

Macro Monthly

Economic insights and asset class views

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For global professional / qualified / institutional clients and investors



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US election: Assessing the scenarios

Highlights

- Our view is that global equities will finish 2024 on a strong note, almost regardless of the US election outcome.
- A Trump win is consistent with US equity outperformance, while a Harris win could lead emerging market assets to outperform on reduced tariff risks.
- Some value is beginning to open up in duration, though a Republican sweep (Scenario 1 below) could drive yields even higher at least in the near term.
- Long USD positions against the CNY and EUR can help hedge tariff risks in a Trump win.

The US Presidential election remains a coin flip, but one thing we feel confident saying is that whoever becomes the next president will inherit a rather healthy US economy. Q3 GDP is tracking at a robust 3.4% according to the Atlanta Fed, while company earnings and guidance have been upbeat. Meanwhile, inflation continues to make progress and the Federal Reserve is still set to cut rates by 50 basis points by year end, in our view. This is a great recipe for risk assets, which we think will finish 2024 on a strong note almost regardless of election outcome.

Of course, it is worth considering how different presidential and congressional election results could impact cross-asset performance. This is not to bet on a particular outcome, but to manage risk into the election, as well as prepare for opportunities to capitalize on market overshoots.

We discuss how we think markets will perform in the four potential electoral outcomes, but caution that there is considerable uncertainty in these assessments, especially as they will depend on how investor positioning shifts ahead of election day.

Scenario 1: Red Sweep

We start with the Republican or Red Sweep which, of the most likely scenarios, would have the largest impact on markets. While neither candidate is running on fiscal austerity and both sweep scenarios would likely lead to a rise in the US budget deficit, a Red Sweep is the most fiscally expansive scenario, at least based on the candidates' economic plans. We would expect to see most of the Tax Cuts and Jobs Act (TCJA) extended, with some modifications. It is also possible that corporate tax will be cut to 15% at a cost of USD 600 billion over 10 years, which could be funded by rolling back energy tax provisions in the Inflation Reduction Act.

Tariff revenues may partially cover reduced tax revenues; however, it is difficult to predict what Trump's ultimate tariff policy would look like, especially amid legal questions about executive branch-driven, across-the-board tariffs and potential congressional pushback (even within the Republican Caucus). Moreover, revenue impacts from tariffs are not dependable ex-ante. Tariff revenue collection would be sensitive to import volumes which have already declined on items that have been tariffed the most. It is likely we would see

more import substitution in a second Trump administration. The deficit would widen under a Red Sweep, at a time when investors are becoming incrementally more focused on the trajectory of US debt.

In addition to tax cuts and tariffs, a Trump presidency would come with potential tailwinds of a lighter regulatory touch in sectors like financials and energy, although also macro headwinds associated with a possibly much stricter immigration policy. Both Trump and Harris will look to slow immigration (and indeed the Biden administration already is), but any move where net immigration goes into reverse could lead to lower potential growth and higher wage pressure.

The policy mix in a Red Sweep contains a lot of countervailing forces for risk assets. The primary upside comes from the combination of deregulation and tax cuts, which together could unleash animal spirits in the US. However, increased tariffs and the risk of sharply higher bond yields (from deficit expansion and potential inflationary consequences of tariffs) may complicate the outlook.

We suspect that for US equities, the above tailwinds are more powerful than the headwinds and in general US equities have tended to rise during periods where Red Sweep probabilities implied by betting markets have moved higher (Trump-Biden debate, the first assassination attempt on Trump, and in recent weeks). We suspect international equities would underperform in such a scenario, given increased trade uncertainty related to the imposition of tariffs.

A Red Sweep is most negative for duration given the expected deficit widening and policies that are generally inflationary, but an overshoot in yields following the election could provide an attractive entry point for fixed income. The USD would likely rise in a Red Sweep, due to the combined effects of higher US yields and increased tariff risk for US trade partners.

Scenario 2: Trump becomes President with divided government

A President Trump with a Democratic House would be constrained in delivering a full extension of the TCJA, and additional tax cuts would be highly unlikely. In this scenario, there would be little after-tax impact to company earnings, but actual deficit expansion would be lower as well.

On the positive side for risk assets and the economy, Trump would still be able to push forward much of his regulatory agenda. On the negative side, tariffs and a potentially draconian approach to immigration would represent negative supply shocks, weakening growth and put upward pressure on inflation. The impacts on the economy would depend on the severity of policies announced.

In a simplistic sense, we would argue that this scenario could usher in a lighter version of market performance than in the Red Sweep. While US equities would still be likely to outperform and the USD should strengthen, the magnitude would probably be smaller. The primary difference between a Republican Sweep and Trump with divided government is less fiscal expansion. As such, duration would likely face less downside pressure.

Scenario 3: Harris becomes president with divided government

Given a difficult Senate map for Democrats this election cycle, a Harris win would likely come alongside divided government. This would largely represent a 'status quo' for the economy and

markets. On fiscal policy, we expect bipartisan support to extend most of the TCJA, excluding high-income earners (USD 400,000 - USD 450,000). As a result, the net fiscal impulse would be close to neutral. Harris's proposals on a higher corporate tax rate and child tax credits would likely fail to garner the needed bipartisan support for passage.

While in a vacuum a Harris administration would mean little for markets, it does appear that markets have increasingly priced in a higher probability of a Trump victory and a Red Sweep in recent weeks. It is difficult to know how much recent increases in the USD, yields, financials and small caps have been driven by 'Trump anticipation' as opposed to positive economic and earnings data, but there does seem to be some 'Trump premia' occurring in the market.

Given this backdrop, we would expect a Harris win would lead to some unwind of this price action. We would also expect international equities, which remain much cheaper than those in the US, to experience a relief rally on sharply reduced tariff risk. The USD and yields would likely fall as well.

Scenario 4: Blue Sweep

A Blue Sweep is the least likely outcome given the Senate map and polls for key states that are outside the margin of error. Still, election surprises happen, and it is worth considering the risk of one. A Blue Sweep would likely result in a wider deficit than in a divided government, but a narrower deficit than in a Red Sweep. This is because increased spending plans would be partially offset by increased taxes on high-income households, capital gains and, most importantly for markets, corporations.

The risks around a Blue Sweep are therefore less about fiscal prudence, and more to do with policies that may be viewed as unfavorable to US equities. A weaker USD – driven by lower tariff risk – might provide some offset, but higher corporate taxes would weigh on company earnings. These factors would increase the likelihood of US equities underperforming the rest of the world. Yields may be jittery at first on the prospect of a wider deficit, yet assurances of higher taxes funding spending could present a buying opportunity for duration.


























Asset Allocation – Back to the big picture

With election noise building, it is easy to lose sight of the big picture, which remains a very healthy macro backdrop for risk assets. Historically, equities have tended to rally into year-end regardless of who wins the election as policy clarity comes into view. In all scenarios above except the unlikely Blue Sweep, we see US equities performing well for the rest of the year. And in that scenario, international equities are likely to outperform on relief from tariff risks. We are overweight equities via US and emerging markets on their healthy earnings profiles, while remaining underweight European stocks due to ongoing economic and earnings challenges.

The recent rise in yields has opened up some value for duration, but Red Sweep risks are high enough that it is sensible to wait before adding. In foreign exchange, we maintain preferences for the JPY on BoJ tightening and some high carry EM like BRL and ZAR. However, it is prudent to hedge broad EM exposures with USD upside against CNY and EUR given the likely rise in tariffs under a Trump administration.

Asset class views

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 22 October 2024. The colored circles provide our overall signal for global equities, rates, and credit. The rest of the ratings pertain to the relative attractiveness of certain regions within the asset classes of equities, bonds, credit and currencies. Because the Asset Class Views table does not include all asset classes, the net overall signal may be somewhat negative or positive.

	Underweight	Neutral	Overweight	
				
Global Equities				Constructive macro and earnings backdrop means more upside despite elevated valuations. Election will decide near term relative performance between the US and rest of the world.
US				Relatively strong earnings profile and less manufacturing sensitive than global equities.
Europe				Disappointing economic and earnings data. Ongoing challenges in manufacturing is a weight.
Japan				Ongoing corporate reform, solid earnings countered by renewed JPY strength.
Emerging Markets				Constructive earnings and China's policy pivot mean further upside over time. A Trump victory and tariffs present a near term risk.
Global Government Bonds				Valuations have improved, increasing the attractiveness of duration. However, a Red Sweep election result could lead to a sharp rise in yields on deficit concerns and higher tariffs.
US Treasuries				Inflation moderation offset strong growth and risks of larger fiscal deficits in a Republican sweep
Bunds				Persistently weak growth and slowing inflation suggest market could revise lower estimate of neutral rate.
Gilts				Expect wages and service sector inflation to slow; gilts are attractively valued.
JGBs				Wages & underlying inflation accelerating while market is pricing in too accommodative policy.
Swiss				Disinflation caused by FX while domestic conditions remain relatively resilient amid expensive valuations.
Global Credit				The risk-reward outlook for credit is not particularly attractive, especially in the US, where spreads are close to cycle tights. EUR and Asia HY still offer the best carry opportunities.
Investment Grade Credit				Spreads are around usual cycle tights, while corporate fundamentals remain relatively healthy. Returns will likely be driven by carry with little additional upside. Investor demand remains firm.
High Yield Credit				US HY spreads have dropped below 300bps on solid growth and falling funding costs, and we expect carry-driven returns. HY bonds in Europe and Asia offer more attractive valuations and risk-adjusted carry.
EMD Hard Currency				In the near term, US election risk may be a headwind to EM bonds. A stronger USD and / or higher US yields weigh on funding costs. Medium-term, many EM issuers still benefit from solid credit fundamentals.
FX				
USD				Overall neutral, though we are biased to be underweight USD vs. pro-cyclical currencies and JPY.
EUR				Neutral, though a potential increase in ECB dovishness amid weak data keeps us cautious on EUR.
JPY				Need for more hawkish repricing of BoJ amid very cheap valuation keeps us bullish JPY.
CHF				Increased dovishness from the SNB and an expensive valuation should weigh on CHF vs. JPY and EUR.
GBP				Data remains relatively resilient; however, we think UK rates are pricing a terminal rate that is too high.
EM FX				Overall bullish EM FX with overweight positions in BRL and ZAR.
Commodities				As the Middle East conflict is unlikely to affect oil supply for now, Brent stays in a USD 70-80 range. China stimulus will likely be less supportive for base metals than in the past.

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 22 October 2024. Views are 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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Americas

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