American Portfolios Research Report: Election Outlook
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THE U.S. ELECTION has taken center stage as the next significant catalyst for risk assets. Given the 2016 upset win by President Trump, followed by the massive equity market rally that lasted through January 2018, we thought it would be interesting and helpful to outline the potential outcomes and risks of the Nov. 3, 2020, election. Herein, we will discuss the issues surrounding the election, how absentee ballots or a contested election could impact the markets, what the Presidential debates mean, the likelihood of a “blue wave” sweep and other possible outcomes.

ELECTION ISSUES

According to a recent report by the Pew Research Center[i], the top five issues of the upcoming 2020 national election as indicated by registered voters are (in order of stated importance):

1. The Economy
2. Health care
3. Supreme Court Appointments
4. COVID-19
5. Violent Crime

The data from the aforementioned report indicated that the economy and supreme court appointments were very important to members of both parties, while health care and COVID-19 were significantly more important to polled Democrats versus Republicans. Violent crime was significantly more important to Republicans. We will take a look at each of these issues and add a few of our own.

Our amended list adds two important items that could impact the election, in our opinion.

1. Taxes and Household Net Worth
2. Trump versus Not Trump

THE ECONOMY AND COVID-19

The economic data has certainly recovered, but has started to wane. Despite the rhetoric, we see little stimulus for a renewed leg up from here. Will it be enough for President Trump? This remains to be seen. However, historically, Republicans have been more pro-business (and tax friendly, as discussed below). The COVID-19 response of the government ties into the economic debate. We said very early on that it would be difficult to determine if we overreacted to the threat of the pandemic, but it would be very clear if we underreacted. While death rates from COVID-19 have leveled off and are nowhere near the previously-feared levels of the Spanish Flu, the lasting health effects many of those infected are facing are certainly not to be trifled with.

As far as the economy is concerned, the first Presidential debate identified a stark contrast between the candidates as President Trump was adamant about opening the economy while former Vice President Joe Biden supported business closures. There has been enough economic destruction from this pandemic, so we think more voters favor President Trump's stance than Biden's. That being said, we think some voters will hold President Trump accountable come Election Day for the slow response early on during the initial spread of the virus, while Biden gets a pass, solely because he was not in office at the time, and mistakes were certainly made by the government. Furthermore, while some believe President Trump could garner some sympathy votes after contracting COVID-19, we think it is more likely this unfortunate event is likely to garner a negative reaction toward his incumbency with many pointing to a general disregard of public health restrictions during his campaign rallies. Taking these two issues together, we think President Trump has a modest advantage here with Americans choosing an open economy with health precautions rather than another shutdown.

HEALTH CARE

On the health care issue, once again, the candidates offer a stark contrast with President Trump focused on repealing the Affordable Care Act (ACA), while Biden looks to fix and build on ACA by increasing premium assistance and offering a public plan option similar to Medicare. We give a slight nod to Biden here, as President Trump heretofore has been unable to eliminate ACA and the efforts to reduce insurance company subsidies has resulted in higher premiums for consumers.

THE SUPREME COURT

Of all the issues listed, President Trump's Supreme Court nomination of Judge Amy Coney Barrett could be the biggest hot-button issue of them all. The mudslinging has already begun. The contrast between the Republican nominee and deceased SCOTUS Justice Ruth Bader Ginsburg, who Coney Barrett is lined up to replace, could be described as near polar opposites. This nomination—should it be approved, either before this election or after with a victory from President Trump—could cement a conservative-leaning Supreme Court for decades to come. We think this nomination fires up Biden's base more than it does President Trump's, offering a slight boost to the Democrats' efforts to take back the White House.

As a side note, this nomination points out just how flawed our government has become. It's not about what's right, but about who can grab the most power. While Republicans push to get their nominee confirmed prior to the election, Democrats call into question the fairness of doing such in an election year. Both parties have seemingly forgotten that they were on opposite sides of the issue in 2016 with the Merrick Garland nomination on the heels of Justice Antonin Scalia's passing.

THE RISE IN VIOLENCE

The rise in violence in major cities around the country has become a significant issue. In some cases, peaceful protests have morphed into looting and destruction, and violent crimes have skyrocketed in places like New York City, Chicago, Philadelphia and Portland. A recent Wall Street Journal report[ii] highlighted a 24 percent increase in homicides across the country, year to date.

Certainly, this is another complicated issue. While President Trump's federal response to the violent protests could be seen as a government overreach, Biden was late to condemn the violence and many Democrats in office have yet to do so. Further exacerbating the issue is the push to defund the police by many Democrats. There is a massive difference between police reform, the elimination of no-knock raids and/or qualified immunity, and cutting billions of dollars in police funding. We believe that President Trump and Republicans hold a strong advantage is this area.

THE TAX CODE

We add taxes to the conversation because the Tax Cuts and Jobs Act (TCJA) of 2017 was the largest single overhaul of the U.S. tax code in more than three decades and offers Americans a direct link between policy and their pocketbooks. This is an important issue because Democratic nominee Biden is proposing another sweeping change to the current tax code, including:

- Increasing the top rate of income tax from 37 percent to 39 percent
- Increasing long-term capital gains taxes for those earning more than $1 million, possibly a jump for top earners from 20 percent to 39.6 percent
- Imposing limits on various tax breaks for higher earners
- Increasing corporate taxes from 21 percent to 28 percent, though not all the way to the 35 percent rate before President Trump's cuts

Setting minimum corporate taxes for domestic and foreign income, Biden has made tax policy a centerpiece of his campaign.

While social issues are seemingly gaining in importance as we head into this election, perceived Republican strength on the economy and taxes could be hard for voters to pass up, despite other headwinds. We would argue that taxes are likely to rise in some of the aforementioned areas, even if President Trump is re-elected. Democrats could force such a move in exchange for an increase in the debt ceiling, which we don't believe many are focused on. Investors should be prepared for a potential government shutdown next summer, lots of mudslinging and deals to get beyond a debt impasse. Regardless, we do not believe voters are focused on this, and even if taxes are set to rise next summer under President Trump, he still gets a sizable nod on the tax front, in our view.

TRUMP VERSUS NOT TRUMP

In another Pew Research Center poll[iii], registered voters were asked the main reason they favored their chosen candidates. While President Trump's leadership and stance on issues received 23 percent and 21 percent votes, respectively, 56 percent of those who supported Biden identified the main reason for their support was that he was not President Trump.

While this has often been the case in American politics (George W. Bush and Hillary Clinton likely come to mind for some), President Trump is probably the most polarizing president ever. While personality is not a campaign issue like tax policy, likability can play a huge role in voters' opinions of a candidate, despite the candidate's stance on the issues.

Certainly, President Trump has many staunch supporters, but there are many voters that clearly do not like him personally. This is a big advantage for Biden, as the polling data clearly shows. The question remains, can President Trump change minds by softening his abrasive personality over the next few weeks? Based on his performance at the first Presidential debate, we think not; but, it remains a possibility. To us, Biden gets the advantage here.

CONTESTED ELECTION AND ABSENTEE BALLOTS

As we game plan possible outcomes for November's U.S. presidential election, the 2016 election could be a guide to what can happen in a contested election. As you may recall, U.S. stock futures plummeted overnight with safe-haven assets like gold rising, only to recover dramatically at the market open. At the time, many believed the stock market feared a Trump presidency. However, we doubt that was the whole story or even most of it. Are we really to think that billion- and trillion-dollar asset managers sold heavily on the election night's results, only to dramatically change course after sleeping on it?

We suspect the more likely explanation is that the drop occurred because Hillary Clinton did not concede the race until the next morning and the stock market feared a contested election. It is certainly possible that this could happen again. While Biden did state he would accept the results, President Trump has not; plus, Biden could certainly change his mind or be advised to do so.

We expect stock market volatility and sell-offs during the next few weeks leading up to the election. Precious metals, and perhaps U.S. Treasuries, could perform well. If we do have a contested election, we would expect the aforementioned scenario to continue until there is a resolution.

We caution that market participants should be prepared for an election week, or weeks, rather than an Election Day/night outcome. The vote count could take weeks to process given the high level of absentee ballots that are expected to be submitted amid the COVID-19 pandemic.

Each state has unique laws and regulations governing voting across thousands of jurisdictions. The number of mail-in votes will increase the overall processing time. In some states, vote counting begins as much as three weeks in advance of Election Day, but for others, counting begins only on Election Day. Furthermore, some states allow ballots to be turned in as much as five days or more after Election Day. This could elongate the wait for a clear winner. Not to mention, the increase in mail-in ballots potentially increases the odds of election fraud, which we think increases the odds of a contested election, which is more likely if President Trump loses, in our view.

THE DEBATES

The three remaining scheduled debates will likely be lively with a lot of jabs and possibly gaffes, but may not have as much of an impact on election results. The pool of undecided voters this year is smaller than it typically is at this point. In 2016, 15 percent of voters were still undecided at this point in the cycle. In multiple national polls that were conducted in late September[iv], the results indicate that only 5 percent of voters remain undecided. There are a few reasons for this, in our opinion. Both candidates are already well known. Research shows that debates usually only result in large changes in voter intentions if the major candidates are not well known. Furthermore, President Trump is such a polarizing figure. Most voters already have a well-formed opinion of him, good or bad, which leaves few on the fence.

POLLING DATA[iv]

National polls and betting odds both place former Vice President Joe Biden ahead of President Trump by a significant margin. However, this was also the case prior to the 2016 election, which ended in a major upset. We think the situation is similar this time and that the election is likely to be much closer than the polls indicate. Given the great divide of American politics and the emergence of the cancel culture, we think many voters are unlikely to publicly state support of President Trump, or they perhaps seek to skew the polls.

As we look beyond the presidency, current polls suggest that the House of Representatives will remain under Democratic control, but many of the Senate races are reflecting very close contests for the 35 seats that are up for re-election. It is entirely possible that the Democrats flip control of the Senate to their favor.

A ONE-PARTY SWEEP?

Biden is certainly not a lock for the presidency—a lot can happen in the next few weeks—but with control of the House of Representatives and a chance to flip the Senate, Democrats have a significant shot at winning control of all three.

Republicans currently hold the Senate majority with 53 seats. In order for the Democrats to win the majority, they must win a net three seats if they also win the presidency because the vice president casts the tie-breaking vote in legislation, or net four seats if they do not. This year, 35 seats are up for election: 23 currently held by Republicans and 12 by Democrats. There appear to be at least seven competitive races (Arizona, Colorado, Georgia, Iowa, Maine, Montana and North Carolina) where Democrats could possibly flip Republican seats, but it is likely that Republicans will flip the Democratic seat in Alabama.

In the House, all 435 seats are up for election. Democrats currently hold 232 seats and Republicans hold 198; there are four vacancies and one Libertarian seat up for grabs. Assuming the vacant seats return to the party that held them, the Democrats would control 233 seats and the Republicans 201. This would leave the Republicans needing a net gain of 17 seats to regain control. While that is certainly possible, during the last three presidential elections the House swung on average by a net 12 seats. We typically see larger swings during mid-term election years, which has become a vote for or against the president's first two years of the new term.

A lot has to go right for either party to sweep government control, but we think it is likely that the Democrats either win all three branches or only maintain the House, given party voting lines down the ticket. Should the Democrats succeed, we would expect higher taxes and more government spending. That shouldn't surprise anyone. The question that needs to be answered is, will spending increase enough to offset higher taxes and a greater debt load? This remains to be seen. Not to mention, we would expect to see increased regulations on many industries, including conventional energy and technology, should Democrats sweep on Election Day, likely putting pressure on the financial markets.

If Republicans retain control of either the Senate or the White House (and assuming the Democrats retain control of the House), we would expect the major aspects of current fiscal policy to be unchanged until at least the 2022 Congressional elections. Other policy issues in play for notable shifts are health care, minimum wage and immigration. Regardless of the election, trade conflict with China will likely persist, though the rules of engagement could change and perhaps soften with Democratic leadership.

HOW TO INVEST?

At the time this Research Report was published, we think the U.S. presidential race is a toss-up, with President Trump holding a much greater chance of re-election than the general public seems to acknowledge. What's more, we also believe the financial markets are positioned for this. As we've stated in the past, should Biden win, we think the market will sell off (or perhaps will do so prior to the election if it becomes clearer that he will win) as the Biden tax and economic shutdown plans become a greater reality.

We believe that investors should continue to monitor economic fundamentals, tilt toward quality in both equity and fixed income, and maintain a well-diversified allocation. We expect volatility around the election and perhaps a notable sell-off. Depending on how one is positioned, this could offer an opportunity to add risk for the long-term. Investment time horizons extend far beyond election cycles and presidential terms, so sticking to a long-term investment plan is crucial during times like these.

We also note that it is just as important to avoid certain actions. Politics has become emotional for many, shaping our identities. As investors, we must avoid allowing how we feel about politics to overrule our investment philosophies. Imagine having been upset that President Trump won the presidency in 2016 and missing out on the massive equity run of 2017, and longer-term throughout his first term. Focus on policies that impact the economy and financial market, and leave everything else out of your investments.

Taking a long-term view is an important factor here, but there are a host of sectors and investment areas that could be impacted by the election. We've listed a few which we believe will be most impacted.

Should Biden win, we think international equity markets could outperform U.S. equity markets, a function of a weaker dollar, tax pressure on the U.S. economy and a shift away from the America-first philosophy of trade held by the current administration.

A Biden administration would impact real estate in a significant way, in our view. He has proposed to eliminate the 1031 exchange for investors with income over $400,000 as a way to partially fund his $775 billion "Caring

Economy" plan, which provides funding for the elderly and children. Should this come to fruition, the real estate sector could see notable pressure.

Also at stake are regulations and investment opportunities in energy. This election will offer significant ammunition to one side of the battle between renewables and traditional U.S. energy infrastructure/offshore drilling. Big tech is likely to see anti-trust and anti-competitive legislation under a Biden presidency.

Furthermore, health care is likely to change significantly with a change in administration. Should President Trump get re-elected or Republicans maintain control of the Senate, the risk of material federal health policy changes would likely be eliminated and remove a material valuation overhang on the majority of the sector. If not, uncertainty in the sector will rise, likely putting pressure on earnings multiples, if not earnings themselves.

All in all, the next few weeks are going to be interesting with three more debates (two presidential; one vice presidential) and the election with significant implications for years—and even decades, with the election's potential impact on the Supreme Court—to come.

Whatever happens, stick to a long-term philosophy and don't let personal opinions cloud sound financial judgement. Our team will likely host a conference call on Nov. 16 to follow up on the election and discuss our look forward into 2021 as we (thankfully) put 2020 in the rear view.

QUESTIONS AND COMMENTS

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Disclosure:

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