Investment Strategy

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بنك أبوظبي التجاري
ADCB
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US elections: implications for US equities

- **US election is arguably the most important event risk facing equity markets in the near-term**
- **In this note, we list some key considerations that matter the most for US equity investors**
- **We are comfortable with our sector positioning given this event risk and broader macro risks**

With both the Republican National Convention and the Democratic National Convention now concluded, both Presidential Candidates – Donald Trump and Joe Biden – are engaged in a tight race. Despite the Trump bump in August, polls continue to suggest the possibility of a blue wave. On November 3rd, US electoral base will make their choice for 538 Electoral College electors, 35 seats in the senate and 435 seats of the house (exhibit 1). Whilst the choice of the President is important, we believe that who controls the congress will matter the most. Equity markets tend to do better when Congress is split between Republicans and Democrats, rather than controlled by one party. Here, it is worth noting that of the 35 senate positions coming up for election this year, 23 are currently held by the Republicans and the other 12 are currently held by the Democrats. Therefore for Democrats to take control of the senate, they just need to retain the current level and win three additional seats currently held by Republicans if they also win the Presidency (or four additional seats if the elected President is not a Democrat). Against this backdrop, polls seem to suggest the possibility of a blue wave despite a strong rise of Republicans in the race for Presidency and the Senate control during August (exhibits 2-5). We would highlight that reliability of election polls has been increasingly called into question over recent years. Especially in the US, they do not correctly predict the Electoral College as much as they do predict the popular vote. However, as we move into September and October, markets might start to track the polls rather closely. In this context, it is worth watching the developments in swing states: Florida, Wisconsin, Michigan, Pennsylvania, Arizona and North Carolina.

As can be seen from exhibit 6 where we look at the last 120 years under 20 different US Presidents, equity markets tend to do well under Democrat Presidency rather than under Republican presidency. For instance, equity markets rose 81% on an average under Democrat Presidents while they rose only 40% under the Republican candidates. What is even more interesting is the profile of these returns – under a Democrat President markets see plenty of earnings growth but valuation multiples de-rate but under a Republican president, most of the returns are driven my valuation expansion. Underlying the strong earnings growth during Democratic Presidency is the fact that they tend to see fewer economic contractions (as per the NBER data, over the last 120 years, 22 episodes of contraction have occurred – 16 under Republican Presidency and just 6 under Democrats). Exhibit 7 summarises performance of other macro measures under both Party Presidents. When it comes to equity sectors, we could obtain data only since 1989 and here the trends suggest that irrespective of the party the President belongs to, IT and Healthcare continue to do well (exhibit 8).

In our view, the upcoming elections will likely impact the policy on three different fronts: 1) Policy for a post-COVID-19 recovery 2) International trade relations and 3) Domestic policy construct. On the latter, the biggest concern for equity market investors has been the Democratic proposal to raise corporate taxes. Here it is worth noting that whilst the current proposal by Mr. Biden increases the taxes on corporate earnings, the tax rates do not reach the level of pre-Trump tax cuts (exhibit 9). Further, it is worth considering the possibility of a delay in corporate tax rate even under a Democratic rule as policy makers make efforts to support the recovery. Whilst Mr. Trump's win will mean status-quo with the policy (America First / re-shoring, tough-on-China and tough-on-trade, infrastructure spend, second round of tax cuts, less regulation and higher deficits), Mr. Biden's win could change the policy at margin in some cases and significantly in others (Tough-on-China but multi-lateral push, student debt reform, climate change, healthcare strategies, higher corporate taxes, additional economic stimulus and higher deficits). As such, VIX curve is pricing in a rise in volatility around the election time (exhibit 10). This is in part the reason why we are cautious tactically but constructive strategically on equities. Top of mind for most investors is the possibility of a major tech regulation under a new President. Here, we doubt if US law makers would want to really beat their national tech champions at a time of engaging in a tech-war with China. Remember, being tough on China is a bipartisan consensus. In exhibit 11, we summarise our considerations sector-wise for the US and we note that we are comfortable with our current positioning (exhibit 12).

Investors should keep in mind the impact of COVID-19 on US elections. Primarily, public perception of the administration's handling of the crisis is a key swing factor. Further, higher rates of infections could result in lower voter turnout. In case of higher level of mail-in voting (which in the recent years has become more available and popular), potential for delay in vote counting looks likely.

Kishore Muktinutalapati
Equity Strategist
Tel: +971 (0)2 696 2358
kishore.muktinutalapati@adcb.com

Luciano Jannelli, Ph.D., CFA
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

Prerana Seth
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

Mohammed Al Hemeiri
Analyst
Tel: +971 (0)2 696 2236
mohammed.alhemeiri@adcb.com

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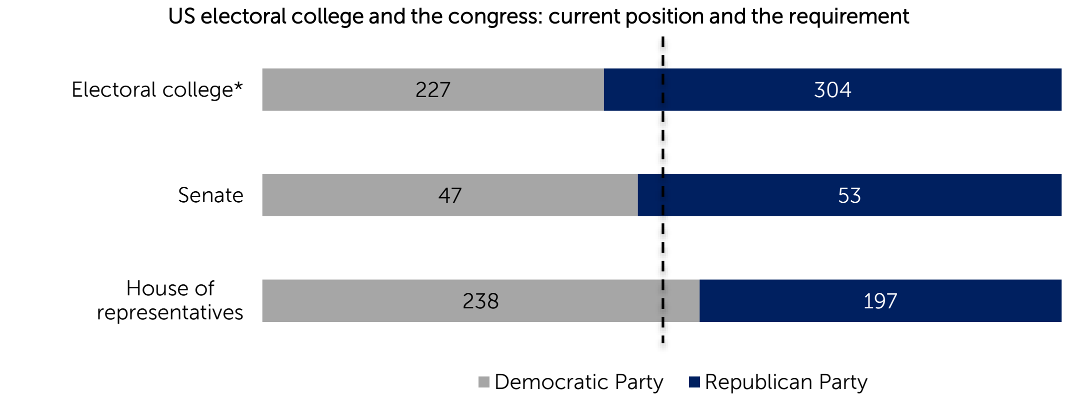
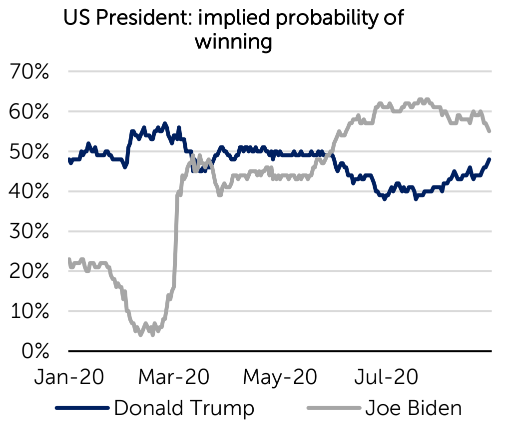
Exhibit 1: What will be voted for on 3rd November?



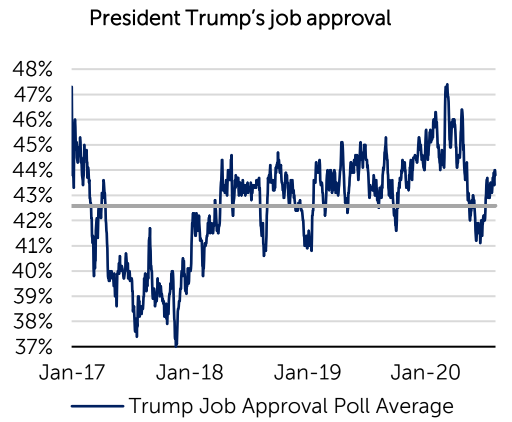
Source: ADCB Asset Management | Notes: *In 2016, 7 votes lost to faithless electors in the official tally – Mrs. Clinton lost 5 and Mr. Trump lost 2.

Exhibit 2: Trump bump in August is significant



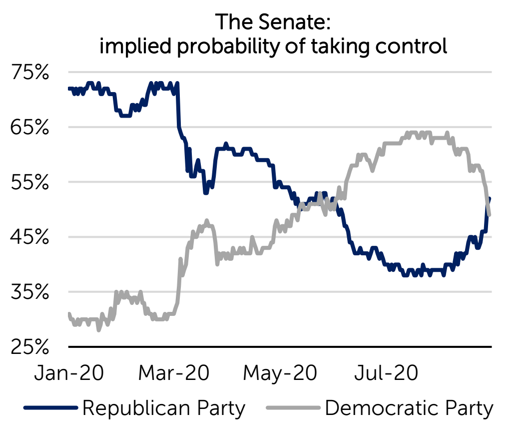
Source: PredictIt, Bloomberg and ADCB Asset Management

Exhibit 3: President Trump's job approval rising



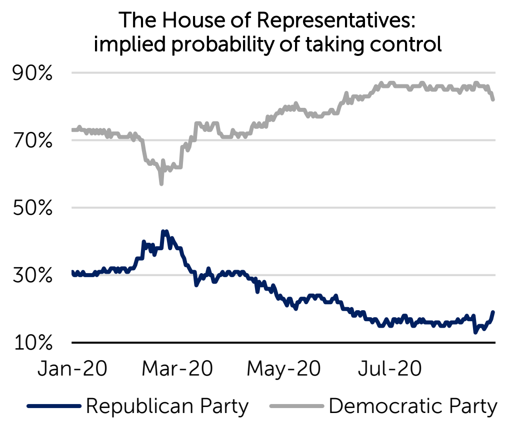
Source: Real Clear Politics, Bloomberg and ADCB Asset Management

Exhibit 4: Republicans' chances increased in the Senate



Source: PredictIt, Bloomberg and ADCB Asset Management

Exhibit 5: Strong chances for Democrats to keep the House



Source: PredictIt, Bloomberg and ADCB Asset Management

Exhibit 6: Performance of US equity markets under the last 20 US Presidents (over the last 120 years)

Order	From	To	President	Affiliation	No. of NBER economic contractions	S&P 500 price returns (%)	S&P 500 earnings growth (%)
26th	14-Sep-1901	4-Mar-1909	Theodore Roosevelt	Republican	2	12%	26%
27th	4-Mar-1909	4-Mar-1913	William Howard Taft	Republican	2	-1%	9%
28th	4-Mar-1913	4-Mar-1921	Woodrow Wilson	Democratic	2	-22%	-1%
29th	4-Mar-1921	2-Aug-1923	Warren G. Harding	Republican	1	18%	31%
30th	2-Aug-1923	4-Mar-1929	Calvin Coolidge	Republican	1	214%	63%
31st	4-Mar-1929	4-Mar-1933	Herbert Hoover	Republican	1	-76%	-71%
32nd	4-Mar-1933	12-Apr-1945	Franklin D. Roosevelt	Democratic	2	129%	133%
33rd	12-Apr-1945	20-Jan-1953	Harry S. Truman	Democratic	1	83%	148%
34th	20-Jan-1953	20-Jan-1961	Dwight D. Eisenhower	Republican	3	128%	33%
35th	20-Jan-1961	22-Nov-1963	John F. Kennedy	Democratic	0	22%	25%
36th	22-Nov-1963	20-Jan-1969	Lyndon B. Johnson	Democratic	0	40%	45%
37th	20-Jan-1969	9-Aug-1974	Richard Nixon	Republican	2	-25%	55%
38th	9-Aug-1974	20-Jan-1977	Gerald Ford	Republican	0	37%	11%
39th	20-Jan-1977	20-Jan-1981	Jimmy Carter	Democratic	1	28%	48%
40th	20-Jan-1981	20-Jan-1989	Ronald Reagan	Republican	1	115%	64%
41st	20-Jan-1989	20-Jan-1993	George H. W. Bush	Republican	1	52%	-20%
42nd	20-Jan-1993	20-Jan-2001	Bill Clinton	Democratic	0	207%	151%
43rd	20-Jan-2001	20-Jan-2009	George W. Bush	Republican	2	-35%	-75%
44th	20-Jan-2009	20-Jan-2017	Barack Obama	Democratic	0	163%	690%
45th	20-Jan-2017	29-Aug-2020	Donald Trump	Republican	1	54%	0%
				Republican	**16**	**40%**	**12%**
				Democratic	**6**	**81%**	**155%**

Source: NBER, Robert J. Shiller "Stock Market Data Used in "Irrational Exuberance" Princeton University Press, 2000, 2005, 2015, updated", Angus Maddison Project 2018, thebalance.com, White House, Bloomberg and ADCB Asset Management

Exhibit 7: Performance of US economic metrics under various US Presidents since the depression of the 1930s

Order	From	To	President	Affiliation	Real GDP growth (%)	CPI change (%)	Debt/GDP ratio change (ppt)	Govt. balance (% of GDP) - average	Individual income tax receipts (% of GDP) - average	Corporate tax receipts (% of GDP) - average
32nd	4-Mar-1933	12-Apr-1945	Franklin D. Roosevelt	Democratic	141%	41%	57%	-9%	2.6%	2.6%
33rd	12-Apr-1945	20-Jan-1953	Harry S. Truman	Democratic	14%	49%	-18%	-3%	7.1%	4.8%
34th	20-Jan-1953	20-Jan-1961	Dwight D. Eisenhower	Republican	26%	12%	-19%	-1%	7.5%	4.5%
35th	20-Jan-1961	22-Nov-1963	John F. Kennedy	Democratic	9%	3%	-4%	-1%	7.7%	3.6%
36th	22-Nov-1963	20-Jan-1969	Lyndon B. Johnson	Democratic	34%	16%	-12%	-1%	7.6%	3.7%
37th	20-Jan-1969	9-Aug-1974	Richard Nixon	Republican	19%	40%	-5%	-1%	8.1%	2.9%
38th	9-Aug-1974	20-Jan-1977	Gerald Ford	Republican	5%	17%	1%	-3%	7.8%	2.4%
39th	20-Jan-1977	20-Jan-1981	Jimmy Carter	Democratic	14%	49%	-1%	-2%	8.4%	2.4%
40th	20-Jan-1981	20-Jan-1989	Ronald Reagan	Republican	30%	39%	17%	-4%	8.2%	1.6%
41st	20-Jan-1989	20-Jan-1993	George H. W. Bush	Republican	9%	18%	13%	-4%	7.7%	1.7%
42nd	20-Jan-1993	20-Jan-2001	Bill Clinton	Democratic	36%	23%	-7%	-1%	8.6%	2.0%
43rd	20-Jan-2001	20-Jan-2009	George W. Bush	Republican	18%	21%	13%	-3%	7.6%	1.8%
44th	20-Jan-2009	20-Jan-2017	Barack Obama	Democratic	12%	15%	36%	-6%	7.7%	1.6%
45th	20-Jan-2017	29-Aug-2020	Donald Trump	Republican						
				Republican	**14%**	**13%**	**3%**	**-2%**	**8%**	**2%**
				Democratic	**35%**	**35%**	**7%**	**-3%**	**7%**	**3%**

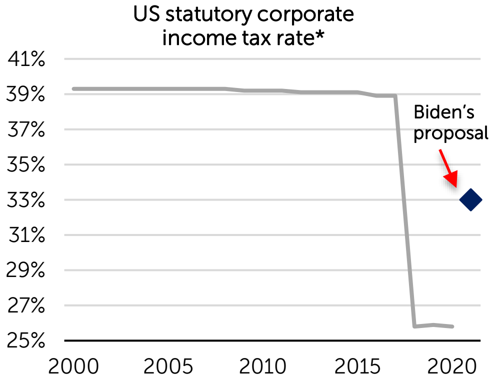
Source: NBER, Robert J. Shiller "Stock Market Data Used in "Irrational Exuberance" Princeton University Press, 2000, 2005, 2015, updated", Angus Maddison Project 2018, thebalance.com, White House, Bloomberg and ADCB Asset Management.

Exhibit 8: Performance of US equity sectors under the last five US Presidents

	George H. W. Bush*	Bill Clinton	George W. Bush	Barack Obama	Donald Trump**	Average (excluding Mr. Trump)	
	Republican	Democratic	Republican	Democratic	Republican	Republican	Democratic
Comm. Services	6%	98%	-43%	58%	9%	-18%	78%
Cons. Discretionary	30%	141%	-29%	282%	77%	1%	212%
Cons. staples	70%	138%	4%	116%	21%	37%	127%
Energy	10%	167%	60%	44%	-51%	35%	105%
Financials	20%	301%	-57%	129%	3%	-19%	215%
Health Care	49%	335%	-30%	158%	54%	10%	246%
Industrials	20%	215%	-27%	160%	13%	-4%	187%
IT	-1%	584%	-51%	249%	140%	-26%	416%
Materials	11%	50%	5%	127%	22%	8%	89%
Real Estate	NA	NA	NA	144%	18%	NA	144%
Utilities	17%	93%	-32%	67%	25%	-7%	80%

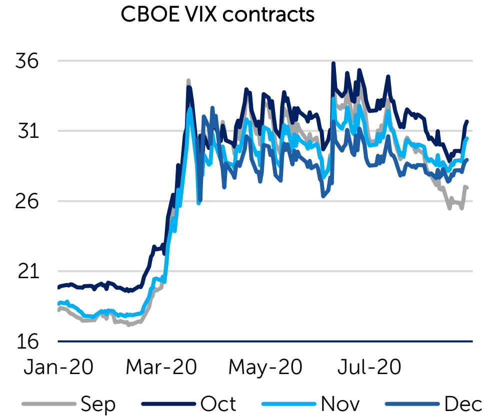
Source: S&P, Bloomberg, and ADCB Asset Management | Notes: *data available only from September 1989. ** data as at end of 28 August 2020

Exhibit 9: US tax raises top-of-mind for investors



Source: OECD, Bloomberg, and ADCB Asset Management | Notes: *Combined corporate income tax rate - shows the basic combined central and sub-central (statutory) corporate income tax rate given by the central government rate (less deductions for sub-national taxes) plus the sub-central rate.

Exhibit 10: Higher VIX around election time



Source: Chicago Board Options Exchange, Bloomberg and ADCB Asset Management

Exhibit 11: Impact of US presidential election outcomes on US equity sectors

Communication Services

- Media sector, which is fairly small in weight in the overall communication services sector is likely to face higher level of regulatory scrutiny.

Consumer Discretionary

- Post-pandemic policy support to define consumer spends especially relating to durable goods. Minimum wages are likely to result in higher costs. Climate focus will likely impact textile, apparel and auto manufactureres.

Consumer Staples

- Less trade tensions could mean lower commodity prices - feeding into better profitability. Tax proposals benefit discretionary rather than staples.

Energy

- Most negative impacted under Biden Presidency. Rising enviromental regulations will significantly curtail oil field activity on Federal lands. Exploration and production companies will be negatively impacted.

Financials

- Increased supervision under a new Consumer Financial Protection Bureau is a risk. Under Democrats, banks are likely to face higher regulatory scrutiny and higher capital requirements.

Health Care

- Healthcare services likely to benefit from increased Medicaid under Democrats. Drug price reform is a clear negative for pharmaceutical manufacturers.

Industrials

- Bigger drag from corporate tax raises and lower defense spending under Mr. Biden. Infrastructure push under Mr. Trump could provide tailwind.

Information Technology

- Benfits from increased focus on promoting tech companies to counter Chinese dominance in the tech sapce. Investments into 5G networks and upgrade in digital infrastructure. Under Mr. Biden, easier visa policies are likely to help further.

Materials

- Infrastructure investments under Mr. Trump are likely to help. Under Mr. Biden, clean energy push could help to some extent but tax rate raises will be a drag on profitability.

Real Estate

- Post pandemic recovery plan and its implications for residential real estate are key in determining the outlook. Worthnoting that the housing sector has been fairly strong over the recent months.

Utilities

- Profits shielded from a possible increase in tax rates proposed by Mr. Biden as companies are likely to pass on the increased rates to customers. Focus on climate change under Mr. Biden is likely to help capex for the sector.

Source: ADCB Asset Management

Exhibit 12: Global equity strategy summary

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Regions				
US			■	Higher quality, higher RoE/RoA
Canada		■		Stick with the benchmark
Europe ex UK	■			Heavy exposure to financials sector
UK		■		Stick with the benchmark
Japan		■		Prefer 'new economy' enablers
Asia Pacific ex Japan		■		Focus on new China vs. old China; neutral India
EM LatAm	■			Constrained by commodity-dependence, debt vulnerabilities, outflows and weak currencies
EM EMEA	■			
GCC		■		Stick with the benchmark
Global sectors				
Comm. Services			■	Prefer US exposure over rest of the world
Consumer Discr.		■		Prefer Internet & direct marketing retail
Consumer Staples		■		Prefer Household & personal products
Energy			■	Focus on capital discipline and makeover stories
Financials	■			Impeded by lower interest rates
Health Care		■		Prefer Biotechnology and Health care technology
Industrials		■		Prefer Commercial & Professional Services
IT			■	New economy enablers
Materials	■			Structural weakness on a shift to 'new economy'
Real Estate		■		Prefer US exposure over Europe
Utilities		■		Stick with the benchmark
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			Strained by leverage
Growth			■	Prefer non-cyclical growth
Value		■		Avoid value in sectors facing disruption
Dividend yield			■	Prefer quality dividends and dividend growth
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Benefits from 'new economy' orientation
Legend	*New* ■	*Old* □	*No change* ■	

Themes that we are watching

Lower returns over the long-term
Services vs. manufacturing
Deglobalising world
Rise of sustainable investing
New economy

Source: ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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