Elections, Equities and the Economy

Disruptive Forces in Investing **August 6, 2024**

Anu Rajakumar: As the 2024 US presidential election approaches, market participants are bracing themselves for what could be a bumpy few months ahead. Investors around the world are closely assessing the economic implications of what is sure to be a closely contested election and wondering about the potential impact on various sectors as well as investment portfolios. My name is Anu Rajakumar. Joining me today to discuss the potential market ramifications of this historic election is Tim Creedon, Director of Equity Research, and Raheel Siddiqui, Senior Investment Strategist. Tim, Raheel, thank you for being here today.

Tim Creedon: It's great to be here.

Raheel Siddiqui: Thank you for having us.

Anu: Okay, so we are in early August right now, time of recording. What are some of the key milestones ahead that you are particularly interested in seeing how things unfold as we get close to the election?

Tim: Yeah, so I think it's, less than 100 days to go into the election, but that's an eternity in politics. And so I think the big issue, over the next month is going to be how Kamala Harris gets defined, from both sides, from the democratic side and the more negative painting that's going to come from the other side. that's going to shape a lot, I think her election odds, and I think that'll be something that we're going to all be watching to see kind of, you know, does the overall polling at the national level and most importantly at the swing state level. Because the reality is this election is most likely to come down to six states and you know, there's a few counties in those states. So I think that's the big thing we'll be watching, you know, less national polling, but kind of where is it shaking out in those kinds of key swing states.

Anu: Yeah, I imagine her vice president pick will also be probably, you know, very much highlighted at the DNC is probably unveiled at that time as well and can have a big impact on some of the swing states. I'm sure.

Tim: It could, although, you know, I don't know. I read a lot of things about how VPs don't seem to matter even though the media likes to make a ton out of it. But I think that is right. Like, I think it gets a short news cycle as we go into conventions, but coming out of it, people are voting on top of a ticket and we'll see kind of, again, how they are defined will matter a lot. because I think I read some interesting stat that most people-- a lot of the people who were all focused on these swing voters, they don't really start paying attention till after Labor Day. So we're all focusing on this like crazy, hearing in early August, but, you know, those critical voters aren't going to pay attention till we get a little bit closer to the actual election.

Raheel: I mean, on the market side, I'd be paying attention to the options market to quantify the buildup in election-related uncertainty. I think that's where you see the expression of election outcome uncertainty most clearly visible.

Anu: Absolutely. Now, you both recently wrote and published a paper titled U.S. Election: Near-Term Turbulence, Long-Term Questions where you cover a ton of ground from market volatility in the lead-up to the election to policy differences, and of course, market impact. So, Tim, maybe starting with you, give us a quick summary of the paper and a few of the key observations.

Tim: Sure. So the main point in the paper was really to help, you know, frame some of the key election issues and what to expect in markets as we get closer to election day. And we think, you know, these points are all still relevant today, even after the crazy events of the last few weeks. If I were to summarize it, you know, I'd highlight a couple of main observations. first I know this election is likely to be a very close one. That's important because close elections almost always historically have been slightly, higher volatility in the final months heading into the election day. That's due to the broader uncertainty around what the election outcome might be.

And, you know, we've seen some recent events that may, indicate that that view is still going to be the case today. While we've had some, move in, the polls after the Trump assassination attempt and the debate, those have now kind of settled back and we're still back to kind of a-a 50/50 race. So we do think we're going to see some near-term market turbulence, and I think Raheel's going to talk a little bit more about that based on kind of some of the history we've seen around close elections.

The second, you know, main point we wanted to bring up, from the paper was just, you know, we are also expecting to see some increasing movement in stocks that are leveraged to policies that are coming out of both candidates. And that's leveraged to the very different views that they have on a number of key areas, whether it's climate, taxes, regulation, immigration, or foreign policy. These policies can have a significant impact on sectors and companies. And frankly, we've seen that already in recent weeks with some of the big moves in stocks that are considered part of the Trump trade or the Trump basket. That includes things like, you know, private prisons or broader areas like drillers and regional banks.

We've seen those trades move up with the Trump odds going up, but then they've come back down more recently as, Vice President Harris odds have increased. So we expect we'll continue to see that type of movement in the sectors and stocks that are most affected by policy in the coming weeks, and it's something that, we highlight in the paper. That said, we do caution here that, you know, there is a big difference between, what is campaigned on and what actually gets implemented. And it's important to remember that some of these potential policy impacts may be constrained by the makeup of Congress.

That depends on whether it's a unified Congress or a split Congress, and even by what magnitude, it goes in either direction. So that was the second main point of the paper. And then the third one is, you know, a bigger picture point that, you know, while these points on volatility and trades that are related to the election, they are relevant and you need to be aware of them, it's important to remember that, you know, these are often shorter-term trades and they're often overwhelmed by the broader economic cycle.

Look no further than the recent election to see what happened with energy stocks outperforming under President Biden due to the rising prices of oil, coming out of the Ukraine, or renewable stocks outperforming during President Trump. And that was due to really the drop in interest rates. Neither of those calls would've been predicted ahead of those elections. And frankly, we see that in markets more recently for all the talk about, you know, election trades over the last couple of weeks, arguably the bigger move in markets has been driven by the business cycle versus the election cycle.

It really is all about what happens with economic growth, interest rates, inflation, et cetera. And we saw that in recent weeks when we saw the weaker CPI print and fall on interest rate, or talk about, decline in interest rates. That's what drove a much broader market rotation, and that's what really matters to keep in mind, in terms of like longer-term fundamentals being the key drivers of markets over time.

Anu: I'm sure, you know, as I think about this from a Multi-Asset perspective, you know, in our recent Asset Allocation Committee publication, we saw committee members, which include the two of you. you know in aggregate, sort of stay a little bit closer to target allocations across most asset classes. Right. Even though there are a number of reasons that the economy's been resilient and there's liquidity and inflation's moderating in general, there's just, there's so much uncertainty over the next few months that taking big swings in specific sub-asset classes just didn't really feel appropriate. And so it seems like that's what a lot of investors are doing right now is staying a little bit closer to home to their target allocations, and again, kind of waiting to see what happens next.

Let's talk about the first point that you made. It was really about how close elections tend to increase market volatility, followed by a relief rally once the outcome is made clear. So, Raheel, why don't you talk a little bit more about this point, this election induced market volatility?

Raheel: Thanks, Anu. when thinking about the election cycle and the stock market, we think it's most helpful to divide the election into close and tight elections. Historically, stock market behavior in tight elections such as the current election and the last six elections is quite different from that scene during predictable elections. So in close elections, we have a very interesting pattern. The market rallies robustly in the first half of the year as it did this year. It becomes range-bound starting mid-July, so about now. The market sells off close to the election and then rallies hard post-election.

I should mention here that the market rallies regardless of whether the winner is a Republican or a Democrat or belongs to the incumbent party or the challenger party. So in essence, it's a catch-up to the fundamental trend prevailing in the first half of the year rather than a vote on who is better for the economy. So it is a classic buildup and release of uncertainty premium in the run-up to the election and beyond. So in close elections, like the one we are in right now, it is typical for the lead to narrow and widen often and even reverse over short periods.

When that happens, the widening of polls accompanies stock market rallies and tightening of polls results in selloffs. And I must say this pattern is not peculiar to the US election alone. We have seen similar market behavior around other close political decisions such as the Brexit poll and the Italian referendum of 2016. So I spoke about the uncertainty around this election, but uncertainty matters beyond the election as well into the next four years of the presidential cycle. Our analysis, and we've talked about it in the paper, suggests that the if the incumbent party wins the election, the stock market returns over the first two years of the presidential cycle are higher than average, which reflects investor comfort with the policy continuity. And the year three and four returns tend to be lower than average.

If, on the other hand, the challenger party wins, the returns of the first two years tend to be lower, reflecting higher policy uncertainty, and the returns in Year 3 and 4 are higher as policy direction becomes more clear.

Anu: Okay. So it kind of switches depending on incumbent versus challenger?

Raheel: Yes.

Anu: Great, thank you, Raheel, that's super, super interesting. Tim, turning back to you, you know, there are obviously significant policy differences between the two candidates. How do you think about different sectors, how do you think they'll be impacted from an investment perspective and what can investors do to prepare?

Tim: Sure. So, you know, I think the first thing you can do to prepare is start by becoming familiar with the different, likely policy. So in terms of thinking through what might have the biggest impact, I'd start with the area where some of the biggest differences on regulation, for example, between the two parties there's a big difference that has implications for key sectors, whether it's financials, energy, healthcare, et cetera. On regulation, I think we would expect the Trump administration to be much more deregulatory in terms of their approach.

And that would have obviously important implications, whether it be for banks, like regional banks, energy, LNG, autos, healthcare, insurance companies, just to name a few. so key differences coming from the regulatory side. The other big one out there that I think is an obvious one is energy. the two sides have very different approaches in terms of how they think about energy with, the Harris administration, thinking very much about, green energy, renewables, the IRA, whereas on the other side, that Trump has talked about actually, you know, defunding a lot of those programs to kind of put more capital into traditional energy, whether that's, oil, natural gas, et cetera.

So a lot of that, again, will depend on legislation which needs Congress. So, you know, it's a little bit more unclear at this point, but could have a very material impact. And then the third big one out there is the policy around tariffs and trade, which obviously, um, is a big topic that, both sides seem very tough on China, which I think is going to continue. But, you know, the Trump policies on tariffs are pretty aggressive. And if those were to go through, we could see a material impact on supply chains, whether that's for the consumer sector or the industrial sector. and, you know, getting ahead of that right now in terms of being aware of exposures, I think, is really important. So those are, I'd say, probably the big areas to monitor as we think about kind of where the most exposure could be.

Anu: You know, you spoke about, tariffs, and some, you know, some of the key issues here. You know, there is concern that imposing tariffs on imported goods, could be inflationary in some ways, which could pose some challenges for the Fed, given where things are going. What's your take on that about some of these policies potentially being more inflationary for one candidate over the other?

Tim: Yeah. Well, I think if we do go through with the, aggressive Trump proposals on tariffs, that will be more inflationary, and that's part of the cause or case to be made that, you know, if we see particularly a red sweep, we could see a much more inflationary environment that could lead to more pressure on keeping interest rates higher for longer, et cetera. So, that's, I think, definitely a factor to consider. And I'd say definitely favors more Republican sweep side because we're not seeing as aggressive proposals like that from the Democratic side.

Anu: Yeah. What about, macroeconomic events, you know, fed cuts or CPI releases, do you think that that will have much impact on how voters vote?

Tim: I mean, I think it could, again, the two big drivers, unemployment and inflation, I think for voters, how they feel about the economy and that's also what the Fed is looking at. So how that plays out in next few months could be important. And then we also have to keep in mind the big-- you know, we typically do see an October surprise and-- you know, often that's a geopolitical one, so we'll see. those are impossible to predict, but that's, I think, another thing that could sway elections as we get, you know, much closer to the actual election day.

Raheel: I think the bigger the improvement in economy is between now and election and the less the market reacts to it, the more release, you know, of this uncertainty, and therefore a bigger rally in the market is possible, you know, on the other side. Just for context, you know, last election, typical rallies from the election date to year end, about 5%. Last election in 2020 it was 15%.

Anu: Wow.

Raheel: Because there was an economic, rebound shaping up, but the market was not reacting to it. If anything, it's sold into the election. So that's why I think it's important to keep track of the economic developments, the improvement in the economy because that will be a guide to how much pent-up, stress is released post-election.

Anu: You know, Raheel in the paper, you speak about the importance of the economic fundamentals, growth, earnings, inflation in driving market performance, but as I mentioned before, investors are so focused on the election. How should they kind of reframe the situation to take a step back, think about the big picture, and how these potential policy shifts could interact with fundamentals over the long term?

Raheel: Oh, thank you for asking that. Much of our discussion today has been around the election and its impact on the stock market. So it is important to contextualize, the importance of election and add that it's critically important to remind ourselves that election uncertainty can change the timing of returns, but it doesn't supplant the primary drivers of the stock market, which are economic fundamentals and earnings growth. And investors should remain focused on the latest developments in the economy, which in our book, have been net positive. Our equity market outlook goes into a fair bit of detail, but let me just list, you know, some of the things that we are seeing.

Disinflationary trends are global, and as a consequence, 44% of central banks now have an easing bias, which is quite stimulative to the interest rate sensitive economy. We are also seeing early signs of revival in real disposable personal income and consumer credit growth, which should begin to offset some of the current concerns about the health of the US consumer. Then the recovery and global industrial activity, non-AI related CapEx, and inventory cycle are also positives. In other words, the traditional economy has begun to gather steam.

Anu: Okay. All right. So Raheel, what have those trends meant in terms of market performance?

Raheel: This has broadened the market leadership from narrow growth stocks to a broader subset that includes more traditional value stocks such as financials and smaller cap stocks. What's particularly encouraging is that the broadening of leadership is also seen at the earnings level. Earnings breadth has begun, to rise, for example, at the start of the year, only one sector had net positive earnings revisions. Today, we have nine. The key risk remains elevated positioning in mega-cap growth stocks and allocation to equities relative to cash is also quite elevated. This is not a good timing tool, but a risk nonetheless, if and when elevated positioning begins to unwind.

Anu: Great. Thank you, Raheel. Tim, any final thoughts that you want to share before we wrap up here?

Tim: Yes, so one other point we make in the paper, which I think is an interesting one, is that, you know, there's a lot of points made about how different the two candidates are and so many different things, but one of the things that, you know, interestingly, where they're very similar is the fact that both of them are basically saying they're not going to touch entitlements, which is pretty interesting, because that's really the big elephant in the room if you think about it. The fact that neither party's willing to talk about entitlements at a time when we're running pretty significant budget deficits late in the cycle is pretty unusual and frankly surprising.

So we have a chart in the piece that looks at overall government debt as a percentage of GDP. We're at record levels right now, and with no one doing anything about it or seemingly intending to do anything about it, it may be left up to the bond market to eventually force the political parties to address this and timing when that happens, obviously, is very difficult. It's the million-dollar question or billion-dollar question, but it's possible we may see a test of that next year when these Trump tax cuts expire and either administration has to come with their own, budget proposals. If we see that happen where, you know, that bond market essentially forces, politicians to reassess that, that would have a big impact on equity markets given equity markets are priced off that risk-free asset. So that's something we know in the paper, it's one of those bigger longer-term questions that's out there, but I think a really important one to think through as we kind of hit closer into the election.

Anu: Yeah, I think that's the big elephant in the room that again, like you said, no one is really talking about, at this time. gentlemen, thank you so much for being here today before you go, I have a quick bonus question for you. I'm going to shy away from asking you who you think is going to win the election and go in a different direction, [chuckles] so hopefully there's a sigh of relief there. you know, we're recording this episode, at the beginning of the 2024 Paris Olympics, which were in full swing. So I'd just love to know what Olympic sport is your favorite and why?

Tim: Gymnastics, uh, 'cause my daughters love it and, we're watching it pretty closely last night.

Raheel: Men's field hockey.

Anu: Terrific. I was a field hockey player for a number of years, and I also loved the field hockey, too, but the men's gymnastics was really exciting to watch.

Tim: Yeah, those guys are pumped up, it was amazing.

[laughter]

Anu: I'm suddenly a big hobble horse fan that I never thought I was before, so, great. Well, thank you very much for sharing and as I said, thanks for being here to delve into how these political shifts might influence, equity markets. Obviously, no one has a crystal ball and knows what will happen, but I think both the paper that you've written, really helps to provide a comprehensive view of the potential market implications of this US presidential election and as you spoke about today, you know, stressing both the potential for, you know, election-induced market volatility in the runup, but Raheel, as you talked about, the long-term importance of economic fundamentals and some of the fiscal, constraints that folks may need to think about, I think all of that has been helpful to lay out.

For those of you who are interested in this topic, I encourage you to go to, nb.com/elections, where you can find, Tim and Raheel's paper, as well as all of Neuberger Berman's latest thinkings on all things related to the election. And so once again, thank you so much for this conversation and I look forward to having you back on the show once we figure out who our next president is.

Tim: Looking forward to it.

Raheel: Thank you.

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