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13 October 2020

US presidential elections: a game changer for the markets?

Overly optimistic expectations for US GDP. Growth likely to slow in Q4. Rising budget deficit. Massive and unconditional support from the Fed. High risks for equities.

Key points

- Second wave of Covid-19 could slow US economic recovery
- Over-optimistic expectations for US GDP?
- US elections will reinforce the new fiscal paradigm
- Rising taxes threaten financial markets
- Massive, sustained and unconditional support from the Fed
- Full monetisation of US Treasury issuance?
- US presidential election: a game changer for financial markets?

Second wave of Covid-19 could slow US economic recovery

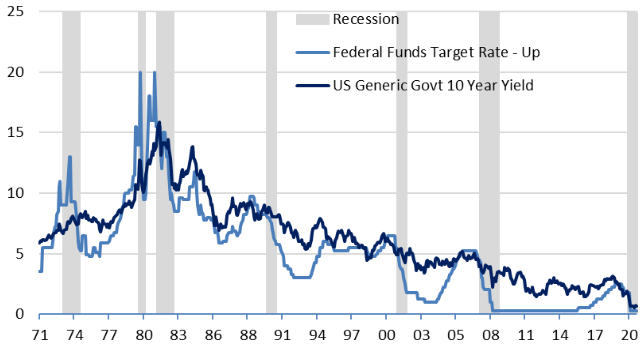
The various lockdowns and other preventative measures implemented by governments caused significant economic contractions in 2Q 2020. The easing of lockdown restrictions in various countries successively at the beginning of Q3, when the pandemic seemed to be under control, only recreated the conditions for a resumption of the pandemic during the summer. Obviously not all countries are equal in the face of these recent developments, but in the United States tensions have remained high, and the public health crisis still seems far from being under control. US President Donald Trump's consistently optimistic statements since the beginning of the health crisis about the US' ability to rapidly discover and produce effective vaccines and treatments do not change the harsh current reality.

The epidemic is still spreading, and the death toll now exceeds 200,000 people in the US. The president's contraction of the virus and his rapid recovery have even reinforced his conviction that Covid-19 is not so dangerous and that there is no need to be afraid of it. In this context, however, it now seems clear to the vast majority of American political leaders that another general lockdown period would not be economically bearable. A further lockdown is therefore not desirable and will be ruled out for as long as possible in most states. However, it may be impossible to avoid increasingly penalising new restrictions, which would have a severe impact on the economy in the coming months and into 2021. Financial markets rose over the last six months in anticipation of a forthcoming resolution of the public health crisis and its economic consequences. Results for Q3 2020 may live up to these expectations, but the risks of disappointment are now more and more likely in the coming months. The current economic situation is therefore still very fragile despite the strong support of monetary and fiscal policies. The risk of a further economic slowdown in the US at the end of the year must therefore be considered more seriously.

Over-optimistic expectations for US GDP?

Economists' consensus forecast for US economic growth in Q3 2020 was revised from +25% to +29.9%, a result which, if true, would almost totally erase the -32.8% collapse observed in Q2 on an annualised basis. Given the public health context of the third quarter in the US, which saw an increase in the number of Covid-19 cases and deaths, this prediction seems optimistic.

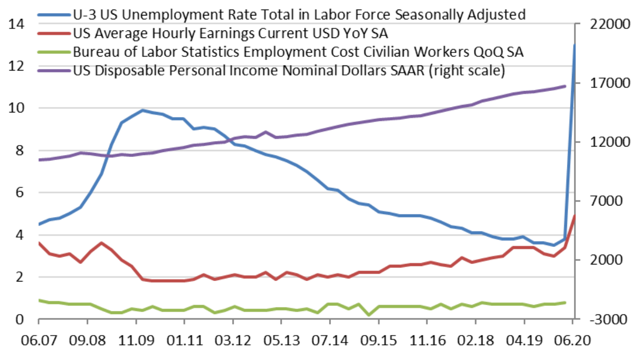
US recession, long-term rates & Fed funds



Sources: BearBull Global Investments Group Limited

Leading indicators have certainly improved, pointing to a clear recovery in activity, and both the services PMI (54.6) and the manufacturing PMI indices (53.2) are above their pre-Covid levels. Nevertheless, the unemployment rate of 7.9% is still halfway between the 4% level reached in March and its peak of 14.7% reached in April. The return to the labour market of workers who were displaced during the initial shock is visible, but it is gradual and still far from complete.

Unemployment, earnings, employment cost, income



Sources: BearBull Global Investments Group Limited

More worrying still, the number of new jobs created is losing momentum, with job creation falling from 4,781 million in June to 661,000 in September. Given the loss of momentum in job creation and the only partial compensation by unemployment benefits, which expired in July, household consumption will not be sufficiently strong for GDP growth to be as positive in Q3.

The Fed's injections of liquidity have been significant, and its balance sheet has indeed surged to support the increase in federal debt, while the US budget deficit will certainly reach USD 3,700 billion in 2020, or nearly 20% of GDP, quite simply the largest deficit recorded since World War II. In 2008, during the systemic subprime crisis, the deficit was "only" USD 1,400 billion.

The risks of disappointing growth in the second half of the year thus seem significant in such a context, even though Donald Trump would welcome such convenient news on Thursday 29 October, right before the presidential election on Tuesday 3 November.

US elections will reinforce the new fiscal paradigm

The Covid-19 pandemic has already completely changed fiscal doctrines in recent months, but the onset of a second wave will significantly strengthen this trend. The political measures implemented to protect populations against the virus turned out to be extremely costly. The initial impacts on the US budget have already been impressive and no doubt will continue to widen the US Treasury deficit in the coming quarters. Fiscal austerity is no longer in fashion.

The aim is no longer to slow the increase in national debt and provide a solution to the transfer of debt to future generations but rather to safeguard the economic system and avoid social collapse and the impoverishment of part of the population. The American presidential election on 3 November could thus reinforce this new fiscal paradigm.

A victory for the Democrats would have the notable consequence of increasing public spending to implement an economic stimulus programme, including support for the American population, estimated at USD 7 trillion. The election of Democrat Joe Biden and his running mate Kamala Harris would therefore have a significant impact on the management of the Covid-19 crisis, which will still be ongoing when they take office in January 2021.

Joe Biden's programme would therefore quickly have a significant first impact on government spending and debt by initially encouraging an expansion of government spending before attempting to rebalance the budget by substantially raising taxes.

Rising taxes threaten financial markets

Current analyses do not yet seem to be paying much attention to the risks of an increase in US taxes, perhaps because this negative factor may well be offset by the positive effects of broad economic support and a further expansion of the US budget deficit should Biden be elected.

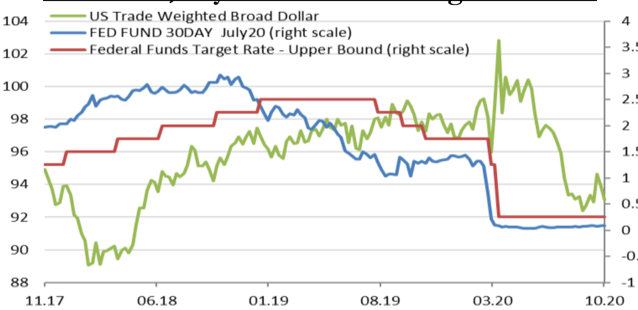
It is true that an economic stimulus estimated at USD 7 trillion would bolster the economy and corporate sales, but an increase in corporate taxation from 26% to 33% would also have a negative impact on earnings growth, which could easily reduce current estimates for 2022 by -10%, to only $171 per share for the S&P500. The current earnings estimate for 2021 is already $168, about +10% above the $155 12-month forward estimate. It is probably too early to consider this possibility. But in the context of what we believe to be the already rich valuation levels of US equities, this uncertainty could well add to the others and tip the cursor towards the risk-off zone in the coming weeks.

Massive, sustained and unconditional support from the Fed

The Fed intervened quickly during the health crisis to control the onset of panic that gripped financial markets in March. It very quickly adjusted its monetary policy to reassure financial markets and provide all the liquidity required to avoid a systemic crisis. Key rates were lowered, approaching 0%, while the asset purchase programme allowed the 10-year Treasury rate to converge, falling from 1.95% at the beginning of the year to 0.5% in early August. During the quarter, the situation remained relatively stable, the Fed's key rate steering policy remained unchanged, and its asset purchases were commensurate with financing requirements.

In the absence of any real acceleration in the US economic recovery, this situation should be considered as the new normal. While on the short end of the yield curve the situation seems unlikely to change for several quarters at least, the situation on the longer end is a little more uncertain. Indeed, the evolution of long-term yields will depend essentially on the situation regarding government and corporate financing needs, net new issuance and the Federal Reserve's capacity to absorb the latter.

Fed funds, key rates & trade-weighted dollar



Sources: BearBull Global Investments Group Limited

Full monetisation of US Treasury issuance?

Governments' additional funding needs to meet the direct and indirect costs of managing the Covid-19 crisis were announced fairly accurately and finally quite quickly after the crisis broke out.

The initial US stimulus package of USD 2.2 trillion will therefore weigh heavily on the US budget and debt levels. These trillions will be in addition to the trillions of dollars of ordinary financing that the US Treasury already relies on to finance and close its annual budget.

Thus, in the exceptional context of 2020, the financing of these new liquidity needs will be ensured above all by the US central bank. The Fed's balance sheet had already ballooned in response to the economic crisis of 2008, but in 2020 it is expected to increase further still with the likely growth of financing needs in 2021. The Fed has thus increased the size of its assets by USD 3 trillion, and the latter may well continue to grow at the same pace in 2021.

The US central bank, like other major central banks, is engaged in an irreversible headlong rush and will probably not stop adding new federal debt issuance to its balance sheet any time soon. Long-term rates are therefore likely to remain under the almost absolute control of central banks, as they have been throughout the last quarter.

However, governments' financing needs will continue to grow, potentially testingcentral banks' resolve and the enthusiasm of private investors. Some of them are already well on their way, while the additional financing needs of the US are emerging and depend on the desired policies.

The Democrats and Republicans have thus engaged in a face-off on the outline of a new stimulus package, which should be USD 3 trillion according to the former and USD 1 trillion according to the latter. Negotiations have not been successful and were undermined by Trump's announcement that nothing would be decided before the elections.

The US Treasury Department, however, already estimated its needs at an additional USD 3 trillion to avoid another economic downturn in the coming months. Continuing failure to come to an agreement would have harmful consequences for the American economy, which could then deteriorate once again in Q4.

US presidential election: a game changer?

In a few weeks the US presidential election could trigger a change in outlook and a reassessment of risks and opportunities in financial markets. As in 2016, the Democratic candidate Joe Biden is ahead in the national polls with three weeks to go before the November 3 election.

However, this may not be enough for him to win against the incumbent president, although he appears to have a comfortable lead for the time being. It is often forgotten that the US system is based on the number of electors in the Electoral College, not the absolute number of ballots obtained. In 2016 Hillary Clinton had won 2.87 million more votes, but Trump won by a majority of electors thanks to a few key states.

Therefore, it is still crucial to be able to estimate which states are likely to swing the majority of those electors in favour of the Democrats or the Republicans in 2020 in order to estimate whether Donald Trump still has a chance of being elected this year if he does not get a majority of the vote.

But beyond electoral speculation, it would appear that the risk of a challenge to the election result is in fact an important new factor of uncertainty to consider Indeed, it is increasingly likely that the results will be contested following the vote and that this will lead to a new phase of uncertainty a few weeks before the end of the year.

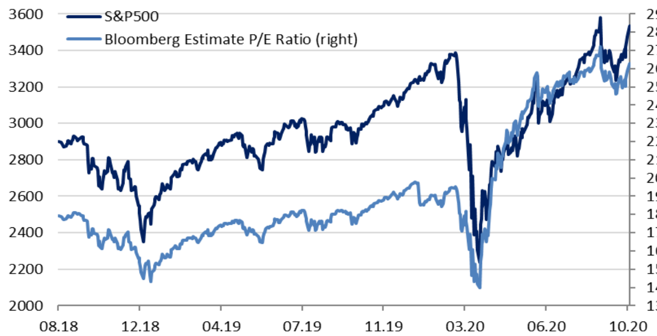
In 2000, Gore's legal challenge had finally led to the election of George W. Bush following a 5 to 4 decision by the US Supreme Court.

The appointment of a new Supreme Court justice by Donald Trump just before the presidential election is particularly sensitive in the current context.

The uncertainty that had lasted a little over a month had caused the S&P500 index to plunge by -10% and the Nasdaq by -28%.

The end of the year could therefore look more uncertain also because of the tax implications for companies and individuals who could see their tax rates increase significantly in 2021.

S&P500 & P/E



Sources: BearBull Global Investments Group Limited

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