

We're All Political Pundits Now

Richard Lawrence »

We are finally closing in on one of the most fascinating, divisive, and unusual elections in U.S. history. Unlike other western developed nations where the election cycle lasts 70-90 days, it feels like we've been at it here for about 18 months and you know what...we have. Ted Cruz was the first of 17 Republicans to announce his candidacy back on March 23, 2015. It's been a marathon, not a sprint, for sure. But keep the faith—we're in the final stretch! At Brandywine Global, our goal is to make informed judgments about economic data together with changes in policy to assess where the information risks and surprises might lie. While we are economic analysts first, handicapping potential political outcomes is a necessary component of our work. No sooner will we get through the U.S. elections before we turn our attention to elections in France and Germany, along with a re-vote in Austria and a critical constitutional referendum in Italy. We're all political pundits now.

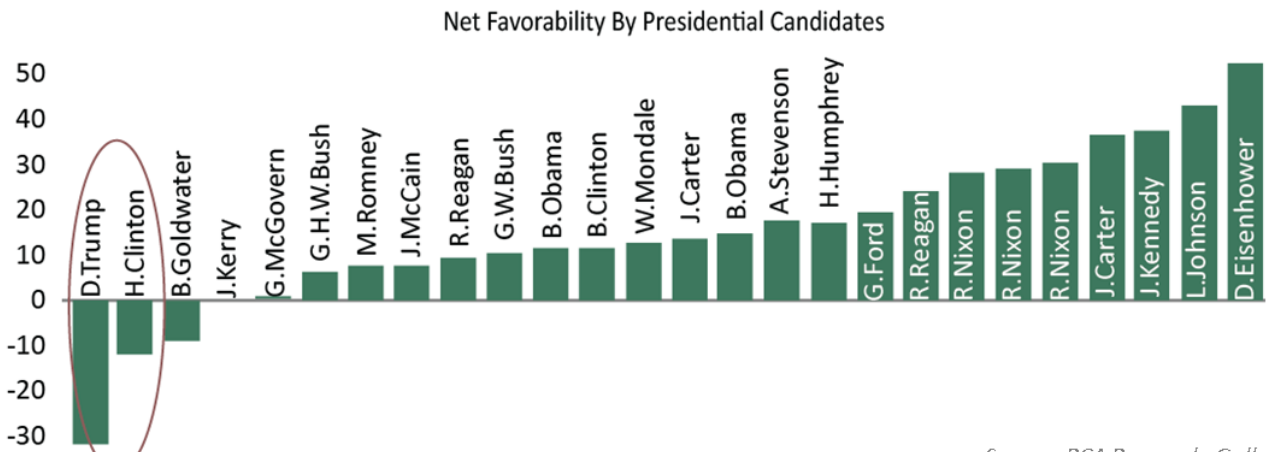
Before we discuss the potential market impact of the U.S. election, let me share some general observations about what we have seen unfolding in this election cycle:

1. The rise of populism is *real*. Donald Trump's popularity—along with that of Bernie Sanders—is the U.S. installment of a growing, worldwide sense of frustration with the status quo. We have seen this play out most prominently in Europe with the "Brexit" vote, along with the rise in popularity of anti-establishment political parties such as Podemos (Spain), Five Star (Italy), Syriza (Greece), and the National Front (France). Some of these parties are staunchly left-wing and others right-wing, but they are bound by a common desire to change the path of policy in a way that they believe benefits the disenfranchised, often via a more protectionist stance.

Implication: ignore this at your peril. Should global trade flows become stymied by protectionist policies, we believe a return to isolationism will have significant long-term investment implications.

2. On a favorability ranking basis, this is the worst election. Ever. For many voters, their candidate selection will instead be a rejection of the other they dislike even more.
Implications: the outcome may be unduly influenced by negative sentiment, which could lead to one of the candidates winning by a significant margin. Traditionally, a presidential candidate who wins by a significant margin also receives a sort of de facto carte blanche to execute a policy agenda relatively unencumbered once in office. In this election, the president elect will not have rightfully earned unfettered policymaking because the landslide victory was not actually precipitated by overwhelming popular support.

Chart 1: Clinton And Trump Are The Least Charismatic Ever



Source: BCA Research, Gallup.

Note: Net Favorability is calculated by subtracting the un-favorability from the favorability rating of each candidate. For each candidate, except for Donald Trump and Hillary Clinton, The Net favorability rating is from October, one month prior to the presidential election in November, for Donald Trump and Hillary Clinton, Net favorability are from October 2016.

3. So much focus gets placed on the president elect, but it is important to assess the likely overall composition of government post November 8. While the candidates talk about their grand plans—taxes, walls, deportations, etc.—history has repeatedly demonstrated that the checks and balances built into the Constitution are highly effective. A Trump victory coupled with a Republican House/Senate sweep implies a totally different governance outcome across all three branches of government than a split decision.

Implication: Asset markets are likely to view a divided government more favorably than a Republican or Democratic sweep. Interestingly, stock market returns have been better in a divided scenario.

Chart 2: Party Implications on Equity Sector Performance *As of 10/1/2016*

Stock Market Performance by Sector, According to Configuration of U.S. Government (Dominant Party In House, Senate, and Presidency, Respectively, D=Democrat, R=Republican)									
Sector		DDD	DDR	DRD	DRR	RDD	RRD	RRR	RDR
Average Weekly Return, S&P 500	Consumer Discretionary	0.04%	0.09%		0.32%	0.38%	0.31%	0.00%	
	Telecommunications	0.07%	0.21%		0.25%	0.19%	0.25%	-0.17%	
	Consumer Staples	-0.01%	0.24%		0.33%	0.24%	0.25%	0.10%	
	Basic Materials	0.03%	0.25%		0.20%	0.25%	0.21%	0.06%	
	Information Technology	0.14%	0.05%		0.27%	0.23%	0.63%	-0.16%	
	Industrials	0.12%	0.11%		0.26%	0.33%	0.34%	0.04%	
	Health Care	-0.02%	0.23%		0.30%	0.29%	0.33%	0.09%	
	Finance	0.07%	0.04%		0.35%	0.24%	0.29%	0.15%	
	Utilities	-0.02%	0.09%		0.18%	0.12%	0.12%	0.11%	
	Aerospace and Defense	0.31%	0.13%		0.29%	0.34%	0.23%	0.18%	
	Integrated Oil	0.09%	0.24%		0.19%	0.26%	0.19%	0.17%	
	Oil Gas Production/Exploration	0.34%	0.07%		0.12%	0.25%	0.04%	0.52%	
	AVERAGE		0.10%	0.15%		0.25%	0.26%	0.26%	0.09%

*Data includes Nixon (1973) to Obama (2016) administration, and the 93rd to 114th Congress.
Source: BCA Research 2016*

4. Beware of the polls and betting markets. Repeatedly over the past two years, we have experienced an unexpected outcome in a vote that was insufficiently discounted by polls or betting markets. This occurred in the 2015 Israeli election, the 2015 U.K. election, and the 2016 Brexit vote.

Implications: We have started to evaluate broader ranges of outcomes and cross-reference as many inputs as possible in light of unreliable polling results.

So what about the market impact?

Our equity outlook depends on what the composition of a presidential cabinet and Congress could look like. Both candidates have announced their intention to support higher infrastructure spending while in office. In the event of a Clinton victory, we don't anticipate radical policy changes if the Republicans can retain their majorities in either the House or the Senate. However, we would need to reevaluate our sector allocations—particularly for healthcare, financials, and energy—should the Democrats sweep Congress. Our view on financials could turn bearish depending on what role Senator Warren plays within a Clinton Administration. Based on our research, we think equities have priced in a Clinton victory; a Trump win would take stocks by surprise. Similar to fixed income philosophy, we will look at periods of volatility as an opportunity to pick value stocks or add to existing positions—we think the perceived safety of defensive stocks are unjustifiably overvalued.

In our view, the U.S. Treasury market may rally modestly in either outcome, although over the coming quarters we expect some modest upward pressure on yields—particularly if the markets discount some sort of fiscal stimulus package, which will be a possibility regardless of victor. Speculation has been building for some time about global fiscal stimulus, and while both candidates have discussed the potential for increased fiscal spending, historically the hurdle for large-scale fiscal stimulus has been high. Typically we only see this kind of fiscal stimulus during recessions.

As for the U.S. dollar (USD), the outcome is less clear. It is possible for a strong dollar rally in the event of a Trump victory, as markets discount the idea of a more protectionist stance, which would boost the dollar as a result of U.S.

consumers buying fewer imported goods. In practice, even if Trump were to win, his ability to “rip up” the North American Free Trade Agreement (NAFTA)—which is in his words the “worst trade deal ever”—may be limited by the system of checks and balances. As you can see below, NAFTA is very much a two-way agreement. Mexico is the first or second export market in 21 states.

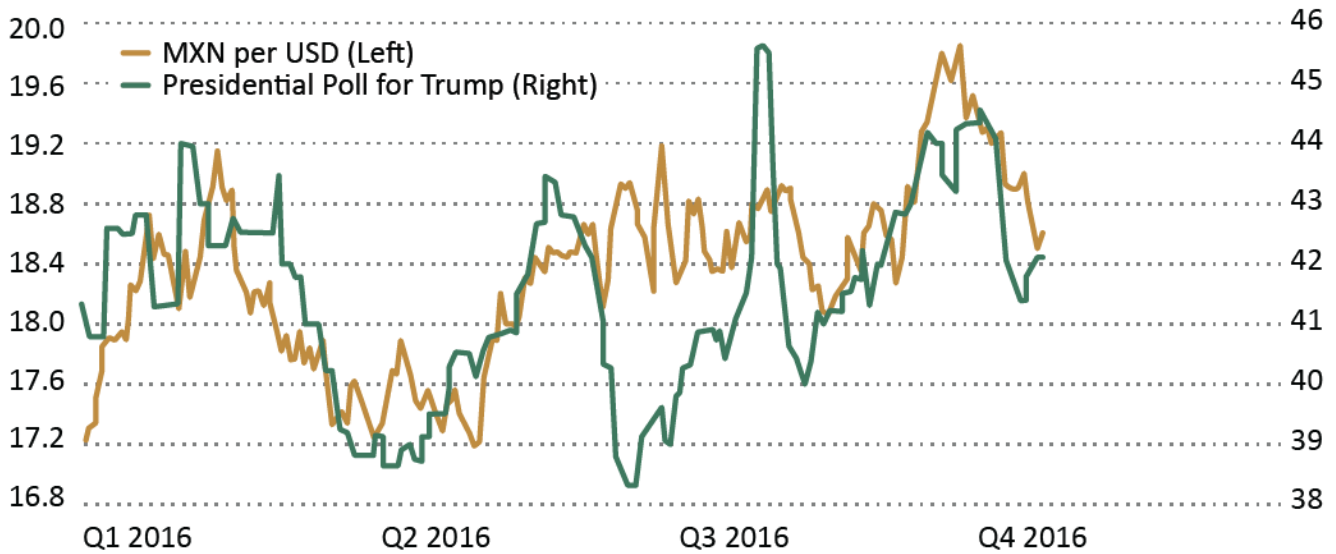
Chart 3: Top U.S. States Trading with Mexico in 2010 (Millions of U.S. Dollars); As of 7/31/2013

U.S. State	Mexico as Export Market #	Export Value	Imports Value	Total Trade
Texas	1	\$72,370	\$78,982	\$151,351
California	1	\$21,002	\$32,753	\$53,755
Michigan	2	\$7,428	\$28,150	\$35,578
Illinois	2	\$4,267	\$8,383	\$12,651
Arizona	1	\$5,055	\$5,630	\$10,685
Ohio	2	\$3,500	\$5,549	\$9,049
Tennessee	2	\$3,040	\$3,666	\$6,706
Mississippi	2	\$1,195	\$4,343	\$5,538
Pennsylvania	2	\$2,387	\$2,823	\$5,209
Wisconsin	2	\$2,010	\$2,910	\$4,920
Missouri	2	\$1,302	\$2,540	\$3,843
Iowa	2	\$1,833	\$985	\$2,818
Kansas	2	\$1,281	\$761	\$2,041
Nebraska	2	\$1,314	\$369	\$1,682
New Hampshire	1	\$1,050	\$570	\$1,620
Colorado	2	\$590	\$644	\$1,233
Arkansas	2	\$544	\$584	\$1,128
Oklahoma	2	\$432	\$653	\$1,085
New Mexico	1	\$429	\$635	\$1,064
South Dakota	2	\$340	\$45	\$385
North Dakota	2	\$166	\$48	\$214

Source: NAFTA Trade Office with Data from U.S. Department of Commerce and ASU, Foreign Trade Division, U.S. Census Bureau

Meanwhile, due to the high level of uncertainty on the issue, the Mexican peso (MXN) is one asset that has taken it on the chin as investors sold or hedged the peso as Trump’s popularity moved higher earlier in the year. His recent missteps have led to stabilization in the currency, and of course a Clinton victory should be modestly bullish for the MXN.

Chart 4: The Trump Effect on the Mexican Peso USD, (%); As of 10/20/2016



Source: Thompson Reuters Datastream

The truth is, Trump's seemingly improbable campaign has been a game changer that has made the job of forecasting potential outcomes more challenging than usual. As you can see from the survey of banks below, the only point of agreement between them is that a Trump victory means higher volatility.

Chart 5: FX Forecasters Stumped by Trump

	HSBC	Bank 1	Bank 2	Bank 3	Bank 4	Bank 5	Bank 6	Bank 7	Bank 8	Bank 9
Stocks	↓	↓ →	↓ ↑	↓ ↑	↓	↓			↓	↑
Bond Yields	↓	↑	↑	↓ ↑	↑	↓ ↑	↑	↑		↑
FX	↓	↑	↓	↓ ↑		↓	↓	↓ ↑	↑	
Volatility	↑	↑	↑	↑	↑	↑	↑	↑		↑

↑ Positive
 ↓ Negative
 → Neutral
 ↑ ↓ Mixed Performance

Source: HSBC

Our process relies on taking a long-term view that is informed by economic fundamentals, coupled with a degree of

political analysis. So while we're all playing political pundit right now, we remain positioned for a global economy that looks to be on a modestly improving path, although we expect some volatility as other political events grab headlines (think Italian referendum, German elections, French elections). Our tried and tested investment process has thrived through many market cycles, crashes, recoveries, tail events, and elections. In fact, near-term volatility in markets has historically created some significant opportunities to invest in assets with prices that have suffered some dislocation. An example of this includes after the European Union sovereign debt crisis in 2012. We will continue to monitor current events closely, but stay focused on our time-tested approach that has rewarded our clients in the long run.

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