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U.S. election scenarios

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This report analyzes the political implications of various U.S. election scenarios and their potential short-term impact on financial markets.

Scenario 1: A Democratic Sweep

The Democrats win the presidency and both chambers of Congress. This puts them in an exceptionally strong position to advance their legislative agenda. However, they did not win the enough seats needed to overcome Senate rules requiring 60 votes to close debate and vote on most legislation (otherwise known as the filibustering).

There are two ways to get around this 60-vote threshold. One is to use a process called reconciliation. This allows certain fiscal measures to pass with just a simple majority. The Democrats used budget reconciliation to pass Obamacare in 2015, while the Republicans did the same to pass their tax overhaul in 2017.

The other, more extreme option, which we feel will be chosen by the Democrats, is to lower the bar for passing all legislation to a simple majority of 51 votes. The 60-vote threshold can be eliminated with a simple majority. **This game-changing move would provide the Democrats with an unprecedented opportunity to pass major legislation.**

While this blue sweep could unsettle some investors on account of the pledge by Democrats to raise corporate and capital gains taxes and to increase business regulations, we feel that the negative impact of these policies, at least in the short term, would be more than offset by massive spending. Further, the Biden administration will very likely enact a major stimulus package before addressing tax policy.

Estimates of how much Biden's tax proposals would increase government revenues over the next 10 years are generally in the range of \$3 to \$4 trillion, while the total cost of his policy proposals is estimated at \$7 trillion over the same period. This does not include the imminent approval of another massive stimulus package.

Investors will be able to get a sense of the general ideological direction of the Biden administration by examining whether the people appointed to cabinet posts and chosen to lead regulatory agencies are mostly moderates or mostly progressives.

Finally, on the geopolitical front, taking a tough line on China will remain one of the few areas where there is an overwhelming bipartisan consensus. Indeed, most recent legislation targeting China has passed with near-unanimous support in Congress. For most other legislation not involving China, gridlock is the norm. Tensions with China could even climb a notch if the Democrats follow through on their proposal to impose carbon border tariffs on imports from countries with lower environmental standards.

Market impact: Under this scenario, we would expect a short-term fiscal stimulus package of well over \$2 trillion followed soon by more government spending on infrastructure and the environment. Such a development would support equities relative to Treasuries, which we would expect to sell off at the long end (higher yields). The combination of quantitative easing by the U.S. Federal Reserve and a large fiscal stimulus package would be U.S. dollar negative. The potential introduction of a carbon tax would further crystallize market expectations of higher inflation.

Scenario 2: Democrats take presidency, Republicans retain control of Senate

A Republican-controlled Senate will prevent Biden from enacting most of his ambitious legislative agenda, which means trillions less in spending than otherwise would have been the case under a unified Democratic government.

We still feel that the Republicans and the Democrats will eventually agree to pass another major stimulus package early in 2021 (around \$2 trillion). The driving force behind this agreement will be concerns about a faltering economy and the end of the election cycle during which time both parties feared handing the other party a political victory.

A divided government will force the Biden administration to govern largely by way of executive order. The Republicans will respond by challenging the legality of these orders in the federal circuit courts. While the Supreme Court may be the highest

legal body in the land, it hears only a very small number of cases annually (100 to 150). The vast majority of federal lawsuits are heard one level lower in the circuit courts.

Investors can make a reasonable guess as to how these courts would rule on the legality of Biden's executive orders based on whether the presiding panel of judges were mostly nominated by the Republicans or the Democrats.

A rare area of bipartisan consensus will be legislation targeting China. Politically speaking, being anti-China today is the equivalent of being anti-Soviet Union in the 1950s. Indeed, most of the recent legislation targeting China has passed with near-unanimous support in Congress. For most of the legislation not involving China, gridlock will remain the norm. In the same way that Trump implemented tariffs on China via executive orders, Biden could further ratchet up tensions by doing the same with carbon border taxes.

Market impact: *This scenario limits the scope for a shock-and-awe fiscal stimulus. We see this outcome as negative for equities because more regulation with less stimulus would undermine the profit outlook. We see Treasury yields trading sideways or slightly downward as the prospects of advancing most of the Democratic Party's legislative agenda fade. Against this backdrop, we would expect the U.S. dollar to appreciate slightly.*

Scenario 3: Trump wins election, Democrats retain control of House (status quo)

As in 2016, Trump's surprise victory proves most polls wrong and shocks political pundits. Also, as in 2016, he won the Electoral College but lost the popular vote—an outcome his opponents will find hard to accept.

Given that Trump will continue to preside over a divided government where the Republicans maintain control of the Senate and the Democrats hold the majority in the House of Representatives, this will force Trump to continue governing largely by way of executive order.

The Democrats will respond by challenging the legality of these orders in the circuit courts. Investors can make a reasonable guess as to how these courts would rule on the legality of Trump's executive orders based on whether the presiding panel of judges were mostly nominated by the Republicans or the Democrats.

In the same way that Republicans and Democrats agreed to pass two major stimulus bills in 2020, we feel that the two sides will come together once again to pass another major stimulus package early in 2021. Trump, who has expressed support for another larger stimulus package, will be able to apply greater pressure on Senate Republicans to accept a larger package than Biden could with a divided government. The driving force behind this agreement will be concerns over a faltering economy and the end of the election cycle during which time both parties feared handing the other a political victory.

A rare area of bipartisan consensus would be legislation targeting China. Politically speaking, being anti-China today is the equivalent of being anti-Soviet Union in the 1950s. It is a fact that most of the recent legislation targeting China has passed with near-unanimous support in Congress. For most of the legislation not involving China, gridlock will remain the norm. Look for Trump to continue ratcheting up pressure on China.

Market impact: *This scenario favours some upside for equity markets on the strength of less regulation, continued low corporate taxes, and the President's desire to prop up the stock market with a sizeable fiscal stimulus package (over \$2 trillion). We see Treasury yields moving higher and the U.S. dollar moving lower.*

Scenario 4: A contested election

Biden and/or Trump challenge the validity of the election results with the point of contention revolving around which mail-in votes should be counted or discarded. On one level, this will be a repeat of 2000 when the election hung in the balance for several weeks amid a battle over vote counting in Florida. Back then, the winner was declared on December 13 only once Gore conceded defeat after the Supreme Court intervened to award Bush the state.

However, what will make the dispute different this time around is the much greater animosity between the two parties, with each side portraying the other as a threat to the country's future. It is important to note, also, that the dispute in Florida took place at a time of much less societal tension. That is, it occurred before 9/11, China's emergence as a world power, the 2008 financial crisis, the rise of divisive social media, and Covid-19.

Finally, as in 2000, it is likely that the nation's Supreme Court will be required to decide which side has legal cause sooner rather than later, leaving over 40% of the population extremely disappointed. A key date to watch is December 8, the deadline



for states to appoint the 538 men and women who will make up the Electoral College. Supporters from both sides have already converged on many cities to protest.

Market impact: Markets do not like political uncertainty, especially when it involves the world's largest economy. We would expect equity markets to trade lower. The outcome for Treasury yields and the U.S. dollar is less obvious, but we are tempted to think that bond yields would move a little higher as foreign investors shy away from U.S. assets until the imbroglio is resolved. The U.S. dollar weakens, and the price of gold rises.



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