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US election: result delayed doesn't mean result denied

The rule of law should prevail and the recovery continue, though a long delay could weaken it

The US presidential election is yet to return a clear result. Mr Trump may be claiming victory, but the elections are run by each individual state, not the federal government and certainly not the incumbent President. The race looks to be coming down to four states: Georgia, Wisconsin, Michigan, and Pennsylvania. If Mr Biden wins any two, its likely he wins the whole contest; Mr Trump must win the larger states. With election rules in many states still in flux, not only are votes likely to continue to be counted for many days to come, they may also be subject to legal challenge.

Most battleground states set a very high bar for ordering recounts, so unless the contest is exceptionally close, we expect any delays to be caused by court involvement centred around the counting of mailed-in ballots. The Supreme Court has already intervened in some states. For example, it permitted absentee ballots in North Carolina to be received and counted up to nine days after election day as long as they were postmarked before 3 November. It upheld a proposal to allow for an extra three days in Pennsylvania. However, it denied Wisconsin a similar adjustment. This apparent inconsistency just reflects the complexity of the electoral laws in each individual state. Rules in Michigan and Georgia are yet to be challenged in the highest court of the land.

It is interesting to note that the Supreme Court has ruled in favour of counting votes received after the third. Conservative, Republican appointees hold a majority, and yet this decision undoubtedly benefits Democrats, who, according to survey data, are more likely to be concerned about maintaining social distance and less likely to be concerned about mail-in ballot fraud, and are therefore more likely to use a postal vote. It remains to be seen if this will change now that the new Republican appointee, Amy Coney Barrett, has joined the bench, taking the conservative majority to 6-3.

Ms Barrett is a self-declared 'originalist' who interprets the law based on the original understanding at the time it was adopted. This could be pertinent because in the early days of the US, the state legislatures, not the voters, selected the members of the Electoral College in some states. Indeed this was referenced by the Supreme Court when it adjudicated on the contest between George W Bush and Al Gore in 2000: "*the State, of course, after granting the franchise in the special context of Article II, can take back* [from the voters] *the power to appoint electors*."

A safe harbour in sight

We don't pretend to be constitutional experts, but we must acknowledge that it could be some time before we know the result. Still, it's highly unlikely we will have to wait beyond the 8 December, this year's 'Safe Harbor Day'. As established by the Electoral Count Act 1887, if a state submits its final tally in the presidential contest by this day, that decision is "conclusive" and thus free from legal challenge. The Supreme Court intervened in 2000 to prevent further recounts beyond this day.

An unresolvable election is only a small risk, in our opinion. But it may have a large effect on financial markets. Surveys of institutional investors conducted over recent months suggest that the worst outcome is no outcome at all. A recent survey of 1,377 institutional investors by Citi found that 45% expect US equities to fall by more than 10% if there's no result by Thanksgiving (26 Nov), with another 30% expecting markets to fall by 5-10%. The same survey wasn't even nearly so negative on a Democratic clean sweep, which some investors fear would curtail profit growth with re-distributional policies (although we're a little more circumspect about such generalisations). Correspondingly, the price of volatility protection for November in the futures market has been notably elevated, more so than usual for an election month.

Why are investors more fearful of this scenario than anything else? The S&P 500 fell by just 4% between the contested 2000 election and Safe Harbour Day, and it underperformed the MSCI World by just 0.8%. These are small falls when contextualised: this was at the beginning of the dot-com bust (pets.com went under on 9 November) and leading indicators were signalling an impending recession.

Investors may be giving credence to the speculative think pieces that envisage Mr Trump ordering the army or even armed militia to seize ballot papers. This would certainly undermine the rule of law and democracy which have a well-established and important relationship with economic development and capital market deepness. But these think pieces are rather specious, in our opinion. States run the election, not Washington, and the concession of the incumbent is not required for the transfer of power.

Possibly investors fear civil unrest, but historic mass mobilisations against civil rights violations or the Vietnam war in

the 1960s or the Los Angeles riots in 1992 didn't leave scars on US equities.

Is it all about the stimulus?
We think investors' fears are more about the temporary removal of the fiscal policy backstop which has given them the confidence to look through COVID-related disruption to economic activity this year. While the result is contested, additional fiscal stimulus is unlikely to happen. This could be risky even in the absence of any other bad news, but it could be very problematic if the economy or the virus took a turn for the worse during that time. That said, while delayed stimulus increases the risk of permanent economic scarring, the long-term effect is likely to be relatively small. Moreover, while the fiscal backstop may be removed temporarily, the monetary backstop would remain operational. As such, a significant correction in the event of a delayed result could present a buying opportunity.

For now, key leading indicators of the US economy are still consistent with expansion, and we don't expect the recovery to crash and burn without new stimulus. Indeed, some of our favourite indicators, such as business confidence surveys, are rising to two-year highs in the US while they slump again elsewhere in the world. Third-quarter GDP growth exceeded expectations, and overall the economy is now just 3.5% smaller than it was at the end of 2019.

Yet that's still greater than the *total* peak-to-trough loss of income in most recessions. The recovery still has a long way to go. Industrial production fell back in September and is still 7% below the pre-pandemic high water mark. Housing construction was another early bright spot, but new starts peaked in July and are still 12.5% below pre-COVID levels.

The remarkable thing about the recession spanning the first and second quarters was that personal incomes *increased*, thanks to government stimulus. That's reversing. Real disposable income (that's income after tax, adjusted for inflation) fell 3.5% in August, as the weakest gain in compensation in four months was coupled with a sharp reduction in government transfers to households. Jobs growth is needed to offset the reduction in government transfers. With employment still 10.7 million below pre-COVID levels, it's disappointing that the number of job openings started falling in the summer.

While headline unemployment is falling, the rate excluding those registered as "temporarily" laid off continues to rise. Counting only those who have been unemployed for between 15 and 26 weeks, the unemployment rate in August was double the rate seen in the 2008-09 financial crisis. In September, the majority of people exiting this cohort moved into the next – greater than 27 weeks unemployed – from which history suggests it can be difficult to ever emerge.

To be sure, various surveys suggest that the economy will continue to add jobs. But there is a risk that it could do so at a pace that both curtails consumer-driven growth and disappoints market expectations, particularly given that consensus earnings forecasts have all sectors bar finance and real estate exceeding 2019 profits in 2021.

With the job market at risk of stalling, COVID-19 cases rising for the third time, and flu season approaching, the economy has reached a critical juncture on the road to recovery. It may well continue to head in the right direction without any extra help, but the chances of recovery would increase greatly if consumer spending – the main engine of the economy – as well as beleaguered state and local governments received more federal stimulus.

Bigger forces are at work
For now we'll leave you with this. When thinking about the implications of an election it is important to establish a baseline and some priors – just as it is when trying to interpret any new information. One way to do this is to think about what has been driving markets over the last six months. To our mind, it has been: (i) hope for a timely, effective vaccine; (ii) supportive fiscal policy; (iii) supportive monetary policy; (iv) a levelling-off of previously escalating Sino-US trade tensions. We don't think any election outcome, when it does arrive, will alter the first three.

Another way to establish a baseline is to examine how elections have impacted financial markets in the past. Looking at over 50 years of data – covering equities, the dollar, Treasuries and corporate bonds – we've found that presidential elections generate little noise, but rarely any signal. Popular ideas such as Republican presidents being better for investment returns don't stand up to scrutiny. Even sectoral ramifications are often hard to identify. What were the two worst performing sectors during the Obama years? Financials and energy. The worst under Mr Trump? Financials and energy. There are bigger forces at work.

That said, even with five decades of data, we don't have a large enough sample to refute the possibility that it could be different this time. Joe Biden campaigned on heavily re-distributional policies. But the majority of these policies will be stopped in their tracks if the Democrats don't complete a so-called 'blue wave' whereby they retake the Senate and retain the House of Representatives. That's looking unlikely now, but again we may not know the result of Senate races for a long time either. If it comes down to just one seat, we will have to wait until Georgia's run-off ballot scheduled for 5 January.

Some things both sides agree on
With a split government now looking likely, investors should think about bipartisan issues. To our minds, there are four of them.

First, passing another COVID-relief stimulus package. It's likely to be smaller than in a 'wave' scenario, but sufficient to keep America's extraordinarily strong recovery on a path that satisfies investors.

Second, and related to the first, infrastructure spending. Mr Trump has long-since touted a "$1 trillion" plan, but that has meant just $200 billion of federal government money over 10 years, with $200 billion from state and local governments, and the rest from the private sector. Biden on the other hand has tabled $1.3 trillion of federal spending on infrastructure, matched by another $5 trillion from state and local governments and the private sector.

Of course, a succession of presidential candidates and members of Congress have promised federal infrastructure investment. It's a rare bipartisan issue, though some investors question whether it will ever arrive. However, various Washington policy watchers have said that an infrastructure bill was ready to be signed into law last year: Trump torpedoed it in retaliation to the House Democrats' gimcrack impeachment trial. In June, the Department of Transportation outlined a new $1 trillion plan that focused on projects such as roads and bridges. We expect a bipartisan infrastructure bill to focus on this, side-lining the Democrats' plans for green infrastructure.

Third, drug pricing. Biden's pledges have a lot of cross-over with four Executive Orders Trump signed on drug pricing in July. That got very little attention, but Trump aimed at: (i) replacing pharmacy benefit management (middlemen) rebates in Medicare; (ii) implementing an international pricing index for Medicare drugs; (iii) allowing importation of certain drugs by individuals and states; (iv) discounting injectable drugs. Biden wants to allow Medicare to negotiate on pricing, and Medicare accounts for about 45% of US pharma sales and therefore carries substantial clout.

It is important to note that we are living through a golden age of medical innovation. Huge strides have been made in treating old-age ailments and so-called orphan diseases. Innovations come at a cost, and high drug prices are required to fund all the research and development necessary to find them. Slashing prices on innovative drugs jeopardises future innovations. While there are undoubtedly some instances of price gouging, we do not expect presidential initiatives to target the most innovative companies.

Fourth, anti-China trade policies have become a bipartisan issue. Indeed they have been for quite some time. Biden is the culmination of the Democrats' anti-China shift. Global and US companies with large revenue exposure to China have done well this year; their share prices appear to be moving in line with Biden's polling numbers, suggesting a perception among investors that a Biden victory would be good for China. We think this might be a mistake.

Biden has plans for a new offshoring tax penalty of 10% on the profits of any product by a US company overseas for sales back to the US, as well as a new proposal for a "Made in America" tax credit, available to companies that make investments aimed at revitalising closed or closing factories, bringing jobs from overseas to the US, expanding or broadening domestic facilities, and expanding manufacturing payroll in general. These are policies that Trump touted, but never actually implemented, although he has since said he would.

Biden has pledged to honour multinational agreements, and the World Trade Organisation in mid-September judged that Trump's tariffs on China violated its rules. We may see greater use of non-tariff barriers and tax incentives for re-shoring. Biden may also return to Obama's "Pivot to Asia" policy, which was about countering China with a reoriented globalisation. This could be timely: a more diversified form of globalisation is the rational reaction to COVID – you don't want to source all of your widgets from one country anymore, in case it goes into lockdown. The Biden campaign is open to the possibility of restarting the Trans-Pacific Partnership, which would be relatively positive for those included. Biden would also be more likely to work with other major powers to combat China's bid for economic hegemony, and in this regard may well present more of a threat to China and China-related investments. While we expect western stocks geared into China to continue to underperform, the major beneficiary from Biden's trade policy may be European assets.

Frustrated by a split Congress derailing other projects, Trump may focus a lot of attention on trade, where he doesn't require Congressional approval. This would boost the outlook for US assets relative to non-US assets in our opinion. Over the last four years, huge increases in global policy uncertainty, particularly around what American protectionism/ unilateralism means for foreign export-oriented economies, have augmented the outperformance of US equities. Uncertainty has become greater outside of the US than within it because the US is a more insular economy, with a lower ratio of trade to GDP. In our view, that's benefited US assets relative to non-US assets because its stock market is less cyclical than many others and less sensitive to the global trade cycle.

The biggest risk for markets is that Trump escalates his nascent trade conflict with the European Union (EU). This is particularly likely if the EU impose a carbon border-tax, on which it is currently consulting with the public. A carbon border-tax imposes fees or quotas on carbon-intensive goods imported from countries that are judged to be falling short of climate-related standards, and are essential to ensure that domestic manufacturing doesn't lose out to the cheaper, 'dirtier' processes of countries with less stringent environmental policies. We think such taxes are likely to become widespread at some point in the next decade.

We will be keeping a close eye on these developments and will write to you again when we know more.

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