PLANNING FOR POTENTIAL 2020 ELECTION RESULTS

OCTOBER 2020

We don't know who will win, but because of the expected increase in mail-in ballots, we do believe we may not immediately know the outcome on November 4. The known information as of the end of October 2020 is indicating that Joe Biden has a strong chance to win. Of course, 2016 taught us to understand that the known information in polls may not always prove correct. There is a chance that the presidential election may, once again, come down to the Supreme Court, as it did in 2000 when it declared George W. Bush the winner over Al Gore. That decision was issued on 12 December 2000, so roughly five weeks after the ballots were cast. Notably, this was a time before Facebook, Twitter, and the general proliferation of social media, so a similar five week time frame in today's world might look and feel very different than it did then.

Both the election itself and then the realization of the results, in turn, may have a significant impact on market volatility across many asset classes.

Given that view, we lay out four possible election outcomes, with our thoughts on how the markets may react to each one. Our bottom line: Investors may want to prepare their portfolios for an increase in volatility, but do so in a way that may not take away 100% of the upside potential. We say this because although we can logically see how the votes may take some time to be counted, a sooner than expected result may lead to a rally in risky assets.

POTENTIAL OUTCOME 1: JOE BIDEN WINS, AND THE DEMOCRATS SWEEP THE HOUSE AND THE SENATE

We refer to this as a "Blue Wave" and believe there are at least two potential scenarios under this outcome. We do not anticipate that either party will gain a filibuster-proof majority in the Senate, i.e. 60 senators on one side of the aisle, but some Democrats have suggested they may attempt to overturn the filibuster provision if they win. This is possible because the filibuster is not a Constitutional issue—it's a Senate tradition dating back to the 1850s.

It is also worth noting that the Democrats would not need to eliminate the filibuster in order to pass tax hikes—in many cases, all they would need is a simple majority.

We also believe a Biden presidency would retain Jerome Powell as chair of the Federal Reserve (Fed), which would signal a continuation of a mostly "accommodative" monetary policy.

Scenario: Traditionally, a U.S. government controlled by the Democratic party would lead us first to expect more spending. The fall 2020 discussions of further Coronavirus Stimulus, for example, have the Democratic side of the aisle always pushing for bigger packages and higher dollar amounts. To pay for all of this spending, the traditional path would be to attempt to raise taxes, particularly on businesses and higher income earners. Potential Biden Administration plans under discussion, for example, may make it more difficult for companies with overseas operations to continue to avoid certain U.S. taxes due to geographic revenue recognition provisions in the current tax code.

While in the shorter-term, large fiscal stimulus could be positive for risky assets, when the time comes to be more concerned with paying for the stimulus, that could create some difficulties for the markets.

Potential Market Reaction:

+ **Equity Markets:**

  - Increased fiscal spending with less resistance could be positive in the short-term during the immediate recovery from the Coronavirus Pandemic. In the medium to long-term, if corporate taxes were to be raised, this would be a general headwind to earnings and, depending on the details, could impact certain industries more than others. We expect more infrastructure and deficit spending, causing infrastructure-related investments to do well (materials and industrials).
  - While policies of raising taxes and increasing restrictive regulations can be a negative for equities, corporate tax hikes may not be passed until 2022—the timeline of a tax hike AND the details behind it are critical in assessing its overall impact.
  - The increased potential for a financial transaction tax will be important to follow, as this could be another headwind for the returns of risky assets.
  - Higher unemployment benefits and higher minimum wages would be good for consumer companies.
  - More predictable trade negotiations could be a positive for Asian emerging markets—and China relations, which we expect to remain intense, may improve. To be clear, a tough stance on China currently receives bipartisan support. The tone and tactics could of course change.
  - A key point to watch will be the evolution of inflation data. Usually, easy monetary policy PLUS large fiscal spending packages SHOULD yield higher inflation. However, we must recognize that evidence of significant inflation, as yet, hasn't materialized. If this changes and if the Fed is forced into a position where it needs to tighten policy, that would be a headwind to equity markets. The evidence that we have today does not indicate any of this as a potential concern for the near-term.
  - Equities exposed to 'environmental' thematics such as the battery value-chain could benefit from tightening of environmental regulation (one of the platforms of the Biden campaign).

+ **Commodity Markets**

  - In July 2020, the price of gold exceeded $1900 per Troy ounce, and it has remained close to this level or above since then. If a concern were to arise about 1) increased fiscal spending 2) monetary policy remaining easy for too long or 3) continued issuance of ever growing amounts of US debt, the logical expression of this concern amongst investors would typically be to buy hard assets, like gold. Anyone looking to the future and seeing massive inflation issues should be comforted if they have a portion of their allocation in gold for the future.
  - If the so-called 'Blue-Wave' leads to increased infrastructure spending, this is the type of stimulus that may lead to increases in demand for industrial metals.
  - If there are greater environmental regulations that lead towards electric vehicles, metals like Nickel and Copper might also respond positively. If the regulations go against practices like 'fracking', then it's possible they have a negative impact on the supply of natural gas and oil, pushing prices up conceivably.
  - The bottom line is that if policy leads to an overall environment of higher inflation, that is better for commodities and could lead people to remember the benefit of having them as part of the asset allocation. In a low to no inflation environment, it tends to be far less important to remember a broad commodities allocation.

- **Fixed Income Markets:**
  - US short-term interest rates stay low because of slower growth, the lack of an inflationary backdrop and an accommodative Federal reserve policy.
  - The budget deficit will remain a trillion-dollar phenomenon, which could curb enthusiasm for intermediate- to longer-dated Treasuries beyond the initial flight to safety.
  - There will be high volatility as capital markets nervously reassess the implications of a new policy landscape.
  - The initial flight to safety is likely to be bullish for bonds and the dollar, but it is also likely to be temporary.
  - A lot of this response will depend on how quickly we are able to know who has won and we can put this into our rearview mirror. If different races (i.e. the Presidency, the Senate, the House) are being counted and recounted for weeks and weeks, that would lead to one type of bond market reaction—largely focused on "risk-off" behaviour. If we know the result quickly and the market is immediately thinking of the large stimulus spending being proposed by Democrats today, yields may respond quite differently.
- **US Dollar:**
  - A combination of inflation pressures and reduced trade tensions should be positive for foreign currencies and lead to a weaker dollar. To note, if people have an expectation of a 'weaker dollar', that is another reason to consider hard assets, like commodities, priced in U.S. dollars, like gold.

Potential Positives of a "Blue Wave"

As we have mentioned, under a Democratic sweep, fiscal gridlock is lifted and roadblocks preventing the passage of additional recovery packages are removed. Without the spending checks of a Republican Senate, Democrats are emboldened to increase spending to help the U.S. recover from the pandemic and subsequent recession. The wish list of the progressive wing could fall short of gaining enough traction within the party to move forward with its most ambitious goals, but additional stimulus checks, expanded unemployment insurance and support for small business and local governments have overwhelming support among progressives and moderates alike.

POTENTIAL OUTCOME 2: JOE BIDEN WINS, AND THE DEMOCRATS RETAIN THE HOUSE, BUT THE REPUBLICANS RETAIN THE SENATE

Scenario: Political gridlock remains in Washington, DC, with lower growth, a near-term bipartisan spending blowout focused on Coronavirus Recovery, and an environment where Fed policy is once again a primary driver of and influence on economic and market outcomes.

This scenario may also see an "easing" of anti-China rhetoric. As we noted, both parties are currently "anti-China" (for different reasons), Biden is likely to soften the rhetoric against this important trading partner.

Potential Market Reaction:

+ **Equity Markets:** From a tax perspective, the gridlock would make it tougher to change the current policies. All told, this is a positive scenario for U.S. equity markets and should lead 2020's success stories seeing even more upside—technology leading at the expense of the more cyclical reopening-sensitive sectors like small-cap value strategies.

+ **Commodity Markets:** The long-term impact of global easy monetary policy, in theory, should already be inflationary in the medium to long-term. While the timing could be uncertain, the case for those concerned about future inflation to own gold should remain there, as strongly as we have ever seen in history. From there, we must also note the economic backdrop. If growth begins to accelerate from the Coronavirus Pandemic, industrial metals should be sensitive to this and are likely to respond positively. The gridlock in Washington, DC should also make it tougher for different regulations to pass, so it would be tough to see much change in terms of environmental policy and the like impacting markets.

+ **Fixed Income Markets:**

  - Fed policy remains on "autopilot" based upon its new policy framework of average inflation targeting.
  - Short-term rates remain anchored, but intermediate- to longer-dated yields will be influenced by how this "new" policy framework is executed.
  - We would consider securing incremental income from spread products, which are poised to outperform Treasuries in this scenario.

POTENTIAL OUTCOME 3: DONALD TRUMP WINS, THE REPUBLICANS RETAIN THE SENATE, AND THE DEMOCRATS RETAIN THE HOUSE

Scenario: A continuation of the economic landscape under the Trump Administration after the 2018 election (which resulted in a split Congress, i.e. a House controlled by Democrats and a Senate controlled by Republicans) but prior to the pandemic—a faster-growing economy, political gridlock, and a continuation of easy monetary policy. While we believe there would ultimately be further fiscal spending to help with Coronavirus Recovery, the extent to which we would see 'bi-partisan' cooperation might be an open question.

Potential Market Reactions:

+ **Equity Markets:** The economic reopening should support a cyclical reversion in 2021. In a way, this is just 'grid-lock' under a different wrapper, meaning that it is difficult to see much changing from the current policy landscape. For example, it would be difficult to see substantial changes in tax policy. Therefore, equities should respond to the environment, so if the economy accelerates from a growth perspective, that should allow the different factors that lead in a recovery to lead, as they have done in the past. Small caps, historically, have tended to come out strongly from recessionary periods

+ **Commodities:** Since this outcome is the most similar to the present, pre-election condition, a similar rationale for holding commodities as part of an asset allocation should also remain in place. For those concerned with the excessive printing of money—gold and precious metals are there. For those positioning for a cyclical upturn in economic growth, industrial metals are there. For those looking to diversify, they must remember that agricultural commodities might be the most likely to respond to completely different details and conditions than many other commodities, such as changes in weather. It would also be difficult to see much in the way of increased environmental restrictions or regulations under this particular scenario.

- **Fixed Income:**
  - Similar to outcome 2, Fed policy remains on "autopilot" based upon its new policy framework of average inflation targeting, keeping short-term rates anchored.
  - Intermediate- to longer-dated yields will be influenced by how this "new" policy framework is executed, and the yield curve could steepen.
  - We would consider securing incremental income from spread products, which are poised to outperform Treasuries in this scenario.

POTENTIAL OUTCOME 4: DONALD TRUMP WINS, AND REPUBLICANS SWEEP THE HOUSE AND THE SENATE

Scenario: We refer to this potential outcome as a "Red Wave," and we believe it may result in a continuation of the spending blowout to help with Coronavirus Recovery, a continuation of easy monetary policy, additional tax cuts, an environment characterized by decreasing regulations, and an increased potential for higher inflation as the economy heats up. This could potentially result in the Fed having to reverse its current policy and step in to quell inflation sooner than we'd expect in the other scenarios.

Potential Market Reactions:

- **Equity Markets:** Similar to outcome 3 above, the reopening of the economy should support a cyclical reversion in 2021, with small-cap cyclicals benefiting from the pent-up demand of 2020. Sector-wise, we see strong global growth benefiting cyclicals over defensive sectors.
  - China hawks would pressure emerging markets relative to the U.S. This outcome would lead to the greatest chance of continued strong rhetoric against China, and the most aggressive potential posturing between China and the U.S.
  - We see Financials and Energy being two sectors in particular that could perform well under Trump. We could also see relief for groups like airlines and hotels—and perhaps real-estate investment trusts—with more confidence in an economic reopening.

- **Commodity Markets:** If inflation expectations do move up materially and in a shorter time frame, this could provide a further push to the performance of precious metals, particularly gold. If the acceleration in economic activity does in fact transpire, that should benefit industry metals quite strongly. This would also be the environment with the least likelihood of seeing the U.S. government undertake any further environmental regulation, so one would imagine this would be the easiest set of circumstances for Energy companies, for example, to extract the most oil and the most natural gas with the lowest possible concern for the policies used to do so. Assuming financing is available, that could pressure oil and gas prices as the volume of production rises.

  If the current trade deal between the US and China were to unravel due to more aggressive posturing between the two countries, agricultural commodities like soybeans, corn and lean hogs would suffer the most. Conversely, import restrictions on some metals may tighten domestic US supply, supporting local prices.

+ **Fixed Income Markets:**

  - Risk-on tends to prevail, as the 2016–2017 episode of the "Trump Reflation Trade" is revisited.
  - The yield curve would likely steepen as inflation expectations rise.
  - Credit would likely outperform safe-haven fixed income on a relative basis, but absolute returns are likely to be challenged. Secure income while limiting duration risk.
  - The Fed outlook gets revisited, with the timetable for potential rate hikes and balance-sheet normalization being pushed up.
  - The dollar would be vulnerable during initial risk-on, but its future direction will be dictated by the interplay between increasing Treasury supply and the Fed's gradual reduction of accommodation.

Against all of these potential outcomes are two longer-term unknowns: (1) the continuing evolution of the COVID-19 pandemic and its impact on the economy, the markets and the overall human condition; and (2) the continuation of massive debt and deficit spending.

On the first issue, we are reasonably optimistic - we can envision a tomorrow where vaccines and effective therapeutics are available. We do not know when, but we believe that day will come.

The second issue is more predictable - we are borrowing from the future to pay for today, in a completely bipartisan manner, but eventually, the piper is always paid. We *will* experience lower growth and higher taxes at some point in the future.

But not today, not tomorrow, and not next year. It is an *existential* but not *immediate* issue.

A final unknown is the state of the fiscal stimulus legislation. This will be a known outcome *if* a package is agreed upon to prior to the elections. However, the actual outcome of any stimulus package may be wildly different if it is not enacted until *after* the elections. As we write these words, in the middle of October - we recognize anything is possible - but a pre-election stimulus does not appear to be a base-case type of prediction to be able to make.

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