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US 2020: The COVID Election — Part I

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C20-16582 | 09/2020 | EXP 09/30/2021

Insights
Multi-Asset Solutions

24 June 2020

US 2020: The COVID Election — Part I

Elliot Hentov
Head of Policy and Research

This is Part I of a mini-series that looks at the US Presidential Elections. Part II will consider the policy trends of a second Trump administration or the alternative Biden administration and its relevance for markets.

We had been concerned about the US presidential elections coming into this year, describing them somewhat facetiously as an "EM election with a reserve currency". From past research, we understand how narrow, polarised and disputed elections in emerging markets (EM) reverberate in asset prices. However, we have no such past experience with similar events in an economy with a reserve currency and the deepest of capital markets. In short, the downside risks are far more numerous than any possible upside policy surprises.

Recent social unrest in the United States (US) illustrates the potential for tail risk outcomes. Investors are rightly beginning to re-examine the impact of the upcoming election. Pre-pandemic surveys of international investors had showed majorities in excess of 80% believing that President Donald Trump would sail toward re-election, even as betting markets had ranked his odds around 60%. Our own fundamental analysis had put it closer to a coin toss back in February. The economic shock now lowers those re-election prospects dramatically.

Figure 1
National Macro Indicators and US Presidential Re-Election Correlation

Indicator	Minimum Threshold	2016 Comp	Pre-Covid	Current	Yes/No
Real Disposable Income Growth	1.3%	0.7%	2.2%	1.05%	✗
Nonfarm Payrolls	127k	208k	176k	-3.15m	✗
Real Personal Consumption	2.4%	2.7%	3.9%	-2.9%	✗
Real GDP	1.1%	2.05%	2.05%	-1.35%	✗
Consumer Confidence	84.8	107.9	109.8	100.8	✓
Presidntial Job Approval Rating	47%	51%	44%	45%	✗

Source: Macrobond, US Federal Reserve, Bureau of Labor Statistics, University of Michigan, State Street Global Advisors.

Figure 1 draws on the strongest correlations of indicators in post-war US presidential elections (admittedly a very small data sample), using the 6-month average preceding the election. The second column highlights the minimum threshold that an incumbent party enjoyed during a re-election, while the others give recent point-in-time accounts. Only consumer confidence still hovers above the minimum threshold, though that is an arithmetic function given that we have only had three post-COVID survey results.

Election Uncertainty Premia

Even more ominous given electoral college dynamics, the handful of swing states that are truly relevant in this election have suffered disproportionately from the public health and economic crisis. President Trump's approval ratings in swing states yields an average of 41%; all recent direct head-to-head surveys against Mr. Joe Biden are now below levels needed for re-election, though still conceivably close. The President's strategy now relies on risky gambles to generate a comeback.

These shifting dynamics are introducing "election uncertainty premia" earlier than in typical presidential election years. Moreover, given the broader range of policy outcomes (on top of various Democratic proposals, there is not much clarity about policy priorities in a Trump II administration), this premium will necessarily be wider than in regular election cycles.

In the post-WWII era, presidential election years generated an average 11.6% gain in the S&P 500, a large chunk of which materialised in the second half of the year once markets could forecast the election outcome. The drawdown in the first quarter means such returns are fanciful, but more concerning is whether US polarisation makes these elections a high-stakes drama similar to EM elections. Moreover, there is a considerable risk we see in terms of the long-term erosion of US institutions, notably those that govern the propriety and credibility of its election process.

Already there are a number of significant legal disputes in key swing states in anticipation of the November vote (e.g., felon re-enfranchisement in Florida; voter rolls removal in Wisconsin; voter ID requirements in North Carolina; ranked-choice voting in Maine) that may not be resolved by then. Any election victory that relies on the outcome in just one or two states is liable to be challenged by the losing party in a drawn-out legal process. In any event, COVID-19 means that the share of mail-in ballots will reach an all-time high, preventing the declaration of a winner on election night unless it is a landslide.

Investment Implications

From a market perspective, the worst outcome would be a narrow loss for President Trump that he refuses to accept, plunging the US into a constitutional crisis far worse than the 2000 Florida recount. It is not clear how many weeks would pass before weak sentiment could further damage real-world capex and consumer confidence suffering from the pandemic overhang.

In comparable EM elections, asset price movements follow a conventional pattern: higher volatility, sharp currency depreciation and depressed equity markets as foreign investors head for the exit. But how would this play out with the world's reserve currency, the largest equity market and the quintessential risk-free asset? The 2008 financial crisis originated in the US, but US assets nonetheless still operated as the safe-haven vehicle in the actual crisis. Would a home-made political crisis alter that safe-haven perception?

There remain few alternatives to US dollar instruments that offer the same safety and liquidity characteristics, but we would expect some capital outflows. This would not only mean classic safe-havens such as the yen, Swissie (USD/CHF) and gold would benefit, but there would be capital flows driven by home bias and safety parameters, benefiting most counterparts to the US dollar. In short, the US election could provide the trigger for the long-awaited end of the strong dollar cycle with big implications for the coming decade.

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ID242783-3136988.1.1.GBL.RTL 0620
Exp. Date: 30/06/2021