Economic Insights

US election: Second wave or blue wave?

Financial market events

- **The US Presidential election is on Tuesday 3 November 2020 (Wednesday 4 November 2020 AEDT). This note updates the detailed election preview issued on September 22. The initial report can be found at:**

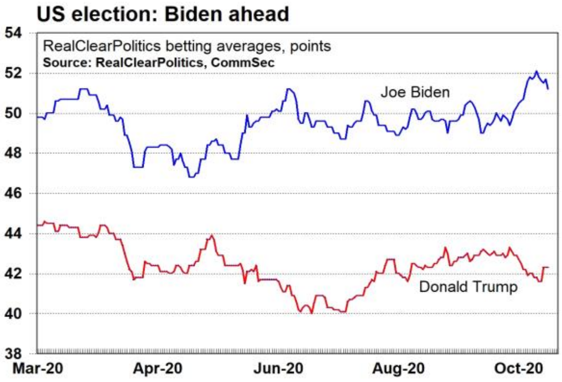
https://www.commsec.com.au/content/dam/EN/ResearchNews/2020Reports/September/ECO_Insights_220920-The_panedemic_presidential_election_&_financial_markets.pdf

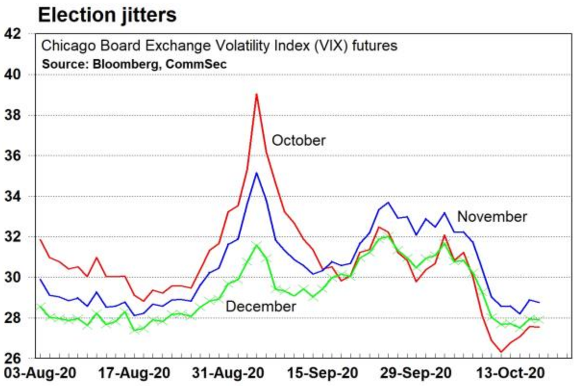
- **Since the first presidential debate on September 29, former US Vice-President Joe Biden has increased his lead over incumbent US President Donald Trump in opinion polls.**
- **President Trump announced on October 2 that he had tested positive for COVID-19, but was released from the Walter Reed military hospital on October 5. A passenger on Joe Biden's campaign plane tested positive for the virus on October 15, but Joe Biden has since tested negative to the infection.**
- **The second scheduled presidential debate was cancelled on October 9, but the vice-presidential debate was held on October 7. The final presidential debate takes place on October 22 in Nashville, Tennessee.**
- **There is growing consensus amongst investors for a period of extended volatility around the election, despite volatility options positioning normalising a little in recent weeks. The majority of Wall Street investors still expect a contested US election result due to large volumes of postal and absentee votes. And possible candidate ill health from virus infection or re-infection remains an election 'wildcard'.**

US Presidential elections are periods of uncertainty, potentially affecting investors, businesses and consumers decision-making.

What does it all mean?

- US President Donald Trump returned to the campaign trail last week – less than a fortnight after testing positive for COVID-19. The President appeared at a rally in Florida, claimed to be *"immune"* to the virus and danced to the Village People's song 'Y.M.C.A.' The upbeat tone probably reflected the President's attempts to rejuvenate his flagging campaign by speaking directly to his voter base in the 'Panhandle', Pennsylvania, Iowa, Michigan and Wisconsin. The rallies took place without social distancing despite President Trump refusing to take part in a second scheduled presidential debate on October 9, just days after being released from hospital.
- Of course, the decision to avoid the debate - and conduct rallies and virtual town halls - may have something to





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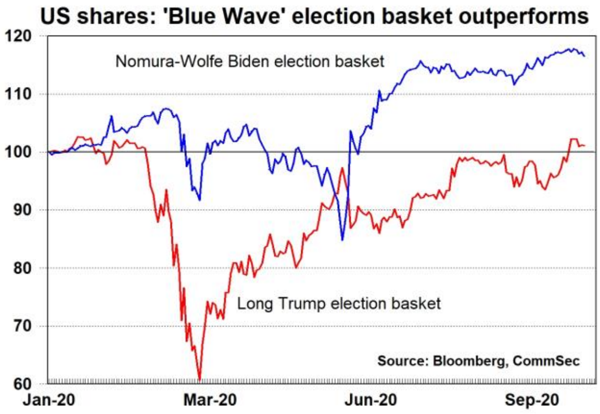
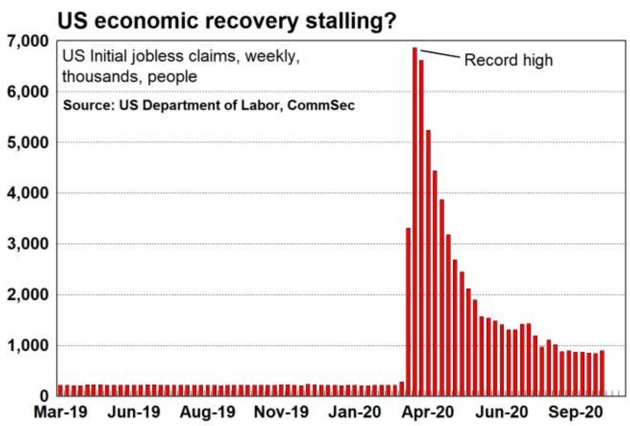
do with the optics of the ill-tempered first presidential debate held on September 29. The 'debate' descended into 90 minutes of chaotic exchanges, insults and interruptions as the candidates duelled on the pandemic, the economy, law and order, and the environment.



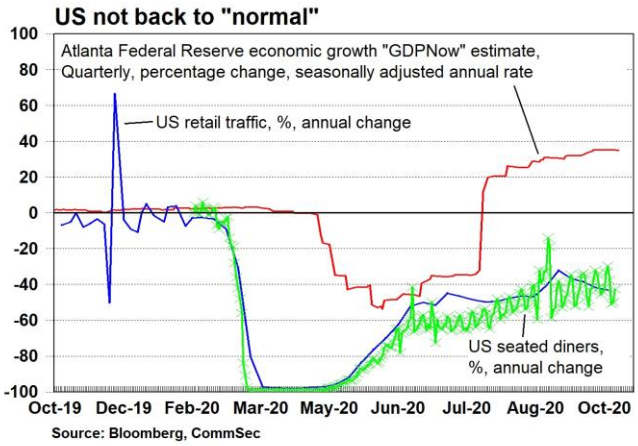
- It has been a tumultuous few weeks for the President. Some political commentators have argued that President Trump's disregard for health protocols, the contentious nomination of Federal Judge Amy Coney Barrett to the US Supreme Court and concerns over his tax affairs have antagonised voters.
- The polls have certainly taken a turn for the worse for President Trump. According to RealClearPolitics, its average poll spread had former Vice-President Joe Biden ahead of President Trump by 6.1 points (Biden 49.4 versus Trump 43.3 points) just prior to the first debate. That lead has since widened to 8.9 points (Biden 51.2 versus Trump 42.3 points) on October 15. Importantly, Democratic nominee Biden continues to hold a lead - albeit narrower - across key battleground states of around 4.5 points.
- Election betting market averages shifted decisively in Joe Biden's favour in October with pollster 'FiveThirtyEight' now assigning an 87 per cent probability of him winning the US Electoral College - and presidency. In response, financial markets are increasingly pricing-in odds of a Democratic Party clean-sweep ('Blue Wave') - including gaining control of the prized US Senate – while factoring in less chance of a contested election outcome.
- That said, the reliability of opinion polls remain questionable in the aftermath of unexpected 'populist' victories in recent years. And if the October Bank of America Merrill Lynch (BofAML) survey of global fund managers is any guide, professional investors still remain largely unconvinced that risks have dissipated over the potential for a drawn-out and disputed election outcome. In fact, with the election just weeks away, 61 per cent of Wall Street fund managers said they believe the election result will be contested.
- And that doesn't take into account the potential for both presidential candidates to be infected or re-infected with COVID-19 – potentially delaying the election or increasing uncertainty. On October 15, a passenger on Joe. Biden's campaign plane tested positive for the virus, but he has since tested negative to the infection. Of course, President Trump's negative attitude to face masks has meant that he's vulnerable to re-infection – especially with a resurgence or 'second wave' of virus outbreaks across key swing states – Illinois, Ohio and Michigan. Daily case records have been broken in Illinois, Wisconsin and North Dakota in recent days.

Is Trump's presidency terminal?

- As detailed in our previous report, history is against President Trump. His chances of being re-elected has been dented by the dual-pandemic recession and US sharemarket correction during the presidential campaign. Of course, the election will also be a referendum on the Trump Administration's handling of the health crisis.
- In the most recent Wall Street Journal/NBC News telephone poll of 1,000 registered voters conducted between October 9 and 12, 57 per cent of respondents disapproved of Trump's handling of the pandemic. And 39 per cent of those surveyed said that the coronavirus was their top election 'issue' with 98 per cent nominating Joe Biden as best placed to handle the virus resurgence. And the most COVID-19 affected cohort - voters aged 65 years and older – appear to be mobilising behind former Vic-President Biden. An October 7 Quinnipiac University poll shows that seniors prefer Biden to Trump by 51 per cent to 40 per cent in senior-heavy swing state, Florida.
- But all is not lost for the President. The economy remains 'front of mind' for most voters (47 per cent), according to respondents in the Wall Street Journal/NBC News telephone poll last week. And 74 per cent of those surveyed think President Trump is best placed to guide the US through its post-pandemic economic recovery.



- Why? Prior to the pandemic, the jobless rate hit 50-year lows, small business confidence was at 30-year highs, shares and corporate earnings lifted following tax cuts and the wages of America's poorest were growing at the fastest pace since 2008 at 4.7 per cent per annum.
- But what does the most recent US economic data say? Job gains slowed (+661,000) in September – the last before November's presidential election. The jobless rate has fallen to 7.9 per cent after hitting 14.7 per cent during the April lockdown. But the participation rate fell 0.3 percentage points to 61.4 per cent - as women gave up looking for work possibly to care for children - as the virus re-intensified.

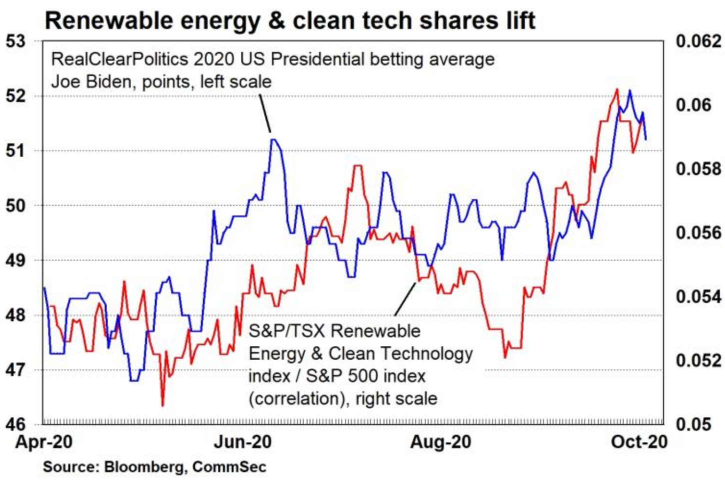


Also, average hourly earnings rose by just 0.1 per cent in September. And initial jobless claims (claims for unemployment benefits) hit two-month highs (898,000) in the week ended October 9, implying that the economic recovery is stalling as America struggles without a COVID-19 vaccine and fresh economic stimulus. A stimulus package now appears unlikely until after the election – especially with some Republicans opposed to increasing government deficits and debt. That said, US Democratic House Speaker Nancy Pelosi has recently said, *"relief will not wait until January."*

- The lapse in jobless aid for unemployed Americans and small businesses has shown up in an easing of consumer spending, off post-lockdown high levels. Consumer sentiment improved in October, but remains below pre-pandemic levels. Minneapolis Federal Reserve President Neel Kashkari said that he's concerned about the absence of near-term fiscal stimulus - which could dampen economic sentiment - leading to heavy losses by businesses and rising unemployment.
- The strong housing market - fuelled by ultra-low borrowing costs, the rebound in sharemarkets and a potential passing of a virus relief package ahead of November 3 could yet boost the President's re-election prospects. And a survey of economists by Bloomberg forecast a 29.2 per cent rebound in annualised economic (GDP) growth in the September quarter after the 31.4 per cent GDP plunge in the June quarter.
- The Economist magazine polling analysts are cautioning that, *"The race for the White House is a little closer than it looks."* In its view, Donald Trump's supporters may be declining pollsters' calls because their candidate is behind in polls. This phenomenon is called "differential partisan non-response." Therefore, The Economist model is *"slightly more bearish"* than others on Joe Biden's lead. Nevertheless, the pollsters still only assign a one-in-ten chance of a Trump victory even when adjusting for his silent or hidden voters.
- Despite this, President Trump won with only 46 per cent of the popular vote in November 2016 - yielding 306 electoral votes - so he does have a decent buffer before he drops below the 270 Electoral College 'danger zone.'

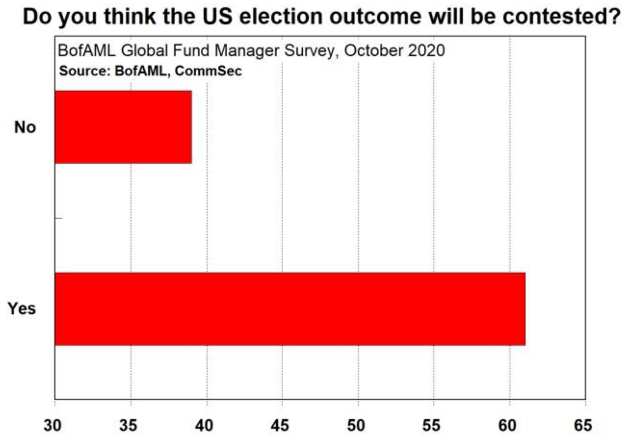
Bidenomics and financial markets

- A unified Democratic government – complete with huge fiscal stimulus – could boost economic growth, risk assets and the US Treasury term premium, while attracting capital inflows.
- Of course, supressing the 'second wave' of virus infections will be Joe Biden's top priority should he be handed the keys to the White House. Former Vice-President Biden has already said that he will provide more testing and contact tracing and that American businesses and schools both need more funding and directives from government agencies to reopen and contain the virus. Containing the virus – given recent vaccine trial setbacks – is critical to avoid the re-imposition of government restrictions. A return to lockdowns could stall the economic recovery, jobs market and weigh on confidence. This scenario has already contributed to a recent sell-off in European sharemarkets.
- The next pressing matter is economic stimulus. A Biden presidency and Democratic Senate 'sweep' (in addition to their hold on the US House of Representatives) would likely mean a larger fiscal stimulus plan - more than what conservative Republicans Senators are currently willing to provide. A Biden recovery plan could amount to US$2-3 trillion, including boosting unemployment insurance, support for state and local governments, extended loans to small businesses, green-friendly infrastructure spending, R&D on technology and renewables, and increased spending on healthcare, education and social housing. Combined with ultra-easy monetary policy, fiscal stimulus could boost risk assets, such as shares. Goldman Sachs has estimated that near-term fiscal stimulus would add 1 percentage point to the annual GDP growth rate in Biden's first term as President.



- But Joe Biden is also widely seen on Wall Street as likely to raise taxes – mostly on the wealthy and corporate America. If tax rates – including on capital gains – were to be lifted on January 2022, shares could be pressured in late 2021. In 1986 and 2012, US shares fell by around 5 per cent after capital gains taxes were increased, but the downward pressure was short-lived with shares recovering in the first halves of 1987 and 2013.
- US banking giant Citigroup released its September quarter earnings results last week. When asked

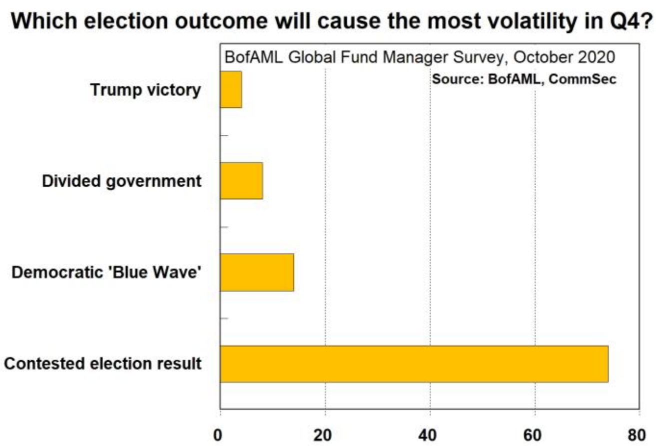
about the possible implications of a corporate tax increase from 21 per cent to 28 per cent - as proposed by Democrats - Citigroup's Chief Financial Officer Mark Mason said that the shift could bolster its deferred tax allowance by US$4 billion. In fact, US banks with significant carry-over losses and foreign tax credits like Citigroup, JPMorgan and Bank of America, may in fact benefit from a tax hike because their tax assets would rise in value in proportion to the tax rate increase.



- But the American Enterprise Institute's Penn-Wharton Budget Model found that the Biden tax plan could reduce average annual GDP by just 0.2 percentage points in the long run, while boosting wages. And investments in infrastructure and clean energy would lift productivity growth.
- Already traders are bracing for a potential 'Blue Wave'. The expected big lift in government spending, a less confrontational trade policy (in favour of alliances and 'consensus competition') and focus on infrastructure and clean energy investment is being expressed by investors across the risk spectrum ahead of the election.
- **US shares:** Savvy investors are already 'loading up' on renewable and clean energy shares with the S&P/TSX Renewable Energy & Clean Technology index outperforming the benchmark S&P 500 index. Renewable and clean energy shares have surged 84.4 per cent over the period from March 23 (COVID-19 lows) to October 16 – well ahead of the 55.7 per cent lift in the S&P 500 index.
- **US government bonds (Treasuries):** Bond traders and investors are positioning for higher spending under a Biden administration, which could have implications for inflation, debt issuance and US Federal Reserve interest rate expectations. Investors continue to sell 5-year and 30-year US Treasuries. In fact, shorts - as a share of open interest - are the largest in two years, while investors are the shortest they've been since mid-2006 for the 30-year maturity. As a result, the popular 5s30s yield curve continues to steepen ahead of the election, but investors remain slightly long (overweight) 10-year Treasuries. The ICE BofA MOVE index of US Treasury volatility has lifted off low levels in recent weeks.
- **US corporate bonds:** CCC credit rated US corporate paper has outperformed, likely reflecting a declining risk premium and expectations of stimulus.
- **Currencies:** A large stimulus package under Joe Biden would weaken the US dollar (USD). Investors are already betting on a Trump defeat by selling the Russian ruble (RUB) and buying the Mexican peso (MXN) – reversing the 2016 'Trump trade' when President Trump said he'd build ties with Russian President Vladimir Putin while building a border wall with Mexico. Appetite for riskier emerging market currencies - Brazilian real (BRL), South African rand (ZAR) and the RUB - have lifted, but new global virus woes threaten their near-term demand. And the Chinese yuan (CNY) has rallied as China's economy has recovered, while former Vice-President Biden is seen as likely to be less confrontational on trade.
- **Gold:** While a disputed election outcome could boost the allure of safe-haven gold, a weaker US dollar – courtesy of stimulus – could also support gold prices. Gold investors have been pushing Exchange Traded Fund (ETFs) holdings higher in anticipated of the next 'leg up' in the rally.

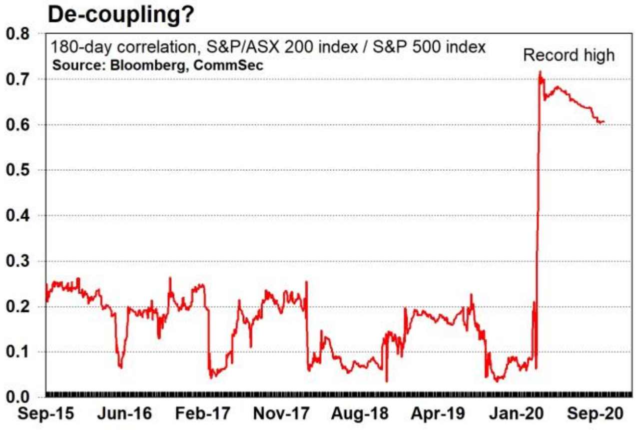
Contested election?

- Are financial markets getting complacent about a potential 'Blue Wave'? While Joe Biden raised a record US$383 million in September, the 'smart money' certainly isn't convinced that Trump won't 'pull a rabbit out of his hat.' In the October BofAML survey the US election is viewed as the second largest 'tail risk' for markets. And when asked what outcome causes most volatility, 74 per cent of respondents said a contested election, 14 per cent nominated the 'Blue Wave', 8 per cent said a divided US Congress and 4 per cent said a Trump victory.
- Sharemarket investors have been in a defensive crouch in the lead up to the election, expecting the usual fireworks from the Trump campaign. Demand for hedges to protect against volatility has been strong. Insuring against losses on the S&P 500 index is most visible in the current shape of CBOE Volatility (VIX) futures curves. In fact, November VIX futures - which reflect the market's expectations for volatility through November 18 - are more expensive than October, while December futures prices have been creeping higher as traders increasingly anticipate a delayed result. That



said, all curves have normalised a little since President Trump's virus recovery.

- Put options that protect against a 10 per cent drop in the S&P 500 over the next three months traded with an implied volatility of around 32 as of October 2 – the day of President Trump's COVID-19 diagnosis. That compares with a reading of about 20 at around the same time before the prior two elections and still below the 35 recorded in the 2008 Global Financial Crisis.
- In our view, there are three likely electoral outcomes – (i) A Democratic sweep; (ii) A Biden presidency, Democratic House and Republican Senate; and (iii) Trump is returned, the Republicans control the Senate and the Democrats control the House. In scenario one, a progressive set of policies would be implemented. For scenario two, the Republican controlled Senate would oppose Biden's more progressive agenda with gridlock likely for at least two years. In scenario three, the continuation of Trump's 'America First' and deregulation agenda would continue.



- Given the uniqueness of the pandemic presidential election anything seems possible in the lead up to November 3 and beyond. The unprecedented amount of mail-in and absentee voting in response to the pandemic means some swing states won't be able to count all of their ballots on election night because of the rules for when they can start processing and tabulating them. And then there's the possibility of either presidential candidate getting ill before the election or inauguration day. President Trump has already threatened to dispute the election and Republican voters have expressed distrust with mail-in voting.
- Swing states, Florida, Georgia, North Carolina, Iowa and Ohio, all remain tight contests. And Arizona, Wisconsin, Michigan and Pennsylvania could still lean in Trump's direction. The Democrats are favoured to win the Senate, but again political pundits expect voting to go down to the wire.

What are the implications for Aussie investors?

- Uncertainties over the virus 'second wave', a potential vaccine, fiscal stimulus and the US election outcome are likely to introduce bouts of extreme volatility to financial markets over the coming months. Australia's economic outlook is largely dependent on Melbourne successfully emerging from its second lockdown, despite remaining captive to overseas developments.
- Interestingly, a measure of 180-day correlation between Australia's S&P/ASX 200 and the US S&P 500 indexes has eased since hitting highs of 0.7178 on March 18. Australia's recently announced government stimulus measures and relatively higher yielding assets may contribute to an even further decoupling from its US peer.
- Aussie investors are in for a big couple of days in early November. Commonwealth Bank (CBA) Group economists expect the Reserve Bank to lower the cash rate target, term funding facility rate and three-year bond yield target to 0.10 per cent as well as potentially announcing purchases of longer-dated bonds on Melbourne Cup Day (November 3). Then everyone will be fixated on their screens on Wednesday November 4 as the US election results trickle through.
- CBA Group currency strategists have assessed a range of scenarios for the Aussie dollar against the greenback based on the 2020 US election result, as follows:

Possible market reaction for three US election scenarios

	Scenario 1	Scenario 2	Scenario 3
President	Biden	Biden	Trump
House of Representatives majority	Democrat	Democrat	Democrat
Senate majority	Republican	Democrat	Republican
Potential one-month market reaction			
AUD/USD	2%-3% rise	2%-3% fall	4% fall

Source: CBA

- If former Vice-President Joe Biden's 9 point poll lead holds through to November 3, President Trump will need to produce the biggest comeback since World War II to overturn the deficit. According to Deutsche Bank, the largest polling error occurred in 1948 when President Truman won by 5 points despite being behind by 4.4 points in the final pre-election polls.
- But rather than focusing on the election outcome, Aussie investors should assess whether their existing investment allocations still align with their current set of personal circumstances and speak to their financial advisors.

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