US Elections Season (Part two): Trump or Biden: Divergent market response

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- **Market volatility could pick-up considerably over the next few weeks as investors brace for the election outcome. Global investors continue to price in higher odds of a 'Democratic Sweep' that is getting reflected in most polls**
- **For investors, the problem is that Trump and Biden have a fairly different policy approach**
- **Whoever comes in next, we expect a fiscal stimulus package to go through by Q12021**
- **Under a Trump administration, we would expect: (a) tax cuts, (b) hawkish protectionist agenda and (c) continued de-regulation of financial markets**
- **Under a Biden administration, we would expect: (a) a substantial increase in spending, (b) tax hikes to fund spending plans, (c) a less confrontational trade policy and (e) increase in regulation**
- **US monetary policy is expected to remain on a pre-set course**
- **Past election episodes, shows that either a 'Democratic' or 'Republican Sweep' has a fairly positive effect on equity markets as was the case in 1992, 2004 and 2016. The effect on USD and US yields is slightly more ambiguous**
- **A close election that is 'legally challenged' can lead to considerable weakness in equity markets in the immediate aftermath of the election as w**
- **has the case in 2000. A similar outcome in 2020 cannot be ruled out**
- **Among te various scenarios, we see the following:**

  1. **Democratic Sweep: We see a sharp rally in equity markets and a weaker USD. The CNY and other trade-dependent EM FX could benefit the most. DM FX could also rally against the USD. US sovereign yields at the longer-end are likely to trend higher in the short and medium-term. A bearish steepening of the yield curve could intensify**

  2. **Democratic Breeze: We would not rule out a short period of risk aversion but see a recovery in risk sentiment kicking in from 2021 onwards once a new round of fiscal stimulus gets passed. The USD profile is likely to remain lower and US sovereign yields at the longer-end could trend higher in the medium-term not in the near-term. EM FX and CNY profile is likely to remain unchanged over the medium-term**

  3. **Republican Breeze: We see risk aversion setting in as investors could price-in 'policy uncertainty'. The USD could rally initially but trend moderately lower in 2021 as global economy recovers further from COVID-19. US sovereign yield profile at the longer-end is likely to be much flatter over 2020 and only start to rise in H22021. USD/CNY and USD/EM could trend lower in 2021 but focus will shift back to US-China trade talks and negotiations**

  4. **Republican Sweep: We see the US equity markets rallying sharply but see underperformance in global equity markets pricing in a very 'hawkish US protectionist framework'. The USD could rally over the remainder of 2020. We will review our USD projections for 2021 but see US yields trending higher over the near and medium-term. A similar response as was seen post the 2016 elections outcome is likely**

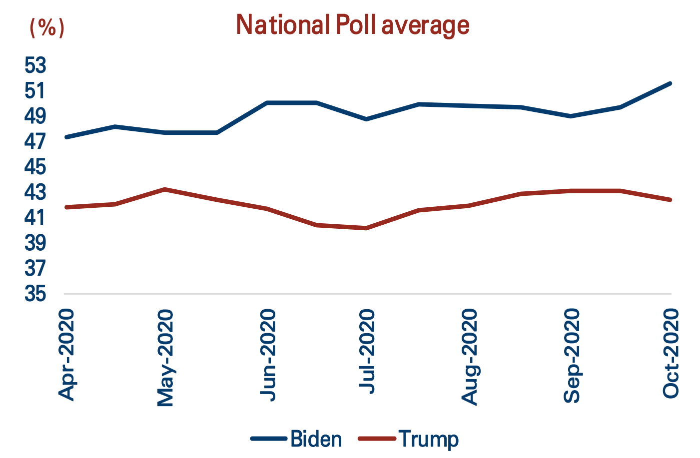
Chart 1: Summary of US elections scenarios: Impact on markets

US election outcome: Assessing the impact on the Market		Democratic Sweep	Democratic Breeze	Republican Breeze	Republican Sweep
USD	Q42020	Very Bearish	Mildly Bullish	Bullish	Very Bullish
	2021	Bearish	Bearish	Mildly Bearish	Mildly Bearish
CNY	Q42020	Very Bullish	Flat	Bearish	Very Bearish
	2021	Very Bullish	Bullish	Mildly Bullish	Mildly Bullish
DM FX	Q42020	Mildly Bullish	Mildly Bearish	Bearish	Very Bearish
	2021	Bullish	Bullish	Mildly Bullish	Mildly Bullish
EM FX	Q42020	Bullish	Mildly Bearish	Bearish	Very Bearish
	2021	Bullish	Bullish	Mildly Bullish	Mildly Bullish
US rates	Q42020	Very Bearish	Flat	Flat	Bearish
	2021	Very Bearish	Bearish	Bearish	Very Bearish
US equity markets	Q42020	Bullish	Mildly Bearish	Bearish	Bullish
	2021	Bullish	Bullish	Bullish	Bullish
Global equity markets	Q42020	Bullish	Mildly Bearish	Bearish	Bearish
	2021	Bullish	Bullish	Bullish	Mildly Bullish
Gold prices	Q42020	Flat	Mildly Bullish	Mildly Bullish	Flat
	2021	Bullish	Bullish	Bullish	Bullish

Source: ICICI Bank Research

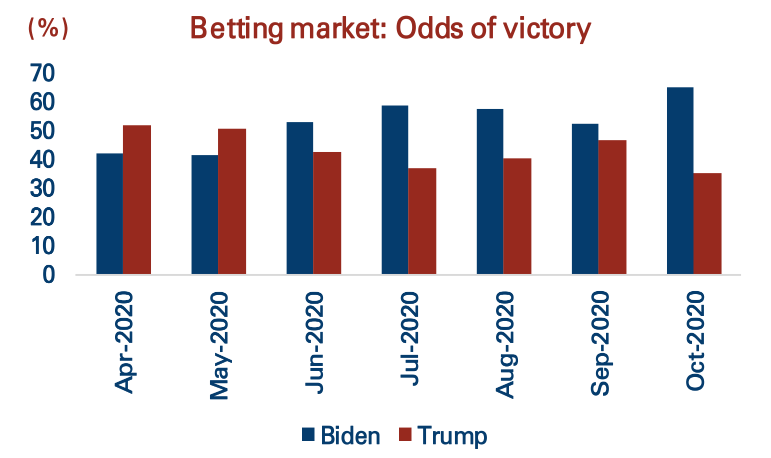
A quick recap: As election day in the US draws closer, investors appear to be pricing in a 'Biden victory' along with a 'Democratic Sweep'. The divergence has in particular intensified since the Presidential debate that took place about more than a fortnight back and after the US President tested positive for COVID-19. **However, the lesson from the results of the Presidential elections in 2016 is that 'polls are not always correct'. The complicating factor for the market in positioning for a US Presidential election is that the outcome is driven not by the 'popular vote' but by the 'electoral college' outcome.** We subsequently take nothing for granted in formulating our expectations, both in terms of policy and assessing the possible impact on the market. Hence, we examine the possible impact of all four scenarios: (a) A Democratic Sweep, (b) A Democratic Breeze, (c) A Republican Breeze and (d) A Republican Sweep.

Chart 2: Biden appears to have taken a decisive lead



Source: Realclearpolitics.com & ICICI Bank Research

Chart 3: The betting market is providing fairly high odds of a 'Biden victory'



Source: Realclearpolitics.com & ICICI Bank Research

Trump versus Biden: Different policy prescriptions: We expect a sharp knee-jerk reaction to the outcome especially if there are any deviations from market expectations. **The reason for a sharp reaction is because of the substantial differences that exists in several areas of policymaking between Trump and Biden. The US economy could go on very different paths in the near and medium-term depending on the configuration of the new administration, especially with regards to foreign policy.** We also need to emphasize that in case of close elections that forces either candidate to challenge the result, there could be a short period of uncertainty that might weigh on all risk assets. However, if the outcome is won by a comfortable margin, a sharp pick-up in volatility is unlikely even if a legal challenge is made to the election outcome. Instead, investors will respond to the possible implications of the next political configuration.

Trump versus Biden: Battling COVID-19: A different approach:

Trump's COVID-19 approach:

- We think that the efforts will largely be the same with local state authorities left to tackle the problem. No unified national response is likely to be considered.

Biden's COVID-19 approach:

- Biden will likely move towards increasing testing, contact tracing and mandate the use of masks across the country. Some measures that might require Congressional approval.
- He will follow the official advice on when to release the vaccine and the type of medical treatment that might be required to tackle COVID-19.

Chart 4: Trump & Biden: Will take a different policy approach

Trump versus Biden: Snapshot of policy expectations

	Trump	Biden
COVID-19	Status quo with continued emphasis on local authorities to tackle the problem	More unified federal approach and might mandate wearing of masks as compulsory along with increased contact tracing
Tax policy	Will extend the tax cuts under the Tax Cuts and Jobs Act of 2017	Proposed to raise revenues to the tune of USD 3.4 tn via taxing the rich and middle income brackets, capital gains taxes, payroll taxes and higher corporate taxes
Government spending	Might agree to an increase in infrastructure related spending	Proposed to increase spending by USD 5.4 tn over the next decade in education, infrastructure, housing, social security, healthcare and paid leave
China	Protectionist' agenda to continue with a possible re-negotiation of phase-one trade deal; or phase two trade deal along with higher tariffs	Will Maintain 'America first' policy but resort to a less confrontational approach with regards to China
Global policy	Will continue to favour 'bi-lateral' trade agreements and might intensify pressures with EU	Will move back to negotiating 'multi-lateral' trade agreements and less protectionist agenda
Financial Regulation	Deregulation stance/drive to continue	Might favour more regulation

Source: Media reports & ICICI Bank Research

Trump versus Biden: Fiscal Policy: Expansionary but via a different design

Trump's Fiscal Policy focus:

- The US President has committed to providing further fiscal relief that could come in 2021 but the size of the stimulus package might be a little less than that being proposed by the Democratic Party. It could be to the tune of USD 1 tn or USD 1.5 tn.
- In terms of other commitments, the US President has indicated that he would extend the tax relief that was provided under the Tax Cuts and Jobs Act (TCJA) of 2017 beyond the 2025 date that they are set to expire. These tax cuts would benefit the middle-income and high income categories.
- There could also be some reduction in corporate tax rates to encourage businesses to move back to the US. However, so far no specific details have been provided on the matter.
- The US President might also agree to an increase in fiscal spending in areas such as infrastructure but the quantum is unclear at this stage that could set the stage for a 'bipartisan' agreement if required at a later date.

Biden's fiscal policy focus:

- The former Vice President's approach will be to move towards an expansionary fiscal policy stance but with a different approach.
- The first order of business will be to move forward with a stimulus plan in Q12021 that is estimated to be to the tune of USD 2.2 tn as is being proposed by the Democratic Party.
- Going forward, the 'Biden Plan' entails a substantial ramping up of spending in infrastructure, healthcare and social security measures. He has laid out a USD 5.4 tn spending program over the next decade.
- However, he proposes to finance this higher spending via increasing taxes on the following manner: (a) raising tax rates for high income earners above USD 400,000 per annum from 37% to 39.6%, (b) eliminate tax breaks for capital gains and dividend payments, (c) increasing the corporate tax rate from 21% to 28% and (d) high income earners above USD 400,000 will also be subjected to payroll taxes. The slew of proposed tax proposals will also be accompanied by a repeal in several elements of the TCJA that was introduced in 2017 by the Trump administration.
- In his campaign, he has proposed to introduce a 10% 'Made in America' tax credit for businesses that bring back jobs in the US.
- He also proposes to introduce taxes to penalize companies that move their headquarters out of the US for 'tax benefit' purposes.
- Mr. Biden's plan is to generate ~USD 3.4 tn in terms of revenues via his tax proposals over the next decade to partly finance an increase in spending.
- He is also considering raising minimum wages.
- **In short, Biden proposes to have a much more expansionary fiscal policy stance than Trump as total net spending could be considerably higher. Public debt to GDP ratios could also trend higher in the process.**

Trump versus Biden: Foreign Policy: More versus less protectionist

Trump's Foreign Policy focus:

- **We expect him to continue with his trade protectionist agenda.** The 'Phase-One' trade deal is likely to get re-visited with possible increase in tariffs or a more protracted 'phase two' negotiations.
- Pressure on China could also be raised via increasing non-tariff measures. Policy measures that either directly or indirectly encourages a diversification of value-chains out of China could also be in the pipe-line.
- He might also continue with increasing pressure on other trade partners such as the Euro-zone.
- The focus will be on 'bi-lateral' trade agreements not multi-lateral trade agreements.

Biden's Foreign Policy focus:

- **Although Biden does have an 'America first' policy, he is likely to be less confrontational.** Further tariff hikes on China are unlikely while revisiting the 'phase-one' trade deal and there could be another round of negotiations to move towards phase two. However, a roll-back of tariffs is unlikely.
- He could also be more open to multi-lateral trade agreements while also putting indirect pressure on China by seeking consensus with key allies.
- The US could re-enter the Paris Accord for climate change.
- 'Biden' could also use taxation policy to force US corporations to move back home.
- **In short, Biden's foreign policy prescriptions could be less aggressive than Trump's.**

Trump versus Biden: Financial Regulation: Deregulation versus more regulation

Trump's Financial Regulation focus:

- We do not envisage any changes on this front. The US President should continue to move ahead with his deregulation approach.

Biden's Financial Regulation focus:

- Mr. Biden would probably want to move towards a tighter 'financial regulation' regime by making the relevant appointments across the different market regulators such as the SEC.

Trump versus Biden: Implications for US Monetary policy: Accommodation to remain: **Given that the FOMC has just changed its monetary policy framework to a 'flexible average inflation targeting regime', we do not expect any major changes on US monetary policy.** We think that the accommodative framework will remain unchanged for a considerable period of time. The primary decision that the next administration will have to take is on whether to extend Chairman Powell's tenure that is due to expire on February-2022. Trump might continue to call for 'negative interest rates' but that seems unlikely to materialize given the current configuration.

Trump versus Biden: Implications for the economy: Ultimately, the shape of the recovery will remain contingent on how quickly a 'medical solution' is found to COVID-19 as it will increase mobility subsequently driving economic activity higher in the process. However, we think that whoever comes in, both fiscal and monetary policy will remain accommodative and subsequently supportive of growth.

On balance, a 'Biden-led Democratic Administration' will imply a more expansionary fiscal policy path over the medium to longer-term given that multipliers related to infrastructure spending are a lot higher than multipliers related to tax cuts. Inflation pressure could also pick-up incrementally more than with a Biden-Led Administration. A 'Biden-led' administration could also have important implications for the energy sector given his proposals for cleaner energy.

For the global economy, a Biden-led administration will imply a more favourable foreign policy from the US relatively than a Trump administration. Hence, trade-dependent economies such as China, Germany and most of the ASEAN economies (excluding Indonesia) should benefit from reduced uncertainty. A Biden administration would also resort to a lesser restrictive immigration policy that would be favourable as well.

Market response: Lessons from the past: We look at how the S&P-500, DXY, US 10-year yield and gold prices have responded to the immediate aftermath of the US Presidential elections from 1980s onwards. We find the following key trends:

Chart 5: Risk aversion dominated the post-election outcome of 2000 that was challenged in court

Performance post 2000 elections: A close & challenged outcome

	1 month	2 month	3 month
S&P-500 (% MoM)	-6.2	-3.4	3.3
DXY (% MoM)	-1.7	-4.5	2.3
US 10 year (Change in bps)	-56	-38	18
Gold prices (% MoM)	4	-2	-2

Source: Reuters & ICICI Bank Research

Chart 6: US equity markets and the DXY rallied in response to a 'Democratic sweep' in 1992

Performance post 1992 elections: Democratic sweep

	1 month	2 month	3 month
S&P-500 (% MoM)	2.4	0.2	3.8
DXY (% MoM)	1.8	2.5	2.0
US 10 year (Change in bps)	2	-687	641
Gold prices (% MoM)	-1	-2	0

Source: Reuters & ICICI Bank Research

- **Close-election that was legally challenged: Looking at 2000: Risk aversion was the result:** We draw on the outcome of 2000 as a possible example of what could happen in case of a close elections or if there is a challenge to the election outcome. In 2000, there was a build-up of uncertainty as the electoral college outcome for the state of Florida had gone to the Supreme Court. A key take-away is that there was a step up in risk aversion as was visible in the fall in equity markets, softening in US treasury yields and rise in gold prices during this period. The USD also came under pressure as concerns about the US political environment intensified. **However, after the resolution there was some sign of stability that set in after a two-month period.**

- **A Democratic or Republican Sweep: Supports equity markets:** In previous elections, there were broadly four periods in which there have been a clean sweep with one party taking the Presidency, House and Senate at one shot. Although the Democratic Party also won the Presidency, House and Senate in 2008, the outcome came at the same time as the peak of the financial crisis. Markets were responding to a variety of factors and subsequently we exclude looking at the post-election outcome for 2008.

    1. **Democratic Sweep of 1992:** Mr. Bill Clinton won the Presidential elections and the Democratic Party was able to retain the House and Senate. In an immediate response to the outcome, the equity markets and the USD rallied simultaneously and gold prices fell sharply reflecting reduced uncertainty. US yields were fairly volatile during that period but on balance softened sharply.

    2. **Republican Sweep of 2004:** Mr. George W. Bush retained the Presidency. The Republican Party retained the House and won the Senate. The net result was that the US equity markets rallied over the next two months but the USD came under pressure as it had entered in to a structural 'bear-trend' that lasted till 2008. US yields exhibited a fairly mixed trend.

    3. **Republican Sweep of 2016:** Mr. Trump won the Presidency. The Republicans retained the House and took the Senate. During this period, there was a sharp rally seen in US equity markets, the USD and US yields as investors started to price in the tax proposals of the next administration and a 'protectionist' trade stance. Gold prices also fell quite sharply.

Chart 7: US equity markets rally in response to a 'Republican Sweep' but DXY weakens

Performance post 2004 elections: A Republican Sweep

	1 month	2 month	3 month
S&P-500 (% MoM)	5.3	1.8	-1.5
DXY (% MoM)	-4.1	-1.3	3.3
US 10 year (Change in bps)	36	-20	-7
Gold prices (% MoM)	7	-2	-4

Source: Reuters & ICICI Bank Research

Chart 8: Across the board outperformance in US asset classes in response to the 2016 outcome

Performance post 2016 elections: A Republican Sweep

	1 month	2 month	3 month
S&P-500 (% MoM)	5.0	1.4	0.8
DXY (% MoM)	3.3	1.1	-1.9
US 10 year (Change in bps)	53	3	-7
Gold prices (% MoM)	-8	0	6

Source: Reuters & ICICI Bank Research

- **A Mixed outcome results in a mixed performance:** In years in which there has been a mixed outcome in terms of the Presidency, House and Senate; we do not find a clear trend. This was seen during the 1980, 1984, 1988, 1996 and 2012 period respectively. Investor tend to re-calibrate expectations based on the impact that the new political configuration could have on the underlying economic scenario.

What to expect post November-2020?: An important lesson from looking at past episodes is that equity markets respond in direct proportion to the election outcome—less uncertainty with a one-party taking control of the House of Congress along with the Presidency results in a rally but uncertainty results in a period of weakness as was the case in 2000. **For the USD and US yields, there is no clear trend that emerges but instead the current underlying macroeconomic landscape matters more.** In the current environment, the main focus for investors is on 'fiscal stimulus' and the risk of a 'challenged election' outcome. We see the following trends emerging:

Democratic Sweep: Biden Wins; the Democrats keep the House and take the Senate:

- **Risk-on: Immediate reaction:** A 'Democratic Sweep' will likely prove to be the most favourable outcome for the markets as it will considerably reduce 'policy uncertainty'. A new fiscal stimulus is likely to get implemented by Q12021. Even if the election outcome is contested, if the margin of a 'Biden-victory is significant the overall effect is likely to remain limited, although a brief period of volatility cannot be ruled out.

- **USD weaker particularly against CNY:** A 'Democratic Sweep' will also mark a substantial change in external policymaking that could prove relatively more favourable for China in particular. Hence, the USD/CNY pair could dip sharply lower possibly to the 6.55 mark. Other USD/AXJ pairs could also move lower in the process. USD/DM could trend lower but both the EUR and GBP could underperform in the near-term relative to the EM FX. The GBP in particular could respond more to the outcome with regards to 'Brexit'. The DXY could break below the 93 level in such an outcome.

- **US Bond market: A big negative hit:** The US fiscal deficit has already hit a record high. However, we think that there will be a re-pricing in of additional stimulus and increased paper supply over the medium term. The net result will be a further uptrend in US yields particularly at the longer-end resulting in a bearish steepening in the US yield curve. We are likely to make upward revisions to our projections with the US 10-year sovereign yield likely to move towards the 0.90% mark in the near-term.

- **Medium-term outlook on the economy could be raised, the USD revised lower and US yields revised higher:** Depending on the type of fiscal policy measures that might get implemented, we might raise our US and global growth projections higher. However, a medical solution will still remain critical to drive a secular rebound in the global economy that we assume will start happening from Q2-Q32021 onwards. Our FX market outlook and framework is unlikely to change considerably. We would still maintain our bearish USD projections, although we might revise our CNY projections and EM FX projections higher. Besides, the 'tax proposals' of a Biden-led administration could also undermine US equity markets relative to the rest of the world that might work as an important factor in resulting in a downward revision to our USD projections. However, a 'Democratic Sweep' could prove to be considerably more negative for the fixed income markets than we currently have projected with US bond yields expected to rise at a much sharper pace over the medium-term reflecting a more accommodative than currently priced in fiscal environment.

Democratic Breeze: Biden Wins; the Democrats keep the House but Republicans keep the Senate:

- **Mild risk-off: Immediate reaction:** A 'Democratic Breeze' will work as a disappointment that might result in a mild risk-off in the market that could persist for a two-month period. A lot will than come down to negotiations between the Democrats and the Republicans on a possible fiscal relief bill. We think that a 'bi-partisan' fiscal deal might get concluded by Q12021. However, further fiscal spending might be limited as compared to the 'Democratic Sweep' scenario.

- **USD downside might be limited in the near-term:** The USD could trade flat or might even rally at the margin in response to this outcome. The DXY could break towards the higher end of our 93.00-95.50 range that we have for Q42020. Focus will then shift to negotiations. However, a further escalation in US-China relations appears to be unlikely and subsequently a sharp rise in the USD is not on the cards. The USD/CNY pair could trade flat in the 6.60-6.80 range over Q42020.

- **US bond market: Range in the near-term but bearish in the medium-term:** US yields could trade flat with a slight downside bias reflecting some degree of risk-off. However, a move towards a fiscal negotiations and a stimulus in Q12021 could limit sharp downside in yields. The US 10-year sovereign yield is likely to remain trapped in the 0.60%-0.80% range.

- **Our medium-term outlook will remain unchanged:** We would not make substantial changes to either our projections on the global economy or on the markets. We would still see a gradual 'U-shaped' recovery to take hold driven with a 'medical solution' working as the primary catalyst. The USD would be expected to weaken over 2021 after a mild period of strength in Q42020 driven by improving global growth conditions and subsequently risk sentiment. We would still expect US yields at the longer-end to trend higher over the medium term but it could be more moderate than in the 'Democratic Sweep' scenario.

<u>Republican Breeze: Trump wins; the Democrats keep the House and Democrats take the Senate or Trump Wins; Democrats keep the House and the Republicans keep the Senate:</u>

- **Substantial risk-off: Immediate reaction:** A 'Republican Sweep' will likely work as a substantial negative given that it will imply some degree of policy uncertainty going forward. We suspect that a fiscal stimulus will likely get passed in Q12021 but there could be several rounds of negotiations that might create some degree of uncertainty. It will reflect a 'status quo' outcome.

- **USD could rally in the near-term:** The possibility of 'policy uncertainty' and no clear path of another round of fiscal stimulus could result in a rally in the USD across the board. The DXY could break above the 95.50 mark in such a scenario. There could also be some retracement in trade-dependent EM currencies as it would likely signal a status quo on the external policy front. The prospect of tariff hikes and possible re-negotiations of the US-China phase one trade deal cannot be ruled out.

- **US bond market: bullish in the near-term:** US yields could trade with a downside bias reflecting risk aversion, concerns about policy paralysis and the prospect of uncertainty about scale of fiscal expansion. The US 10-year sovereign yield could break below the 0.60% mark.

- **Our medium-term outlook could be revised:** The path ahead in terms of policy could be less clear. However, we suspect that substantial changes are unlikely but with the exception of the fiscal stimulus package that could get introduced in Q12021. We are unlikely to revise our growth projections for 2021 but would have a re-look at our outlook for trade-dependent EM economies. There could also be a pick-up in uncertainty about US-China relations going forward. China's growth projections could also get revised lower in 2021. For the USD, we would still maintain our bearish call but see a shallower upside than we have currently in place over the medium-term. On the other hand, US bond yields at the longer-end could trade flatter for longer and only start to show signs of picking up in H22021.

<u>Republican Sweep: Trump wins; the Republicans take the House and retain the Senate:</u>

- **Substantial risk-off but US equities could rally: Immediate reaction:** We suspect that there could be divergence in performance between US and global equity markets. US equity markets might rally on possible tax cuts, fiscal stimulus and easier financial regulation. However, global equity markets might fall sharply reflecting an increase in the US administration's 'protectionist agenda' similar to what was seen during 2016-2018 period.

- **USD could rally sharply in the near-term:** We see the USD rallying sharply in such an outcome as investors brace for a local stimulus accompanied with a hawkish external policy. A 're-pricing of the US policy framework' could open up considerable upside for the DXY. There could be a repeat performance of what was seen during 2016. USD/CNY pair could break above the 6.80 mark.

- **US bond market: bearish:** US yields at the longer end could start to move higher reflecting expectations of a fiscal stimulus in Q12021 along with further tax cuts in the medium to longer term.

- **We might make substantial changes to our medium-term outlook:** While global growth could be expected to improve further as a 'medical solution' could be found to COVID-19, we would likely see a flatter pick-up than our base-case projections. Growth in China and other trade-dependent economies could get revised lower reflecting a hawkish US protectionist agenda or possibly an escalation of US-China trade wars. Our medium-term USD projections could be revised higher. However, we will maintain our expectations of US sovereign yields particularly at the longer-end trending higher but the pace could be more moderate than in a 'Democratic Sweep Scenario'.

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