US ELECTIONS 2024: THE REAL ELEPHANT IN THE ROOM

31/10/2024 | RAPHAËL GALLARDO, KEVIN THOZET, LLOYD MCALLISTER

Raphaël Gallardo, **Kevin Thozet**, and **Lloyd McAllister** look ahead to the potential impact of the US election result on the economy, markets, asset allocation and sustainable investments.

- **The election** is set against the backdrop of an economy more vulnerable than its recent performance suggests.
- **A 'Red sweep'** would be inflationary and widen the deficit. Bond yields would increase sharply.
- **A 'Blue sweep'** would mean a 'tax and spend' programme negatively impacting equity markets.
- **A divided government** would keep the extremes at bay – markets generally prefer stalemate to policy uncertainty.

A PARADOXICAL BACKDROP

Raphaël Gallardo

The US has enjoyed the most robust post-pandemic recovery of all the large, developed economies. Nevertheless, this long expansion has aged into a slowing phase, as the 'sugar-high' from giant Covid-related stimulus measures fades, a strong dollar weighs on the manufacturing sector, and the high real rates that were needed to fend off inflation have crushed demand in rate-sensitive sectors such as construction and real estate.

Consumers are still carrying the torch of growth, but, despite a low level of unemployment, most of the dynamism increasingly stems from the highest quintiles of the wealth distribution, who benefit from the ongoing wealth effects of an already expensive stock market. Ageing, increased welfare transfers and subsidies to the energy transition have also widened the fiscal deficit to levels unheard of outside of recessions, wars, or pandemics (7% of GDP).

This is the paradox of this election. After eight years of outperformance of the US economy and a stellar performance of its equity market, voter frustration with the state of the economy has shaped the electoral platforms of the two main candidates.

The next administration will inherit an economy that is more vulnerable than its recent track record suggests, and why the populist measures that both candidates defend could have outsized impacts on financial markets.

The real elephant in the room, is that regardless of the outcome, this election could change the engine of an economy that has been the envy of the world for decades.

IMPACT OF THE DIFFERENT SCENARIOS

	54%		46%	
	SCENARIO 1	SCENARIO 3	SCENARIO 4	SCENARIO 2
Subjective probability	Red sweep	No sweep	No sweep	Blue sweep
	38%	16%	29%	17%
GDP	+0.1%	-1.0%	+0.3%	+1%
CPI	+1.1%	+1.0%	+0.1%	+0.3%
Fiscal balance	-3.2%	-2.1%	-0.4% to -0.7%	-0.7%
EPS impact	+5%	Differentiated according to sensitivity to tariffs/ deregulation	Slightly positive	-6% (tax hikes)
USD impact	Strongly up then downside tail risk on Fed intervention	Up	Down	Down
Fed policy in 2025	Plateau at 4% then return to 5% by end '25 until Trump interferes	Plateau at 4%	Cuts to 3%	Plateau at 4% then hikes until equity market breaks
Bond yields	Strongly Up	Up	Flat	Up initially

Annualised impact in 2025-2026 vs current trend. Based on Carmignac calculations as at 21/10/2024.

RESULT SCENARIOS

Given the high probability that the Senate flips Republican and the fact that the winner of the White House will probably also carry the House of Representatives, we have narrowed down the outcome of the election to four scenarios.

Scenario 1: Republican sweep

Economic implications [illegible] generation can be as polluting as coal.

- More broadly, and possibly more consequentially in the long term, is the potential for the gutting of federal institutions.

[illegible]
[illegible]
[illegible] based on
revised demand requirements and higher rates. As a consequence, the uncertainty in future cash flows from the reduced
[illegible]
pressuring prices down (a deflationary boom), our assessment is that these forces would be counterbalanced by the negative
[illegible] change has been a polarising topic.

[illegible]
[illegible] systems push back, especially following the surge in interest in ESG investing
between 2015 and 2020.
Even in a watered-down application of all Trump's promises, GDP would barely move from its baseline 2% trend, given a starting
[illegible]
from a sustainable investment perspective. A Trump administration would seek to dismantle a 'pro-ESG architecture' to
[illegible] deficit would widen towards 10% of GDP.

[illegible]
[illegible] rates, lower trade deficits and an inflow of foreign capital chasing
[illegible]

- Trump will likely begin proceedings to withdrawal from the Paris Climate Accord.

[illegible]
[illegible] implementation of his
agenda.
[illegible] equity markets would reverse the wealth effects that
[illegible] administration with significant push back on simply mandating
companies to disclose pollution levels – an established practice around the rest of the world.
[illegible] will be under the microscope.
The IRA is forecasted to causally reduce GHG emissions by 8%(from a forecast base) through swifter adoption of clean
[illegible]
[illegible]
[illegible]

[illegible]
[illegible] protectionism and the fossil-fuel complex (services as well as infrastructure) from
the prioritisation of domestic oil and gas production.
Musk's relationship with Trump reduces the risk around EVs, but not entirely, as Musk has publicly stated that removing the
[illegible] trade tensions with China could negatively impact the
global supply chains of firms such as Nvidia or Apple.
As a China-hawk, Trump is likely to rescind the current flexibility from the Treasury in delaying the domestic supply chain rules
[illegible]
[illegible]
[illegible]

[illegible]
[illegible] standards - a key driver of automakers' shift to EV – will be scrutinised.
California, which leads the charge on emission standards, requires sign-off from the Environmental Protection Agency (EPA) to
[illegible]
[illegible] compensation required for holding longer-term bonds, advocates for a flexible
[illegible]

Scenario 2: Democratic sweep
Economic implications (Raphaël Gallardo)

Kamala Harris basically has a 'tax and spend' program that entails $5-7 trillion (over ten years) in tax cuts and welfare spending for the middle class, financed by corporate income taxes.

Assuming Democrats enjoy even a thin majority in both chambers of Congress, President Harris could pass most of these measures through a reconciliation process despite lacking a super-majority in the Senate (albeit the measures would have a lifespan limited to 10 years).

Intense lobbying from K Street and resistance from moderate Democrats would water down the tax bill in the end, but we fear the most influential outcome of such a fiscal plan would be a sharp revision lower of the earnings prospects of US equities.

Equity wealth effects have effectively been the main driver of continuous growth in private consumption, so a de-rating of the US equity market would thus aggravate the slowing of the US economy. It would then behove the Fed to pursue audacious rate cuts to safeguard a soft landing for the economy in 2025.

Market & investment implications (Kevin Thozet)

The Democrats 'tax and spend' programme would basically mix new welfare spending with large tax increases, thus limiting the impact on long-term rates.

Cuts to discretionary spending, like defence, along with increased regulation and corporate taxation would negatively feed into earnings expectations and reduce returns on capital, hence threatening current equity valuations and the US dollar.

We expect a negative impact of -6% in earnings per share growth for 2025 as a result of an increase in corporation tax from 21% to 28%. Such measures could also weigh on valuation multiples. The average stock in the S&P 500 is being priced at 22 times next year's earnings, likely reflecting the current exceptional profit margins of US companies. A 28% corporate tax would put the US on par with countries like the Netherlands, Canada, or France, where average valuations are 7x lower than their US peers.

Harris's policies could stimulate consumer spending among the lower and middle income cohorts while the top quartile of earners (who account for close to 50% of total US consumption) would be negatively impacted. As a result, the 'value end' of the consumption spectrum could benefit, at the expense of the 'premium end'. Consumer staples would be expected to outperform the consumer discretionary sector in a period of stock market uncertainty. The former would also see less of a hit from corporate statutory tax rates rising.

The real estate sector would benefit from plans to build millions of housing units and assist first-time buyers with deposits. Healthcare and renewables could also prosper given Harris has, in her vice presidency, contributed to the implementation of humongous subsidies supporting access to health care and climate change mitigation.

In fixed income markets, some form of fiscal 'responsibility' (albeit not huge, given the budget would still be running at an estimated additional +0.7% deficit), higher taxes and increased recessionary dynamics would likely ultimately keep bond yields in order, following an initial period in which they will rise, on the back of more upbeat economic growth. The longer-term downward adjustments of US equity valuations, and the consequent negative spillover to consumer confidence, means bond yields would eventually start to trend lower.

Scenario 3 & 4: Divided government
Economic implications - Republican president, Republican Senate, Democratic House (Raphaël Gallardo)

Even without control of the House, Trump could still enact some key pillars of his program: impose tariffs, close the border, reallocate some federal funds to finance a deportation campaign, and deregulate the economy through executive orders and nominations of pro-business justices.

What he could not do is pass all his promised tax cuts. Admittedly, the Democrats would likely agree to a renewal of some of the 2017 tax cuts limited to the middle classes, but that would still leave some tightening taking place on the fiscal stance.

Overall, this cocktail would be net stagflationary (GDP down 1.6pt vs potential, inflation up 0.6%).

The magnitude of the slowdown would probably convince Trump to water down some of his signature policies, but financial markets would still suffer from a reintegration of a stagflation risk premium into bonds and equities.

Economic implications - Democratic president, Republican Senate, Democratic House (Raphaël Gallardo)

Given Harris's agenda mostly consists of redistributive policies, lack of control of the budget process (which requires approval by both chambers) means that her agenda would be dead on arrival.

If the Democrats control one chamber (plausibly the House), they could forge a compromise on the renewal of the 2017 tax cuts in exchange for some increase in social spending. In that case, the fiscal stance could shift more positive by the turn of the year and facilitate the pursuit of a soft landing, helped by a Fed on a methodical rate-cut path.

Market & investment implications (Kevin Thozet)

Divided governments have been synonymous with periods of tamed volatility and favourable market outcomes. This implies some fiscal compromise leading to positive fiscal impulse i.e. nothing thrilling but nothing dramatic either. And, it would likely prevent the candidates most 'disruptive' measures from coming to fruition. Ultimately, markets prefer stalemate stability over policy uncertainty.

In a Trump presidency, executive actions would likely see him pass some of his most inflationary measures, but without full control of the two houses, there is limited potential for pro-growth policies. A combination which would likely see him dialling back on some measures, but the risk for markets is a period where the negative combination of higher prices and lower growth ('stagflation') is reflected in asset prices first.

Nevertheless, regardless of who secures the presidency, the increased probability of renewed gridlock could, counterintuitively, result in a positive market environment, as it would lead to further liquidity being injected in the system with the US treasury raiding (again) its general account at the Fed. Likewise, given the difficulty of a lame-duck government to enact important fiscal support, the Fed would have to do most of the heavy lifting, while not having to worry about inflation pressure.

In terms of sectors, growth stocks which are less (or in some cases, not) dependent on the economic cycle to flourish, would likely be sought after. While those more dependent on government spending or regulation, such as environmental services, and those leaning on consumer confidence and spending, such as financial services, would lag – with the exception of infrastructure which could benefit from middle ground and bipartisan support.

[1] https://s3.documentcloud.org/documents/25042572/e2-clean-economy-works-ira-two-year-review_august-2024.pdf

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