovery carries on, investors should continue to shift from high-flying mega-cap tech stocks to cyclical sectors such as financials and industrials. However, the economic recovery seems to be losing momentum, which is the main reason why we do not advocate for an immediate switch of the entire portfolio towards this theme. Furthermore, we continue to recommend a "bar-bell" portfolio with exposure to cyclical stocks that can benefit from the economic recovery, and tech mega-cap stocks that have acted as safe havens, and can still provide upside from the secular changes in consumption dynamics.

In fixed income, sovereign and corporate bonds are still expensive as yields and spreads have collapsed and remained at historical lows. Bonds are producing almost no income, and the recent rally is unlikely to produce additional gains. Similar to what happened over the last decade, fixed income investors have been pushed out of their zone of comfort in the search for yield. With this is mind, we continue to advocate for high yielding strategies such as hybrids, perpetual and preferred securities, which are still providing attractive income levels for investors, and better compensating them for the risks taken.

In conclusion, financial and economic indicators contradict political indicators (like polls and betting markets), so we frankly do not feel comfortable in predicting a result. We feel that two weeks in this election campaign is similar to the last 5 minutes in a basketball game: anything can happen. We think the debate on October 22 and the potential effect of the Democratic Party's position (or lack of) regarding topics like court packing and Hunter Biden emails issue, could still affect the election results. Nevertheless, we think it is very unlikely we will know the outcome of the election on the night of November 3, upsetting investors' hope and confidence in an uncontested outcome. As such, this could provoke increased hedging activity and spike in volatility and the VIX in the days prior to Election Day.

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