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Flash commentary

UBS Asset Management I Still waiting on a US election winner – immediate takeaways for markets

Highlights from our Investment Solutions team

- The winner of the presidential election is unknown. Tight races in Sun Belt and Midwestern states will determine the result, and a Biden win looks most likely.
- The odds of a Blue Wave are thoroughly diminished after Democrats underperformed in Senate contests. This likely reduces the size of potential fiscal stimulus, but also means taxes are unlikely to rise in the near term.
- We discuss the three most likely potential scenarios from here on out: a President Biden with a Republican Senate, status quo, and/or a contested election.
- No matter the eventual victor, or when the result is finalized, we believe the broad outlook remains generally supportive for risk assets into 2021.

Investors craving a conclusive US election outcome will have to wait longer, and the odds of a drawn-out, contested election have increased materially.

There is much left to be decided – chiefly, which presidential candidate can win a majority. The Blue Wave outcome that investors had been pricing in ahead of the event does not appear likely to materialize. Democrats failed to make sufficient breakthroughs in key Senate races. The slump in the 10-year Treasury yield, which fell as much as 17 basis points from its session peak before retracing some of that move, shows investors downgraded their expectations on the growth and inflation outlook now that the substantial and potentially ongoing fiscal stimulus that would have accompanied a Blue Wave is very unlikely to come to pass.

Markets were tumultuous overnight as investors wrestled with the diminishing odds of a Blue Wave, outperformance by President Trump in some swing states, and the realization that a conclusive outcome would not be forthcoming.

Beyond the states solidly in his favor, Biden will need to secure 32 more electoral votes through Pennsylvania (20), Georgia (16), Michigan (16), North Carolina (15), Wisconsin (10) and Nevada (6) to emerge victorious. Both candidates have a path to victory, but Biden's is clearer. He would have to only maintain his slim leads in Nevada and Wisconsin while flipping one of Michigan or Georgia to win. Many of the votes yet to be counted are mail-in ballots, which have been breaking decisively in the Biden's favor and challenging President Trump's re-election prospects. Bottom line: this is a very close election. This deluge of mail-in votes may also delay the announcement of a winner, and likely be subject to legal challenges, as well. The event has passed, but the event risk has not.

Scenario 1: Biden still most likely victor but with a divided Congress

Based on what we know now, Biden appears to have an advantage. However, if he eventually emerges victorious, the incoming president would likely assume office with a divided Congress. This scenario is likely to result in the lowest amount of fiscal support going forward, with a Republican Senate serving as a check on Democrats' spending ambitions and rediscovering a commitment towards fiscal hawkishness. The downside risk associated with this election outcome is that there is no additional fiscal support in the offing.

Given the better-than-expected labor market recovery to date and stock of excess savings, even a meager stimulus could be sufficient to diminish downside risks and keep the US expansion firmly intact.

From a market perspective, this outcome does offer positives. The strong rally in Nasdaq futures triggered circuit breakers in the overnight session, indicative of pricing out the tax and regulatory risks that may have arisen under a unified Democratic government. A more subdued outlook for activity generally benefits secular growth stocks.

At the same time, a President Biden would be likely to engage in a more predictable foreign and trade policy, which may diminish much, but not all, of the protectionism discount embedded in foreign assets. As such, we also view the rise in the US dollar to be inconsistent with the implications of a Biden presidency. We would expect the US dollar to weaken, particularly vs. emerging market currencies, should clarity towards his eventual victory emerge.

Scenario 2: More of the same

Should Trump win re-election, we would expect a repeat of some of the trends that marked his 2016 surprise win: the outperformance of US equities, and a stronger dollar. US equities would be expected to do better than their international counterparts due to their elevated weighting toward high-growth companies, which tend to outperform in sluggish growth environments and worsening COVID-19 outcomes. In addition, global assets would have to price in a higher degree of trade risk in Trump's second term. The President's limited room to make headway on legislative priorities implies that he might pursue an even more activist trade policy, as he enjoys a high degree of autonomy in this area.

A key benefit of a Trump victory is that it opens up the possibility that a fiscal package is passed expediently before year end, which would help cushion the economy though any seasonal acceleration in COVID-19 case counts.

Scenario 3: Lingering uncertainty

Investors must also steel themselves for the possibility that state recounts and judicial challenges mean the outcome of the presidential election is uncertain past the end of this week. Protracted uncertainty could undermine the economic outlook at a time when COVID-19 cases are picking up across the developed world, and scuttle the limited prospects for fiscal support during the transition period. We would expect equities to perform poorly in this environment. Other haven currencies could be poised to gain relative to the US dollar, with riskier emerging market currencies coming under pressure. Persistent election uncertainty may create market dislocations that can serve as attractive investment opportunities.

That's because even as the continued trickle of election results continue to make headlines, the big picture remains broadly supportive for financial assets. The global economy is bouncing back from a severe shock faster than analysts expected, with global manufacturing enjoying a robust, broad-based rebound. More fiscal stimulus to augment the expansion is likely coming, regardless of the election outcome. And while COVID-19 remains a key risk into the winter months for most advanced economies, we expect emergency approval of an effective vaccine by year-end.

In summary

These election-related risks will eventually subside. Amidst the political uncertainty, there is little question that a President will be inaugurated on January 20, 2021. When these political risks eventually ease, investors will be left looking ahead to 2021 – a year slated to be defined by repairing the damage wrought by COVID-19 through meaningful progress towards economic normalization.

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