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Investment Insights

Election 2020 Playbook: Potential Outcomes and Investment Implications

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The U.S. presidential election is the main focus for global investors as we enter the final months of 2020, and near-term market sentiment is likely to hinge on the eventual outcome of the vote. Our principal view remains that progress on economic reopening, the pace of real activity, growth in corporate earnings, and the outlook for monetary policy and fiscal policy will ultimately be the most important drivers of market direction. But headline risk tied to the possibility of uncertainty or delay in the outcome is likely to keep volatility elevated, in our view, while the sector-specific policy agendas of the two presidential candidates should also influence relative returns across individual market sectors and industries.

The latest data from online prediction markets imply as of this date greater-than-even chance of the Democratic Party retaining its majority in the House of Representatives, overturning its 53-47 deficit in the Senate to secure a majority, and installing its candidate Joe Biden in the White House. Meanwhile a look at current polling across eight key swing states accounting for 127 electoral votes—Arizona, Florida, Georgia, Michigan, Minnesota, North Carolina, Pennsylvania and Wisconsin—shows Biden leading in each by a margin of up to eight percentage points (Exhibit 1).

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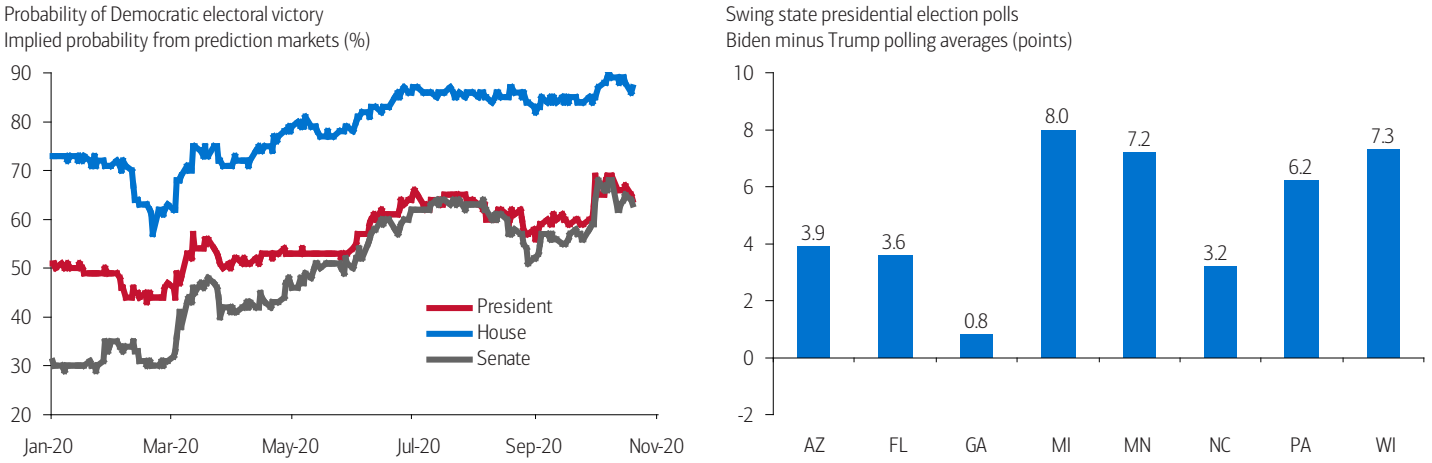
Data as of 10/27/2020 and subject to change.

Exhibit 1: Democratic Party Currently Leading Key Races on Electoral Polling.



Sources: Predictit; FiveThirtyEight; Politico, Bloomberg. Data as of October 20, 2020. Swing states based on polling, demography, election history, voter registration, interviews with state and local party officials, strategists, pollsters and campaign prioritization through staffing, resource allocation, advertising and candidate visits.

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These numbers will of course remain subject to change and, in addition to the outcome of the vote itself, investors could also face uncertainty over the timing of the final result if no clear winner is announced on the night of the election. The higher-than-usual volume of mail-in ballots expected due to the coronavirus pandemic could potentially delay the vote count for days or even weeks after Election Day, and this could come as a source of ongoing market volatility. But what implications could the final result have on markets? How might investors react to a forecast Democratic sweep? Would a party split across the White House and Congress be better for equities? What potential asset allocation decisions should investors consider through the election time frame and into the pent-up-demand cycle of 2021 and the new frontier era of 2022 and beyond?

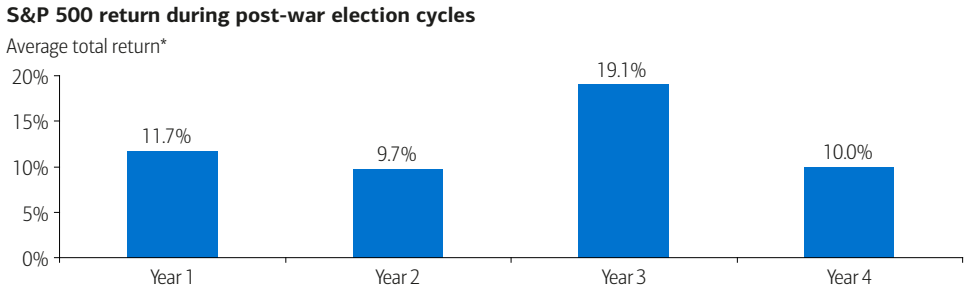
The post-election time line: Key dates to keep in mind

- December 8—this day is designated as the "safe harbor" deadline for states to appoint 538 men and women who make up the Electoral College; critically, it is the date by which states must finish all procedures for the popular vote count, including any recounts or judicial reviews, or risk having Congress getting involved, which is anathema to most governors.
- December 14—the date when electors are required to meet in their states and formally cast ballots for president and vice president.
- December 23—the day states are supposed to transmit their votes to Congress.
- January 3—the new Congress is sworn in.
- January 6—Congress counts the electoral votes and certifies a winner. Note: If no candidate wins a majority of electors, the House votes to determine who becomes president. The Senate votes for the vice president.
- January 20—according to the Constitution, a new presidential term begins by noon of this day. If Congress has not yet certified a presidential winner, the Speaker of the House becomes president. If there is no speaker in office, the President Pro Tempore of the Senate becomes president.

Historically, divided government has typically been considered the best configuration for market returns, as it generally leads investors to expect less interference from changes in economic policy and therefore a greater degree of business certainty. But support for this view has not been conclusive in practice. Indeed over the 18 presidential cycles since World War II, the lowest returns have in fact occurred under a divided government with returns averaging just 8.6% under a Republican president and Democratic Congress. The number of years spent under each combination has of course varied, but party splits have not necessarily always produced the strongest returns. The clearer pattern from post-war electoral cycles is that the third year has been by far the strongest, followed by the first (Exhibit 2). Each individual cycle is different, and the coronavirus crisis has of course been the dominant market driver in the final year of this current cycle. But these historical patterns will nonetheless be worth keeping in mind as we move into year-end and approach the start of the next four-year presidential cycle in 2021.

Exhibit 2: Market Returns and Historical Election Cycles.

Government Configuration *		S&P 500 total return*		
President/House/Senate	Number of years	Average	Maximum	Minimum
D/D/D	22	14.80%	36.30%	-10.00%
R/R/R	6	18.60%	52.30%	-0.90%
D/R/R	10	15.90%	37.60%	-9.10%
D/R/D	4	16.10%	32.40%	2.10%
R/R/D	2	-17.00%	-11.90%	-22.10%
R/D/D	22	8.60%	43.10%	-37.00%
R/D/R	6	16.00%	31.70%	-4.90%



Sources: Bloomberg; House.gov; Senate.gov; Chief Investment Office. Data as of 2020.
*For election cycles from 1945 to 2016. **Past performance is no guarantee of future results.**

Post-election Tax Policy: Biden versus Trump

We would expect the greatest election effect on overall market direction to come from potential regulatory changes and shifts in fiscal policy. And one of the key differences between past administrations across the two parties has been their stance on taxation. In a prospective second term, the Trump administration has expressed support for a "tax cut 2.0" plan that would reduce middle class tax rates and make permanent the individual tax reductions introduced by the 2017 Tax Cuts and Jobs Act (currently set to expire at the end of 2025). Additional cuts have also been proposed, including an indexing of capital gains by adjusting asset purchase prices for inflation.

A prospective Biden administration by contrast has pledged to raise tax rates, generally for those making over $400,000. This would include increases in individual rates (both income and capital gains), an increase in estate and social security taxes, and a partial repeal of the 2017 corporate tax cuts which would lift the corporate rate from 21% to 28% (Exhibit 3). BofA Global Research estimates that tax increases under the Biden plan could reduce 2021 earnings per share for the S&P 500 by as much as 9%, reversing about one-third of expected year-on-year growth.

Exhibit 3: Proposed Tax Changes Under Biden Presidency.

Taxation Category	Proposed Changes
Individual taxes	Raise top individual tax rate from 37% to 39.6%, generally for those making over $400,000. Increase top long-term capital gain and qualified dividend tax rate to 43.4% (ordinary income tax rate plus healthcare surtax) for income above $1 million. Cap the tax benefit of itemized deductions at 28% for taxpayers with rates higher than 28%. Restore Pease limitation* on itemized deductions (which phases out itemized deductions) for taxpayers with income over $400,000. Phase out qualified business income deduction for taxpayers with income over $400,000; expand earned income tax credits; $8,000 tax credit for childcare; equalize tax benefits for defined contribution retirement plans; close real estate tax loopholes, without specifics.
Estate tax	Eliminate step-up in basis on estate-included assets (currently assets included in a decedent's estate are generally stepped-up to date of death values). Currently unclear if such a change would result in (i) a capital gains tax imposed at death, or (ii) require the beneficiaries to take the decedent's tax basis for inherited assets.
Social Security	12.4% Social Security payroll tax on wage income over $400,000 (currently capped at $137,700). Tax would be split between employer and employee. Would result in no Social Security payroll taxes on income between $137,700 and $400,000. No proposed changes to Medicare taxes. Currently 6.2% Social Security tax (employee's share) up to maximum wage base ($137,700); employer pays a similar share. 1.45% Medicare tax full wage base (no cap) and a surtax of 0.9% on wages above $200,000 (couples 250,000).
Corporate taxes	Raise the corporate tax rate from the current 2017 Tax Cuts and Jobs Act (TCJA) rate of 21% to 28%. Impose 15% minimum corporate tax (a so-called minimum book tax) for companies reporting a net income over $100 million. Currently, no corporate alternative minimum tax. Impose a minimum 21% global intangible low-tax income (GILTI) rate on foreign profits (up from current 10.5% rate).

Sources: Tax Cuts and Jobs Act of 2017; Internal Revenue Code; Tax Notes, May 6, 2019; The Hill, July 15, 2019; Scranton, PA speech (Oct. 23, 2019); Bloomberg Tax (Dec. 4, 2019); The Center for Retirement Research at Boston College (Feb. 17, 2020); Tax Foundation, April 29, 2020). Biden's tax plan is estimated to raise an additional $3.8 trillion over next decade (Tax Foundation, April 29, 2020). Signed Executive Order Memorandum on Deferring Payroll Tax Obligations in Light of the Ongoing COVID-19 Disaster (August 8, 2020). Data as of September 2020. *The Pease limitation, named after the late U.S. Rep. Donald J. Pease from Ohio, capped the value of itemized deductions for taxpayers.

Game Time: Potential Election Outcomes and Market Implications

Investors should therefore expect tax rates to rise as stated in Exhibit 3 under a change of administration, but tax hikes would likely only be introduced later in the new congressional term particularly as the economy continues to work through the effects of the coronavirus pandemic. Nearer term, we would still expect volatility around Election Day given investor uncertainty over the outcome of the vote and the risk of a contested result. But as we get through the election period, equity markets should continue to trend higher under any of the three most likely configurations for the White House, the House of Representatives and the Senate.

Under a "Blue Sweep" scenario with Biden winning the Presidency and Democratic majorities in both the House and the Senate, investors should expect passage of a larger stimulus bill next year along the lines of the $2.2 trillion package pushed through the House at the start of October 2020. This would likely generate further gains for equities, a continued rise in bond yields and moderate dollar weakness. A "Status Quo" outcome with Trump winning a second term, Democrats retaining their House majority and Republicans keeping their majority in the Senate would also likely lead to gains for equities as expectations for future tax increases and re-regulation are priced out, while the effects on bond yields and the dollar remain limited. A "Biden Win" outcome with an unchanged Democratic House and Republican Senate would likely result in a watered-down Democratic policy agenda with less post-election fiscal stimulus, more modest future tax hikes, and smaller upward moves for equities and bond yields alongside mild dollar weakness.

Each potential election outcome will also have implications for relative returns across key sectors and industry groups based on the competing policy platforms of the two parties. Among the segments most likely to be affected by new regulations and budget plans that have been under discussion by the two parties are Healthcare, Technology, Energy, Infrastructure and Defense (Exhibit 4).

Exhibit 4: Key Sector Implications of Three Potential Political Outcomes.

Sector	(1) "Blue Sweep" (Biden Presidency – Democratic House – Democratic Senate)	(2) "Status Quo" (Trump Presidency – Democratic House – Republican Senate)	(3) "Biden Win" (Biden Presidency – Democratic House – Republican Senate)
Healthcare	Expansion of the Patient Protection and Affordable Care Act (Affordable Care Act).[1] Public option and expanded Medicaid for those under federal poverty level. Lowering of age for Medicare eligibility to 60. Price control for pharmaceuticals through Medicare negotiation and establishment of drug price review board.	Ongoing attempts to repeal Affordable Care Act. Medicaid spending conversion to block grants, with cap on growth rates of spending. Price control for pharmaceuticals through Medicare pricing and drug importation.	Push for expansion of Affordable Care Act, but public option, expanded Medicaid and lowering of age for Medicare eligibility less likely. Price control for pharmaceuticals through Medicare negotiation and establishment of drug price review board.
Technology	Tougher stance expected on big technology firms through antitrust legislation, stricter privacy standards, and revocation of the Provision of the Section 230 of the Communications Decency Act[2], which gives internet companies immunity from third-party content.	Calls for revocation of Section 230 of the Communications Decency Act and launch of antitrust probe against big technology firms. But more benign stance expected overall, particularly toward gig economy firms.	Tighter rules for big technology firms through antitrust legislation, stricter privacy standards and revocation of Section 230 of the Communications Decency Act. But regulatory measures likely to be diluted by Republican Senate.
Energy	Higher taxation on fossil fuel producers, with subsidies for producers of renewable energy including wind, solar, electric vehicles and biofuels. Rejoining of Paris climate agreement and net-zero emissions target by 2050. Support for federal land and offshore fracking ban.	Ongoing pressure on sector from elevated supply and low prices. But continuation of a favorable regulatory environment for fracking, pipelines, energy exports and fossil fuel energy producers.	Rejoining of Paris climate agreement under new administration alongside net-zero emissions target by 2050. But regulatory and fiscal tightening for fossil fuel producers and fiscal incentives for alternative energy likely to be watered down under Republican Senate.
Infrastructure	Spending plans for over $1 trillion package to include traditional highway infrastructure, rail, 5G, schools and water infrastructure. Strong focus on efficiency and green infrastructure including net-zero buildings and public transportation capacity.	Administration favors large-scale infrastructure plan but unlikely under Republican Senate given disagreement over financing. Greater focus likely on traditional transportation spending with less focus on green infrastructure.	Limited congressional support for increase in spending, with greater emphasis on traditional infrastructure and smaller tilt toward advanced telecommunications and climate change mitigation.
Defense	Support for overseas troop withdrawal, with moderate support for overall budget cuts. More spending expected on diplomacy and technology rather than military hardware.	Support for overseas troop withdrawal, but against cuts to overall defense budget. Continued pressure expected on North Atlantic Treaty Organization (NATO) allies to increase their domestic defense spending.	Support for overseas troop withdrawal, with limited changes to overall budget outlays.

Source: Chief Investment Office. Data as of October 2020. [1]The Patient Protection and Affordable Care Act, commonly known as the Affordable Care Act or Obamacare, is a United States federal statute enacted by the 111th United States Congress and signed into law by President Barack Obama on March 23, 2010. [2]547 U.S.C. § 230, a Provision of the Communication Decency Act. Section 230 says that "No provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider".

Democratic Party expansion of Medicaid under the Affordable Care Act in a Blue Sweep scenario would favor hospitals and Health Maintenance Organizations within the Healthcare sector as insurance rolls are increased. But pressure to reduce drug prices could weigh on pharmaceuticals and would likely come as a larger hurdle for the broad sector under any of the three potential election outcomes given its significant weighting. Similarly both parties have expressed concern over the increased market dominance of the large technology firms, and this could also lead to regulatory pressure in areas such as data privacy and antitrust under either a Blue Sweep, Status Quo or Biden Win configuration. Nonetheless the Technology sector and internet companies within communication services would still remain the biggest beneficiaries of the ongoing expansion of the digital economy, which continues to be accelerated by the need for more digitization in response to the pandemic. Within the Energy sector, Democrats

have pledged to take a tougher regulatory and fiscal stance on fossil fuel producers while favoring providers of renewable energy in an effort to reach net-zero carbon emissions by 2050. In a Blue Sweep or Biden Win scenario, this would mean more pressure for the large oil and gas producers that dominate the Energy sector (although lower supply could stem oil price weakness) with support for producers of alternative energy and related green technologies. Both parties have expressed a desire to increase spending on infrastructure, but a Blue Sweep and, to a lesser extent, a Biden Win would likely result in larger outlays with a greater tilt toward advanced telecommunications and climate change mitigation. On defense, Democrats would be likely to oversee gradual budget reductions in a Blue Sweep scenario while shifting the emphasis on spending away from traditional military hardware. By contrast, Republicans would look to maintain defense outlays nearer to current levels. Both parties would also differ on trade and labor policy. Support for the unwinding or "decoupling" of technological interdependence with China remains bipartisan, but Democrats have suggested a more multilateral approach that would likely extend to an easing of past tariff increases on allied markets such as the European Union, Canada and Mexico. While trade and technology tensions between the U.S. and China would therefore be likely to persist under a Democratic administration, the tactics employed from the U.S. side would likely change, potentially reducing corporate uncertainty over new capital expenditure plans. On labor, Biden has expressed support for higher rates of unionization and an increase in the federal minimum wage to $15 per hour, measures that would pressure margins for labor-intensive sectors such as Consumer Discretionary and Staples. But under a second Trump term, federal government policy would most likely continue to favor employers over labor unions and congressional Republicans have continued to oppose increases in the minimum wage. The net effect of these policy tilts will vary across individual markets and sectors, but crucially, on a trend basis, they should be dominated by the broader trajectory of economic activity and earnings growth.

Asset allocation through Election Day and beyond

As we look ahead to the remainder of the year and into 2021, we still expect progress on economic reopening, accelerating real economic activity, rising corporate earnings, central bank policy accommodation and fiscal policy to remain the most important drivers of market direction. But given the range of uncertainties over the outcome of the 2020 presidential election, the timing of the result and its varying implications for individual markets and sectors through regulation, taxation and spending, investors should nonetheless expect continuing volatility around Election Day and should look for any lasting market effect to be driven by the policy agenda of the new government.

Post-election volatility is likely to remain elevated even absent a contested election, in our view. This is primarily due to our belief that uncertainty over any potential policy (domestic and geopolitical) changes should most probably remain high well into the first half of the new presidential term. This time frame is also coming as the level of current fiscal and monetary support is the largest on record, and the pandemic workout process is still unfolding. At first, asset class rotation may not be as active as most are currently suggesting (given still-record-low rates in fixed income and zero percent baseline or close to it for cash), but rotation within each asset class is likely to be significantly above average, in our opinion. Rotation into more cyclical exposures within equities heading into and through 2021 should occur as the recovery gathers momentum in all three election scenarios given the strong pent-up demand by the consumer, solid growth momentum in housing, focus on job growth by both platforms, and potential for continued improvements on virus treatments, testing and potential vaccines.

In addition, we expect operating leverage in the corporate sector and rising capital investments accelerated by the pandemic to support a better-than-expected profit cycle in the next few years. Some of this positive expectation could be balanced out by a rise in corporate taxes. However, the effect of a change in corporate taxes is generally felt in

the first base year in which policy is implemented and the subsequent years corporations begin to adjust, recalibrate and focus on margin improvement, productivity, and operating leverage to support profits in the long run.

With this view in mind, we expect the equity asset class to provide wide opportunities set on a relative-to-fixed-income-and-cash basis and on absolute basis. Investor cash positions still remain above average and fixed income positioning, particularly in the institutional space, is likely to produce income streams below their current long run targets.

In our opinion, we expect long-term investors to begin to raise equity allocations in the coming years in order to increase potential portfolio returns over time. Higher equity allocations, an increased focus on alternative return streams, more frequent portfolio rebalancing, an increased focus on tax efficiency, and a major re-investment in dominant growth themes within the equity asset class are a part of our expectations for a wave of portfolio considerations in the next few years. Portfolio advice and guidance should rise in importance as rates remain at or close to record-low levels in fixed income, policy uncertainty in the U.S. and globally remains high, deficits continue to expand, prospects for a correction in the U.S. dollar rise, and the development of new themes that have been accelerated by the pandemic continue to gather momentum in a world still grappling with the increasing need to produce cash flow in order to pay down future debts.

In summary, we don't necessarily subscribe to the growing belief that "there is no alternative" other than equities as it relates to asset class exposure. Rather, we do believe that the equity asset class still has the highest ability to potentially produce attractive compounded absolute growth and on a significantly wider total return opportunity set relative to fixed income and cash in the coming years. Elevated political uncertainty, in our view, could actually compound this thinking as the need for growth rises in the years ahead! There is clearly a lot of work to do with the pandemic workout process and political uncertainty remains significantly elevated. However, we continue to focus on the ability of the private sector to ultimately produce new jobs, invest in areas of innovation, and increase growth (dominated by the U.S.) mixed with powerful demographic trends as millennial incomes grow and a powerful housing cycle continues to develop. These are all supportive of equities in the long run. As volatility in the capital markets rises into year-end, we believe investors should consider re-balancing their portfolios back to their target asset allocation, which may include re-risking up in equities as we head toward "full recovery" in the economy next year.

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Indexes are all based in dollars.

S&P 500 is a stock market index that tracks the stocks of 500 large-cap U.S. companies. It r epresents the stock market's performance by reporting the risks and returns of the biggest companies.

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