ESCALA
PARTNERS

July 2020

MONTHLY AGENDA - 100 DAYS

Chief Investment Office

100 Days

100 Days

This month we focus our attention on the upcoming US presidential election. This is timely for two reasons. First, we are now three months out from the election. This is typically the time markets begin to focus more on the outcome. Second, we now have the July consumer confidence reading for the US. Historically, the July consumer confidence reading in an election year has been statistically significant predictor of the election outcome.

We look at the current polling, what the data is suggesting the outcome will be, how financial markets react before and after election day, and what the key policy differences are between the two parties. We finish with some potential investment implications.

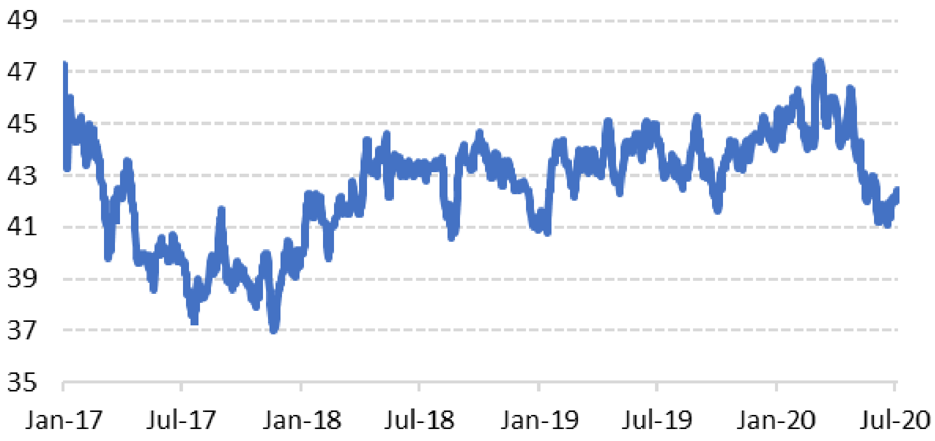
Current polling not great for the Republicans

Current polling

It will take 270 electoral votes to win the 2020 presidential election. Incredibly, there are no fewer than 39 different polling sources for this years' election. The average of the five most recent polls has Biden ahead of Trump by ten percentage points.

This is consistent with President Trump's low job approval rating (chart 1).

Chart 1: Trump Job Approval Rating (%)



Source: Bloomberg

A president as unpopular as Donald Trump has never won a second term. The average job approval rating for a two-term president is 53.2%. As the chart above shows, Trump's job approval is currently sitting at 42.4%. Indeed, no other president has had an approval rating this low in modern history.

Happy shoppers are key

Consumers may already know the result

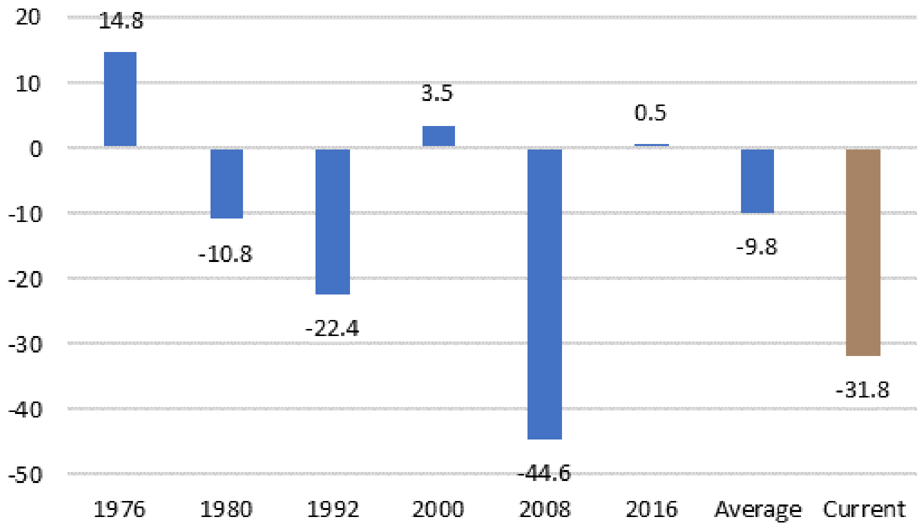
Predictions around election outcomes are difficult to make and, recently at least, have not been all that accurate. So it is with some degree of caution that we highlight an interesting relationship between consumer confidence and the election outcome. TS Lombard, an independent research provider, found that in election years, the result in November tends to follow the Conference Board Consumer Confidence Survey measured in the previous July.

On average, if consumer confidence in July is below 92, the incumbent party has lost the election; if it is above 98, the incumbent has won. In other words, a party in charge of a faltering economy has never been re-elected.

The July Conference Board Consumer Confidence survey was released last Tuesday. The result came in at 92.6, just above the 92.0 threshold.

The chart below shows the annual change in that same consumer confidence index when the incumbent was defeated. The current reading of -31.8% is significantly below the average when previous incumbents were defeated (chart 2).

Chart 2: July consumer confidence (yoy%) when incumbent defeated



Source: Bloomberg

So while predictions are difficult to make, Trump's current combination of weak consumer confidence and weak job approval does not bode well for the Republicans.

Financial market response

Financial market response

We look at what happens to US and international equities, US bond yields and the AUD/USD exchange rate before and after a presidential election. Our data set goes back to the 1936 election for US equities, the 1964 election for US bonds, and the 1972 election for international equities and the AUDUSD exchange rate.

Chart 3 shows how the US S&P500 performed in the 6 months prior to election day (ED) and in the 6 months following. The heavy black line is the average across the 21 elections studied and the red line is the tracking for the current election year.

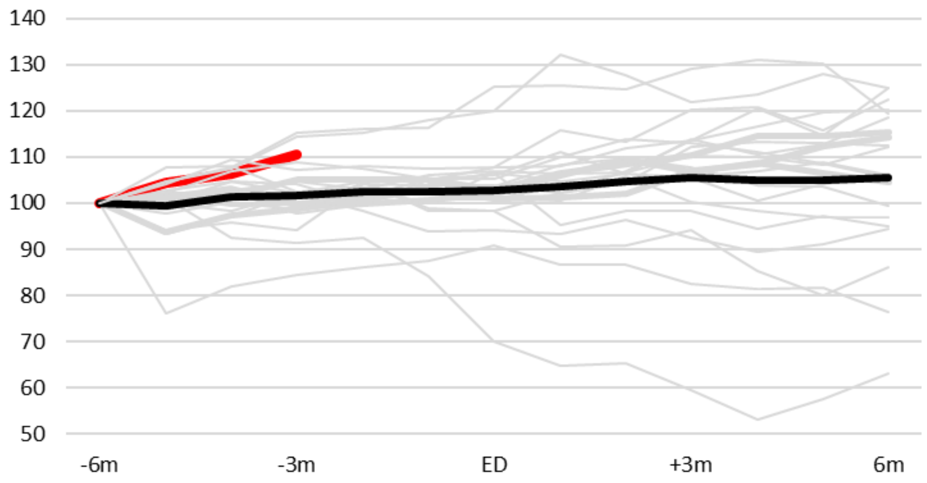
Two things are clear from this chart. First, the average is weighed down by the 2008 global financial crisis. Excluding this, US equities tend to rise 4.5% in the 6 months leading up to the election and rise a further 3.1% in the 6 months after.

Second, the current market is tracking well ahead of the average of the previous election years. Indeed, just two years exceed the current trajectory – 1936 and 1980.

On average, US equities have performed better in the 6-months following election day under a Democrat victory. This is particularly the case when 2008 is removed from the sample (+4.0% vs +2.2% under a Republican victory).

Elections rarely are the sole key driver of equity market performance, however. The domestic economy and financial conditions in particular play a far greater role. This goes some way to explaining the outsize result for the current year.

Chart 3: S&P500 performance in previous elections



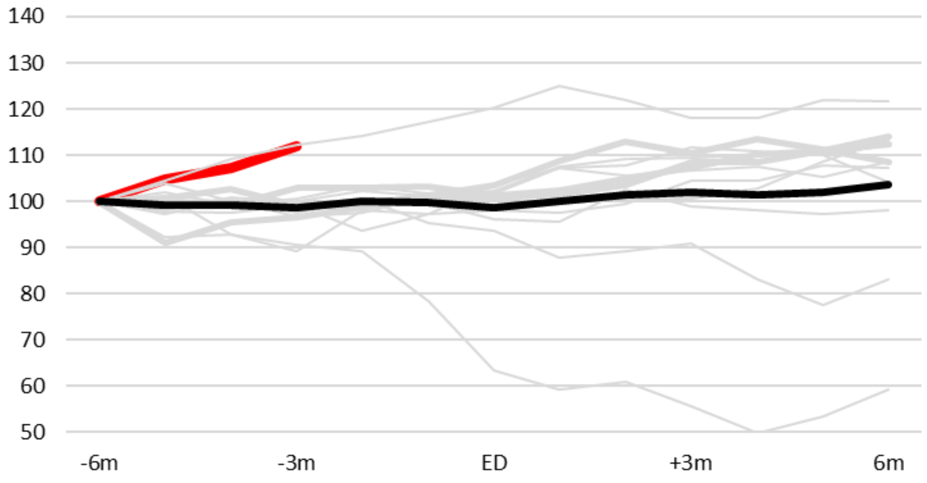
Source: Bloomberg

Chart 4 shows the same analysis for global equities.

The lower bound of the dispersion is again captured by the performance in 2008 while the upper extreme, against which the current performance of global equities is tracking closely, was 1980. On average, global equities underperformed very slightly in the leadup to election day and outperformed by 3.6% in the 6 months after.

This outperformance was particularly apparent when the Democrats won (+6.2%). Digging deeper, the German DAX was up on average 7.3% following a Democrats victory while the Japanese Nikkei was up 17.3%. Under a Republican win, the DAX rose 3.6% while the Nikkei rose 6.7%.

Chart 4: MSCI global equities performance in previous elections



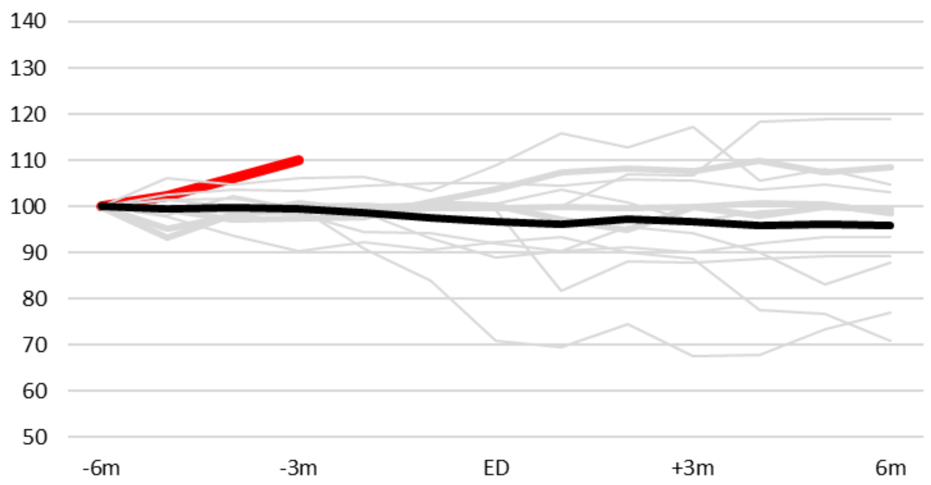
Source: Bloomberg

Chart 5 shows the performance for the AUD/USD exchange rate.

The US dollar has tended to strengthen against the Australian dollar in the lead-up to the election by around 3.3%. This trend continues in the aftermath of the election with an average decline in the Australian dollar of 0.8%.

The current trajectory of the Australian dollar has it well ahead of any path taken in previous years. The weakest path was that taken in 2008 when the Australian dollar fell some 30% in the year-to election day. This highlights the importance of economic and financial factors as more important drivers of the currency than elections.

Chart 5: AUD/USD performance in previous elections



Source: Bloomberg

Financial market response

Policy differences

While Joe Biden is a moderate, he is proposing higher taxes (reversing half of Trump's corporate tax cut and returning the top marginal tax rate to 39.6%) and more regulation. Both Trump and Biden plan to spend around $1 trillion on new infrastructure over the next ten years.

On climate policy, Biden wants the US to reach net zero emissions by 2050 by raising the cost of fossil fuels & boosting the development of alternatives (possibly with a carbon tax). Biden also wants to strengthen Obamacare and limit drug prices.

Biden would likely de-escalate tensions with Europe and strengthen the alliance, work with international organisations like the World Trade Organisation, work to re-establish the nuclear deal with Iran and adopt a more diplomatic approach to dealing with trade & other issues with China (working with Europe and Asian allies in the process). By contrast a re-elected Trump is likely to double down on his trade war with China and possibly elsewhere including Europe.

Investment implications

Investment implications

If we have learnt nothing from recent history, it is the danger in trying to predict the outcome of an election. That is not the intention of our analysis. The point here is to show that the election outcome is finely balanced. Clearly, if the US economy and by extension the virus, continues to weigh, it will be very difficult for the already unpopular Trump to win a second term.

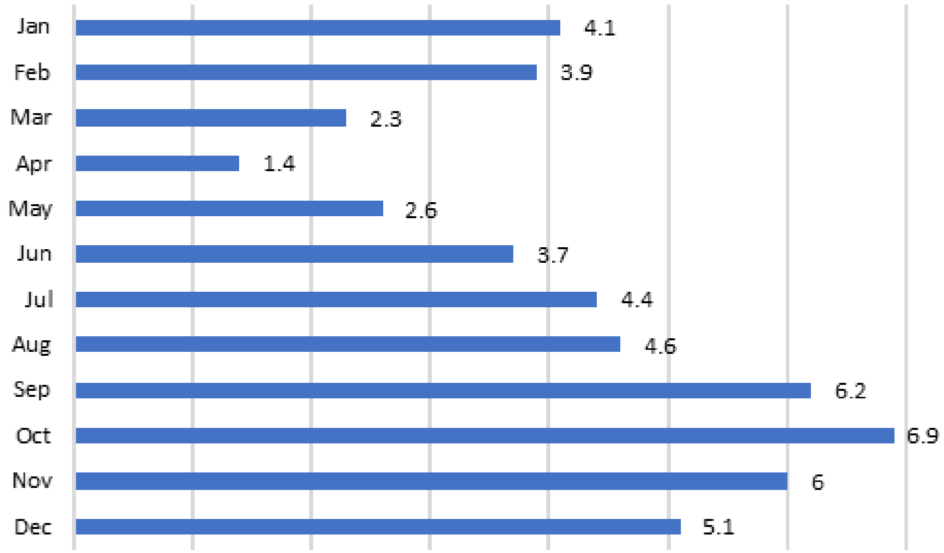
We would also caution on reading too much into past analogs of how financial markets have performed in an election year, particular in a crisis year such as the one we are currently in. There is no definitive heuristic that a victory by party X is good or bad for asset Y.

In that light, we prefer to offer observations rather than clear conclusions.

First, the study suggests that whoever wins on November 3rd, US equities perform well in the following 6 months. The performance is slightly stronger under a Democrat victory. This may be due as much to seasonality as anything political.

The six months from November are historically one of the best performing six months of the year for US equities (chart 6).

Chart 6: Avg S&P500 6-month return from:



Source: Bloomberg

Second, a Democrat victory also appears to be associated with a strong performance for international equities in the 6 months following the election.

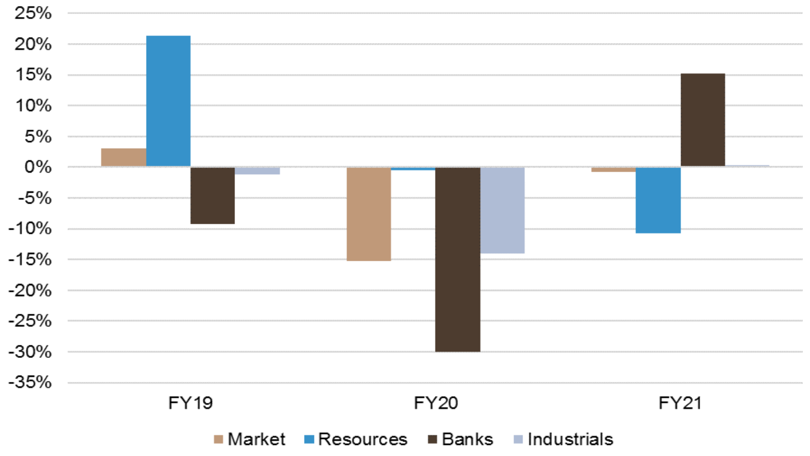
US and global equities have already outperformed the average of previous election years. In our view, further significant outperformance is likely to be more reliant on the path of the coronavirus than the outcome of the election.

Third, the strength of the US dollar in the leadup to and following election day should be viewed cautiously given the evidence of seasonality. As we show in chart 12 on page 8, the last five months of the year tend to be associated with US dollar strength.

Finally, we struggle to find a statistically significant result for the direction of bond yields under a Democrat win. A win for the Republicans, on the other hand, has been associated with higher bond yields 75% of the time.

In our view, we believe both US and international equities can move higher from here, particularly if the virus case count is controlled. A Biden victory has the potential to add to that though much would depend on whether he passes legislation to raise taxes. We would suggest a Trump victory is most likely to see the US dollar strengthen given the likelihood of an escalation in the US/China trade war.

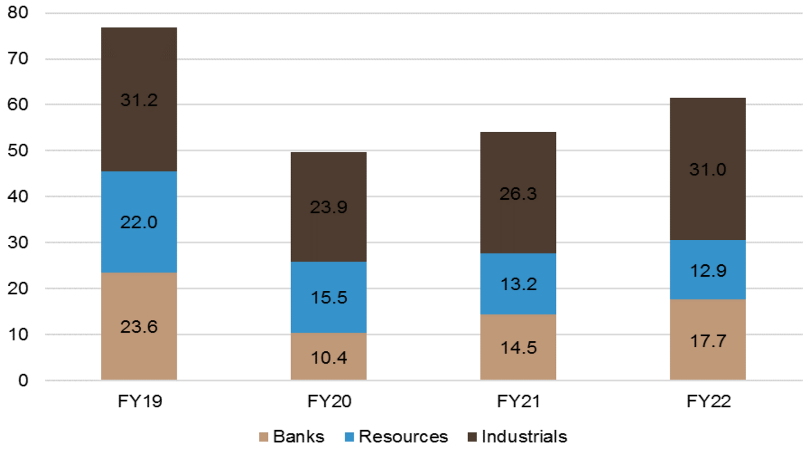
Chart 7: ASX 200: Actual and Forecast EPS Growth



Source: Citi, IBES, Datastream

FY20 earnings announcements will be a key focus of the market through August, with companies detailing the impact to earnings related to COVID19, particularly in the June quarter. For the 12 month period, earnings for the ASX 200 are forecast to decline by 15%. Of the three broad sectors of the market, only resources are expected to hold up well on the back of a robust iron ore and gold price, while banks are likely to show a 30% drop in profits. Earnings from industrials are more mixed and are expected to show a 14% profit contraction, with varying degrees of impact from lockdowns.

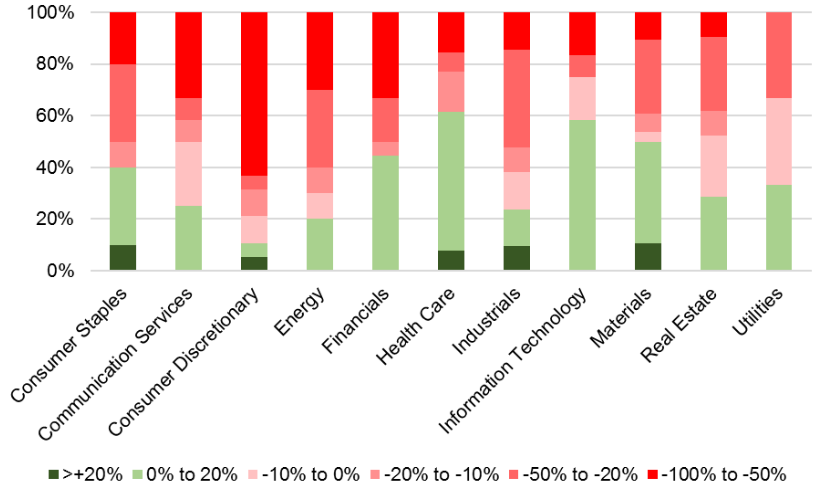
Chart 8: ASX 200: Consensus Aggregate Dividends



Source: Citi

Aggregate dividends for the market are likely to be much lower this financial year, with companies prioritising balance sheet strength amid a fall in profits and an uncertain outlook. While all three broad sectors will likely announce lower dividends, the most significant decline is the major banks, which typically account for a large percentage of the overall market's dividends. Consensus forecasts show a gradual recovery over FY21 and FY22, although these outer years are still expected to be below the dividends paid in FY19.

Chart 9: ASX 200: Dividend Growth (August Reporting Season)

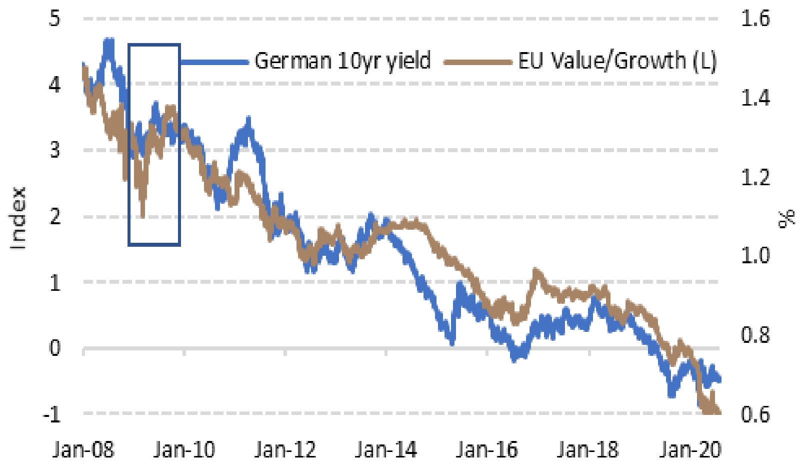


Source: Bloomberg, IRESS

Which sectors are likely to show the greatest dividend declines in August's reporting season? The chart illustrates groupings by number of companies in each sector of the Australian market. Consumer discretionary stocks are expected to be hurt significantly, with many experiencing a large fall in demand caused by the change in conditions over the last several months. Energy dividends will be down on the back of the decline in the oil price. In terms of higher dividend security, the health care sector stands out in the Australian market.

International Equities

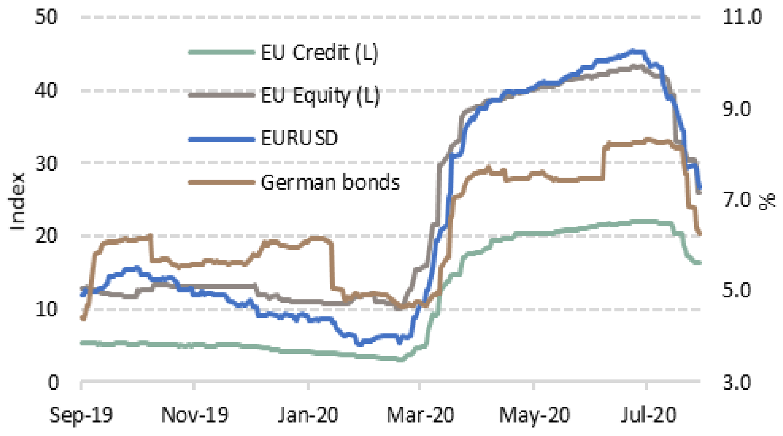
Chart 10: Europe value stocks haven't outperformed like in 2009



Source: Bloomberg

Record drop, record recovery, and unprecedented policy action. This year's extraordinary market environment is tearing apart long-standing relationships between asset classes and investment styles. The market has shrugged off the earnings drop on bets of a fast recovery. Other breakdowns include links between bond yields and equities, as well as oil shares failing to follow crude prices higher. One striking difference from the 2009 rebound is the absence of a real outperformance of value stocks, globally and in Europe. In fact, far from leading the rally, banks remain one of the worst performers this year.

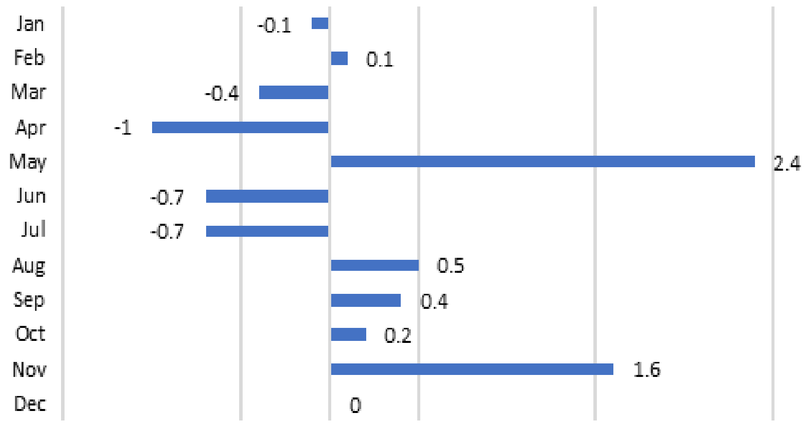
Chart 11: Volatility across asset classes is falling (90d vol)



Source: Bloomberg

The Covid-19 pandemic and subsequent responses from governments and central banks have created market dislocations that are becoming more apparent as the equity rebound gains momentum. Besides distorting historical market relationships, the massive stimulus response is also crushing cross-asset volatility, making many public market investments absurdly priced from a risk-adjusted perspective.

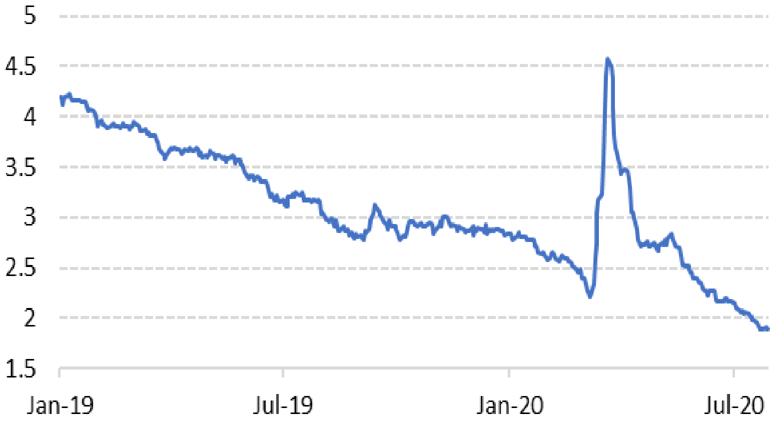
Chart 12: Avg monthly gains (%) USD over past 10yrs



Source: Bloomberg

The pace of the dollar's drop may subside if seasonal strength in August is anything to go by. The currency has risen in August in seven of the last 10 years, posting an average gain of 0.5% and thereafter registering monthly gains for the rest of the year. August advances are usually associated with higher currency, emerging-market, or financial-market volatility.

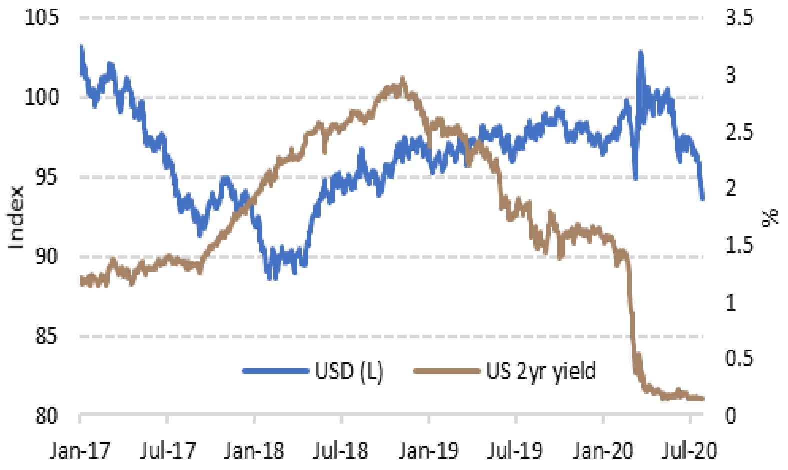
Chart 13: Yield to worst on US investment grade bonds (%)



Source: Bloomberg

Holders of highly rated bonds have never been paid so little. Yields on U.S. investment-grade corporate debt are a basis point or so wider in the last couple of days but are still pretty close to the record low reached earlier this month. Why is this happening? Because the US Federal Reserve is in the market as a buyer of last resort, so investors are demanding less yield for the amount of risk on a company's balance sheet than at any time in at least a decade.

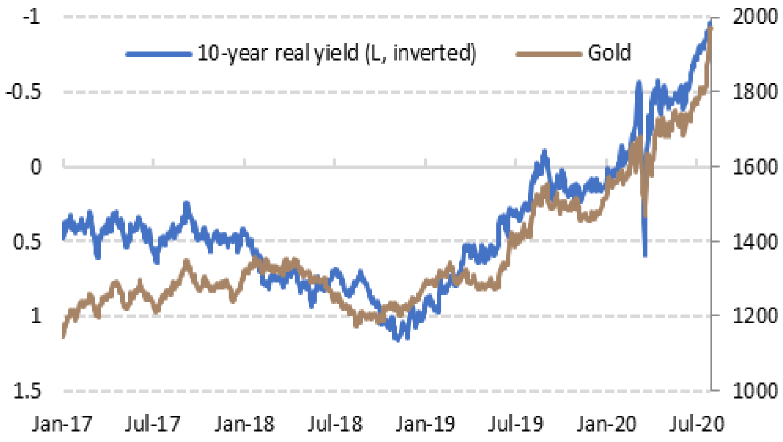
Chart 14: Falling 2-year US bond yields weigh on USD



Source: Bloomberg

The positive U.S. yield premium is no longer a source of support for the dollar. The premium has been overcome by the aggressive Fed policy response to combat the effects of the coronavirus and an associated 150 basis points slide in two-year Treasury yields since January. That's an overwhelmingly negative factor for the US dollar. The dollar isn't always strongly correlated to yields, but with the two-year Treasury yields below 0.15% and markets already priced for lower interest rates in the EU and Japan, the minuscule absolute advantage of Treasuries isn't much of a draw for yield hungry investors.

Chart 15: US 10-year Real yield (%) and Gold (USD/Oz)

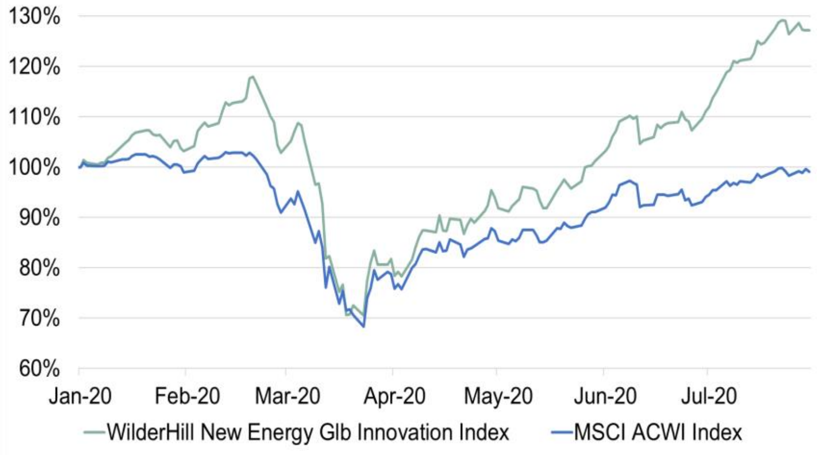


Source: Bloomberg

The consensus is calling for a major shift at the next meeting of the Federal Reserve in September, when the U.S. central bank is expected to lay out a new monetary framework, possibly involving average-inflation targeting and strengthening forward guidance. Investors are already bracing for the potential change. Real yields continued to drop, and traders see no rate hikes until late 2023. At its latest meeting, Chair Powell reiterated the Fed's commitment to low rates until there's a durable recovery. That is pushing gold and currencies higher against the dollar.

Alternatives

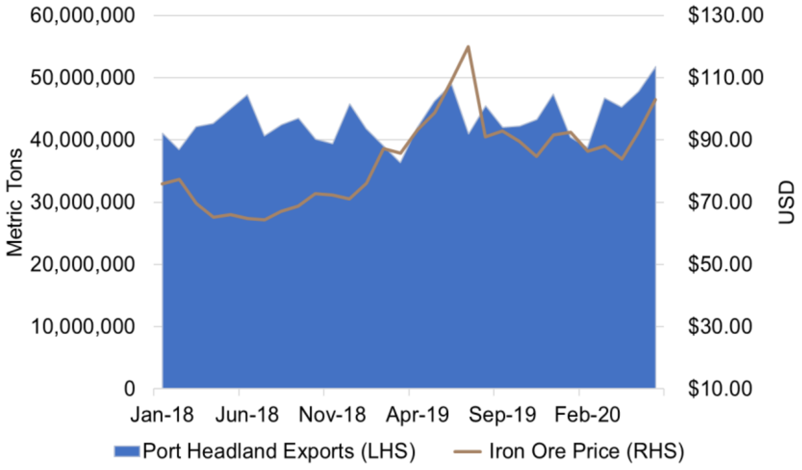
Chart 16: Global renewable energy outperformance (1 Jan 2020 = 100%)



Source: Bloomberg

The WilderHill New Energy Global Innovation Index tracks the performance of companies active in the renewable and low-carbon energy product innovation and development. The year to date performance of the index along with record inflows into ESG focused ETFs are seen as indications of the increasing commitment of investors to sustainable investing. The index has returned 27.2% vs -1% for the MSCI ACWI Index for the year to 30th July 2020. 12 of the 87 index constituents have doubled in price year to date as targeted fiscal stimulus from regions such as the EU act as a tailwind for these stocks.

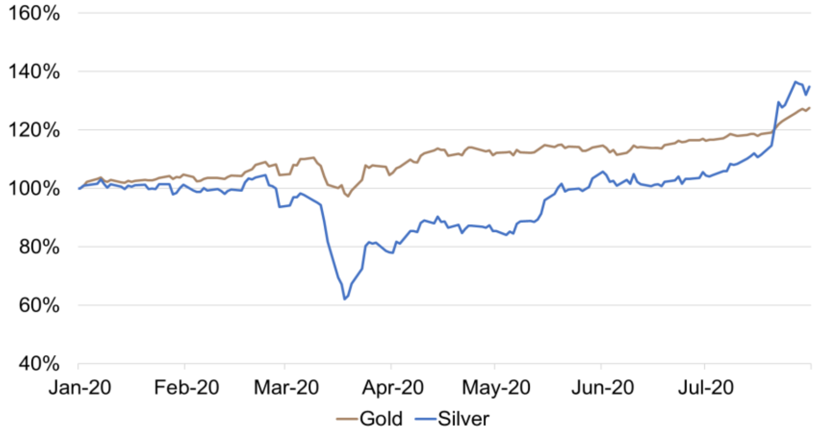
Chart 17: Robust iron ore demand continues



Source: Bloomberg

Shipments from Australia's main iron ore export terminal, Port Headland swelled to record levels at the end of June on robust demand from China. As the world's largest exporter of the industrial metal, Australian minders including Fortescue Metals & BHP Group have benefited from disruptions to competitors based in emerging market countries that are struggling to deal with the spread of Covid-19. Iron ore spot prices are up 12.5% year to date whilst total exports continue toward highs last seen at the end of 2017.

Chart 18: Precious metals prove their store of value (1 Jan 2020 = 100%)



Source: Bloomberg

With the Federal Reserve reiterating their lower for longer outlook on interest rates and a weakening USD, gold continued its surge higher setting new record prices last week, hitting a high of $1,981.27. Silver also continued its exceptional run, now up 32% for the year ahead of golds return of 25% year to date. Analysts are not forecasting a slowdown just yet however; Goldman Sachs have a $2,300 price target on gold whilst Bank of America see the safe haven asset soaring to $3,000.

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