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OBSERVATIONS ON MARKET REACTIONS TO US ELECTION OUTCOMES

A Clinton victory is the most likely outcome, even though polls suggest that the US presidential race has tightened materially over the last week. This note examines possible immediate and medium-term market reactions to a Clinton or an unlikely Trump victory. As such it reflects these assessments, which are speculative. Obviously, uncertainty abounds. Among other things, it is unknown to what extent the market has "priced in" a Clinton victory or how "relieved" it will be that Trump will not be President; nor are the Congressional election outcomes known, which will determine which party controls the House of Representatives and the Senate or to what extent markets will adjust their expectations of likely policy outcomes based on any changes in Congressional control or even changes in plurality in either the House or the Senate. Moreover, as detailed in past reports ("US presidential candidates' economic platforms", April 28, 2016), there is no guarantee that the President will stick to what they campaigned for or whether the new Congress will allow or block the new President's agenda. Predicting market behavior is always difficult. These observations are based on the candidates' platforms and some insights into Washington's legislative and regulatory apparatus.

Possible Market Implications for Clinton Victory

A Clinton victory and Republicans maintaining control of the House--the most likely outcome according to leading political polls--would likely generate a positive announcement effect in markets. Stock markets in the US and globally would rally and the US dollar would rise. Yields on US treasuries would rise as investors move to riskier assets and gold and other hedges against risk would decline.

Markets are attracted to Clinton's proposals to increase spending and provide fiscal stimulus to the economy. Even if markets come to expect that Congress would thwart the magnitude of spending proposals and would require tax increases that would constrain the estimated impact of budget deficits, the general view is the thrust toward stimulus is good for the economic outlook, and presumably profits.

On the one hand, markets may have already priced in a Clinton victory. On the other, psychological relief that the ugly and depressing Presidential campaign has ended may contribute to a rally. How long would it last? If Clinton acts diplomatically following victory and reaches out a hand to Republicans in Congress, this may extend the typical "honeymoon" period and positive market vibes may be extended. Remember, everything Clinton has said during the last year has been orchestrated by a well-oiled and Washington-savvy communications team, and Clinton's acceptance speech and initial public pronouncements (which are already in draft form) will lean toward political diplomacy and try to convey a positive image.

Within an initial positive stock market response any rally may be uneven by industry:

- Bank and financial stocks may underperform an initial rally based on fears of more burdensome regulations and fees that have been proposed and promoted by Clinton. This impact would be accentuated if Democrats regain control of the Senate, which would convey added power to Senator Elizabeth Warren, a prominent member of the Senate Banking Committee. Warren is highly critical of the banking sector, proposes breaking up the largest banks and is the leading architect of the Consumer Financial Protection Bureau that has enacted changes that have already cut into bank profits, and the

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likelihood of significantly more burdensome bank regulation and increased government oversight would be expected to further harm bank profits. This is especially true since President Clinton may attempt to placate the far left wing represented by Senators Warren and Sanders, which may effectively convey more power on Warren.

- Consumer discretionary stocks may outperform, based on expectations of more income support for lower and middle-income households as proposed in Clinton's platform.
- Infrastructure related industries. Clinton has proposed a large increase in infrastructure, and this likely would be relative high on the fiscal priority list. The Clinton platform has proposed establishing a new Infrastructure Investment Bank and details a number of areas that need added resources, including pipelines and energy (including alternative energy sources), along with more traditional spending on improving roads and bridges. Congress would reject such a proposal, in part because it would transfer even more fiscal power to the Administration and away from Congress. Nevertheless, both political parties acknowledge the need for more infrastructure spending, so eventually legislation will be enacted. But negotiations between Congress and the White House likely will take some time, leading to a longer wait for policy enactment. Note that infrastructure spending isn't just limited to roads and bridges, rather spending would reach a wide range of sectors including the electric grid, the air traffic control system, cyber security and technology infrastructure and disease control ("US infrastructure spending – a roadmap for thinking broadly", October 24, 2016)
- Alternative energy stocks may outperform given Clinton's desire to push green energy initiatives.
- Pharmaceutical industry would likely be under pressure. Clinton has long maintained a hard stance against the pharmaceutical industry, and as President, would be able to implement sizeable changes that harm profits in the industry, either through legislation or through an array of regulations (including price caps) and administrative rulings. It is also noteworthy that Senator Bernie Sanders advocates the legalization of imports of select pharmaceuticals from Canada, which would squeeze margins of the US pharmaceutical companies (as noted below, Trump also included this in his original campaign platform).
- Food service and low productivity service industries could be impacted if markets perceive that Clinton's plan to raise the national minimum wage to $15/hr would harm profits.

Following the initial positive market reaction, there is a high likelihood that markets would give back those gains. With the wild uncertainties posed by a Trump Presidency in the rearview mirror, the realities of a Clinton Presidency would settle in. First, if Clinton is successful in enacting her initiatives, higher taxes would be required as well as more spending, along with a general anti-business tilt. The higher taxes would greatly dampen the thrust of fiscal stimulus, and could impose economic and financial burdens. Second, if Republicans maintain control of the House, markets would face a looming stalemate in Washington. Markets would then turn their focus back to economic, profit and inflation conditions.

There may be some end-of-year tax-related selling, but also some one-time dividend distributions. Clinton proposes significant tax increases on both dividends and capital gains. While it is unlikely a Republican-controlled House would agree to such large capital gains tax increases, uncertainties about the legislative outcomes may lead cautious portfolio managers to year-end tax selling. Clinton has also emphasized her dislike of cash held overseas by cash-rich US companies. Select companies may choose to make one-time dividend distributions. It is noteworthy that in December 2012, in anticipation of scheduled tax increases in January 2013, one-time distributions were sizeable.

In the low probability outcome in which Clinton is elected President and Democrats take control of Congress, markets would need to react to the reality that most if not all of Clinton's major spending and taxing initiatives, and her heavy regulatory initiatives, would be enacted in fairly quick order. Following an initial relief rally, the markets would have to weigh the tradeoffs between the short-run economic benefits of higher spending offset by higher tax burdens on the one hand, versus the depressing impact these fiscal policies and heavier regulatory burdens would have on profits and longer-run potential growth. Markets likely would recede as a reflection of these realities.

Also in this scenario, the stronger growth in real GDP stemming from higher infrastructure spending would lead the Fed to more quickly raise interest rates. The Fed has already begun to discuss publicly its estimates of how higher spending and higher taxes would raise real interest rates. Under this scenario, there would be a lot of uncertainties.

Possible Market Implications of a Trump Victory

If Trump wins, expect an immediate negative market reaction. The heightened concerns and uncertainties would generate a selloff in equities; note the decline in stock markets over the last week as the Presidential race has tightened. Initially, it is likely that all sectors would be adversely affected. The dollar would likely depreciate against major currencies, but likely appreciate versus Mexico and China. US Treasury bonds and gold would rally as investors seek safe havens.

Eventually, markets would recover. The extent and duration of a broad stock market decline would be determined by Trump's early public statements, how quickly the new Administration establishes the priority of economic policy initiatives and some of the high-level appointments. The markets will be looking for signs of reasonableness. Following such an erratic and unpredictable and distasteful campaign, it may take a lot to change market sentiment. On the other hand, if the new Trump Administration transforms select campaign initiatives into legislative proposals that are perceived to be pro-growth--such as corporate tax reform, a low tax on repatriated corporate cash, and the establishment of policy task forces to identify reasonable policy alternatives that would improve economic performance--then confidence would build and markets would rally. Presently, that seems like a stretch, but...

Several sectors may respond unevenly:

- Infrastructure and energy. Trump favors a significant infrastructure spending program, but its focus would be somewhat different and its implementation and financing would be completely different than Clinton's. Trump would allocate more resources to traditional energy sectors (oil, gas and coal) than would Clinton, but allocate less to alternative energy industries. Trump advocates block grants to states that would implement and oversee the programs, rather than central control in Washington.
- Basic manufacturing industries. They would benefit from Trump's corporate tax reform, which would involve lower rates and the expensing of investment and a broader tax base (through modifying deductions, deferrals, credits and exemptions) along with Trump's proposal to assess a one-time low tax on corporate cash repatriated from overseas. However, the benefits of these may be offset by some of the stances taken by the new Administration on trade policy--and the negative sentiment it would convey. It must also be kept in mind that even a Republican-controlled Congress would require that any corporate tax reform be close to relatively deficit-neutral, which may affect the eventual legislation.
- Healthcare and insurance reactions are complex. Trump has proposed to repeal the Affordable Care Act and to greatly reform Medicaid. Although a Republican Congress would like to modify the Affordable Care Act (ACA), the probability of Congress approving a repeal without a viable alternative is close to zero. If Trump were elected, the House and Senate Health and Human Services Committees would deliberate on various modifications, and they would have to agree on an alternative. One obvious change that would have an impact on medical care and insurance industry stocks would be to legalize interstate competition of insurance companies, which both political parties now favor. Other modifications would be implemented that would affect beneficiary requirements and provider reimbursements. But it's important to emphasize that the ACA will not be repealed. Policy deliberations will generate market uncertainties.
- Pharmaceutical industry. Trump proposal to legalize the imports of select pharmaceuticals from Canada would squeeze margins of the US pharmaceutical companies. As noted above, this proposal has the support of Senator Bernie Sanders. The downside risks posed by Trump or Clinton have already put downward pressure on pharmaceutical and health care stocks.
- Hotels, leisure and hospitality and the food services. These industries will incur major uncertainties based on Trump's ill-defined proposals against immigrants.

Note that if market turbulence is sustained under a Trump victory, the Fed may decide to delay its December rate hike, another uncertainty that may face markets.

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