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The impact of the US elections on asset classes - Update

Election outcome to catalyse asset prices

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FLASH NOTE

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SUMMARY

- Despite Joe Biden's decision not to seek re-election and his likely replacement by Kamala Harris as the Democrats' candidate, our base scenario remains a clean sweep by the Republicans in the presidential and congressional elections in November. However, a younger, invigorated ticket that enthuses and mobilises the Democratic base marginally dents the prospect of a Republican clean sweep. A Trump win with a divided government, our next most likely scenario, is now looking slightly more feasible. We expect Trump's policies on taxes, trade and immigration to be more inflationary than those of a Democratic administration. The fiscal deficit is likely to rise the most under a Republican sweep as Trump has proposed tax cuts that would not be fully offset by the revenue generated by his proposed trade tariffs.
- **Fixed income:** In case of a Trump victory, higher inflation would likely constrain Fed rate cuts, and a higher deficit (among other factors) could also push the term premium higher. Hence, we expect the 10-year Treasury yield to rise to 4.9% if the Republicans win control of the presidency and Congress, and to 4.6% in case of a divided Congress. A Democrat win in the presidential election would be the most favourable outcome for US Treasuries in our view, as further disinflation could enable the Fed to cut rates more aggressively than markets currently price. In this case, we would foresee the 10-year US Treasury yield falling below 4% in 2025, likely to a level around 3.7-3.8%.
- **FX:** The rise in trade tariffs (if they are not reciprocated), higher inflation and thus higher interest rates will likely drive the dollar higher against the euro (to USD 1.05 by end-2024) in case of a Trump victory. A Democratic victory could instead see valuation concerns return to the fore and lead to gradual USD depreciation.
- **Equities:** While political news flow can create short-term volatility in equity markets, longer-term performance will reflect the extent to which political decisions impact economic growth, interest rates and profit trends. We do not

believe any of our four main scenarios for the November elections explicitly represents an outright 'good' or 'bad' outcome for stocks given that each contains a mixture of implications. While we believe a Republican victory is likely to lead to a bigger 'knee-jerk' equity rally initially, this does not imply that a Democratic presidential win would represent a negative for US stocks.

Table 1: Potential outcomes of US elections and their impact on macro variables and asset classes

	Republican sweep	Republican divided Congress	Democrat divided Congress	Democratic sweep
Inflation	↑↑	↑↑	=	↑
Fiscal deficit*	↑↑↑	↑↑	↑↑	↑
Trade tariffs *(likelihood)*	↑↑↑	↑↑↑	=	=
US equity	↑	=	=	↓
World ex-US equity	= / ↓	↓	=	=
Long-term policy rate in % *(end-2026)*	4.00	3.75	3.00	3.00
2-year US Treasury in % *(end-2025)*	4.50	4.30	3.80	3.80
10-year US Treasury in % *(end-2025)*	4.90	4.60	3.80	3.70
EURUSD *(end-2024)*	1.05	1.06	1.07	1.08
EURUSD *(end-2025)*	1.02	1.04	1.08	1.10

Source: Pictet Wealth Management, as of 22.07.2024

FIXED INCOME: RISK OF HIGHER US TREASURY YIELDS SHOULD TRUMP WIN

Our forecasts for the 10-year US Treasury yield are shaped by a model presented in a 2018 paper by D'Amico, Kim and Wei[1] (DKW, *see chart 1*). This assumes that the **10-year Treasury yield is the average short-term nominal rate expected over the next 10 years plus the nominal term premium** (the additional yield investors require to hold longer-term debt over shorter-dated debt). Although the 10-year term premium on US Treasuries remains close to zero (0.13% on June 28) and is much lower than in the past, we have identified four main factors that could push this premium up towards 0.7%-0.9% in the coming years, whatever the election result. These are:

1. **Greater dependence on price-sensitive buyers**, as less price-sensitive buyers such as the Fed and emerging-market central banks reduce their Treasury holdings.
2. **A more uncertain and volatile** macroeconomic and market environment.
3. The return of a **positive correlation between returns from bonds and equities**. In a world where US Treasuries no longer protect against risk-off market movements there is less diversification benefit to owning them in portfolios.
4. **A lower scarcity premium**, as a rising deficit results in higher net Treasury issuance.

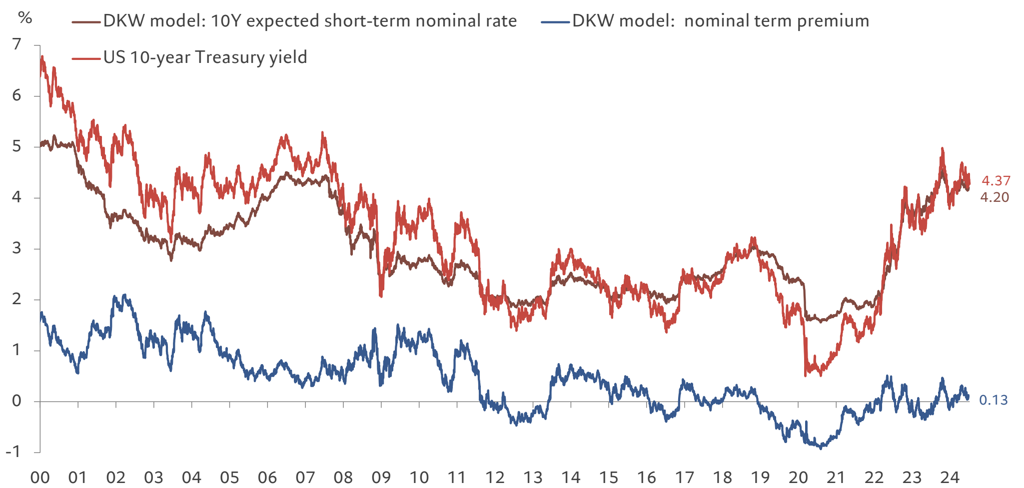
[1] Kim, Don, Cait Walsh, and Min Wei (2019). "Tips from TIPS: Update and Discussions," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, May 21, 2019, https://doi.org/10.17016/2380-7172.2355.

Whether we see new tariffs that push inflation higher after the election will help determine the trajectory of policy rates (i.e. short-term nominal rates) in the years ahead. **Inflationary pressures are likely to be the strongest in the case of a Republican sweep of the presidential and congressional elections. This is because** more trade tariffs and fiscal stimulus could potentially stop the Fed from cutting rates below 4.0%, largely in line with current market pricing. The policy rate is expected to average 3.9% over the next 10 years, according to the US dollar overnight index swap (OIS, on 19 July). Nevertheless, **the 10-year US Treasury yield could potentially rise from 4.24% (on 19 July) towards 4.9% by end-2025 because of the many factors pointing to a structural rise in the 10-year term premium.** A Republican sweep is also the scenario in which we would see the **US yield curve steepening the most**, with the slope between the 10-year and two-year parts of the yield curve climbing to 40 bps by end-2025 from its current level of -27 bps (on 23 July). More limited rate cuts from the Fed would mean the two-year yield remains close to its current level (4.5% on 19 July).

In the case of Trump winning but with a divided Congress, the negative impact of higher tariffs on economic growth would not be fully offset by more fiscal stimulus. In this case, **the 10-year yield might only rise towards 4.6% as the Fed could cut the fed funds rate to 3.75%.** This would likely drive the two-year yield down to 4.30%, also resulting in a steeper and upwardly sloping yield curve.

A Democrat win in the presidential election **would be the most favourable outcome for US Treasuries in our view, as further disinflation could enable the Fed to cut rates more aggressively than current market pricing**. In this scenario, we could see the Fed cutting the Fed funds rate to 3.0%, which is about 75 bps lower than current market pricing (according to the USD OIS curve on 19 July). In this case, **we would foresee the 10-year US Treasury yield falling below 4% by end-2025, likely to a level of around 3.7-3.8%.** In such a scenario, we could also see the two-year yield falling below 4%, potentially towards 3.8%. **This would result in a flatter yield curve.**

Chart 1: US 10-year Treasury yield breakdown between expected short-term rate and term premium



Source: Pictet Wealth Management, FactSet, https://doi.org/10.17016/2380-7172.2355, 28.06.2024
DKW model based on a paper from D'Amico, Kim and Wei (DKW), 2018

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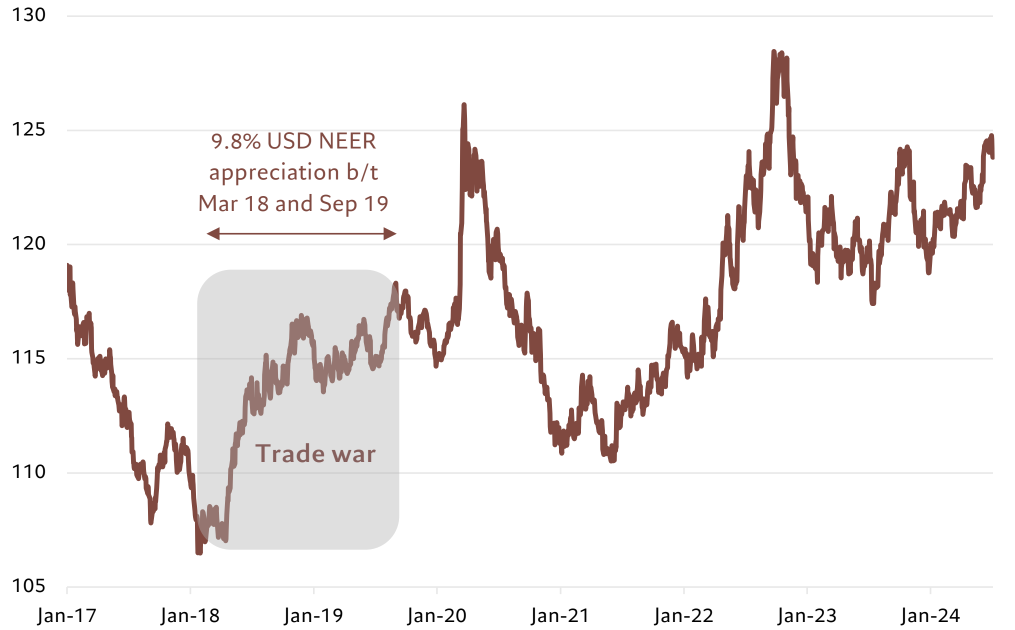
US DOLLAR: LIKELY TO STRENGTHEN FURTHER

Under our base case of a Trump victory and a Republican Congress, the US dollar will likely strengthen significantly, mostly due to the imposition of wide-ranging tariffs, even if the net effect will depend on any retaliatory measures adopted by the US's trading partners. Protectionist measures will also likely have an inflationary effect, which would lead, all else being equal, to higher policy rates and an upward shift in the US Treasury yield curve. Even if price and rate shocks weigh on domestic demand in the short term, US growth is likely to continue to outperform that of its peers.

Equity markets are expected to continue to perform well, bolstering positive sentiment towards the US dollar. Finally, the prospect of sustained re-shoring, increased capital expenditure and a US manufacturing revival could provide additional fundamental support for the USD in the medium term. **We expect the EUR/USD rate to reach 1.05 at end-2024 and 1.02 at end-2025 in this case. In the case of a divided government, USD appreciation would be less pronounced** given the constraints on policies dependent on legislative approval, but the effect would still be positive.

In case of a Democratic victory, we do not expect an increase in protectionist measures, thus eliminating an important factor for US dollar appreciation. However, this also means that a possible extension of Trump's 2017 tax cuts would lack a (partial) source of funding and the fiscal impulse would be expansionary as a result, even if insufficient to add to inflationary pressures. But these issues would only come to bear in 2026. The Fed would likely ease rates as we currently project, i.e. four more 25 bps cuts in 2025, after two rate cuts this year**. Eventually, lower interest rate levels could bring valuation concerns back to the fore and exert downward pressure on the dollar.**

Chart 2: USD nominal effective exchange rate index



Source: Pictet Wealth Management, Bloomberg Finance L.P. as of 12.07.2024

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US EQUITIES: UNLIKELY TO BE DERAILED BY ELECTION OUTCOME

While political news flow can create short-term volatility in equity markets, longer-term performance will reflect the extent to which political decisions impact subsequent economic growth, interest rates and profit trends. We do not believe any of our four scenarios explicitly represents an outright 'good' or 'bad' outcome for stocks given each contains a mix of implications.

For example, while we expect markets will react most positively to a Republican 'clean sweep' (at least initially) on hopes that further tax cuts and de-regulation foster stronger profits, the prospect of higher trade tariffs means this is likely to come at the expense of stickier inflation, fewer rate cuts and higher US Treasury yields. This trade-off suggests that a repeat of the low-quality, pro-cyclical rotation in stocks we saw after Trump's 2016 victory is unlikely to be sustained. **Nor would such an outcome be a major threat to US tech's market leadership.**

While we believe a Republican victory is likely to lead to a bigger 'knee-jerk' equity rally initially, this does not imply that a Democratic win in November represents a negative for US stocks, especially if Congress remains divided, as now. **A Republican victory should favour US stocks over their global peers given the prospect of additional tariffs and a stronger US dollar.** We see less US election risk for Japanese stocks than for either Europe (more sensitive to trade restrictions) or emerging markets (negatively exposed to a stronger US dollar).

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