Final Election Preview
Should You Be Concerned?

Managed Asset Portfolios

This is it… the final week before America's favorite national pastime: the presidential election. With all of the debates passed and polls leaning heavily towards Biden and the Democrats, we want to preview potential scenarios and what they may mean for your portfolio.

First, a caveat: it has historically been difficult to not only predict elections, but also to predict the market reaction to elections. Pundits on both sides of the aisle in financial and political media will tell you that if the opposing candidate wins, the stock market will crash and the economy will be in shambles. The task is made even more difficult this year due to COVID. With cases surging worldwide, the virus remains a crucial issue for the U.S. and world economy. The stock market has appeared to recover since the nation's first peak in the Spring, but we are heading into yet more unknown territory: a full winter with COVID.

Alas, we endeavor to give you our election preview. What do we have to look forward to on November 4th? Stock market collapse, surge, or relative calm?

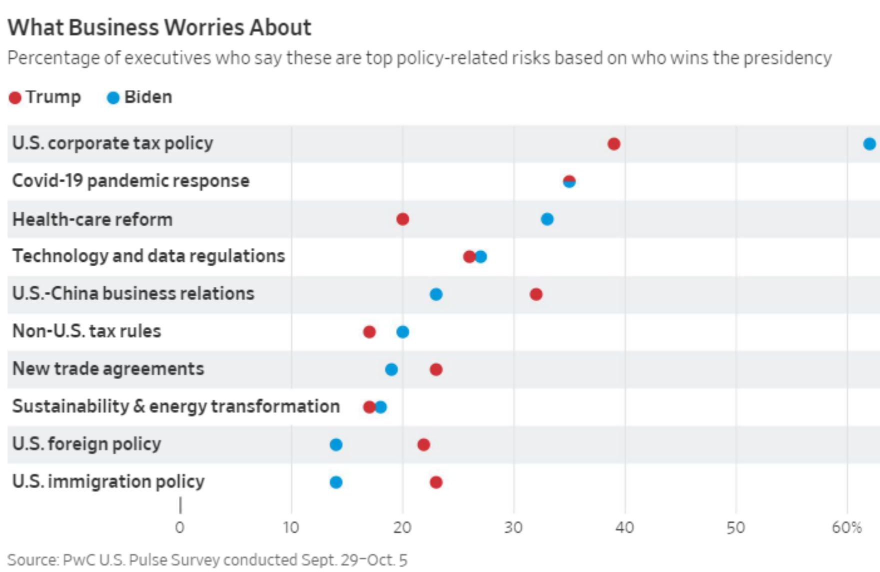
Market Expectations

At this point in the cycle, polls are showing Joe Biden with a large lead in the popular vote. Republicans are keen to point out that at this point in the 2016 election, polls were showing it was likely that Hillary Clinton would win the presidency. Forecasting is hard. Forecasters have been wrong in the past and will continue to err in the future.

However, by this point the market is expecting a Biden victory, with Democrats controlling both the House and the Senate. A Trump victory is still very possible. But unlike 2016, we wouldn't expect an election night futures crash in the event of a Trump victory. We have seen what a Trump presidency looks like for stock markets.

The Policies That Matter

There are three major policies that the market will look towards after the election: taxes, COVID response, and trade:



Source: https://www.wsj.com/articles/business-on-biden-not-so-bad-given-the-alternatives-11603645608?mod=hp_lead_pos7

The above survey by PwC finds taxes to be the main concern for executives in the coming election. Joe Biden has released a plan which would roll back much of the Trump Administration's tax cuts, including raising the corporate tax rate to 28% from its current 21%, and increasing capital gains rates for those with over $1 million in income.

Coming in second in the survey was COVID response. There is little doubt that without the massive and speedy government response seen during the Spring peak, the economy and stock market would look very different. As we enter the winter flu season and COVID cases appear to be steeply rising, a new COVID relief package could be needed soon. The extent of which could depend on who is in power.

Lastly, we will examine trade. The days of U.S. trade policy being at the forefront of financiers' minds seem long gone. However, trade is still a crucial issue for markets. President Trump has taken a hawkish approach to foreign trade during his tenure. Will we see a continuation of this policy in the future?

With these three issues in mind, there are three scenarios and a wildcard which could play out next week: a Democrat sweep, a split, and a Republican sweep. The wildcard is chaos. Each will be examined for their potential effects on markets in the next three months to four years.

Scenarios

Scenario 1: A Clean Sweep for Democrats

Likelihood

The most likely scenario if polls are to be believed.

Taxes

In the above chart, you can see that businesses are by far most concerned about Biden's corporate tax plan. A 7% jump in the corporate tax rate is significant to bottom lines. Additionally, of concern to stock markets is the potential for long-term capital gains tax rates to rise for the wealthy. Anticipation of the tax-hike will cause some wealthy investors to sell their holdings and book the lesser rate prior to any increase.

COVID Response

Democrats have signaled that they are very interested in passing a COVID relief plan, with the House passing a $2.2 trillion bill earlier this month. The bill will not make it through the Senate, but it shows that if the Democrats take control, they will be very willing to pass economic aid. Any bill the Democrats pass will likely be more focused on workers and families than businesses, but the bill passed earlier this month extended PPP aid and offered $25 billion to airlines to stem layoffs.

In the case of a Democratic sweep, the 2 ½ lame duck months could prove difficult. If coronavirus cases continue to rise and Americans are forced (by government decree or fear or both) to stay home again, aid will be needed. Days and weeks matter for families, and it will be difficult to handle another round of layoffs without additional money from the government. An already bitter rivalry between the two parties could further sour if Democrats sweep the elections.

Trade

Joe Biden has signaled that he will continue to take a tough approach when it comes to China. However, Biden is a career politician and will likely take a more conventional angle towards trade relations. The former Vice President has specifically signaled that he would coordinate with U.S. allies on trade, a much different approach than Trump's administration, which has sparked trade spats during their regime.

The Verdict

A Democrat sweep is net neutral for markets. Planned tax increase will hurt the bottom line, but Wall Street expects that it could happen and therefore it is likely priced in. The Democrats have signaled that they are more than willing to pass large relief packages. Outside of major medical advances, the government response to the pandemic could prove to be the most crucial driver for markets in the coming year. While Democrats will look to continue the U.S tough stance on China, a more measured approach will soothe market jitters. Patching trade relations with the EU and other key allies will further put the market at ease when it comes to foreign trade. The high spending nature of Democrats would push up inflation, which has historically signaled a rotation to value stocks.

Scenario 2: A Split

Likelihood

The second most likely scenario. Republicans have a good chance of taking either the Senate or the Presidency or both.

Taxes

It would likely be very difficult for Democrats to pass meaningful tax legislation without controlling both legislative bodies and the presidency. Republicans would be reluctant to roll back any tax cuts and infuriate their base. We would likely see a continuation of the major portions of the Trump tax reforms, and any changes would be incremental.

COVID Relief

This could prove to be a major sticking point between the two parties. The House and Senate have been unable to agree on major additional aid since the CARES act in March. The two parties would likely butt heads on the extent and direction of potential future aid, and either party could become further embittered if the election does not go their way.

Trade

Much of the trade issue will depend on who is President. A Trump presidency will likely be a continuation of the frenetic approach to trade of the last three-and-three-quarter years. Meanwhile, a Biden presidency wouldn't follow exactly in the footsteps of the Obama years, but would certainly more resemble the U.S. traditional approach to trade.

The Verdict

This may be the most dangerous outcome as it pertains to markets. Taxes would likely stay the same, which is a net positive for businesses. However, significant delays in COVID-relief bills, especially in the absence of any major breakthroughs in vaccines or treatments, could prove to be highly troubling for financial markets. Fiscal austerity on the government's part will create trouble for the broader economy and could create deflationary pressures. Trade is a toss-up depending on who wins the Presidency.

Scenario 3: Republican Sweep

Likelihood

Highly unlikely. The House will be very difficult to win for Republicans, with some forecasters putting its chances at less than 1%.

Taxes

Any new tax plan that would be passed by a Republican government would be business friendly. No clear plan has been released by the Trump administration, but Republicans are pro low tax and would not raise taxes on businesses under a Republican regime.

COVID Relief

Republicans are open to the idea of further COVID relief, but with a lower price tag than what Democrats have put forth. Republican plans would also be more business facing i.e. helping businesses pay employees rather than direct aid to the employees themselves.

Trade

The China phase one trade deal from January still stands, but the Trump-Xi on again off again relationship is difficult to decipher. Trump has taken a tough stance on trade with China and U.S. allies. Prior to the pandemic, trade was the number one concern for many market participants. It is likely that Trump would continue to use tariffs as his favorite tool to push U.S. trade policy, especially if COVID concerns weaken. Additionally, Chinese tech companies have come under extensive scrutiny during the Trump administration. The U.S. and the world now relies on a steady stream of semiconductors coming from Taiwan – any provocation that causes a disruption to semiconductor supply would cause trouble for the tech sector as well as broader markets.

Trade would continue to be of market concern and may be a drag on broad market performance during a second Trump administration.

The Verdict

Because this scenario would be so unexpected, it is the most difficult to predict the market's reaction. However, given the Trump bump seen post-Election Night 2016, it is likely that a red sweep would be seen as a net positive for markets. Looser regulations and a coherent COVID recession economic response would offset any trade war worries. A continuation of the Trump-era tax policies would be a positive for corporate bottom lines. The country would likely avoid a deflationary environment, as Republicans would pass a COVID relief bill, albeit likely smaller than a Democrat-led COVID relief bill.

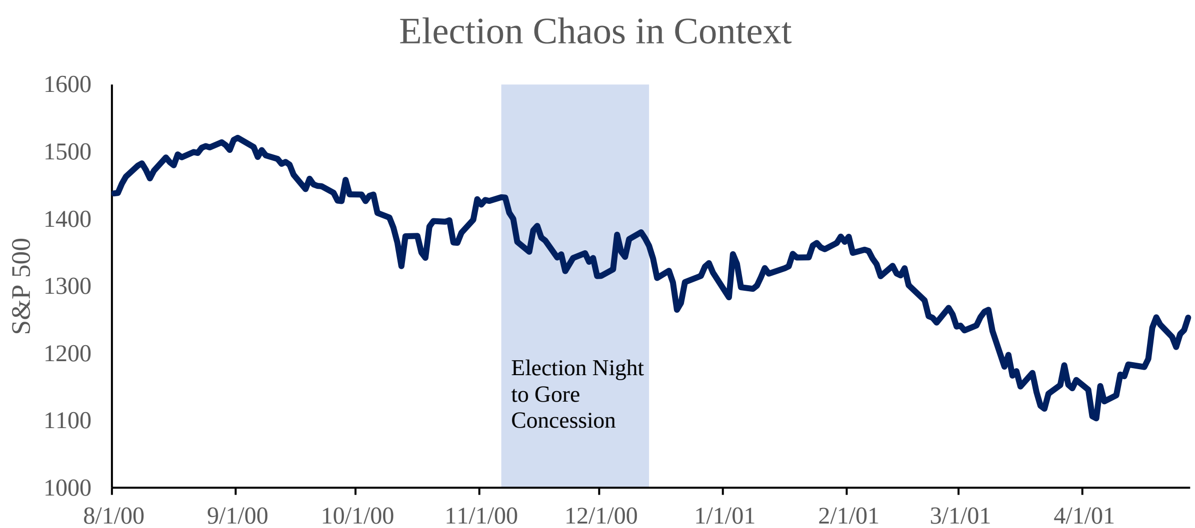
Wildcard: Chaos

President Trump has consistently fretted over mail-in ballots and the potential for voter fraud, even going so far as to remain non-committal when asked whether he will accept the results. This has worried Democrats, although fears of post-election chaos have been somewhat allayed by Senate Majority Leader McConnell's promise of a peaceful transition of power.

Delayed results, at the very least, are already expected. The forecasters at the Good Judgement Project expect place a 70% chance that the results will be delayed at least 5 days, and a 20% chance that results will be delayed until after Thanksgiving. The investing public should be anticipating this as well. Again, markets do poorly with unanticipated shocks. Anticipated negative events often have muffled effects.

The 2000 election is the most recent case of delayed results. Between Election Night 2000 (November 7) to Democratic Candidate Al Gore's final concession (December 13 of the same year), the S&P 500 fell around 5%. While 2020 has desensitized the investing public to moderate market swings, 5% in a little over a month is a noticeable drop.

In context however, the 5% swing was likely due to the prevailing market conditions at the time: the tech bubble collapse was just beginning, and valuations were coming back to earth. There doesn't seem to be much signal for panic here. In fact, looking at the returns data for the time periods surrounding the kerfuffle, the legal battle taking place to decide the 2000 election looks like a period of relative calm:



Source: Yahoo Finance

Oftentimes this is the case. While financial media so desperately wants to assign reasons to market moves, the root cause is not always so obvious.

MAP's Approach

This will probably not shock our frequent readers: we remain steadfast in our long-term and global approach.

MAP has constructed its portfolios with risk in mind. This allows us to avoid significant downside from the macro-environment, while we focus on what we do best: fundamental bottom-up style investing. Our current portfolio is constructed in a way that will allow it to benefit depending on which of the above scenarios plays out: consumer defensives and international investments help protect it from inflation and election chaos, infrastructure companies will benefit from increased government spending, and our tech allocation will benefit from any continuation of the status quo.

It is unlikely that the U.S. elections will cause lasting market turmoil. But, if we do see volatility and swings concentrated to the U.S. following November 3rd, we believe we are far better positioned to handle choppiness in U.S. markets than the average U.S. investor. Global investing adds an extra layer of diversification that many U.S. investors aren't getting.

As always, there is plenty of uncertainty as to what markets will do. Those who are certain are often wrong. Partisan talking heads and bombastic commentators will try to tell you that their least-liked candidate will crash the markets and the economy. In prior elections, that has simply not been true. There is no real reason it will change in 2020.

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