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# International

Global research and insights from Frontier Advisors

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## Capital Markets Virtual US Trip

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# Frontier Advisors

*Frontier regularly conducts international research trips to observe and understand more about international trends and to meet and evaluate, first hand, a range of fund managers and products.*

*With COVID-19 leading to a re-think, our Capital Markets team recently completed a 'virtual' trip to the US ahead of the upcoming Presidential Election.*

*This report provides a high-level assessment on the key areas and observations unearthed during this trip. We would be pleased to meet with you virtually in person to provide further detail on these observations.*


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Philip Naylor is a Principal Consultant and senior member of the Capital Markets and Asset Allocation Team, having joined the firm in 2018. Philip has over a decade of senior experience, much of that in currency and fixed income trading roles with the Reserve Bank of Australia (RBA) in both Sydney and New York, and as the RBA's representative on the G20 Investment and Infrastructure Working Group. Philip has also worked as a consultant to the World Bank in Washington DC and as an Economist at Macquarie Bank. Immediately prior to joining Frontier, Philip was the Economic Advisor to the Treasurer of the Northern Territory. Philip holds a Bachelor of Business (Honours) in Economics and Finance from RMIT University along with a Master of Public Administration (MPA) in Economic Policy Management from Columbia University in New York. He is also a CFA Charterholder.


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Cadence Ho joined Frontier as an Associate in 2016 with a capital markets and asset allocation focus. Prior to joining Frontier, Cadence was a Product Specialist for UOB Kay Hian Holdings in Singapore, where she undertook product analysis and structuring, and business development. She also spent a year as a Fund Accounting Associate at Citibank, also in Singapore. Cadence holds a Bachelor of Business Administration from the National University of Singapore, Master of Economics at the University of Queensland and is currently undertaking her CFA.

# Introduction

On Tuesday, 3 November 2020, Americans will go to the polls to decide who will be President for the next four years—Joe Biden or Donald Trump.

Given geopolitical events can be an influential focus of financial markets, members of our Capital Markets and Asset Allocation Team recently set-off on a 'virtual' trip to the US to meet with several investors, think-tanks, academics and pundits to discuss how investors should be thinking about portfolios heading into this event.

While there were many themes from these meetings, overall, some of the key take-aways were:

- Biden is widely expected to win the Presidential election. However, there were differing views on if this would be 'good' or 'bad' for equities.
- It is not clear what the process is if the election outcome is contested, or how long it could be disputed for. An 'unclear outcome' appears to be one of the most disruptive scenarios potentially for markets. Most people see this possibly playing out if Trump disputes the mail-in votes.
- The Senate outcome could be critical to what policies a potential Biden President could enact, including raising the corporate tax rate.

When it comes to positioning portfolios for events like these, we remain of the opinion that long-term investors need to be cognisant of event risks (such as elections). However, taking a long-term perspective to investing means looking through some of the short-term market hype.

The historical analysis on how markets react to events such as these is far from certain—there is no clear playbook for how markets will react under a Trump or Biden Presidency.
In terms of policies, as one example, while Biden's proposed policies include an increase in the corporate tax rate (which could be negative for share markets), his policies also include significant spending (which given the current economic juncture could bode well for markets). Biden is also widely seen as being 'more predictable' in his approach to foreign policy (which again could be a positive for equities given China-US trade tensions were a major theme in markets pre-COVID).

# Polls, battlegrounds and demographics

Some key aspects of the polls, regions and demographics which will impact the election include:

- Turnout matters, which makes predictions tricky. Historically, only roughly half of eligible US citizens vote. (To put this in perspective, if 'did not vote' was a measured category in the last election, it would have won by a landslide).

- Due to COVID-19, mail-in voting will have a significant impact on this election. Mail-in voting is expected to favour Biden (though this is somewhat disputed).

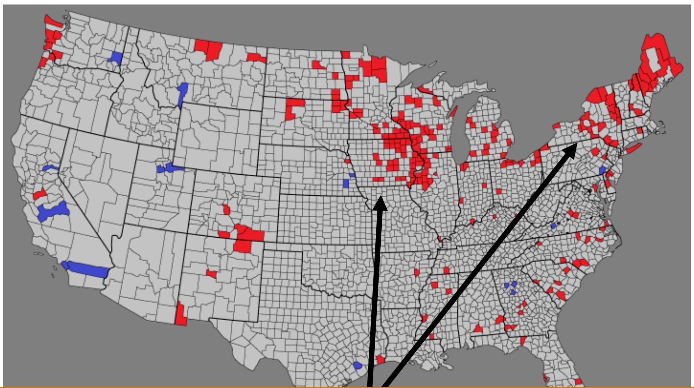
- Trump took a big hit in the polls in June as the COVID-19 situation got worse in many states and as his response was widely seen as lacking. However, that gap has narrowed significantly in recent months. It is still very much "50-50" race (though Biden is widely seen as the ultimate winner).

- The North-East and Mid-West are key battlegrounds that would need to be re-won by the Democrats in order for Biden to win. Chart 1 shows which counties switched parties in the 2016 Election, compared to the outcome of the 2012 Election.

- Demographics plays a key role in voter preferences. Research from the PEW Research Study Centre shows those that are most likely to align as Republican are: Christians, males, older people and white people. Whereas black voters are much more likely to vote for the Democrats.

- Due to COVID-19, mail in voting could play a particularly important role in the outcome. As a result, it may not be clear on the night who will be the election winner. Across meetings we had, it was not clear when a result could emerge.

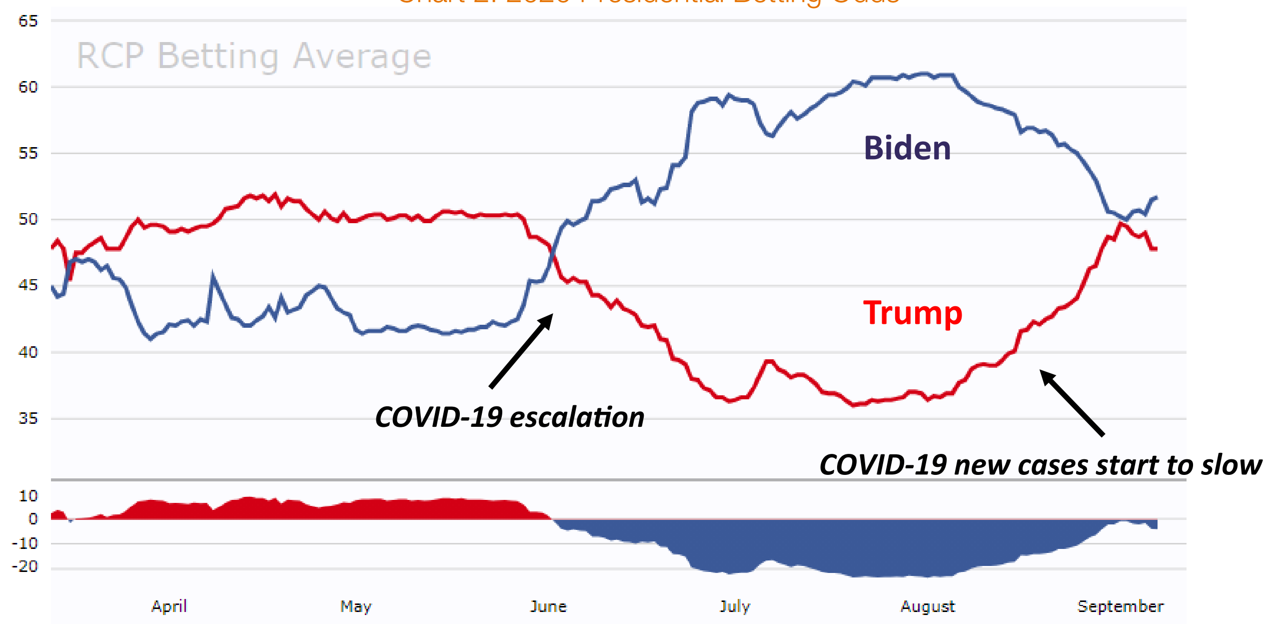
Chart 1: Difference in 2016 v 2012 election results



Key counties that Trump will need to retain in 2020

Source: BrilliantMaps

Chart 2: 2020 Presidential Betting Odds




Source: Real Clear Politics

# House and Senate

Alongside the Presidential election, there will also be elections for the House of Representatives and for part of the Senate. In particular, the outcome in the Senate could be very impactful for what policies could be progressed by the next President.

## The House of Representatives

The House is made up of 435 Congressional District seats, based on population. All seats are two year terms and all will be contested on the same day as the Presidential election. The Democrats currently hold power in the House with 232 seats (53%). Most polls expect the Democrats to retain power in the House.

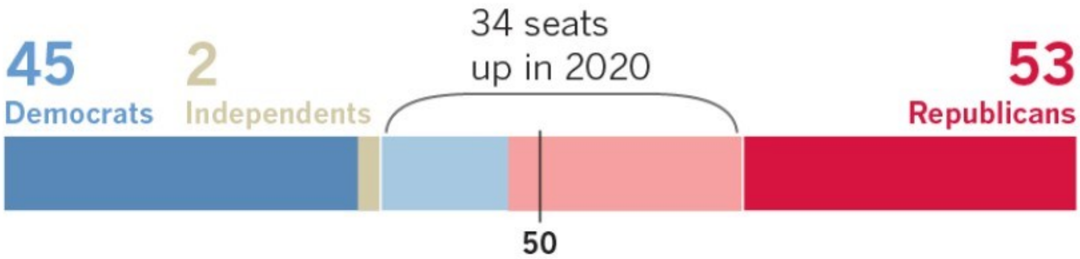
## The Senate

The Senate is made up of 100 Senators—two for each of the fifty states. Senators serve six year terms on a staggered election cycle. 35 seats will be up for election on 3 November. Republicans hold power in the Senate 53 seats to 47. Of the 35 seats up for election, 23 are held by Republicans.

Throughout our meetings, the potential Senate outcome was a key topic. Some of the issues and opinions raised include:

- The Democrats will need to gain three or four of the 23 Republican held seats up for grabs.
- Some people are of the view that the Senate outcome is critical. If Biden is unable to win the Senate, then some are of the view that he will not be able to pass many of his policies, including an increase in the corporate tax rate.
- Even if the Democrats win the Senate, some are of the view that Biden's policies might be 'watered down.' i.e. a Democrat win in the Senate will involve winning marginal moderate seats, with Senators that would be less willing to support policies deemed 'radical'.

Chart 3: The United States Senate




Source: Cook Political Report

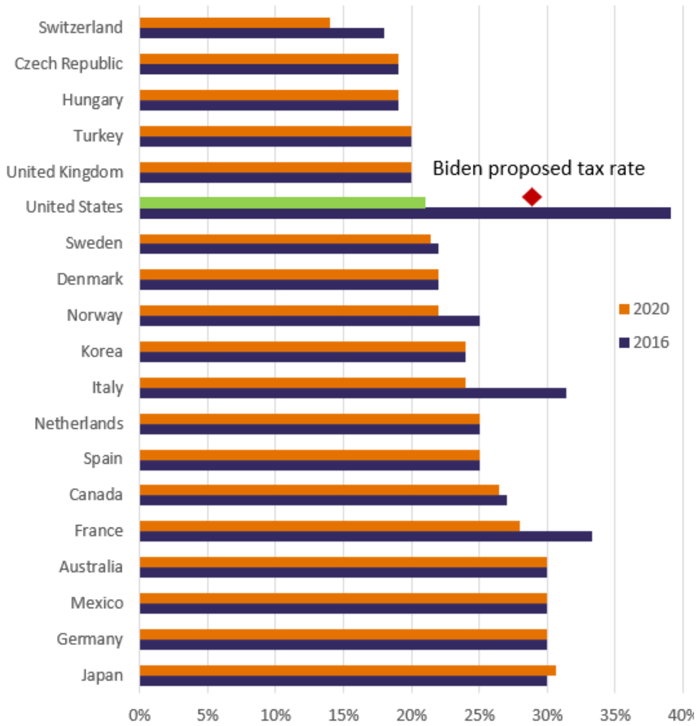
# Fiscal policy

While the Presidential election is as much about ideology as it is policy, there are some key areas investors should take note of.

A high profile aspect of Biden's fiscal policy, compared to Trump, is a proposal to reverse part of Trump's corporate tax cuts, lifting the rate to 28% from 21%. While this is often used as an argument for why stocks may do worse under a Biden win, we think a few points are worth considering:

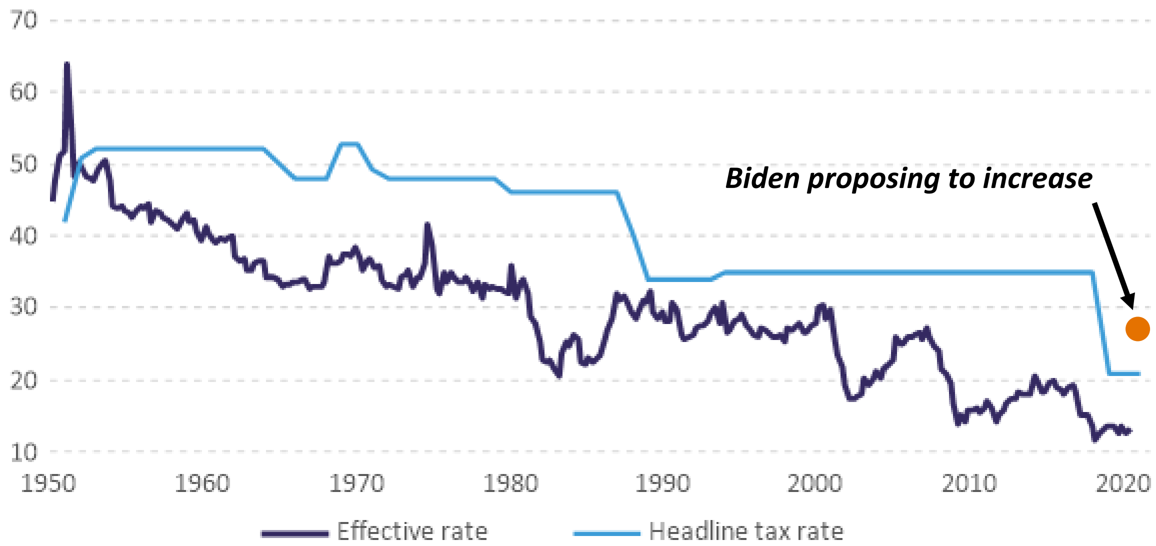
- As well as expecting to raise around $4 trillion in total revenue measures over ten years, Biden's spending policies, including heavy infrastructure investment, that could sum to around $11 trillion. So the net fiscal expansion could be large under a Biden win, which could bode well for risk sentiment at a time when the economy is facing a large economic contraction.
- There could be a mismatch in the timing of when Biden's policies will be enacted. For example, Biden may decide to push spending policies early in his Presidency, and delay tax reforms to later into his four year term.
- Although the corporate tax rate is high profile, corporate taxes do not make up a large proportion of total US Federal Government revenue.
- Given the importance of the Senate election outcome, Biden may have difficulty passing a full increase in the corporate tax rate. He may find it easier to pass his spending plans, and may need to water down plans to increase taxes.

Chart 4: US corporate tax rates (%)




Source: Frontier, KPMG

Chart 5 US corporate tax rates (%)



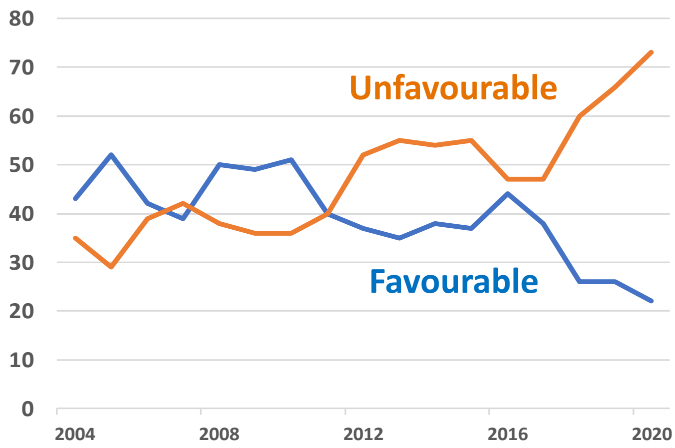

Source: Refinitiv Datastream

# Foreign policy

Foreign policy is another key area which could come under focus by financial markets. This could be an area of particular importance for Australian institutional investors given Australia's economic ties to China. Overall, China trade tensions are expected to stay, regardless of who wins the Presidential election. We continue to view China-US tensions as an issue that will not be resolved anytime soon. A few key points with respect to the election are:

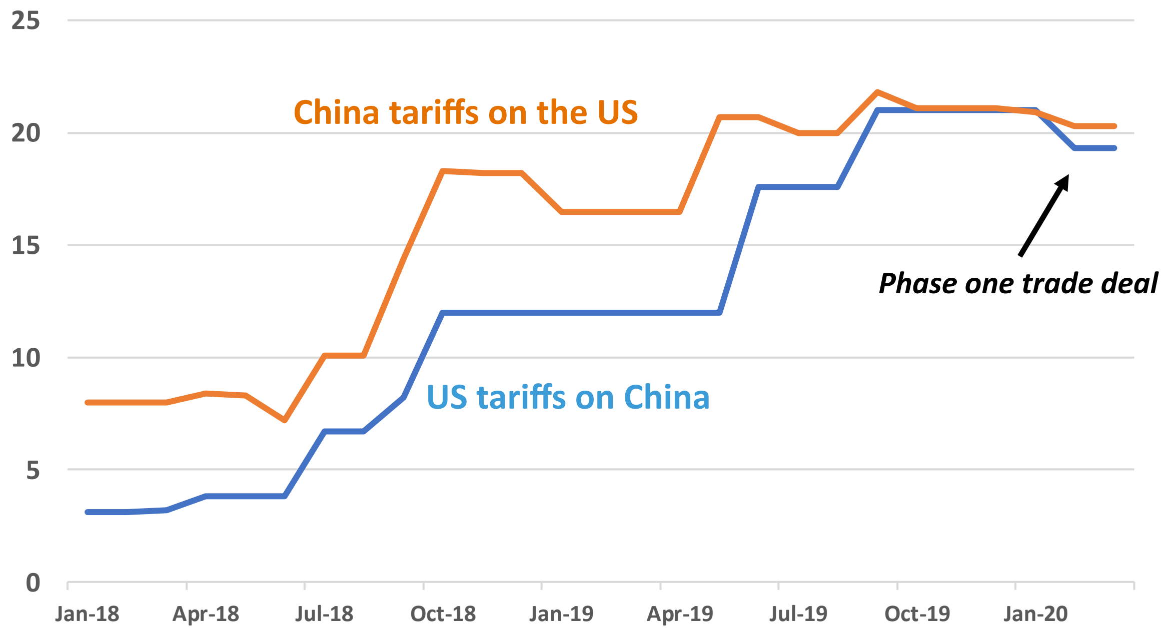
- The US-China trade war has seen a significant ratchet up in bilateral tariff rates between the two countries. Although stabilised under the 'phase one' trade deal, bilateral tariffs are now around 20% (a 2x or 3x increase since 2018).
- While Trump has been the focus of the trade war, indications are that Biden would not seek to reduce tariffs introduced under the Trump Administration.
- One reason Biden might choose to also take a hard line approach to China is that overall public opinion towards China has moved to be increasingly unfavourable. Survey data suggests animosity towards China is higher for Republican voters (83% unfavourable) compared to Democrat voters (68% unfavourable. Nevertheless, the data shows that the increasingly negative view on China is evident across both sets of voters.

Chart 6: US citizen views on China




Source: Frontier Advisors, PEW Research

Chart 7: Average tariff rates




Source: Frontier Advisors, PIIE

# US election cycles and equities

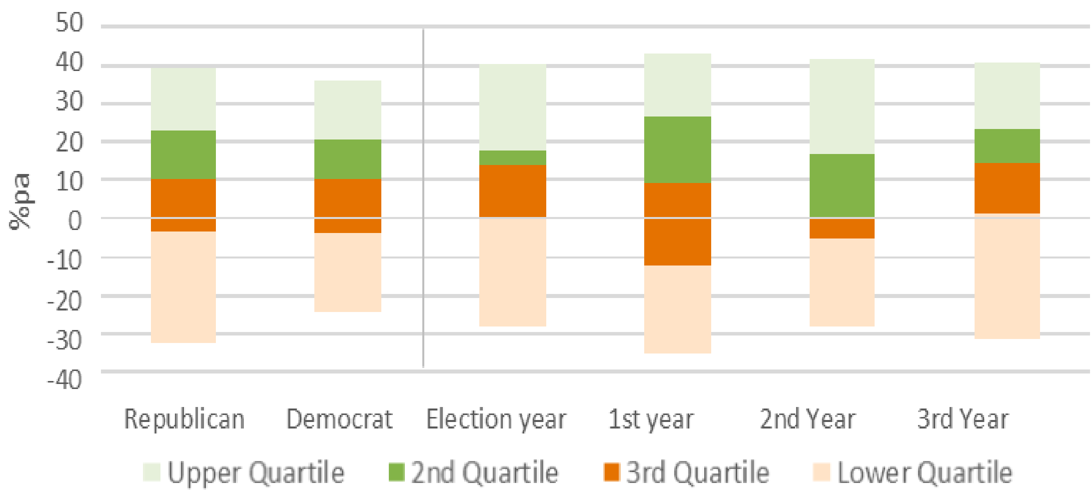
A large amount of effort has been made in the investment banking and asset management industry in slicing and dicing financial market returns to draw conclusions about how US elections and US political parties effect asset prices, particularly the share market.

We are unconvinced by the arguments that prices move in any conclusive manner, adding to our view that long-term institutional investors should generally look through elections or results as a reason to change asset allocation in and of itself. (That is, rather than relying on a perspective of ‘markets go up/down under Democrats/Republicans’, investors may be better to focus on understanding elections and political cycles in the context of policy differences and important underlying economic and social change that may be occurring).

Using US share market returns since the 1900s, we highlight why we are hesitant to draw conclusions based on election outcomes.

- Many other studies of returns tend to focus on differences in the median or ‘average’ outcome under different Republican/Democrat Presidents. These results tend to mask or ignore the large range of possible outcomes. For example, we find that over more than one hundred years of data, US share market returns have been slightly higher under a Democrat President. But the results also show that returns anywhere between –5% and +20% are very possible under either a Democrat or a Republican President.
- Presidential elections only occur every four years, so the number of observations can get very small. Some studies compare return outcomes by election year (replicated below), or by outcome in the Senate and House. However, investors should be cautious in interpreting arguments put forward for market moves under specific election scenarios when that analysis is based on a very small number of observations. Even splitting over a hundred years of share market returns into individual election cycle years leaves only 25 observations in each category, and again can mask large variation in returns under all outcomes.

Chart 5: US stock market returns since 1900




Source: Frontier Advisors

# The final word...

For a long-term investor, elections will come and go. Taking a long-term perspective to investing means sometimes looking through market hype, including a 24 hour news cycle coverage of the US election. Picking both the outcome of an election and the market reaction appears to be a very difficult task for investors to do on a consistent basis.

However, this does not mean elections, like the upcoming US Presidential election, should be ignored.

Understanding the context of elections and policy differences is important in understanding an ever shifting macroeconomic landscape.

For example, the rise in populism and increase in anti-China sentiment among Americans is likely to lead to an ongoing fractious relationship between the US and China. Relatedly, trade tensions are unlikely to disappear. A move towards a less globalised trading world is one of several key secular themes we think investors need to be thinking about.