Connecting The Dots

Episode 3: US elections – what are investors watching?

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Opening soundbite, Anthony Balestrieri, CIO, Americas: *Tax will be the big issue for either candidate, whoever wins, because obviously the Trump tax cuts expire at the end of 2025. The bad news there is that neither party wants to eliminate them altogether.*

Romil Patel: Hello and welcome to Connecting the Dots, the podcast brought to you by M&G Investments, where each month, experts from across our global network of investors join us to bring you their views across equities, fixed income, private markets and occasionally, the macro picture. My name is Romil Patel and I'm delighted to be joined today by Anthony Balestrieri, Chief Investment Officer in the Americas, and Tony Finding, Fund Manager based in London. Welcome to you both.

Anthony Balestrieri: Thanks, Romil.

Tony Finding: Hello.

Romil: 2024 has seen the largest democratic exercise in human history with billions of people taking to the ballot boxes to action their right to vote. We've had election results from the UK, India, Indonesia, Mexico, France and many more. Now all eyes are on the US, specifically Congress and the White House. The options for voters are a second term for a Trump presidency, or the first female president in US history should Kamala Harris emerge victorious. Well, let's go to Anthony in Chicago for more. Anthony, how are things looking on the ground and what are you keeping an eye on?

Anthony: Certainly there's been a lot of focus on the US election, particularly the top of the ticket. This has been a very unusual election cycle where you had a sitting president who stepped out of the race midway and a vice president who stepped in. That being said, the election still remains very close and while the market is focusing on the top of the ticket I think the more interesting fact is what's going to happen behind the ticket. That's where you're looking at the Senate and the House of Representatives and how that plays out, because that will really drive what whoever gets elected will be able to do once they're in office. If we just set the stage there, if we look at the Senate, the Democrats currently enjoy just a two vote lead in the Senate.

Joe Manchin of Virginia is retiring – that seat will likely go Republican. So that puts you at 50-50 in the Senate, and if we look at what's going on, a third of the Senate is going to be re-elected this year. More Democrats are facing re-election in states that Trump won than Republicans are facing re-election in states that Biden won. So the maths works in the Republicans favour.

It's likely that Senate will move to the Republican side. The House is just the opposite – if you look at the House of Representatives, Republicans enjoy a modest lead there. The entire House is up for re-election this year, but more Republicans are facing races in states that Biden won than Democrats are facing re-elections in states that Trump won in. So the maths in that case works in the Democrat's favour. It's likely that those two houses will be split, which will limit the amount of legislation that will be able to be passed by either party regardless of who wins the election. Tony, I don't know how you guys see it from Europe when you look at the landscape here in the US.

Tony: I think the good thing with the US system as you've just described it there is the checks and balances. If that is indeed the case come November, then how much power the president's actually going to have will be checked, so it's then all about compromise and I think who wins is actually not that important for investors in American assets. The trajectory of the global economy is seldom sustainably influenced by election outcomes and I think if that sort of outcome is what happens in the US, it may ought to just be any short term noise really in terms of market behaviour.

Romil: Anthony, what will investors be looking out for in the event of either a Kamala Harris victory or a Trump 2.0 presidency – in particular when it comes to spending promises? You mentioned fiscal discipline, given the government is currently running a cumulative deficit of $1.9 trillion so far in the current fiscal year.

Anthony: I think that's the troubling part. Neither party has shown any discipline when it comes to fiscal spending. The $1.9 trillion number is big, but if you put it in the context, we're running deficits that run anywhere between 5% and 6% of GDP. If you look at the Congressional Budget Office estimates, it looks like we're going to be running deficits in excess of 5% for the next ten years – [that's] not good. We get away with it because we are the largest economy in the world. We are the reserve currency, but we're spending like we're in a recession and in fact, the economy's growing rather robustly. Add on top of that the expense of interest, it's approaching $1 trillion just in interest expense – that's about 12% of what we spend every year and that number just goes up. So the concerns I have around that is do you end up getting a crowding out effect where the government is coming to market to continually fund new initiatives, pushing more debt in? Obviously your interest expense going from a world of zero rates to a world of rates that are significantly higher puts pressure on other asset classes in terms of competing for funding, and then keeps longer rates higher than they would be otherwise.

Tony: I'd totally second that. Neither party appears to have any intention really of addressing this huge fiscal expenditure. It almost appears to do so would be political suicide so it just seems to be promises and it's a question of where that where that goes.

I don't know how you feel, Anthony, about other stuff around tax policy or business regulations, tariffs, antitrust [and] those kind of factors.

Anthony: Tax will be the big issue for either candidate whoever wins, because obviously the Trump tax cuts expire at the end of 2025. The bad news there is that neither party wants to eliminate them altogether. On the Democratic side, they want to maintain the tax cuts for people that make under $400,000. That would add another $4 trillion to the deficit.

Trump is obviously talking about extending the entire package and maybe adding more tax cuts. So those numbers that I gave you before in terms of the projections that the CBO [Congressional Budget Office] makes assumes that all those tax cuts go away and in fact, we know they're not. So it's going to be a significant portion of it, or all of it depending on the candidate, they'll attempt to push through.

On the tax side, it just aggravates the situation. The flip side is we look at executive orders on trade. The dynamics on trade are interesting because there's a lot of concern around Trump and you're in a campaign season, so lots of rhetoric is thrown around. It's one-upmanship and it's whether it's no tax on tips, down payment assistance on new homes [or] capping grocery prices. So all these goodies that candidates throw out to try and generate votes, the reality that a lot of that stuff goes through is pretty small, but it does indicate lack of fiscal discipline so that will be challenging.

Once again, tariffs. If you look at the tariffs during the first Trump administration and then what happened when the Biden administration took over, oddly enough, most of the tariffs were left in place. They weren't taken down and if you look globally now, we're de-globalising, it's a tariff war. So obviously electric vehicles – 100% tax in the US, the bills being pushed through the other day looked at Chinese content and EVs. Europe is doing something similar – all of that I don't think is constructive for growth. That's a net that ends up being a tax on the world and it's beyond cars. It's because of the pandemic and the supply chain issues and concerns around domestic security where we're onshoring supply chains, and there's a desire to get industries that were abroad back onshore.

In most of the Western countries we're just not good at it. If you think about EVs, China dominates, they make 4 million cars more than they need every year. Solar panels, same thing, wind turbines as well. But we in the West want to onshore all that stuff so we're laying tariffs on those goods to not allow them in our country to try and let domestic businesses evolve. There's a cost to doing that which, I think, ends up remaining in higher rates and it is somewhat inflationary. So, the picture isn't great.

Tony: How all of this ultimately manifests itself is really interesting in that inflation issue as well. Do we just continue to be in a very, very low inflationary world? You're putting an awful lot of onus on the technology side, advances in AI and everything else to keep a lid on inflation, but all of this borrowing, how does it eventually resolve itself? Analytically, I think that really does pose some issues for where you think bond yields ought to sit. What is the shape of that yield curve? Will investors demand a risk premium for long-term inflation risk? I think we keep an open mind on how it resolves itself ultimately.

Romil: As you both know, elections tend to dominate the news cycle both at home and abroad. But beyond the headlines, what really matters to investors? In other words, what evolution of the economic fundamentals are investors tracking and why?

Tony: Well, certainly from our point of view in the macro team, I would say there are three key variables that we look at here and that would be profits, inflation and real interest rates. So if the election – wherever it may be – doesn't fundamentally alter any of those three then I think the long-run trajectory for markets ought to be somewhat unchanged.

But any measures that do attack profits or promote huge profits growth would have long-term consequences. Likewise inflation – which we've just touched on – potentially some inflation risks in the system, again that affects the rating of assets, what required yields do you need on fixed income assets and everything else? Real interest rates, again, the valuation of all assets are impacted by that. So we really try and filter out the noise and focus on the trajectory as a result of the election – or any other event – on those fundamental factors that we think anchor the returns that investors achieve off assets in the very long run.

Anthony: I tend to agree those are the things we look at. Just looking at a bit more granularly in the US, we've talked about the fiscal trajectory not being great, [there's] concern about how that ends up affecting inflation. We are certainly slowing in the US, [there's] a lot of talk about soft landing versus recession, but you are seeing some signs, certainly in the lower economic strata of stress. So while inflation has come down, prices are still 20% higher than they were pre-pandemic. A lot of times people look at the rate of change versus the level, and the rate of change certainly looks good now but the level is still problematic for many. That puts some stress on the lower level, and you've seen that in credit card delinquencies, auto loan delinquencies and you're watching that to see how far up the economic strata it moves. You have seen a lot of the consumer-facing companies face some stress – that goes from the luxury providers down to the quick service restaurants where they've had to retrench. Earnings have not been good, which once again, indicates some stress on the consumer side. We don't expect big changes from the election, but we think there's some trends that are in place that are worth just keeping a close eye on.

Romil: Markets can overreact when unexpected outcomes are produced. That's something that we saw following the Mexico election results. Does this also create potential investment opportunities?

Tony: It certainly does. If we get a genuine overreaction in markets this would be something, that we as investors would be looking to potentially exploit.

Our framework does keep a sense on those medium term anchors in terms of inflation, profits and real interest rates. Mexico's a great case in point here. You had an election where the ruling party wins [and] ends up having a bigger majority than people expected, which spooked markets because things like judicial reform would be seen as market unfriendly.

But in the case of Mexico, you've got an economy and a government that has, over the last several years, produced some very good economic outcomes in aggregate. The Mexican peso had been one of the strongest-performing currencies and then you get a surprise around the election and it's the extent of the election victory that causes the Mexican stock market to fall over 10% in one day. This was something that we as a team did look to exploit and our macro strategies did tactically engage in Mexico around that time.

Anthony: I would agree with Tony that the valuation framework in the US is not compelling at the moment. Things are priced fair to expensive, so you certainly would welcome a shock that will allow you to step in. We both work with a valuation framework and to steal one of your terms, Tony, an 'episode' where the market overreacts to a particular fundamental which allows you to step in if you take the longer view. Right now, the market seems to be shrugging everything off. If you look at some of the geopolitical stuff that's going on globally, you've got Russia-Ukraine still going on and the Middle East is heating up. The market's just shrugging all of that off and valuations are not very compelling, so a little bit of volatility would be very welcome.

Romil: Well elections come and go but disciplinary forces are ever present. How cognisant should politicians of today be about real time feedback from markets?

Anthony: It's an interesting question. Take the US as an example – if you were to have politicians key on market outcomes, the markets have actually performed very well in the US. But you could say a large part of that is from us throwing a lot of money – whether that's fiscal or monetary – at the economy overall.

We spent trillions of dollars with pandemic aid, there's been the Inflation Reduction Act, the CHIPS [and Science] Act, the Infrastructure Act – all those things have kept momentum going so the markets reacted well to that. On the flip side, the balance sheet side of the equation has been deteriorating. The deficits are going up and costs are going up, so the long-term trends are not great, but the market certainly is loving what's happening right now. The message you get necessarily as a takeaway from the market for politicians is unclear. I think politicians generally are a short term animal where they're looking towards the next election, so they're looking to their next vote, not necessarily looking at the long-term implications for the economy. They certainly will react as things deteriorate, but my expectation is nothing changes until you get some bad news.

Tony: Yes in fact, I remember the Trump administration was often pointing out the S&P 500 as a sort of barometer of the success of his economic policies. In the case of the UK just a couple of years ago in 2022, Prime Minister Liz Truss, certainly her tenure as prime minister was very short. I certainly think that the performance of markets – the big sell-off in quite a chaotic fashion in the UK gilt market, the fall in sterling as well – were contributing factors and I think most people would think that given the recent election in the UK, the Labour Party, is very, very conscious of that episode and that is potentially checking their willingness to do anything too radical with fiscal policy, but we'll see.

Romil: Well, we could go on, but sadly, we must leave it there for this episode. Anthony, Tony, thanks indeed for sharing your insights with us. We really appreciate it.

Anthony: Thanks, Romil.

Tony: Thank you.

Romil: And thanks to you, our audience over for tuning in. Don't forget, you can subscribe to our podcast and we look forward to seeing you next time. But it's goodbye for now.

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