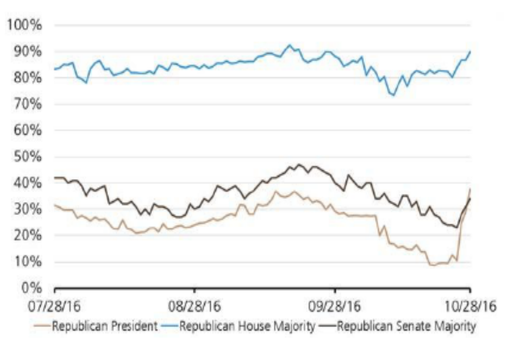
US presidential elections

Are markets bracing for a major shock in November?

Markets are now predicting a high likelihood of a Republican House majority, but Democrats are still favored to win the White House and a Senate majority.



Source: Iowa Electronic Markets - 2016 US Presidential Election Markets (Winner-Take-All), UBS, as of 28 October 2016. PredictIt.org - Will Republicans maintain a Senate majority after the next election? UBS, as of 28 October 2016. PredictIt.org - How many House seats will the GOP hold in January? UBS, as of 28 October 2016.

A Trump presidency no longer "unthinkable"

Polls giving Trump slight lead

- A Donald Trump presidency is no longer as "unthinkable" as some had initially believed. The populism that appears to have underpinned the UK's Brexit result is a global phenomenon and one that Donald Trump has successfully exploited, by presenting himself as the anti-politician.
- The disclosure by Director James Comey that the FBI was reviewing new emails related to Hillary Clinton's use of a private e-mail server during her tenure as Secretary of State saw the Democrat's lead narrow with the latest polls showing now a slight lead for Trump.

There seems to be no good outcomes

- A Trump presidency with a Republican Congress brings the possibility of significant policy changes if his rhetoric on trade, immigration, and debt service are pursued.
- Hillary Clinton has questioned both NAFTA and the Trans-Pacific Partnership in their current form. Should some of the extreme antitrade rhetoric become policy, the negative effects would be meaningful for Europe and EM equities. Overall, macro implications of Clinton's policy proposals are modest. A split Congress will make it difficult for Clinton to push through her agenda. A Clinton victory is likely to bring a continuation of Obama policies that have resulted in a weak economy, rising debt, weak productivity, lack of business formation.
- Both presidential candidates have floated plans to spend on infrastructure. However, any progress is likely to be slow, with funds likely only to be available as a result of a tax raised on forced repatriation of cash balances held abroad by large US multinationals. Clinton has pledged a $275bn dollar plan while Trump has promised a $1tn rebuilding program with little detail on financing other than through the economic growth he says his economic policies will unleash. The US Senate is likely to remain Republican–dominated and it could take a long time to get projects signed off and through to fruition

Congress will matter

- The congressional races are likely to prove more important for the US economy and markets than the actual presidential nomination.
- Although the Democrats are currently tipped to win the Senate, the size of the swing from current polling data suggest that the Republicans will likely retain control of the upper house alongside maintaining their House majority.

Risk-off mood

Businesses seem to prefer a Clinton victory

- Stocks have historically done better under Democrat Presidents, especially when opposed by a weak republican Congress
- Investors so far appeared to have priced out a Trump victory.
- The disclosure by Director James Comey that the FBI was reviewing new emails related to Hillary Clinton's use of a private e-mail server during her tenure as Secretary of State and the fact that we are talking about a close race again is clearly rattling investors and has been the catalyst for some fairly significant risk-off moves.
- The Mexican peso fell against the dollar amid renewed concerns that this development could increase the prospects for a Trump presidency.
- The disclosures had only a marginal impact upon market expectations for a Fed rate hike, with Fed funds futures still pricing in about a 70% probability of a 25 basis point increase by December.

Financial markets implications uncertain

A Clinton victory: business as usual?

- **Modest positive market** is likely as economic policy uncertainty diminishes. Clinton's victory preserves a status, a Democrat as president and republicans controlling the House of Representatives, limiting the likelihood of policy changes and hence uncertainties.

- **On the equity level**:
  - An increase in fiscal spending on <u>infrastructure</u> projects and tax cuts for the middle class would support domestic growth and <u>global US equities</u>.
  - Regulatory pressures will remain high for sectors such as <u>energy</u>, <u>financials</u> and perhaps components of <u>healthcare</u>. Clinton has publically attacked pricing strategies of drug companies. The healthcare service sector however could be a key beneficiary. Additional scrutiny on the sales practices of all banks and financial institutions might lead to greater uncertainty for the financial sector.
  - Clinton's support of renewables and C02-friendly solutions should benefit companies involved in <u>renewable energy, electric vehicles</u>, <u>power generation (smart grids), solar farms</u>.

A Trump victory: fears exaggerated?

- Political uncertainty will be high and could hurt **risky assets**. Trump's lack of governing experience and unpredictable style widens the range of potential policy outcomes. Markets tend to demand a higher risk premium for stocks when the policy outlook is murky,
- **A flow into safe haven assets** looks likely (gold, CHF, JPY) as Trump's intention to cut taxes, increase the fiscal deficit speak for a USD

depreciation. Rising interest rates however would support the greenback.

- **EM currencies** could face pressure due to the threat of trade wars.
- **On the equity level**, the sector impact would be mixed:
  - Healthcare would face significant uncertainty over Obamacare reform,
  - Trump's policies could be "quite positive" for the US economy and businesses. Pro-growth agenda and the prospect for fiscal stimulus and lighter regulation would boost several other sectors (technology, financial services, energy, consumer discretionary, consumer staples, and industrials). Defense companies should benefit from increased defense budget.
  - EU automobiles and luxury goods may suffer from increased protectionism

- **Bonds** would likely suffer from the higher perceived risk of inflation, higher budget deficits, and uncertainty surrounding the conduct of monetary policy. Any sort of haircut on Treasuries would be negative for the asset class

Investment Conclusions

- As the outcome of the US elections remain uncertain, we do not recommend making radical asset allocation bets.
- A fairly sizable portion of the electorate is believed to have already cast their votes, suggesting the pool of potential voters that could be influenced is smaller than in prior election cycles.
- That said, the disclosures may still impact "down ballot" elections for Senate and House seats in competitive races that will ultimately decide control of the legislative branch.
- Both candidates in this election are talking about tariffs and protecting US industry, which may be good for US equities.
- A trade war would tend to hurt revenues and profits of many multinational companies.
- Politicians seldom have the opportunity to move the needle dramatically.
- A major correction may prove temporary with investors buying the dips.

Ideas that should work in both scenario:

- Infrastructure related stocks, industrials, materials, transportation, construction and house builders given the huge financial pledges to upgrade the US infrastructure
- Security and safety themes,
- US inflation-linked bonds vs Treasuries
- IG Credit: a repatriation holiday - a tax break for individuals and/or businesses who repatriate income earned in other countries - would bring a lot of potential investment back to the US economy. The extra cash on US corporate balance sheet could improve credit quality
- Anti-trade measures implemented by either candidate could temporarily trigger a slide in EM currencies against the dollar and hurt other EM assets.

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