BERGOS' US ELECTION SCENARIOS AND THEIR IMPLICATIONS FOR CAPITAL MARKETS

On November 3, the 59th US presidential election will take place in the United States of America. In addition to the president, a new House of Representatives and a third of the Senate will be elected. There are several different outcome-scenarios that this election could result in and their respective impact on capital markets would differ quite a bit. We quantify the probabilities for these scenarios and asses their consequences for global financial markets and individual market segments.

BIDEN FAR AHEAD IN POLLS, BUT RACE MAY BE CLOSER THAN IT SEEMS

The democratic Presidential candidate Joe Biden is leading the polls with an almost unassailable lead. Accordingly, the relevant statistical models[1] and experts[2] see an average probability of Biden's election success of about 90%. Considering the prediction markets[3], however, things are much tighter. After all, the surprising election outcome four years ago showed all market participants how easily models and experts can be mistaken. Interestingly, back then they were even more sceptical about Trump's chances compared to the prediction markets.

According to the best-known survey aggregator[4], Biden is currently about 8 percentage points ahead of Trump in terms of total votes. However, it is not the popular vote that is crucial, but the votes of the Electoral College. As a reminder, Hillary Clinton won 66 million votes four years ago, while Trump won only 63 million - she was thus over 2 percentage points ahead of Trump. However, in the end Trump received 304 electoral votes (Clinton 227, seven voted for neither of them). We think that due to this persistent disadvantage of the Democrats, Biden requires a lead of about 3 to 4 percentage points in the popular vote in order to achieve a tie in the Electoral College.

So the race may be closer than it seems – especially if one takes into account the usual margin of error in surveys: comparing the average of the polls on the eve of the election with the actual results, since the 1980 presidential elections, the (symmetrical) error rate is on average 2 to 3 percentage points. In extreme cases (Reagan vs. Carter 1980), this gap can be as high as 7 points. The determining factor for the outcome of the election is likely to be the results in the so-called "Swing States", i.e. those states where both parties have similar levels of support among voters. Currently, everything from a narrow Trump victory to a landslide victory for Biden seems possible.

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CONGRESS COMPOSITION IS CRUCIAL

However, it will not only be the election of the president that matters. The future composition of the Congress will be at least as important. At present, one of the two chambers, the Senate, is in the hands of the Republicans and the other, the House of Representatives, is in the hands of the Democrats. In general, more significant policy changes can be expected if the party of the future US president has a majority in both chambers of Congress. In such a case, stronger reactions in certain segments of the financial market can be expected.

In the case of a President Biden and a Democratic majority in the Congress, we will hereafter refer to as a **"Biden Triumph"**; if the Republicans provide the President and are in charge of both Houses of Congress, to a **"Trump Triumph"**. History has shown that investors generally favour a constellation - as seen in the past two years - in which the president dominates at most one of the chambers and his party has to come to terms with Congress. [5]

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	PRESIDENCY	SENATE	HOUSE	YEAR-END 2020	6-12 MONTHS
TRUMP WIN (38%)	R R	R D	D D	↗	↗
BIDEN WIN (12%)	D	R	D		
BIDEN TRIUMPH (50%)	D	D	D	→	↗
CHAOS (30%)	?	(?)	D	↘	—

↗ RISK-ON → NEUTRAL ↘ RISK-OFF

SOURCE: BERGOS BERENBERG

SCENARIO 1:

STATUS QUO - TRUMP AS PRESIDENT WITHOUT A MAJORITY IN CONGRESS

We currently assign a probability of 38% to the status quo scenario of a **"Trump win"**. In such a case, we expect a rather positive US market reaction following the election. Looking at the campaign themes, Trump is focusing primarily on continuity, i.e. tax cuts, deregulation, "fairer" trade agreements, and the release of energy reserves. In an initial reaction, US investors are probably relieved that the tax cuts introduced under Trump will not be reversed. Beneficiaries of the tax reform include the communications sector. The US energy sector is also likely to benefit, as the headwind for fossil fuels expected under a President Biden would not materialize. This could possibly lead to price gains for the respective companies. On the other hand, companies that rely on renewable energy sources are likely to face a more difficult time. Telecommunication companies would probably be spared stronger regulation.

All in all, the outlook for equities should be positive in this scenario (ceteris paribus), even though a majority for further US economic stimulus packages would be difficult to obtain. In addition, Trump's erratic approach to foreign policy and aggressive dealings with trading partners could become an even greater burden than in his first term in office.

SCENARIO 2:

BIDEN PRESIDENCY AND A DIVIDED CONGRESS

For the scenario that Biden is elected President but Congress continues to be divided, we see a rather low probability of currently 12%. In the case of **"Biden win"** we (c.p.) expect a slightly positive momentum for equities. Especially European and emerging market equities should experience some kind of relief, as Biden is expected to take a more conciliatory tone on trading issues than Trump. We equally also see the winners of the tax reform at an advantage in this scenario as the Senate would then put the brakes on Biden, so that he would only be able to implement parts of his program. Tax increases that are being considered are likely to be more moderate or even completely withdrawn. On the other hand, the fiscal measures that Biden has announced will also not be fully implemented. With regard to the sectors, we expect market reactions to be similar to those of a **"Biden Triumph"**, although the overall effects would probably be less pronounced.

SCENARIO 3: "BIDEN TRIUMPH”

Under a President Biden, who is supported by both Chambers of Congress, the US stock market could initially experience cautious reactions on balance, as tax increases are expected, which affect companies in particular. However, the declines are likely to be limited, as Biden and the Democrats are not expected to raise taxes drastically as long as the economy is weakened by the Corona measures. In addition, the negative effect of the tax increases should be mitigated or even offset by lower tariffs and additional fiscal measures to support the economy. With a current probability of 50%, we consider this scenario to be the most likely one.

We think the advantage of a Biden Presidency is that it is less unpredictable than a Trump Presidency and probably more moderate towards China. As in scenario 2, a reduction in tensions in global trade should bring relief to Europe and the emerging markets. In terms of sectors, we expect that if the Democrats control both chambers, it will be mainly the companies active in the renewable energy sector that will benefit. On the other hand, companies that earn their money from fossil fuels are likely to face some headwinds. We also see a disadvantage for the beneficiaries of the tax reform (including the communications sector) as well as the telecommunication, pharmaceutical and tobacco industry. Since a **"Biden Triumph"** is likely to involve a more extensive investment program to support the US economy than a second term of President Trump, we expect a steeper yield curve and some increase in inflation. This would argue in favour of cyclical value stocks, such as the financial sector.

"TRUMP TRIUMPH" OUT OF THE QUESTION

We currently consider a **"Trump Triumph"** to be out of the question, because then not only would President Trump have to be confirmed in office, the Republicans would also have to have a majority in both Houses of Congress. However, we consider it certain at this time that the Democrats will defend the majority in the House of Representatives.

THERE MAY NOT BE A FINAL OUTCOME ON ELECTION DAY

Market participants should prepare themselves that the result will probably not be determined on Election Day, November 3: due to the Corona situation, more and more people are voting by mail. Counting these votes (some of which arrive late) may take a few days, so that the election outcome in several states may be uncertain at first. An "election week" (as opposed to an "election day") does not seem unlikely. Especially in the Swing States such delays are of great relevance and could last for several days. Only then, on the basis of the majorities in individual states, can the electoral candidates be determined. They will then elect the President and Vice-President on December 14.

SCENARIO 4: THE WORST CASE "CHAOS"

There remains a considerable risk that there will not be a clear outcome even a long time after the election or that the outcome will be so close that one of the candidates will not accept and challenge it. Particularly in the event of a close election result in favour of Biden, it is expected that Trump will contest the election, as he has signalled on several occasions. But even in the opposite case, it cannot be ruled out that Biden will still try to come to power. In the most extreme case, as it was in the 2000 election, it will be up to the Supreme Court to decide on the outcome. Such delays would bring additional uncertainties and initially lead to a negative sentiment and increased volatility in global markets. A broad-based "risk-off" could lead to a flatter yield curve and a flight to safer asset classes such as gold. We consider the probability of such **"Chaos"** immediately after the election to be of 30%. In the long term, of course, this scenario will resolve and lead to one of the other three possibilities.

FOOTNOTES

[1]E.g. FiveThirtyEight or The Economist Model
[2]For example, The Cook Political Report, Sabato's Crystal Ball or Inside Elections
[3]The Bergos mix of different prediction markets considered Trump a "promising outsider" in 2016, but in all nine previous elections the candidate with the highest implicit probability on the eve of the election always won. Bush Jr. was also favoured in 2000 (with a good 60% probability of victory) and 2004 (with 55%), and the other 7 winners (2x Reagan, 1x Bush Sr., 2x Bill Clinton, 2x Obama) all had a probability of between 66% and - in the case of Bill Clinton - over 90% just before election day.
[4]RealClearPolitics
[5]As background information on the subject, we recommend this article published in the Neue Zürcher Zeitung , which is largely based on a comprehensive Bergos analysis.

TILL CHRISTIAN BUDELMANN

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