SPECIAL REPORT | Friday 30 October 2020

focus

The **Red Pill** or the **Blue Pill?**

The markets' attention next week will squarely be on the US election. Will Democrat Joe Biden oust Republican incumbent Donald Trump from the Presidency? Will the result be clear on the day, or will we have to wait days or even weeks to know for sure? Will we see a "Blue Wave" with Democrats sweeping the Presidency, Senate and House of Representatives, or will Congress remain split?

FORSYTH BARR

…Betting odds suggest the most likely outcome is a "Blue Wave"…

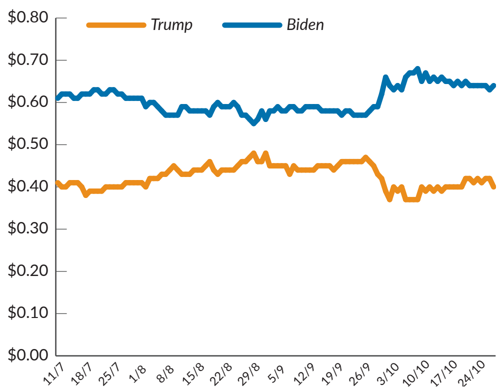
While in typical American fashion elections are accompanied by a lot of hype, the impact for investors tends to be overstated. Most big picture drivers of markets won't be affected by the result. The government will continue to support the economy with huge fiscal spend. The central bank will keep interest rates near zero and continue massive "quantitative easing" (literally digitally printing money). And tensions between the world's largest powers the United States and China will likely continue. History highlights the governing party has little impact on investment returns – dating back to 1860 the performance of a balanced portfolio has been nearly exactly the same under Republican and Democrat Presidents.

More than just the Presidency up for grabs

Despite receiving the lions share of the limelight, the President is only part of the election equation. US voters will also choose representatives in the two houses of Congress. The ability of a President to implement policies depends on which parties control the Senate and the House of Representatives.

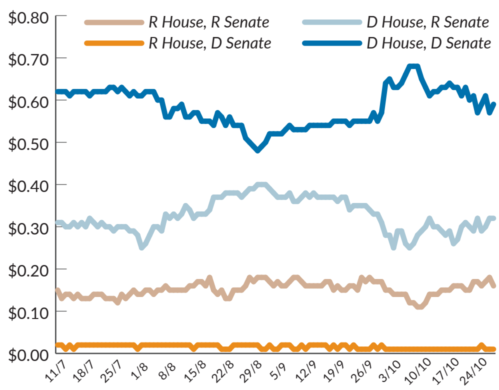
Betting odds suggest the most likely outcome is a "Blue Wave" where Biden wins the Presidency, and the Democrats control the House and Senate. A Blue Wave would provide Biden the best opportunity to implement his policies. If Trump remains President current polls predict a very low chance of a Red Wave, making pushing through policy more challenging.

'BETTING ODDS' PRESIDENTIAL WINNER



Source: PredictIt, Forsyth Barr Analysis

'BETTING ODDS' PARTY IN CONTROL OF SENATE AND HOUSE OF REPRESENTATIVES



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To secure the Presidency, swing states, not total votes, are key. For those who remember, in 2016, Hillary Clinton won the popular vote, receiving 3 million more public votes than Trump, but not the Presidency.

The President is elected by the Electoral College (consisting of 538 electors). The electoral votes for each state is the sum of the state's membership in the Senate (two for every state) and House of Representatives (based on population). As such, the electoral vote is not completely tied to population. Furthermore, all states except two (Maine and Nebraska) allocate the Presidential electoral vote on a winner-take-all basis, i.e. whichever candidate wins the popular vote receives 100% of that state's electoral votes. Candidates focus on winning the key swing states in order to secure Electoral College votes rather than increasing popular votes in states they are already likely to win. Key swing states this election are expected to be Florida, Michigan, Pennsylvania, Ohio, and Georgia.

We might not know on the day

While many will eagerly await the results, don't hold your breath. With COVID-19 concerns, absentee voting (voting via mail) is expected to be much higher than usual – potentially delaying the final result by a week. Absentee votes tend to be Democratic leaning – we may see Trump leading on the day, only to be defeated after counting the absentee votes. If the race is tight, there is also a risk of a contested election, where a determined campaign could challenge the result into January next year.

Policies to watch

Although we don't expect the election results to have substantial implications for markets as a whole, there are some potential issues and risks which do warrant investors' attention.

The most polarising policy debate has been on taxes. Joe Biden is proposing to increase a number of taxes, including corporate taxes, from 21% to 28%. Even under a Blue Wave there is no guarantee if and when the full tax policy will be implemented. Clearly, taxes will reduce corporate earnings, however, this should not be looked at in isolation. Biden's proposed fiscal stimulus package and infrastructure expenditure is larger than Trump's and will provide an offsetting boost for economic growth. Companies with an exposure to green initiatives, transportation infrastructure, and 5G mobile are expected to benefit from Biden's proposed spending.

Biden is also proposing to lift the capital gains rate for taxpayers with income over US$1 million. History suggests hikes in capital gains taxes can spark short-term selling of equities. Evidence from 2013 shows wealthy investors sold equities ahead of capital gains tax increases, only to repurchase afterwards.

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Big Tech and healthcare have been front and centre in elections of recent past, and this election is no different. Irrespective of who wins the election it is likely that Big Tech will face increased regulatory scrutiny, albeit probably with added weight under the Democrats.

With US healthcare costs the highest in the world (and increasing) a change in Presidency could lead to healthcare reform. Whilst the complexity of the US healthcare system doesn't make it easy, some expansion of public healthcare coverage would be likely under Biden, and both candidates support drug price reform. This leaves pharmaceutical companies exposed.

Despite disagreeing on a number of fronts, taking a harder stance on China is actually an area where Trump and Biden find some common ground. Biden's approach towards China is unlikely to be materially different to Trump's, but it is expected he will better strengthen alliances with traditional allies.

Elections typically provide a lot of talking points for investors, but when they're done and dusted, generally not a lot actually changes. We may see some market volatility, particularly if the result isn't clear on the day, which may evoke some short-term nervousness (and potentially provide opportunity). But for long-term investors an election shouldn't be a source of trepidation (at least regarding the performance of their portfolios).

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Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

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