What the U.S. Elections Mean for Global Financial Markets: A Roundtable Commentary

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INTRODUCTION

As the political season in the U.S. reaches a fever pitch and voters prepare to cast their ballots on November 8, the world eagerly waits to see who will emerge victorious in one of the most closely watched political contests of the modern era. With plenty of surprises along the way, polls indicate a closely fought presidential race, leaving many to consider the impact that each candidate could have on both the U.S. and the broader international economy.

Very few areas stand to feel the effects of the ongoing speculation more than global financial markets, particularly as each candidate continues to articulate their respective platform. To help provide more clarity on the possible consequences of each outcome, three members of our investment staff answer key questions about how markets and investors could potentially react and identify other factors worthy of consideration.

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Do you believe that the election will be viewed as having broad-based implications for financial markets or is it more just another event on the calendar?

Eric McLaughlin: It is certainly not just another event on the calendar. We would expect very different agendas from the two presidential candidates. Perhaps equally important is what could happen in the House of Representatives and Senate, where a sweep by either party would likely rattle markets. The current split in power between the Democratic President and Republican Congress has led to some compromise but also plenty of gridlock. I expect that one party holding both the White House and a majority in Congress will likely result in policy uncertainty and market volatility.

Ken O'Donnell: Uncertainty creates volatility in markets, which generally results in increased risk aversion by investors and a corresponding weakness among risk assets. Elevated uncertainty surrounding the expected outcome of the presidential election will likely follow this course. Historically, market returns have been uncorrelated with any specific political party, although this time may be different. A Clinton presidency would be considered less disruptive to the status quo, while a Trump administration could create a cloud of uncertainty, especially with regard to immigration policy, foreign relations and trade. It's also important to recognize that the outcome of the congressional elections may be more pivotal than the presidential election. A split Congress, with Democrats retaking control of the Senate and Republicans maintaining leadership in the House of Representatives, would severely limit the powers of the executive branch regardless of the presidential election results.

Steven Friedman: I think there are some important implications for markets because this election is largely about voter frustration with a political order that is seen as out of touch, particularly in terms of economic well-being. The incumbent party asks voters to trust that it understands their frustration and has concrete proposals to improve opportunity and wealth, but it has been met with deep-seeded skepticism due to perceptions of deteriorating income inequality under President Obama. Over the past 15 years, the median household income has flat lined. Certainly from an economic perspective, voter frustration is entirely justified.

Under a Clinton presidency, I would expect some increased infrastructure spending and progress on health care and corporate tax reform. However, there is a legitimate question about whether any of her policies are truly transformative, particularly in terms of setting the stage for higher potential growth. Therefore, we could find ourselves four years from now with an equally angry, if not angrier, electorate.

In contrast, Trump has pledged a much more radical restructuring of the political and economic order. Some of his ideas about trade, immigration, foreign policy and fiscal policy are potentially disruptive and could weigh on sentiment in financial markets, as well as business confidence.

As a result, these two candidates represent starkly different visions of the country, with potentially significant implications for the economy, national security and markets.

Should we expect stock market volatility leading up to the election and immediately afterward?

Ken O'Donnell: Volatility in the pre-election period will depend largely on the evolution of voter polls. A reduction in the magnitude of Clinton's lead in the battleground states would increase the potential for an upset by Trump on Election Day. While this appears to be an unlikely outcome, the prospect may be too large to discount. With less than two months to go, polls are narrowing; however, the results are highly sensitive to specific samples, including registered voters, likely voters, number of names on ballot and more.

In the post-election period, I expect that a Clinton presidency would be less volatile and have fewer unknowns than a Trump presidency.

Eric McLaughlin: Above all else, markets hate uncertainty, and many investors move to the sidelines to wait for clarity. With equity prices near all-time highs and relatively weak catalysts on the horizon, we would expect volatility in the weeks leading up to the election. For instance, we see headline risk for large banks during the campaign, with tougher regulation and taxes as a tail risk after the election.

Steven Friedman: I think we have already seen evidence of some increased market volatility as the race narrowed and attention turned to the first debate. If the race remains tight, and particularly if Trump pulls ahead, then I would expect some additional volatility. This is because Trump's ideas represent a break from the policy consensus and, at least in my thinking, could lead to lower growth and higher inflation even if we wind up with watered-down versions of some of his proposals. For example, his plan to impose import tariffs on Mexican and Chinese goods would most likely lead to retaliatory tariffs on our goods. This trade war could result in higher inflation and job losses among U.S. exporters, as well as compressed profit margins for corporations that use Mexican and Chinese goods in their production processes. In addition, Trump's plan to deport millions of undocumented workers would decrease the U.S. labor force and could boost inflation while lowering potential growth over time.

The president has quite a bit of leeway over trade and immigration policy, so Trump's proposals in these areas would not require direct congressional approval. In addition, his plan to lower taxes without identifying spending cuts has two major consequences: 1) the tax cut benefits accrue disproportionally to the wealthy, so there would be a minimal spending multiplier associated with them, and 2) without identifying spending cuts, the loss of revenue would need to be financed through a significant increase in outstanding debt. The required increase in debt could pressure interest rates higher, impacting investment spending and consumer borrowing, with knock-on effects influencing the housing market.

Another issue is that many of Trump's proposals are vague and fluid. The inability to pin down his thinking on a number of key topics could also be a near-term negative for stocks. It is one thing for investors to react negatively to the candidates' policy choices, but it is a separate issue for investors to be highly uncertain about what the policy proposals actually are.

What should we expect regarding major economic policy changes from a Clinton presidency versus a Trump presidency, and how will markets react?

Eric McLaughlin: It's difficult to pin down specific policies from either candidate, but their general bias is clear on several economic issues. These issues include taxes, trade deals, favored types of infrastructure such as green versus conventional energy, preference for monetary policy, as well as their expressed views on industries such as health care and energy.

Steven Friedman: There are at least three areas for possible compromise between a Clinton administration and a Republican-controlled or split Congress: reform of the Affordable Care Act (ACA), infrastructure spending and corporate tax policy.

- While Republicans would want a more drastic overhaul of the ACA, they may come around on Clinton's plan for improving the current system. This is because of the broad understanding that deadlock on this issue has very significant consequences for those who rely on the program. Additionally, the program has become more expensive to maintain, so Republicans will want to stem the fiscal bloodletting.

- Infrastructure spending also has bipartisan support, but there is the question of how to pay for it. This is where corporate tax policy comes in. A deal to allow corporations to repatriate profits held offshore at a lower tax rate is quite possible and could be enough to pay for the infrastructure program. This is not as far-fetched a solution as it sounds; a bipartisan agreement on repatriation almost came to fruition in 2015, and the incentives to compromise are even greater now.

- Finally, on corporate tax policy, there appears to be recognition by both parties that corporate tax rates are too high and need to come down. The extent to which tax rates should be lowered is a point of contention, but there is definitely scope for compromise.

I think markets would react positively to bipartisan progress in these areas because it would indicate a pro-business, pro-growth consensus among the two major parties. In addition, Democrats are highly unlikely to pick up majorities in both houses of Congress, which means that some of Clinton's proposals that were more worrisome to markets, such as a tax on high-frequency trading, stand little chance of being implemented. Additionally, the infrastructure spending program could provide some necessary fiscal stimulus if its large enough. Meanwhile, Clinton's initiatives to increase spending on early childhood education and college tuition support could wind up on the cutting room floor since a Republican Congress would not likely pass the tax increases necessary to fund them.

To use a more nuanced brush on a Trump presidency, we should keep in mind that we could likely see larger Republican majorities in the Senate and House of Representatives in this scenario. Many market participants will cheer the resulting cuts to household and corporate tax rates, while others, including myself, will fret about a deteriorating deficit. Infrastructure spending would also likely move forward, as would a plan to allow corporations to repatriate offshore profits. The key question, though, is whether these positives will prove to be sufficient enough to outweigh the negatives associated with Trump's trade and immigration policies.

Do you expect the election to influence U.S. Federal Reserve (Fed) policy over the next year?

Steven Friedman: It certainly could, although it is hard to be too concrete on this topic without knowing the outcome of the election, the composition of Congress and the willingness of the two parties to compromise. If Clinton can succeed in forming a pro-growth coalition with moderate Republicans, we could see an infrastructure spending bill passed in the first half of 2017. If it's large enough, the spending program could change the outlook for growth, employment and inflation, and it could lead to a tighter monetary policy stance, though probably not immediately.

If the first-order effect of a Trump presidency is uncertainty over his policies, with all else remaining equal, the result could be a somewhat easier stance of monetary policy in the near term. Over time, the Federal Open Market Committee would have to weigh the inflationary and growth consequences of Trump's more controversial policies. His plan for higher tariffs, and the potential resulting trade war, could lead to higher inflation combined with lower growth, which is an uncomfortable combination for any central bank.

Eric McLaughlin: The Fed is certainly no stranger to criticism, with Republicans feeling that the central bank has too much power, while Democrats want it to do more to reign in the big banks and financial institutions. While the Fed likes to steer clear of politics, a unified Congress and White House might decide to act and change the Fed's mandate. Of course, any kind of split control raises a big barrier to change. The two parties want different things and are diametrically opposed. Down the road, one notable consequence of the election's results would be what happens when Janet Yellen's term expires at the beginning of 2018. The Fed chair position is immensely important, so the election winner would have a considerable impact on the central bank by making that appointment.

Ken O'Donnell: Because the Fed remains independent of partisan politics, a new administration is unlikely to impact monetary policy in the near term. Several leading Republicans, however, have been openly critical of the Fed for some time. A Republican presidency may increase the level of scrutiny, although it is unlikely to impact the long-term independence of the central bank.

Which asset classes may be most impacted by this U.S. presidential election?

Ken O'Donnell: Market sector correlations tend to rise during periods of volatility. Fear and uncertainty drive investor risk aversion, which impacts risky assets in similar ways. The short-term direction of the U.S. equity market will likely be the best indicator of investor sentiment in the days leading up to the election, with other risky assets performing in line. The risk-free U.S. Treasury market would be the clear beneficiary of a rise in risk aversion. Over time, market valuations are likely to revert to more traditional valuation metrics.

Eric McLaughlin: Within equity markets, a victory for Trump and the Republicans would most likely benefit domestic oil producers, as it could lead to more drilling, but it could also be a negative to the overall energy sector because the increased supply would keep prices low. A Republican sweep could also bring a stronger dollar, which would help the consumer through imports but also damage exporters. Conversely, a Clinton White House likely means a clearer path for health care services, clean energy and engineering & construction more so than defense stocks.

CONCLUSION

The outcome of the U.S. elections in November could potentially have considerable ramifications on global financial markets. The starkly different views of both presidential candidates have emboldened uncertainty among investors, raising the specter of increased volatility, while the implications of the congressional results could introduce an entirely different set of outcomes. Important issues including infrastructure spending, health care and tax reform are center stage for both parties, yet their respective approaches and the degree to which they intend to resolve them remains a question. Compromise between political parties and improved bipartisan politics have the potential to assuage global investors, but the number of unknowns remaining will surely hold the attention of the global community leading up to one of the world's most hotly contested political battles.

BIOGRAPHIES

Steven Friedman
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Steven is a Senior Investment Strategist at BNP Paribas Investment Partners. In this role, he is responsible for developing thematic views on the market, economic and policy outlook in the US and other major economies. Steven joined our company in 2013 and is based in New York.

Prior to his current role, Steven was a Director for the Central Banks and Official Institutions team at FFTW, a subsidiary of BNP Paribas Investment Partners. Steven also held various positions at the Federal Reserve Bank of New York, most recently as Director of Market Analysis, where he worked on both market and policy analysis and relationship management for the Bank's Investment Advisory Committee on financial markets. Prior to that, Steven worked in other roles within the Markets Group, including, Director of Foreign Exchange and Investments, where he had oversight for the Fed's and Treasury's foreign exchange portfolios. During the financial crisis, he worked on the design and implementation of a number of liquidity facilities, such as swap lines with other central banks. Steven also spent two years at the Bank for International Settlements as a member of the Basel Committee Secretariat.

Steven has over 18 years of investment experience. He holds a BA in Government and Russian studies (with honors) from Wesleyan University, an MA in International Relations from The Paul H. Nitze School of Advanced International Studies at The Johns Hopkins University, and an MBA (executive program) from Columbia Business School.

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Senior Investment Specialist
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Eric is a Senior Investment Specialist for the US Equities team at BNP Paribas Investment Partners. He has responsibility for marketing communicating the team's investment approach. He joined the company in 2005 and is based in Boston

Prior to joining us, Eric was with Deutsche Asset Management, where he was Vice President of the Investment Products Group. Prior to that, he was Director of the Investment Strategies Group at MetLife. He began his career at the Harvard Management Company in Risk Management and Operations.

Eric has 26 years of investment experience. He earned his BS in Finance from Fairfield University. Eric is a CFA Charterholder, a member of the CFA Institute and the Boston Security Analysts Society, Inc.

Ken O'Donnell, CFA
Head of Short Duration Fixed Income
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Ken is the Head of Short Duration Fixed Income at FFTW and is responsible for performance, growth, and development of short duration products firm wide. Ken is also the Senior Portfolio Manager for short duration strategies, which includes US short duration, US short-intermediate duration, global short duration and LIBOR related portfolios. Ken has a broad base of experience in global fixed income markets, having managed multi-sector portfolios including structured securities, corporate and government bond portfolios. He joined FFTW, a subsidiary of BNP Paribas Investment Partners, in 2002 and is based in New York.

Prior to joining us, Ken was with Standish Mellon Asset Management in Boston. There, he held roles in various fixed income segments, including high yield and securitized trading. His primary responsibilities included managing credit exposures for a diversified group of client portfolios.

Ken has 18 years of investment experience. He holds an MS in Finance from Boston College and a BS in Mechanical Engineering from Syracuse University. He is a member of the New York Society of Security Analysts and the CFA Institute. Ken is a CFA Charterholder.

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