BNY MELLON

AERIAL VIEW

ACCESS A BROADER MARKET PERSPECTIVE

ELECTION OUTCOMES YOU'RE NOT WATCHING

BY DANIEL TENENGAUZER AND JOHN VELIS

HIGHLY DIVIDED ELECTORATE AND WIDE POLICY DIVERSION

between Republicans/Democrats, as well as within the Democrats themselves

MARKETS ARE PRICING IN A TRUMP OR BIDEN WIN,

but Biden may not get the nomination easily or early enough

POSSIBILITY OF A BROKERED CONVENTION IN JULY

if no Democrat has sufficient delegates

THE EARLY PRIMARIES ARE KEY:

first few races in the past have predicted the ultimate winner

The next administration of either party could be

A SOURCE OF POLICY RISK

Divided government is

NO GUARANTEE OF MARKET-FRIENDLY POLICIES

COVER ILLUSTRATION: ROB DOBI

INVESTOR CONFIDENCE IS HIGH AHEAD OF THIS NOVEMBER'S PRESIDENTIAL ELECTION. BUT WITH A HIGHLY DIVIDED ELECTORATE AND PLENTY OF ROOM FOR AN UPSET, MARKETS SHOULD BE WARY OF COMPLACENCY

BY DANIEL TENENGAUZER AND JOHN VELIS, BNY MELLON MARKETS

With the 2020 US primary election season soon upon us, investors are faced with potentially market-moving outcomes in the next 12 months.

One thing is clear: despite Donald Trump's atypical governing and communication style over the past three years, his policies – in conjunction with successive rate cuts over the past year – were market friendly. Rollercoaster headlines aside, the market has exhibited a fundamental resilience.

Total returns from the S&P500 were 31.5% last year, even with all the concern over a looming recession, yield-curve inversion, and mounting trade-war worries. From Election Day on November 8, 2016 through year-end 2019, the S&P500 had a total return of 60.8%.

These moves reflect solid US fundamentals, particularly compared with the rest of the world; an elongation of the US economic recovery, in part due to Trump's corporate tax cuts; and a rebooted and accelerated US labor market.

So how should investors approach the upcoming election season? The market reflects a relatively sanguine view of things. Yet the policy implications of a win on either side are even more dramatic than they have been in previous years. The country is also highly divided politically and the various policy proposals from presidential hopefuls reflect that fact. Furthermore, there is deep anger within the country at the growth of income inequality since the 2007-2009 global financial crisis.

Many of the Democratic policy plans are meant to help address the income gap and Trump as well is more populist than previous Republican presidents. This sets up the potential for a larger US deficit, the fallout from which could affect market confidence.

WHAT'S PRICED IN?

The Democratic primary season begins Feb. 3 with the Iowa caucuses and continues in weekly succession thereafter. Helpfully, the economic backdrop is solid. Despite a manufacturing slowdown in the US – and an even more acute slump globally – the US consumer, constituting 70% of GDP, continues to power the US economy. Related to this, there has been a positive wealth effect created by the fact that US households are more exposed

There may be more risk to the markets in the next few months than is currently priced in... Yet the policy implications of a win on either side are even more dramatic than they have been in previous years.

to equities than they have been since the late 1990s (see chart 1).

The risk of volatility this year, however, is heightened because of the very different proposals and policy preferences between the Democrats and the Republicans.

The market is currently pricing in more of the same – essentially a business-friendly administration and Republican control of the Senate. In practical terms, that means a second Trump administration or a more centrist Democrat in a Biden or Bloomberg vein.

So what do we know? The betting markets reflect that Trump is predicted to beat all of the top four primary challengers in a general election this November (see chart 2).

Further, the health of the economy is a key factor in the likelihood of any presidential reelection and recent polling has shown an inflection point in America's confidence about the economy.

For Trump perhaps more so than his predecessors, equity markets see the economy as the key issue for his reelection. According to December 2019's Quinnipiac University poll (see chart 3): "Registered voters are feeling more positive about the economy than at any time in the last 18 years, as nearly three quarters, 73%, describe the economy as either excellent or good, while only a quarter, 25%, say not so good or poor."

While there are limits to polling data, a swing state CNN poll in December 2019 highlighted this favorable showing by Trump. The polling across Arizona, Florida, Michigan, North Carolina, Pennsylvania, and Wisconsin suggests that, in this election, Trump beats every candidate except for Biden, where he falls short by 1-2% or is tied.

In Iowa, Trump beats every candidate including Pete Buttigieg, the local favorite. The same CNN poll showed a declining favorability among the Democratic candidates across the board. The President appears to be headed into 2020 with an improving electability profile.

On the Democratic side, the betting markets show Biden beating all the other challengers within the Democratic camp on a national basis (see chart 4). In the interim there will be Trump plot twists but the bigger risk for markets is a centrist not getting the Democratic nomination after all.

In particular, it looks like Biden and Sanders have been direct beneficiaries of Warren's loss of momentum after the details of her "Medicare for all plan" emerged in the fall. Biden gets further strength from the recent Iran crisis as he is seen within the Democratic voting population as most capable of directing foreign policy and handling international crises, according to a recent Emerson College poll.

Biden also may benefit from being able to stay in Iowa, along with Buttigieg, as the senators in the race – Klobuchar, Sanders and Warren – must head back to Washington for the Trump impeachment trial.

Finally, if there is any question about whether the stock market even cares about who sits in the White House, look no further than the performance of healthcare stocks in 2019. Healthcare stocks last year traded in negative correlation to Warren's odds of winning the Democratic nomination.

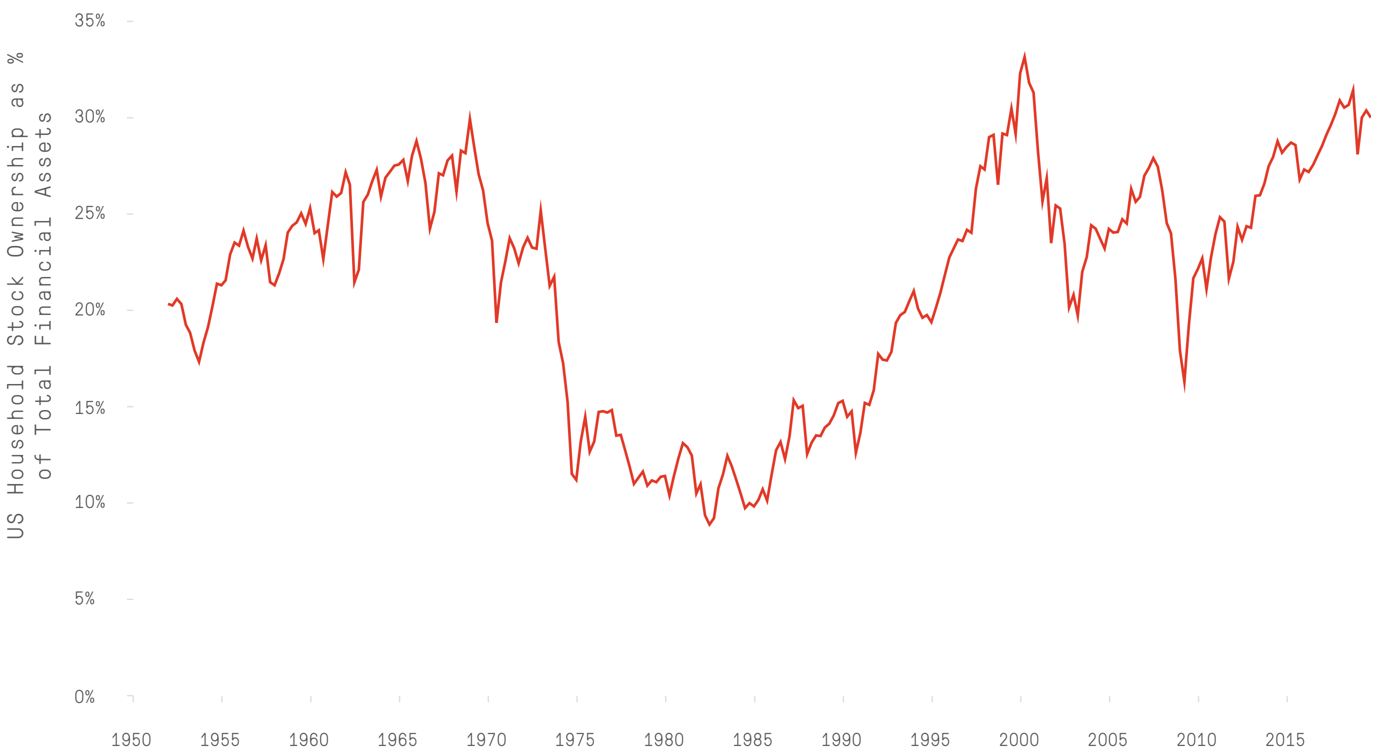
As Warren rose in the polling during the summer, the entire sector sold off – even during a risk-off market, which is typically when healthcare outperforms (see chart 5). The reacceleration of healthcare stocks in the fourth quarter tells us that the market is less worried about a Warren presidency and the implied impact on the private health insurance industry.

Therefore, at first blush, it seems that the market is on a sound footing with the expectation that either Trump or Biden will win the 2020 election. Compared to Trump, Biden is likely to

CHART 1

HOME RUN

US households are more exposed to equities than they have been since the late 1990s

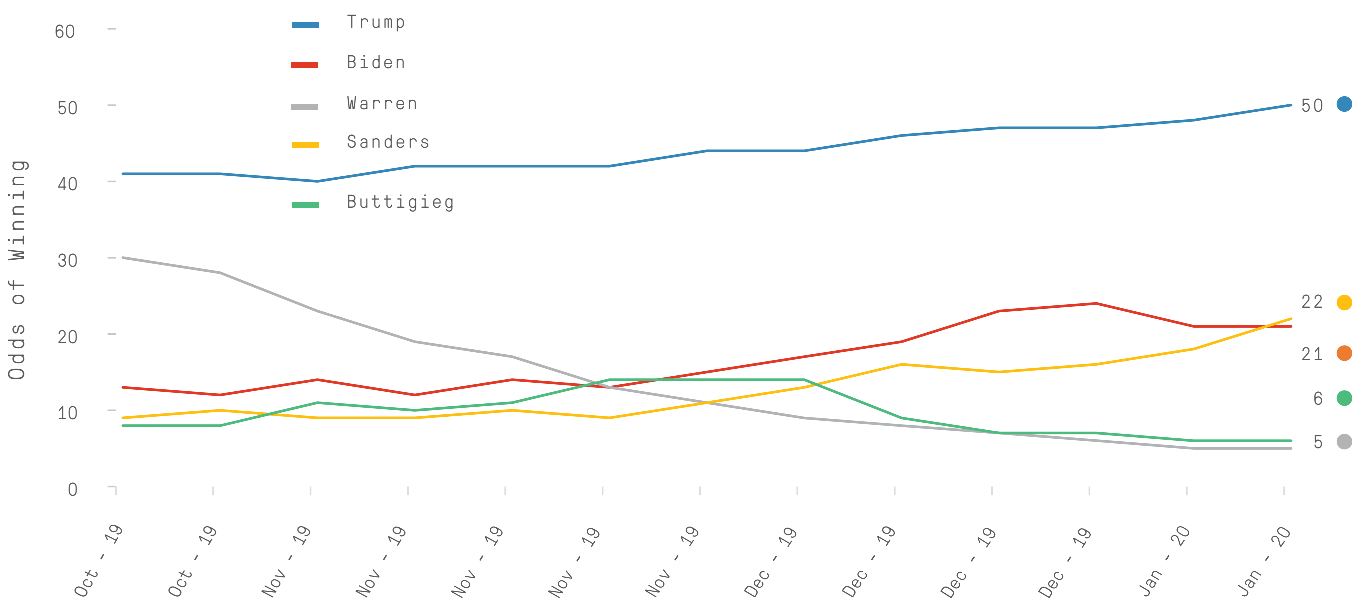


SOURCE: FactSet
Data as of Q3, 2019

CHART 2

LEADING THE PACK

Betting odds favor Trump to win the 2020 election this November

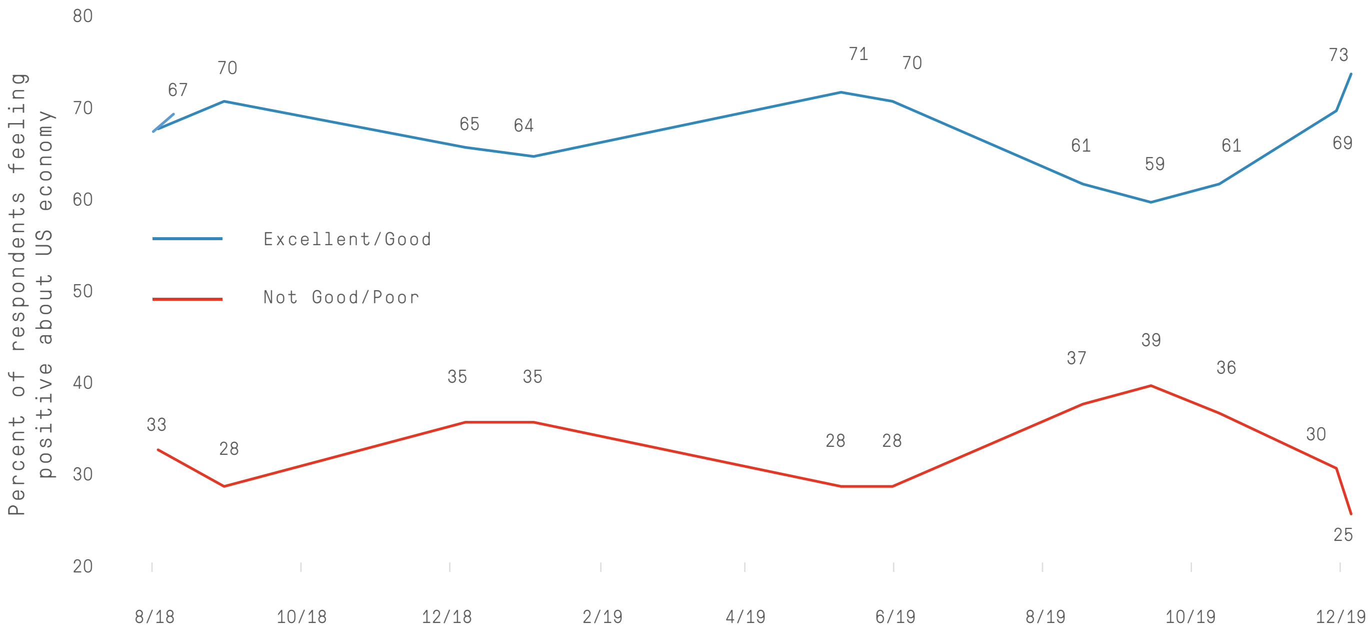


SOURCE: Predictit
Data as of January 10, 2020

CHART 3

SANGUINE MOOD

Registered voters are more bullish about the US economy than at any time in the last 18 years



SOURCE: Quinnipiac University
Data as of December 2019

be easier for US allies, create less tension with China, and ultimately prove to be more business-friendly than the other leaders of the Democratic camp.

But this confidence may prove misplaced. There may be more risk to the markets in the next few months than is currently priced in.

WHY DO MARKETS CARE?

Why would the market really care about who sits in the White House? After all, they have over time become comfortable with major policy shifts revealed on Twitter, trade wars, tariffs, unilateral withdrawal from international treaties and geopolitical crises.

Markets don't typically reflect a preference over which party holds power. Markets like incumbency, regardless of party, because it brings them clarity. They tend to sell off when it looks like the opposing party is about to take the White House and also tend to perform better in the following year when the incumbent party retains the White House, according to Strategas.

Ultimately though, markets trade on the prospects for the US economy and specifically for US corporate sector profitability. As long as the economy, the labor markets and the corporate sector are growing, the market will reflect that fact. Further, a divided government has typically been supportive for the stock market as it prevents excesses on either side and few see the Senate turning Democratic even should a Democrat win the White House.

At issue for 2020 is that the major Democratic candidates' economic plans have major and mostly negative implications for the profitability of the corporate sector, in our view.

The Tax Cuts and Jobs Act of 2017 decreased the US corporate tax rate from 35% to 21%, making the US corporate tax rate among the lowest across industrialized economies. This resulted in increased earnings, increased cash flow, increased dividends and increased stock buybacks over the last two years. All of this was positive for shareholders.

With the one-time tax of 15.5% on repatriated cash, it also resulted in more than $1 trillion of overseas cash being repatriated to the US, according to US Department of Commerce data, since it was no longer tax efficient for corporates to keep it overseas.

Every major Democratic candidate has proposed reversing the corporate tax cuts, either entirely or in part. All else being equal, every 1% increase in the corporate tax rate leads to a 1% decrease in S&P500 earnings.

Sanders, Warren and Buttigieg have all proposed reverting the corporate tax rate to 35% from 21%. Assuming all else remains equal, a back-of-the-envelope calculation implies that the immediate effect on the S&P500 will be a 14% hit to S&P500 companies' earnings. Biden has proposed raising the corporate tax rate to 28%, implying a 7% cut to earnings, while Klobuchar is at a smaller reversal to 25%.

The equity market typically anticipates a slowdown in earnings before it actually happens and therefore could reflect some volatility should Warren, Sanders or even Buttigieg get any traction.

Corporate taxes aside, the Democratic plans for fiscal spending are wide-ranging between the candidates. At the low end there is Klobuchar with $1 trillion over 10 years and at the high end there is Sanders with $51 trillion over 10 years. Only Klobuchar's plans can solely be funded by tax increases on higher income brackets and corporates. Therefore, the assumption is that the US would need to issue more debt – a lot more of it – to pay for these policies.

Typically, easy fiscal policy and debt issuance is negative for sovereign bond markets, leading to increased bond supply, higher real and nominal rates, steeper yield curves and higher inflation expectations. Fiscal easing financed by aggressive monetary policy risks losing market confidence.

Finally, investor sentiment is likely to take a blow from some of these proposals. Sanders, Warren and Buttigieg have all proposed a financial transactions tax for any trade of equities and bonds. In addition, Sanders and Warren have floated ideas to tax unrealized gains, raise the lower long-term capital gains tax rate, and tax financial institutions with more than $50 billion in assets. None of these policies are conducive to investor sentiment or market returns.

WILL BIDEN GET THE NOD?

Maybe not. Or maybe not right away – and this is a source of volatility. We should reiterate that this is a very unusual year with a highly divided electorate and a highly motivated Democratic party that wants to beat Trump. This may be the year that historical patterns get upended but it is worth pointing out what the ground game looks like today through the lens of previous primary seasons.

National polling is not a good indicator of where primary outcomes will lie across the states. The political market, like the real estate market, is local. The first five caucuses and/or primaries are Iowa (Feb. 3), New Hampshire (Feb. 11), Nevada (Feb. 22), South Carolina (Feb. 29) and Super Tuesday on March 3. It seems that in the first few voting states, Sanders has strengthened even as Warren has declined. Polling from *The New York Times* conducted Jan. 20-23 showed Sanders leading in Iowa, while CNN and NBC had Sanders pulling ahead in New Hampshire as of Jan. 26.

In politics as in sports, everyone loves a winner. Future primary results typically depend on who wins the first few races. Literally the first three races. There appears to

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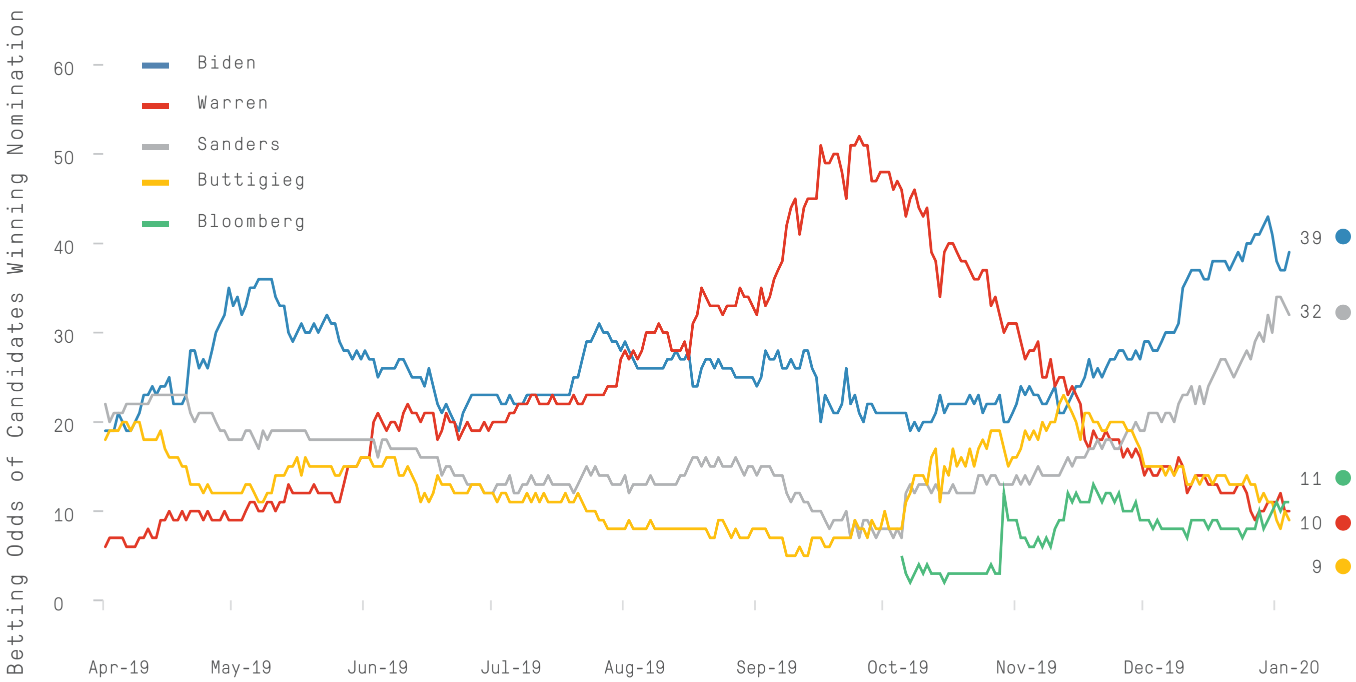
CHART 4

CROWDED FIELD

Betting odds currently favor Biden to win the Democratic nomination



SOURCES: Bloomberg, PredictIt
Data as of January 13, 2020

be a kind of tipping mechanism, where future voters flock to previous winners.

Historically, and this is true for either party, no candidate who won two of the first three states went on to lose their party's nomination for the presidency. It's also conceivable that Biden comes in fourth in the Iowa primaries given Buttigieg's local strength. It would be odd for the Democratic front runner to come in fourth in Iowa and this could tip Biden in the other direction, pulling him out of the race.

Meanwhile, if Sanders sweeps the early states his probability of winning the primary will increase. In the fourth quarter of 2019, Sanders' fundraising easily beat all his rivals. The very fact that the market is not anticipating this could be another source of volatility. But the 2020 election may not be a typical year and therefore patterns of the past may not matter as much.

With some changed rules at the Democratic National Committee, candidates may be able to stay in the race longer than in the past. Unlike in previous years, delegates are now awarded proportionately, meaning that it is very possible that no candidate arrives at the convention in July with enough delegates to win, resulting in a "brokered" convention.

Michael Bloomberg, who has already spent $200 million on his campaign, could stay in the race long enough to make it to the convention in July. If he cannot be the nominee, he has enough firepower to help choose the nominee. Many political consultants see a brokered convention as more likely than in the past, and with the pressure to beat Trump, this could make Biden and/or Bloomberg ultimately victorious even if they come up short in the primaries.

WHAT HAPPENS THE DAY AFTER?

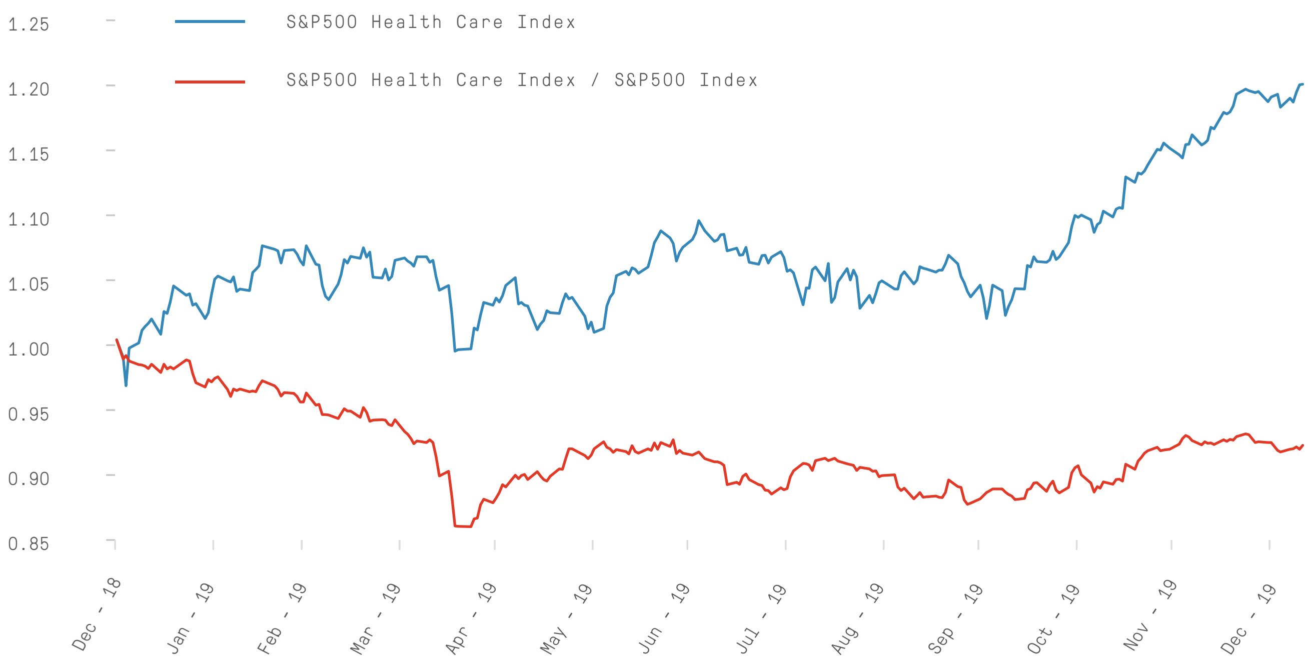
Much remains in play for the next administration, regardless of which party wins. America's relationship with allies and adversaries; the trade relationship with China and indeed with Europe; pharmaceutical pricing; access to healthcare; and individual tax policies are all issues that will challenge whoever holds the office come January 2021.

Whether Trump or a Democrat wins,

CHART 5

THE BEST OF TIMES

In mid-2019, healthcare stocks sold off as Warren polling rose in the summer, before they rebounded



SOURCE: FactSet

it seems clear that the US relationship with China has changed permanently. Remember, the Democrats were traditionally the party that was more uncomfortable with trade agreements and Trump took one of their core issues as the centerpiece of his 2016 campaign and administration. Now it seems the Democrats and Trump are in agreement on China.

It also seems clear that there is no going back to the pre-2018 trade relationship with China. In Phase I, signed in mid-January, China agreed to an incremental $200 billion of agricultural, energy, manufacturing and food purchases. In addition the US was able to get protection for US pharmaceutical intellectual property, removal of financial services foreign ownership restrictions, and an end to forced technology transfers. The deal codifies bilateral consultations for dispute resolution, which gives companies a mechanism to report concerns.

Importantly the US will begin to lift some tariffs, though not all, a key source of business and CEO uncertainty. While the direct hit of tariffs to the US economy was negligible, they indirectly worked their way through the confidence and investment channels. Phase II of the pact, focused on subsidies and state-owned enterprises, will likely be pursued after the 2020 election.

A Democratic administration, theoretically more likely to pursue a multilateral approach, would not necessarily be any easier for China negotiations as these core issues could also be linked to human rights and fossil fuel concerns.

It also should be expected that a second Trump administration wouldn't be any less aggressive about trade than it was in the first. A second Trump term could be riddled with idiosyncratic domestic and foreign affairs policy proposals, a marked increase in the US debt and a doubling down on trade talks. Trump believes that tariffs work. He believes tariffs provide him with unpredictability, and that this can be useful in negotiations as he believes they were with China and Mexico.

And the President wouldn't need to worry about reelection in a second term. Therefore, investors would be wise to be prepared for the likelihood of

CHART 6

COST OF SPENDING PLANS

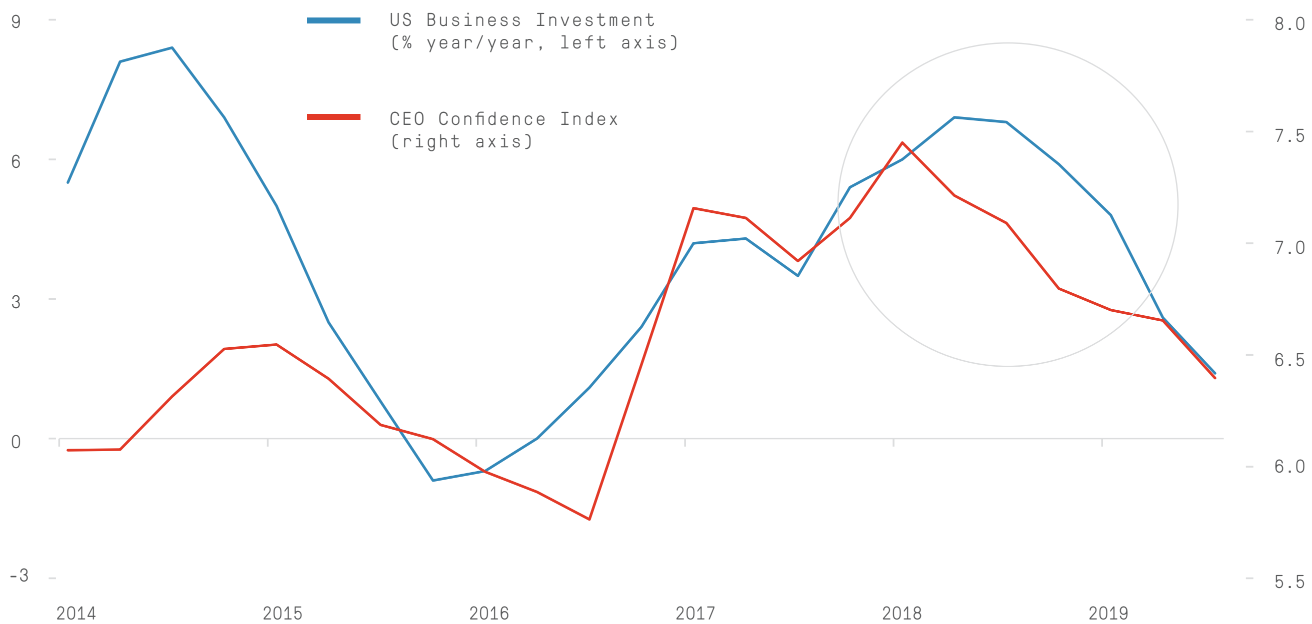
BIDEN	$4.1tn over 10 years
SANDERS	$51tn over 10 years
WARREN	$30tn over 10 years
BUTTIGIEG	$5.5tn over 10 years
KLOBUCHAR	$1tn over 10 years for her infrastructure plan

SOURCES: Strategas Research, Washington Post,
Data as of January 10, 2020

CHART 7

TURNAROUND TIME?

Tariffs are a source of business and CEO uncertainty. More trade deals could reverse this



SOURCE: Bloomberg
Quarterly data as of Q3 2019.

the continuation of trade conflict in a second Trump administration, this time focused on Europe as well. Other policy idiosyncrasies including geopolitical ones are also likely to rear their heads, potentially roiling markets.

With markets near record highs, the next Administration of either party is likely to be such a source of volatility. Finally, for investors who take comfort in a divided government to cushion market returns, it is worth remembering that Presidents can use the executive branch to execute policy, by-passing Congress. In a year where the policy proposals are far-ranging in the Democratic camp and likely to be uncertain and idiosyncratic in a Trump second term, there could be significant impact on eventual policy depending on who wins. This is the case even if Congress remains divided.

Administrative action, meaning without Congressional input, could affect a long list of areas, including: tax policy; trade and tariffs; share buy-backs; banking regulation; environmental policy; fossil fuel regulation and financing; executive compensation; executive liability for public company filings; carried interest; high-priced pharmaceuticals; technology and fintech; student debt forgiveness; and stricter (or looser) antitrust for M&A. Sectors such as healthcare, defense, energy, banks and other financials, and technology would be most vulnerable.

Sanguine investors should remind themselves that uncertainty is the most likely companion to this election season and even beyond it. Not every policy proposal is market or investor friendly and not every political outcome will soothe investors' nerves. US economic fundamentals continue to be solid, but any evidence of softness during a time of uncertain policy direction could affect markets.

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Democratic Presidential Candidates' Tax Proposals

The Democratic candidates' tax proposals on the individual and corporate level are wide-ranging. All top candidates share a dissatisfaction with the Trump administration's 2017 corporate tax cuts, wanting to raise them again to between 25% and 35% from 21%. For individuals, most candidates want to raise or eliminate the income cap on Social Security taxes and propose higher marginal tax rates for top earners, although the extent of their proposals also varies. Most want to raise the capital gains tax for top earners.

	Biden	Sanders	Warren	Buttigieg	Klobuchar
CORPORATE TAX	Raise corporate rate to 28%; Create a 15% minimum book tax on firms with $100mn or more; Double the global minimum tax on offshore profits from 10.5% to 21%; Sanction foreign "tax haven" countries	Raise corporate rate to 35%; Transition to economic depreciation for all investments	Raise corporate rate to 35%; Impose additional 7% tax on a corporation's worldwide profits above $100mn as reported on its financial statements; Eliminate the current system of accelerated cost recovery for large businesses	Raise corporate rate to 35%	Raise corporate rate to 25% to help pay for infrastructure; Reverse the TCJA's international tax reforms
PAYROLL TAX	Eliminate the income cap on Social Security taxes	New 4% employee payroll tax; New 7.5% employer payroll tax; Eliminate the income cap on Social Security taxes for those earning $250k or more	Eliminate the income cap on Social Security taxes for those earning $250k or more; Impose a 14.8% tax on wages above $250k, split between employers and employees		Eliminate the income cap on Social Security taxes for those earning $250k or more
INDIVIDUAL INCOME TAX	Restore the top rate to 39.6%	Add 4 more income tax brackets for income above $250k, with top rate of 52% for income above $10mn	Repeal TCJA's income tax cuts for the wealthy	Would consider a higher marginal tax rate for top earners	Require minimum 30% tax rate on individuals earning more than $1mn
CAPITAL GAINS/ DIVIDENDS TAX	Tax as ordinary income for those earning more than $1mn	Tax as ordinary income for income above $250k	Impose 14.8% tax on investment income for individuals making more than $250k; Tax capital gains as ordinary income for the top 1% of households; Establish mark-to-market taxation of capital for the top 1% of households		Raise the tax rate for individuals in the highest two income tax brackets
ESTATE TAX	Eliminate step-up in basis	Lowers exemption to $3.5mn and increases tax rate to 45%; Adds 3 new higher rates with top rate of 77% on estates worth more than $1bn; Closes loophole for GRATs	Lowers exemption to $3.5mn; Adds 3 new higher rates; Creates a 10% surtax on estates larger than $1bn	Called for a "more equitable use of the estate tax"	
WEALTH TAX		Impose a progressive tax on wealth, beginning with a 1% tax on wealth greater than $32mn for married couples	2% tax on more than $50mn in wealth; 6% tax on more than $1bn	Would consider a wealth tax	
ITEMIZED DEDUCTIONS			Cap at 28% for households earning more than $250k		
CARRIED INTEREST	Has supported treating as ordinary income in the past	Treat as ordinary income	Treat as ordinary income		Treat as ordinary income
FINANCIAL INSTITUTIONS TAX	0.07% tax on covered liabilities of institutions with more than $50bn in assets	Impose fee on financial institutions with more than $50bn in total assets equal to 0.15% of their covered liabilities		Create a financial risk fee on the largest banks	
FINANCIAL TRANSACTIONS TAX		0.5% tax on stock trades; 0.1% tax on bond trades to pay for the elimination of all student debt	0.1% tax on the purchase of most stocks, bonds, and other debt obligations and on the purchase of derivatives	Would consider a financial transactions tax	
SELF-EMPLOYMENT TAX		Requires businesses to report more of their business income as salary			
CARBON TAX				Supports carbon fee and dividend	
LOBBYING TAX				Create a progressive tax on lobbying expenses in excess of $500k	

SOURCE: Strategas Research