GENERALI INVESTMENTS

Focal Point

US presidential elections: What is at stake?

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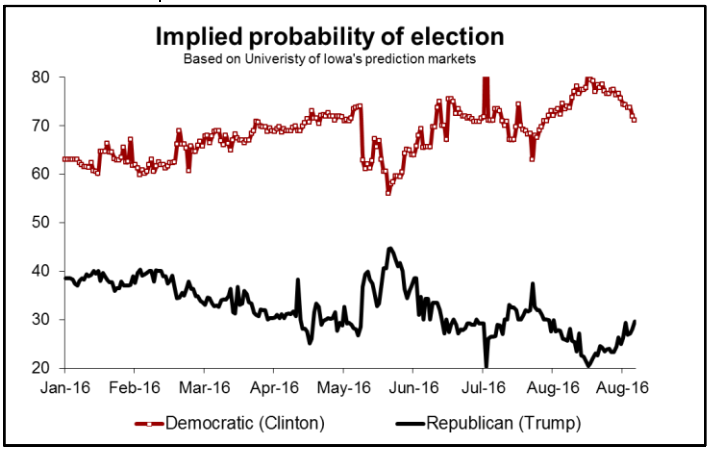
- According to latest polls, the US elections on Nov. 8 are likely to lead to a new President Hillary Clinton poised to deal with a Republican-led Congress. Her fiscal plans would likely be watered down by Congress, while she is more likely to find support for renegotiating trade deals. A split government will make lawmaking more susceptible to gridlocks.
- A victory of Donald Trump would result in much higher political uncertainty. Expansionary fiscal policy comprising tax cuts and spending increases may boost the US economy short-term. But the longer-term outlook would be burdened by an isolationist and protectonist approach to trade and immigration.
- Markets responses to polls suggest that a Trump victory may lift the US dollar and weigh on equities, with a less clear-cut impact on bonds. If he is backed by a Republican Congress, however, the detrimental impact on equities may be offset by markets discounting a stronger fiscal stimulus, lower taxes and a relaxation of financial regulation.

The upcoming US presidential elections on Nov 8 are surrounded by unusually high uncertainty. Both candidates (Donald Trump for the Republicans, Hillary Clinton for the Democrats) have the highest-ever negative personal ratings amid low trust in the political elite and the establishment. Moreover, their political propositions diverge sharply even by US standards. Apart from the presidential vote outcome, the future of US politics also hinges on the composition of the Congress, with the election of a new House of Representatives and 34 out of 100 Senators. Current polls point to a lead of Clinton over Trump, implying a likelihood of 25-30% that Trump prevails in the election. That said, differences in nationwide shares are small so that large swings remain possible already on small events, but even more so on more significant ones (e.g. documents leaks, terror attacks, TV debates). Furthermore, given the unusual circumstances of this year's race, poll methods may be inadequate to capture the true voting outcome. For the Congress, it seems much safer to assume that Republicans wil keep their majority in the House of Representatives, while for the Senate, the latest polls suggest that the Democrats may be able to win back the majority by a narrow margin (with e.g. the model by the New York Times assigning a 55% likelihood for this).

A victory of Clinton, who pursues positions not too distinct from incumbent President Obama, appears the most likely scenario. The need to deal with a Republican House would bring about least change compared to the status quo, but it would maintain the potential for gridlocks in the legislative process. The extreme positions by Donald Trump make the elections an event creating a lot of political uncertainties. His victory especially, if backed by a large Republican majority in the Congress, may allow him to pursue many of his policy proposals, resulting in a significant political and economic impact.



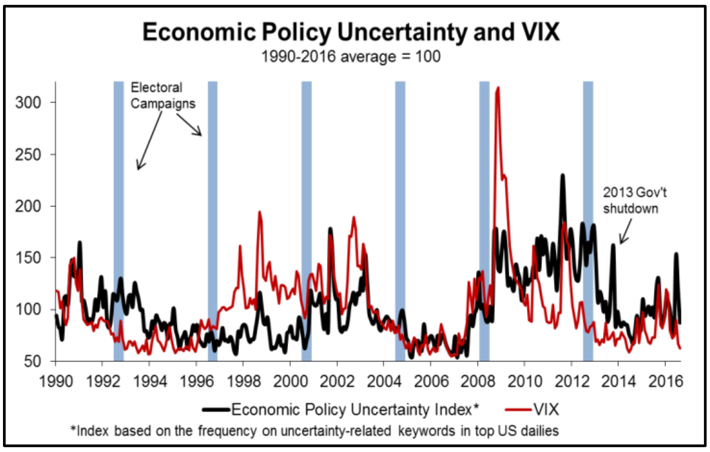
In the following, we review key positions by both candidates and how they may impact the global economy and financial markets. While a whole spectrum of scenarios is feasible, we focus on key positions by both candidates and lay out the implications of the two most likely and relevant scenarios: a Democratic president facing a Republican Congress and a full Republican government.

Clinton victory: only gradual policy shifts

The **fiscal policy** package proposed by Clinton resembles a continuation of the Obama administration's agenda, implying a slightly expansionary stance: Increased expenditure on R&D, infrastructure and education, public funding for medical care and family leave, aiming at boosting female labor participation. This would be financed by increased tax rates on higher income brackets, cutting deductions for households and firms and the linkage of capital gains taxes to the asset holding period. According to the Committee for a Responsible Federal Budget (CRFB), the budget deficit would rise only marginally to 4.1% of GDP vs. a baseline of 4.0% for the coming ten years. Most of the plans, however, will meet resistance by a Republican majority in the House of Representatives and would be watered down. The plan to increase infrastructure investment is more likely to be enacted, given the bipartisan consensus on this issue.

For **immigration**, Clinton pledges to reduce restrictions for highly educated foreigners and facilitate temporary visas. More controversially, the plan includes the legalization of undocumented immigrants complying with specific criteria. In this area the President has quite a lot of power. On **trade**, Clinton has backtracked from her initial endorsement of the Trans-Pacific Partnership (TPP), and in general softened her support to multilateral agreements. On **financial regulation**, she aims to curb market activities of larger banks (with less chance of success), whereas reintroducing divisons between retail and investment banking is broadly shared by the Republicans.

Meanwhile, a split government would mean continued confrontations between the President and the Congress. Clashes like the one leading to the October 2013 shutdown would remain possible, keeping political uncertainty high.



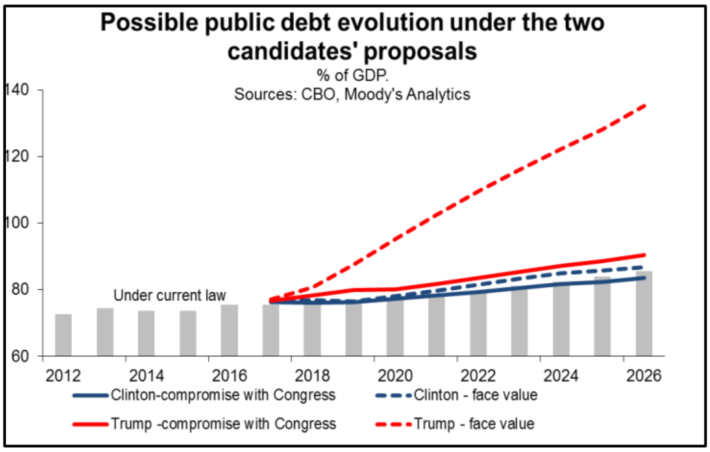
Trump victory: higher policy uncertainty

Assessing Trump's (partly contradictory) economic policy proposals is more difficult. Also, the full economic impact has to consider the increase in geopolitical uncertainty linked to an isolationist foreign policy approach.

The Republican candidate has put forward a very aggressive agenda in **trade policy,** an area in which the President has quite a strong margin for maneuver. He is opposed to the TPP, has critisized multinational agreements and called for curbing WTO powers. He proposes a 45% tariff on imports from China until the yuan is freely-floated and a 35% duty on US firms outsourcing jobs to Mexico. As a result, import substitution could provide a small boost to the US economy in the short term. Importantly, in the longer run, protective US tariffs are likely to trigger retaliation on US exporters and add to global protectionist measures, casting doubts about global trade growth.

Trump takes a tough stance on **immigratio**n, calling for an expulsion of all 11.3 m undocumented immigrants, which make for 5.1% of the total workforce (more recently, he has softened his tone on this demand). Moreover, the program vows to increase border controls and to build of a wall across the whole border with Mexico. Stricter immigration rules would harm US long term growth, given the expected population ageing. Moreover undocumented immigrants are often employed in low-skill tasks that US citizens are probably unwilling to take up (especially since the labor market is currently near full employment); this is likely to create labor shortages in some industries (e.g. agriculture), with negative repercussions on activity and employment in upstream and downstream industries.

Trump's **fiscal policy** is centered on sizeable cuts in individual and corporate taxation, coupled with a scaling back of tax deduction and tax breaks. At the same time his program suggests to increase expenditure in defense and homeland security without cutting public pensions and healthcare. To date, no indication has been given on how this would be financed. The CRFB estimates that, if Trump policies are fully implemented, the fiscal deficit for the next ten years would more than double compared to current law (9% vs. 4% of GDP), sending public debt soaring.



Some temporary relief for public coffers would come from the implementation of a tax window to allow US firms to repatriate earnings currently deposited in low tax countries, estimated at USD 2.1 trillion. A Republican majority in Congress would faciliate the implementarion of the policy, even though not in full, given the Party's preference for a balanced budget.

On **monetary policy** Mr. Trump is aligned with the Republican Party in demanding parliamentary audits on the Fed's monetary policy decisions while criticizing current measures as too accommodative, seedings the risk of financial bubbles. This may increase political pressures towards a more hawkish Fed stance. That said, threats to the central bank independence may make the inflation target less credible in the long term. Finally, the proposed moratorium on **regulation** (especially for financial markets) would find support by a Republican Congress.

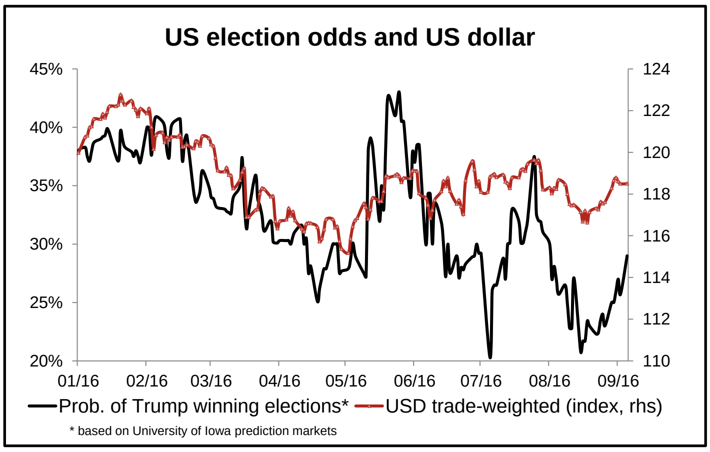
The overall result would be a much bigger fiscal impulse than in the case of a Clinton victory, providing short-term boost to the US economy and adding to price pressures from a tighter labor market and protectonist measures. This would also foster a more hawkish stance by the Fed. At the same time, the medium term fiscal outlook would deteriorate both due to rising fiscal deficits and lower long-term potential growth amid decreased trade and lower growth in the labor force (immigrants accounted for almost half of US labor force growth in 2000-10). Global growth would suffer too, despite some possible short-term relief on a stronger fiscal stimulus. Higher uncertainy would be detrimental to capital flows and investment globally. Rising trade barriers may dampen growth of trade partners even more strongly than the US economy, given that the US are a net importer of goods and services.

Implications for financial markets

A Trump victory will likely trigger a rise in political uncertainty and volatility in financial markets. Furthermore, long-term growth concerns due to much more isolationist and protectionist US trade and immigration policies could weigh on risk appetite, implying lower equities and government bond yields.

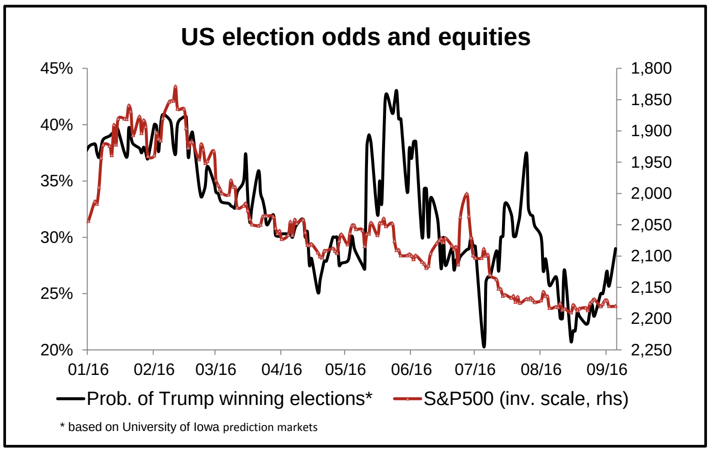
That said, there are offsetting forces which make the ultimate direction of the market impact subject to higher uncertainties. If Trump is backed by a Republican Congress, markets may temporarily focus on an anticipated larger fiscal stimulus, stronger tax cuts and lighter regulation of the financial sector, assuming a risk-on mode. US Treasury yields may additionally rise on faster rising public debt, higher inflation and a more hawkish Fed.

For the US dollar, by contrast, a Trump victory seems unambiguously supportive. Hawkish political pressures on the Fed, hopes that tax incentives for repatriating firms' profits boost demand for the US dollar and expectations of a larger fiscal stimulus should underpin the Greenback. The gains would be most visible against EM currencies (and the Mexican peso in particular) amid rising growth and trade uncertainties.



Financial market reactions to poll results give some insights into current market positioning for the election outcome. Rising odds of a Trump victory are associated with a stronger US dollar and lower US equities. For bond yields, the evidence is not clear-cut. Until the end of the primaries in July, yields tended to rise with higher chances of Trump winning. Since Trump was confirmed as Republican candidate, however, Treasury yields tend to fall on this occasion.

The upshot is that while we do not expect a great financial market impact from a Clinton victory, the US dollar would likely benefit in case Trump prevails. The repercussions on equities and bonds are less clear cut in the latter case and would also hinge on majorities in the Congress. If Trump is backed by a Republican Congress inclined to support his fiscal and financial regulation plans, equities are less likely to suffer, at least in the short run, while yields are more likely to increase.



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