Macro Monthly

For global professional / qualified / institutional clients and investors and US retail clients and investors. For marketing purposes.

UBS Asset Management | Economic insights and asset class attractiveness

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2020 US election & markets: It's complicated

Highlights

- The path to the US presidential election is likely to drive higher market volatility at times in 2020, potentially starting as soon as the February 3rd Iowa caucuses through Election Day, November 3rd.
- Leading Democratic candidate platforms, as they currently stand, call for higher taxation on corporations and the wealthy, along with meaningful increases in regulation. While these platforms are equity market-unfriendly, the degree of policy change depends on whether the Democrats are able to gain control of the Senate in addition to the presidency.
- Policy uncertainty may weigh on US animal spirits and specifically capital investment in 2020, right at the time when US fiscal stimulus is wearing off.
- We prefer ex-US equity markets in 2020 already given cheaper valuations and a greater sensitivity to global manufacturing as the trade war de-escalates. US tax and regulatory uncertainty provides yet another reason to underweight US equities and the US dollar.

For investors carefully considering the 2020 geopolitical calendar and its potential risks, one event looms larger than most. With the major policies of the leading Democrat presidential candidates advocating a stark shift towards a progressive and redistributive agenda, the Democratic nomination process and the subsequent US presidential election on November 3rd have the potential to materially impact markets.

The ongoing impeachment proceedings against President Trump ensure that the starting point to this election year will remain partisan and tense. But we don't see the impeachment as a major market event. Given President Trump's continued popularity among Republican voters, among other things, Republicans in the Senate are extremely unlikely to indict the president. Of much greater significance to markets than impeachment is the Democrat candidate for president, and the wider market's interpretation of the likelihood that the nominee can first unseat President Trump and then progress their legislative agenda.

From a starting field of 25, 15 candidates remain in the Democrat presidential race at the time of writing. Of those 15, we see four as the most viable candidates: Former Vice President Joe Biden, Massachusetts Senator Elizabeth Warren, South Bend Mayor Pete Buttigieg and Vermont Senator Bernie Sanders. Former New York City Mayor Michael Bloomberg has also thrown his hat into the ring. But in our view, Bloomberg's late entry into the race, billionaire wealth and more centrist policies make him a longshot to attract a strong enough base among Democratic Primary voters. In a December 18 poll conducted by Politico.com, Bloomberg had strong name recognition, but was viewed as 'Unfavorable' by more voters than any of the other 14 remaining candidates.

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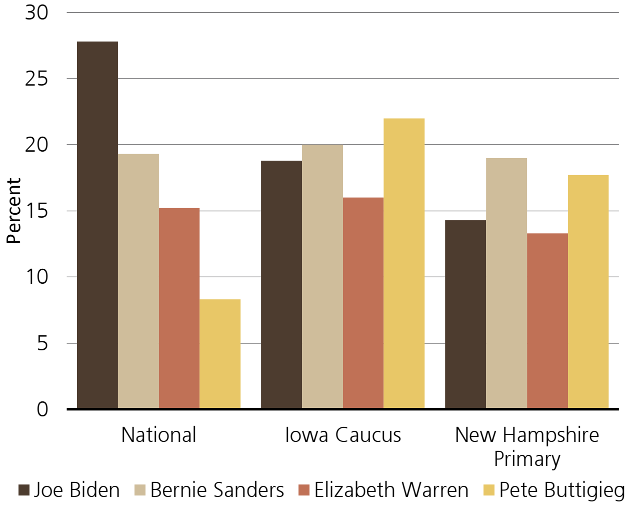
Exhibit 1: Biden leads the national polls, but polling in the crucial first primaries is close among the four



Source: Real Clear Politics as of 18 December 2019.

We do not intend to detail the explicit policies of all four candidates, nor explore the complex potential candidate/running mate permutations. But it is at least worth running through some of the market-relevant platforms to understand the evolution taking place in the Democratic Party. As Exhibit 2 shows, all the leading Democratic candidates for president are proposing policies that were once deemed too radical to garner mainstream political support in the US. While the candidates may, to different extents, frame their agenda as reforming capitalism rather than embracing socialism, there is little question that the overall policy bias in the Democratic party has moved to the political left.

The shift is reflected in proposals from all four leading candidates for rises in corporate and capital gains taxes, rises that would more than offset the tax cuts that came into force in 2017. Sweeping labor market reform and greater worker protections are also on the cards, as is greater regulation to curb the big tech companies. It is no coincidence that the most ticks in our policy summary table are found in Elizabeth Warren's and Bernie Sanders' columns. The senators have the most progressive policy agendas as they take aim at the perceived inequalities created by capitalism.

A Democratic nomination primer

The Democratic Party presidential nomination process is extremely complex, but that complexity is key to its impact on markets. Registered Democratic Party members vote for their

Exhibit 2: Main policy similarities/differences of Democratic candidates

	Biden	Buttigieg	Sanders	Warren
Tax				
Higher Taxes on Capital Gains	✓	✓	✓	✓
Higher Corporate Tax Rate	✓	✓	✓	✓
Financial Transaction Tax		✓	✓	✓
Wealth Tax		✓	✓	✓
Targeted Profit Sharing			✓	✓
Labor Market				
Minimum Wage to $15+	✓	✓	✓	✓
Supports extended protections to workers	✓	✓	✓	✓
Workers Elect Some/40%+ Board Members		✓	✓	✓
Climate and Energy				
Green New Deal resolution	✓	✓	✓	✓
Supports Carbon Tax	✓	✓	✓	✓
Ban fossil fuel exports			✓	✓
Eliminate fossil fuel subsidies	✓	✓	✓	✓
Ban fracking			✓	✓
Reshaping Economy				
Accountable Capitalism Act				✓
Curb Stock Buy backs			✓	✓
Healthcare				
Medicare for All			✓	✓
Expand Obamacare	✓	✓		
Allow Medicare to Negotiate drug prices	✓	✓	✓	✓
Tech Sector				
Name specific companies to break up			✓	✓
Increase anti-trust enforcement	✓	✓	✓	✓
Treat big tech like utilities				✓
Believes some big tech are monopolies	✓	✓	✓	✓

Source: Cornerstone Macro, UBS Asset Management as of December 2019.

favored candidates in each state, although even the basic rules of who can vote are not uniform. Some states only allow affiliated Democrats to vote, some permit voters to cross party lines. Based on the outcome of the vote, each presidential candidate is awarded a number of pledged 'primary delegates' to represent them at the Democratic National Convention (DNC) in July, where the Democratic representative for the White House is ultimately voted for and chosen.

While in broad terms the number of delegates is correlated with population, there are other factors determining precisely how many delegates are allocated to each state. This includes the results of the three previous presidential elections in the state relative to the party's national performance, and each state's Electoral College votes. Bonus delegates are also awarded to jurisdictions based on when the primary is held relative to other states. In a close run race, 'Super delegates', who are elected party officials who are not formally tied to a candidate from the primaries, potentially have a key role to play. In a change to the voting rules since 2016, Super delegates can only vote at the DNC if no clear winner emerges from the primary ballot. Super delegates represent around 15% of the overall delegate base.

Unlike the final presidential vote (and the Republican primary), the Democratic nomination process is not a winner takes all system. Instead, delegates are awarded proportionately to the primary vote, but in most states only for candidates polling over 15%. (Again the process is not uniform across states). Given the number of viable candidates, there is the very real possibility that a major candidate fails to achieve 15% in a major state. This creates some important dynamics as the process progresses.

Crucially, state primaries do not all occur at the same time, but over the course of several months. Winning, or at least showing well in the early primaries of Iowa and New Hampshire often matters enormously to overall electoral momentum, despite the small number of delegates available in these early contests. The timing of candidate drop outs as the process progresses, and the shift to delegates' second choice candidates, may also prove significant.

The process kicks off with Iowa on February 3rd. More than a third of delegates will be determined on March 3rd, so-called 'Super Tuesday', a key date to watch. By mid-March, states representing some 68% of the overall vote will have held their primaries. By late April, some 86% of primary votes will have been cast.

Given how closely the lead candidates are polling, it is also possible that the Democratic presidential candidate will not be clear before the Democratic National Convention in July.

Economic impact

For corporates we believe that the election and the possibility of business-changing policies under a progressive Democratic president represent a sufficient degree of uncertainty to prompt caution that is likely to result in delays to major capital expenditure plans or caution over hiring over the course of 2020. All this comes at a time when the fiscal impulse that supported US economic outperformance in 2018 and 2019 is starting to wear off.

Trade tensions were a major drag on global growth in 2019. But there is no dramatic alternative narrative to the current US/China trade dispute under a Democratic president. Confronting China's growing economic, technological and political impact globally is one of the very few issues that has bi-partisan backing. A Democratic president is therefore likely to continue to use tariffs as the key leverage in discussions with China. In our view, strategic competition between the US and China is here to stay regardless of who is in the White House.

Indeed, while this piece has focused on the downside risks to markets from a progressive Democratic agenda, there may be underappreciated risks of a Trump re-election. Unbound by the political and electoral constraints which may have curbed his instincts on trade, a second-term President Trump could prove even more aggressive and unpredictable in using tariffs on China, Europe and other countries even in the pursuit of non-economic goals.

Finally, it is important to note that while the Democratic policy agenda may well strain markets and unsettle business confidence initially, the economy may not necessarily take a significant hit once the dust settles. Yes, electoral uncertainty may restrain business momentum in the short-term. Some industries are likely to be materially impacted by new policies and there will be clear winners and losers in Health Care, Energy and Technology among others. Any hike in corporate tax rates is also likely to weigh on US margins and investment or be passed on as higher prices, while making ex-US companies more competitive. But the redistribution of wealth to address social imbalances puts money in the hands of people who are more likely to spend it than save or invest it, a potentially structural boost to consumption. Increased government spending on major infrastructure projects is also likely to be positive for jobs growth and for overall domestic demand. As long as the US economy hangs in through the initial policy shock, global exporters to the United States should do just fine assuming no major surprises in trade policy.

Market impact

Low volatility and full valuations suggest to us that US equity investors in aggregate are discounting a market-positive Trump victory. In our view, a still solid economy, healthy real household income growth and strong equity markets in the run up to November 3rd support President Trump's chances of re-election. Indeed, we see the recent progress in trade talks between US and China as at least partly motivated on the US side by such simple political realities.

But in our view, there is more good news priced into US equities than in major equity markets outside of the US and we believe that investors are underpricing the chance of a material shift in US regulatory and tax policy under a Democrat-led legislative agenda.

Perhaps a little ironically, the complexity of the Democratic nomination process, its protracted nature and the lack of a clear front runner may itself be responsible for investors underpricing market downside risks.

But even the more moderate, less progressive Democrats are proposing policies that represent a fundamental shift away from free market capitalism and the profit imperative. In our view, a Democrat-held White House would be a short-term negative for US risk assets, even if the same outcome may be OK for overall demand growth.

But with no obstacles to prevent the progression of core policies, the most negative outcome for US risk assets would likely be a Democratic clean sweep of the Presidency, the House and the Senate. More than half of the 24% rise in S&P 500 earnings growth over the last two years combined came directly from the 2017 tax cuts. A complete reversal of the tax cuts (and more, in some cases), as some candidates are proposing, would mean at least a double digit percentage hit to S&P 500 earnings growth. While a full reversal is unlikely, clearly the risk of any move in this direction should introduce some risk premia into US equities and credit. This says nothing for the potential negative impact on healthcare, energy and heavyweight technology stocks from some of the stated policies, or the increase in risk aversion that a Democrat clean sweep might prompt.

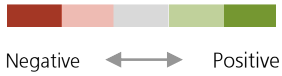
To be clear, we do not put a high probability on this outturn at this point. Our base case is that the US legislature remains divided, a scenario that has generally been positive for US risk assets over the four-year presidential term. The plausible counter to some of the most negative scenarios is that without winning the four 'toss up' seats necessary to overturning the current Republican majority in the Senate (Arizona, Colorado, North Carolina and Maine, according to the Cook Political Report on December 20, 2019), passing progressive policies in key areas is unlikely for any Democratic president. And the reality is that candidates often make aggressive proposals in the primaries that are ultimately dropped as candidates move to the center ground to win a general election. Given that the Democratic majority in the Senate would likely be one seat at best, any new Democratic president would also be constrained by the most centrist senator in their party whose vote is required to pass any legislation.

Complicating the risk outlook still further is that current polling suggests that a very progressive Democrat candidate, while theoretically worse for equity markets, has a lower chance of winning the White House from Trump even if they do manage to win the Democrat nomination.

Finally, we must highlight the possibility that volatility and uncertainty on economic policy continues beyond the November 3rd election date. A close election could lead to vote recounts and an extended period where there is a lack of clarity for businesses and markets.

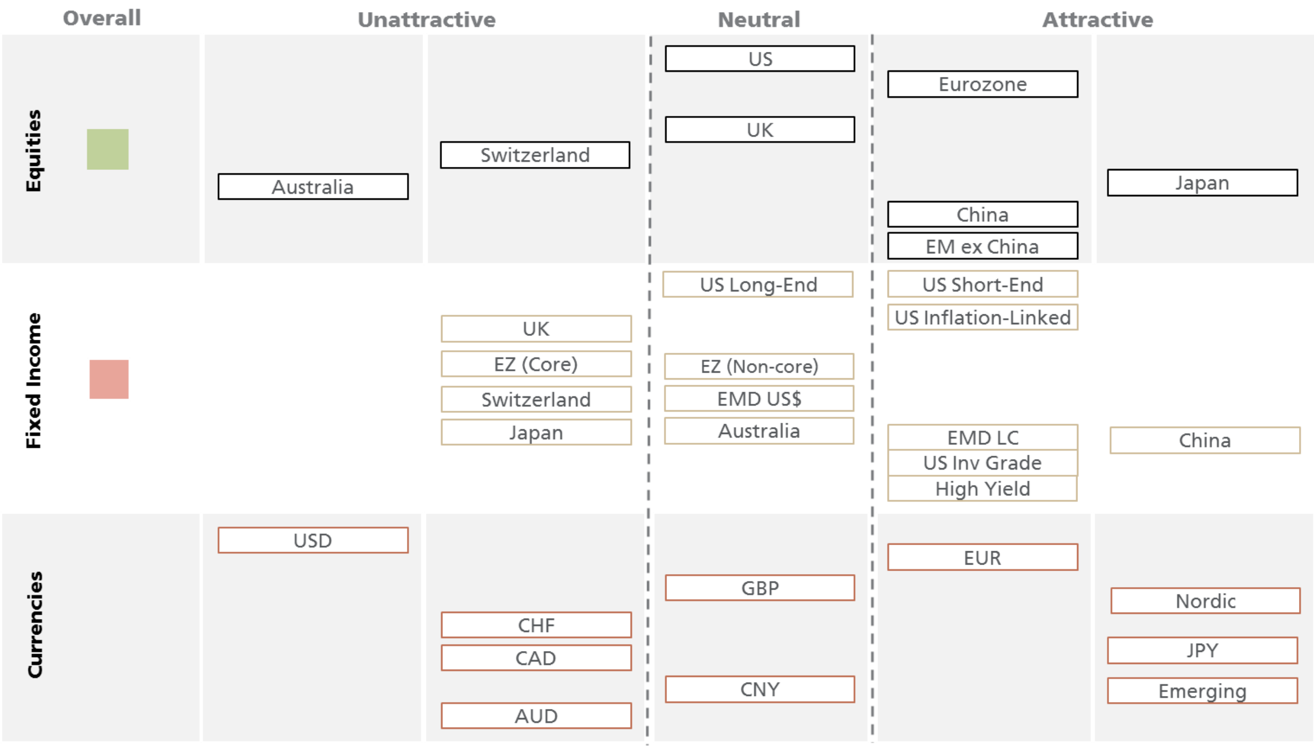
Overall we see the prospect of higher political uncertainty strengthening the relative case for ex-US equities in 2020. After a sustained period of underperformance we currently favor the pro-cyclical and more attractively valued equity markets of the Eurozone, China, Japan and emerging markets over more expensive and 'growth' oriented US equities, as global manufacturing rebounds and China's policy stimulus cushions its slowdown. Recent macroeconomic data suggest the global economy is laying the groundwork for a rebound in the first half of 2020.

Our view is that investors will inject a higher risk premium in US assets to reflect the political uncertainties as 2020 progresses. This is likely to constrain much further expansion in the US equity multiple, offsetting the tailwind of a Fed intent on letting the economy run hot. At the very least, we expect the intermittent bouts of headline and intra-market volatility in 2020 to disadvantage US equities on a relative basis and the US dollar, given high valuation starting points. There is also the potential, albeit unlikely, for a much more negative market outcome for US equities as the presidential race comes to its conclusion.



Asset class attractiveness

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 31 December 2019.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 31 December 2019. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global Equities		– We expect a moderate rebound in global growth in the coming months that we do not believe is fully reflected in global equity prices. Key to the moderate demand pickup we expect is the delayed boost to economic activity from the significant easing of global financial conditions. Importantly, the shift to looser policy has not taken place only in the US, but has been broad-based across both developed and emerging markets. Absent any extraneous demand shock, we see this supporting equities throughout the early part of 2020 as the boost from lower rates feeds through and equities rerate against a backdrop of supportive monetary policy. Should growth falter, we believe that calls for fiscal stimulus to play a greater role in the overall policy mix will grow louder in a number of major economies.
US Equities		– US equities trade at a premium relative to other markets due in part to a resilient domestic economy and a lower exposure to global growth factors. But as the global demand impulse strengthens, we see these factors as more headwind than tailwind; more cheaply valued and cyclical ex-US equity markets are likely to react more strongly. Meanwhile, headlines around the 2020 US presidential election and potentially dramatic changes in US economic policy will likely prompt bouts of volatility that may disadvantage US equities over their international peers given their substantial valuation premium. The long period of US equity outperformance may be drawing to a close.
Ex-US Developed market Equities		– Given historically high equity risk premia and a greater sensitivity to improving global manufacturing demand, we prefer developed equity markets outside of the US. In Europe, recent economic data and business surveys have been mixed but we expect demand momentum to improve over the coming months and for European equities to rerate accordingly. In September, the ECB delivered a stimulus package which is growth supportive and the broad based easing of financial conditions around the world will likely put a bottom under the previously bleak external demand picture. Furthermore, geopolitical headwinds have somewhat diminished in the region with Italy now in a coalition government. These developments are also positive for European equity valuations. – In our view, Japanese equities are one of the best ways to play the global growth rebound. They are positively correlated to the external demand environment, attractively valued and supported by the larger than expected domestic fiscal package taking effect in early 2020. Furthermore, investment is likely to accelerate as we move closer to the 2020 Tokyo Summer Olympics. Improving corporate governance is also a positive.
Emerging Markets (EM) Equities		– In our view there are also strong arguments currently for broad Emerging Market equities on a tactical basis. We see EM as a major beneficiary of a global demand bounce, an improvement in global trade in the wake of a US/China tariff truce and of the cut in USD borrowing costs. After interest rate cuts across the EM universe, monetary policy conditions have loosened significantly. The stabilization of growth in China that we expect is also likely to be positive for wider Emerging Markets.
China Equities		– We remain positive on China as policy measures continue to cushion the economy. The Chinese authorities have shown themselves willing and able to provide additional monetary, fiscal and regulatory support to help smooth the rebalancing of the Chinese economy ongoing developments. Chinese equities still trade at a small PE discount to other markets and further market liberalization could prompt a re-rating. International capital should increasingly flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
Global Duration		– A modest rebound in global demand suggests there will be at least some upward pressure on longer-dated government bond yields given the very low growth and inflation assumptions reflected in the 10yr government bond prices of developed countries including Japan, Germany and Switzerland. With monetary policy likely to remain loose even in the face of improving data, we see developed world nominal yield curves steepening.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
US Bonds		– With the Fed likely to let the US economy 'run hot' before starting to tighten policy again, there is scope for the nominal US Treasury curve to steepen. While we expect increased supply to push yields higher over the longer-term, the scarcity of positive yielding safe assets should continue to drive flows into US Treasuries and limit the scope for longer-dated yields to rise more materially on a relative basis in the short-term. We also expect US inflation expectations to rise and are therefore positive on US 'breakeven' rates – the yield difference between 10y US index-linked Treasuries and their nominal counterparts.
Ex-US Developed-market Bonds		– In aggregate, we see ex-US developed market sovereign bonds as unattractive. The ECB and BoJ have committed to low rates for some time, limiting attractiveness of these markets. Upcoming fiscal stimulus measures in Japan and modest cyclical easing in Europe may also contribute to higher ex-US yields.
US Investment Grade (IG) Corporate Debt		– Given the large proportion of fixed income markets with a negative yield, we believe that US IG is more attractive in relative terms. We expect a cyclical rebound and therefore think IG debt will remain well bid. That said, we acknowledge high levels of corporate debt and the potentially large number of "fallen angels" when economic growth slows down significantly and downgrades begin. Hence, this is closer to a 3m rather than a 12m view.
US High Yield Bonds		– Current default rates in high yield are very low by historical standards. Given the still relatively positive economic backdrop and accommodative Fed, we do not expect a material pickup in US defaults in the near-term. This is a 3m rather than 12m view.
Emerging Markets Debt US dollar Local currency		– We see the rebound in global manufacturing and lower USD funding costs as being supportive for emerging market assets in general. Spreads on both hard and local currency EM debt relative to US Treasuries remain attractive in an environment where positive real yields are scarce. As we do not anticipate a broadening economic downturn, we do not see a major spread widening in EM. An environment of still low developed market yields and decent growth is a positive one for EM carry. However, we believe local currency bonds are in a better position to take advantage of this given very cheap FX valuation.
Chinese Bonds		– Chinese bonds have the highest nominal yields among the 10 largest fixed income markets globally and have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. We believe that slowing economic growth, and inclusions to global bond market indices should continue to push yields down during the next 3-12 months.
Currency		– The USD has been stubbornly strong, but we see the next big move as lower. The USD is overvalued on a real trade-weighted basis. Meanwhile, US economic growth is moderating and the Fed is easing. Over time, we anticipate economies outside of the US will stabilize and investment capital will seek out opportunities in those countries, sending the dollar weaker. Elsewhere, we continue to see strong valuation support for the JPY and see short AUD as an effective hedge against ongoing China weakness in an economy where domestic household leverage is likely to constrain growth.

Source: UBS Asset Management. As 31 December 2019. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

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