

State of Play



29 October 2020

With under a week to go until Election Day has President Donald Trump's inability to change the story from COVID-19 destroyed his chances of retaining the Oval Office? This week's update is a pre-election special focussing on some of the key factors that will drive the outcome and the possible market reaction thereafter.

In this week's special edition I want to breakdown some of the key aspects that might shape the Presidential Election and, perhaps more importantly, what the make-up will be of the democratic houses that propose, debate and vote on what direction the US will follow for the next four years. Lastly what are the crucial factors that may affect how markets react to any of the potential outcomes?

The candidates

Donald Trump is the 74 year old ex businessman and reality TV star, and the incumbent 45th President. Against the odds he won a close race in 2016 against the favourite Hilary Clinton, championing America First policies both home and abroad. He has based his successes during his tenure on the value of stock markets, the economy and keeping his promises on immigration and foreign policy, ripping up many of the international treaties and trade agreements sought during the Barack Obama presidency. At times he has been divisive on racial tensions and on immigration, and has been heavily criticised for his approach to the pandemic. He is unique in his approach to the job - communicating via Twitter on numerous occasions daily.

Former Senator **Joe Biden** was elected the 47th US Vice President with President Barack Obama in 2008 and re-elected in 2012. He is the 2020 Democratic presidential nominee and turns 78 on 20 November, just after the upcoming election. He was first elected to the Senate in 1973 representing Delaware, winning an uphill victory to become the fifth-youngest US Senator elected in the nation's history. The celebration from winning soon turned to tragedy as his

wife and daughter were killed and his two sons seriously injured in a terrible car accident just before he took office. Despite his grief and with encouragement from his family he decided to honour his commitment to representing the people of Delaware. He is a career politician and this is his third attempt to become President.

Key policy differences that markets are likely to focus on

Taxation and spending policy

This is perhaps the most divergent aspect of the Biden and Trump Administrations' plans, and is also the area that has the most direct impact on markets. Joe Biden has been very critical of the Trump Administration's 2017 tax cuts and wants to raise corporate tax from 21% to 28%, creating an earnings headwind on the S&P 500. The Democrats also plan to apply additional income taxes to those making over \$400,000 a year, and to raise the top income tax back to 40% from 37%. These measures are likely to be negative for stock markets. On the other hand, a Trump Administration promises a continuation of the 2017 tax cuts and further measures such as a payroll reduction, capital gains tax, and the indexation of capital gains to inflation.

In terms of spending, Joe Biden has proposed huge investments in clean energy and infrastructure, and has also proposed expanding welfare spending and bolstering the Affordable Care Act (ACA), President Obama's signature healthcare initiative. President Trump also advocates for more spending on US infrastructure but has criticised plans for large spending in green investments. If a President Trump re-election came with a Republican victory in the House of Representatives, then the Republicans would look to scale back ACA, but this is an unlikely outcome.

Trade and industrial policy

US trade policy has been a key focus for markets over the last few years, and will remain so for the foreseeable future regardless of the election outcome. US political opinion regarding globalisation, and particularly Chinese trade practices, has shifted beyond recognition in recent years. A tough stance on China and the re-onshoring of US manufacturing are now bipartisan issues with enthusiastic support among the American public. President Trump's 'America First' trade and industrial policy agenda was a key part of his election victory and has been the most consistent and tangible aspect of his administration's tenure. The core belief at the heart of the 'America First' approach to trade is that large, bilateral trade deficits hurt American workers and should be reduced. President Trump has pursued China on a raft of issues including intellectual property theft, unfair trade practices, and currency manipulation.

More broadly, President Trump has sought to undermine the global trading system that he views as against US interests. A victory for President Trump in November would see more of the same, with his preferred course being one of aggressive unilateral action through tariff and non-tariff actions against America's economic rivals. The Democrats have pivoted their messaging and attempted to regain their past role as defenders of the American worker. Joe Biden has openly condemned abusive trade practices by China in the past,

despite being a lifelong proponent of globalisation and free trade. A Biden Administration would likely maintain significant pressure on China but would adopt a much more multi-lateral approach, banding together with key allies, such as Europe and Japan. The Joe Biden campaign argues that this approach would be much more effective in forcing China to better adhere to global norms. In terms of American manufacturing, Joe Biden has presented his own 'made in America' industrial policy, which includes a \$400bn increase in US Government spending on US manufactured goods and \$300bn in new funding for research and development.

Regulation

The most relevant areas of focus for capital markets in terms of regulation concern energy and technology. On the former, Joe Biden has thus far resisted calls from inside his own party to advocate for a nationwide ban on fracking. However, the Biden Administration does plan to tighten auto emissions standards introduced during the Obama Administration. Conversely, President Trump has made deregulation a core pillar of his administration, unveiling plans to reduce clean air and water regulation. He is also a vocal supporter of US shale oil production.

Regarding large technology companies, both candidates have vocalised concern around data privacy and antitrust issues. The Trump Administration has conducted wide-ranging antitrust probes into big technology companies, and President Trump has accused large social media platforms of discriminating against conservatives. Joe Biden has also voiced concern around big technology firms and has proposed higher taxes on profits, but has stopped short of advocating forcefully for a break-up of these companies. Joe Biden does propose to repeal parts of the Communications Decency Act, which helps social media companies avoid liability for users' posts. Another area of concern for markets will be regulation around labour rights and minimum wages. Joe Biden supports raising the minimum wage from \$7.25 to \$15, which will have repercussions for high labour intensity business.

Latest polling data

Joe Biden has been ahead in the national polls throughout 2020, initially by a small margin, but at times by as much as 10 points. Currently, based on the BBC poll of polls on Monday evening (26 October) which gives a 14 day rolling trend, Joe Biden is once again 10 points clear of President Trump. As we know in the UK, whilst polls provide important insight and guidance to the probable outcomes, as in 2016, these numbers can differ wildly from the final reality. In addition, as I have explained in previous weekly updates, winning the popular vote, as Hilary Clinton managed in 2016, does not necessarily propel you into the White House.

When Americans go to the polls in presidential elections they're actually voting for a group of officials who make up the Electoral College. The word 'college' here simply refers to a group of people with a shared task. These people are electors and their job is to choose the President and Vice-President. The Electoral College meets a few weeks after Election Day, every four years, to carry out that task. The election outcome is based on 538 Electoral College votes apportioned to

each individual state based on population size with a 'winner takes all' system. If either candidate wins the state they claim all of the votes apportioned to it regardless of how close the count might be. The target is to surpass 270 votes to win the right to be President. President Trump won 304 to Hilary Clinton's 227 in 2016 despite her winning 3 million more votes across the country.

Battleground states

There are particular US states which are seen as solid bets for either the Republicans or the Democratic Party. Some US States throughout history may have changed between the parties and probably lean to one party normally but in unusual circumstances or where a revelation comes to light during the election campaign can easily switch, shifting the political momentum in favour of the eventual winner. The remaining US states are considered swing states that have a proud history of voters whom many remain undecided right up until Election Day. These states have a huge bearing on the eventual outcome and can be the deciding factor in a close race.

At present the BBC polling information on these Battleground States places Joe Biden in the box seat with all but 3 of the 14 showing him ahead in the most recent polls. However, many of these are within just 2 points and could easily sway in President Trump's favour come Election Day. At present it looks like Joe Biden's to lose but history shows how unpredictable events can be in the last few days of a campaign.

Why congressional races play a key role

While much of the focus next week will be on the race for the White House, the congressional races will also be important to watch. As it stands today, the Democrats control the House of Representatives and the Republicans control the Senate. While it looks extremely unlikely that there will be a shift in control of the House of Representatives, the race for control of the US Senate is tightening.

Assuming a Joe Biden win, the results of these Senate races will dictate the market's reaction. Joe Biden's ability to implement his governing agenda depends on his ability to push legislation through Congress. A Republican Senate will limit room for manoeuvre and constrain much of Joe Biden's policy action to executive orders. Even if the Democrats take the Senate by a narrow margin, it stands to reason that the type of Democrat that would win a traditionally Republican state is likely to be ideologically to the right of a Joe Biden Administration. This will force compromise on some of the Democrats' more aggressive policy proposals. It is also possible that the Democrats end up with a larger majority - maybe even three or four seats. This would offer the Democrats a chance to pursue their most ambitious policy proposals, even with lukewarm support from the right of their own party.

Current candidate weak spots

President Trump

Much of his 2020 campaign has been completely overshadowed by his handling of the COVID-19 pandemic which reached a peak just over three weeks ago when he tested positive for COVID-19, following an event on the White House lawn to celebrate the nomination of Amy Coney Barrett to become a Supreme

Court Judge (who this week was sworn in just before the election). He has attempted throughout the campaign to change the main story in the media onto his economic track record or the frailty of Joe Biden at the age of nearly 78. So far this failure to change the narrative may yet cost him re-election, but given his supercharged itinerary in the last week with events in all the key states he won't go down without a fight.

Joe Biden

The two key things that have followed his campaign around from the very beginning are his age and his son's business connections. At the time of writing, Joe Biden had gone to ground following a gaff in an interview where he apparently confused President Trump with George Bush, although one explanation was that he was being interviewed by George Lopez and stumbled over his words. President Trump seized on what appeared to be a viral gaff with glee referring to it repeatedly this week in every speech he made. The other key Achilles heel for Joe Biden is his son Hunter's connection and dealings with businesses in both Ukraine and China. He is accused of using his position to enrich his family. So far Joe Biden has managed to navigate his son's history with limited impact but the accusation he is too old and that the enormity of the Presidency is beyond his ageing capabilities haven't disappeared. It seems at the time of writing the Democratic Party is playing it safe trying to ensure they do not snatch defeat from the jaws of victory.

Potential outcomes and market reaction

The only thing harder than predicting the outcome of very close elections is predicting the likely market movements in the event of each outcome. That being said, we can draw some high-level conclusions based on past elections and current market dynamics. I have outlined three potential outcomes at a high level; this list is not exhaustive or particularly specific, but is hopefully a useful framework for thinking about what comes next. In Santander Asset Management's view, the three likely outcomes for the 2020 election are: (i) Democratic sweep; (ii) gridlocked government; and (iii) a contested result.

It is also worth noting the additional complexity that COVID-19 brings to the administrative task of running an election in 2020. This will mostly manifest in an increased number of mail-in ballots, with three key implications: first, that mail-in ballots take longer to count, likely delaying the final election results for days or weeks after 3 November; second, that mail-in voting is much more popular among Democrats than Republicans (especially in swing states like Pennsylvania, Wisconsin, and Michigan), which could lead to a convincing lead for President Trump on election day that is erased as ballots are counted; and third and most importantly, that the sequencing and additional confusion in the vote-counting process could eventually give President Trump the opportunity to claim victory on election night before final results are known. There are a few scenarios where this delay would be fairly irrelevant from a market perspective - for example, if Joe Biden wins Florida. However, given the stress that the pandemic is putting on the US electoral infrastructure, it is unlikely that a winner will be known on election night.

Democratic sweep: The consensus view is that this is the most negative outcome for markets given the planned changes to regulation and taxes. Obviously, the size of the Senate majority would be an important factor in determining a new Democratic administration's room for manoeuvre.

Gridlocked government: You could define this as a result where neither party wins control of the White House and both chambers of Congress. This result can come in a few different forms, but it is unlikely that the Democrats are going to lose the House of Representatives. It is also unlikely (but possible) that President Trump wins re-election but the Republicans lose the Senate. That leaves two likely paths to a gridlocked government: the first is the status quo scenario in which President Trump wins re-election and the Republicans keep the Senate, while the Democrats retain the House of Representatives; the second is that Joe Biden wins the presidency but the Republicans keep the Senate. This is arguably, the most market friendly. Historically, markets have tended to perform well during periods of political gridlock in Washington.

Contested election: Like 2016, it is plausible that the outcome of the 2020 US Presidential Race is decided by a few thousand votes in key districts in the four or five main swing states. Added to this are historic levels of political polarisation, civil unrest in major cities, and the additional uncertainty of more mail-in voting and longer lines at in-person voting stations, leading to a potentially explosive clash over the election results.

The first scenario in which a contested election occurs is that the Electoral College result comes down to the outcome of one state with a very close vote count. Both campaigns have already prepared an army of lawyers armed with extensive knowledge of state-specific election laws, and are ready to challenge any outcome that might give their opponent an advantage. This is not necessarily a scary outcome as the US possesses a remarkably robust institutional framework. Should either side contest the results, the Supreme Court would step in to settle the dispute as was the case in the 2000 Presidential Election. If either party refuses to respect the court decision, the US military, sworn to protect the Constitution, will enforce the result.

The second scenario is that there is a genuine Electoral College tie. Although unlikely, it is certainly possible that after all votes are counted, both candidates end up with 269 Electoral College votes. There are quite a few paths to this result; while it is a low probability outcome, it would be unwise to discount it completely. In this scenario, the US House of Representatives would vote to decide the next winner. This process would involve each state receiving a single vote, and would give President Trump the advantage despite the Democrats having more seats (this is because congressional seats are awarded relative to population, unlike the Senate).

While each scenario is certainly possible and could spook markets in the short-term, it may provide a buying opportunity and Shares could recover quickly as the US institutional safeguards kick in and the resulting administration is too weak to enact much of the market-negative legislation being floated.

Summary

The 2020 Presidential Election has all the ingredients required to make it a significant risk event for markets and investors. The extreme polarization in contemporary US politics, mixed with the additional uncertainty of COVID-19 and this Administration's unique attributes make this the most uncertain US election of modern times. That being said, as an investor it is always important to separate what matters, from what matters for markets. For all of the drama and rhetoric, the US has one of the most stable and safeguarded political systems in the world. Whilst there may be some delay and confusion in vote counting and a host of legal challenges, potentially all the way up to the Supreme Court, it is unlikely that the US institutional system is under threat.

Finally, in terms of results, although President Trump faces a difficult path to re-election due to Joe Biden's commanding lead in the polls, US politics is unpredictable and election politics can move quickly. President Trump contracting COVID-19 came as an 'October Surprise' and its impact on the election is unlikely to be known for a while. As highlighted above, given current polling it is expected for the Democrats to keep their majority in the House of Representatives. The race for the Senate is more difficult to predict, and arguably the most market relevant. Whatever the outcome it makes for compelling drama all the way to the White House.

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Note: Data as at 27 October 2020.



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