Weekly Digest

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O Say Can You See . . .?

In August I began my Monthly Commentary by referring to the three main areas of uncertainty, which – according to neurologists – if left unresolved, can raise stress levels in humans. For those who don't receive that publication, it's worth reiterating them – Outcome, Path and Duration. More simply: where are we going? How are we getting there? How long will it take? Settle these three issues and one's life will be immeasurably calmer. Today, as promised last week, we are going to look ahead to the US Presidential election – just four weeks away now – bearing these factors in mind. What, indeed, can I see, as I start writing by dawn's early light?

I am sometimes chided for spending too much time focusing on matters on the other side of the Atlantic, but it is hard to overemphasise the role that US politics, its economy and stock market play in our investments. Geopolitically, the deteriorating relationship between the US and China has the potential to set the course of global trade for years ahead, and also to have a profound impact on the development of new technologies. There is a real risk of the world splitting into separate standards along the lines of, for example, VHS and Betamax, with all countries having to decide which team they are on. America's economy remains, for now, the world's largest, and therefore hugely impactful on global developments. The US stock market is a behemoth, accounting for 58.6% of the MSCI World Index. Japan is a distant second at 6.6% (latest available data at 31/8/20). The depth and breadth of historical data available for the US stock market is also unrivalled, which is why I often use it to make broader points about long-term investment patterns.

There is no doubt that the US election is the main (scheduled) event in the fourth quarter. It is also a classic trading opportunity for, well, traders. Election Day is fixed in the calendar, the result is binary (ultimately there will only be one winner of the presidency) and with potentially asymmetric investment outcomes within the market (in that there is an extreme ideological and policy divergence between the candidates leading to quite different outcomes in various sectors of the economy – think Green New Deal vs support for fossil fuel).

The potential for big relative movements attracts both a more speculative dollar and interest from more conservative investors wishing to hedge against outcomes that would be unfavourable to their portfolios. This demand tends to push up the price of derivative instruments, such as options, around the event, which raises the market's pricing of implied volatility (the expected daily move in an index or individual stock). About the only thing that commentators are united upon at the moment is

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that there will a period of elevated volatility around the election, which is, in many ways, a great way to sound very clever without actually shedding any light whatsoever on the result.

Exact predictions are not exactly helped by the fact that there are many shades of grey. Not only is this a presidential election, but one-third of the seats in the Senate and all of those in the House of Representatives are also up for grabs. At one extreme outcome we have a "Blue Wave", leaving all elements of government in the hands of the Democrats.

This would lead to the introduction and passing of policies with a greater bias towards "tax and spend", with the emphasis on affordable healthcare, education, infrastructure and the environment. At the other extreme we have "Trump Unleashed", which might look a bit more like the first two years of his presidency with the risk of the escalation of tensions with China. In the middle of the range is something more like the status quo, leading to an inability to get bills passed through both houses of Congress until a crisis is imminent and to a greater reliance on executive orders.

Polling organisations and betting companies are the prime source of intelligence for a predicted result. Nate Silver's highly regarded (although not flawless) FiveThirtyEight – the total number of legislative seats on Capitol Hill – has a "poll of polls" analysis that currently has Joe Biden at 50.8% and Donald Trump at 42.8%, and so a clear lead for the challenger. However, we have probably yet to see the full impact of Trump's Covid infection, on which, again, there is no clear consensus on the influence. Some say it will boost a sympathy vote; others that it only reflects his dangerous attitude towards the virus and therefore his lack of leadership qualities. Take your pick – although you won't be surprised to learn that attitudes will generally be shaped and amplified according to existing beliefs.

Betting website PredictIt currently has Joe Biden a clear winner at 64%, with Trump on 38%. Good Judgement, a "superforecasting" project that brings together the views of people and organisations that it believes are better-than-average at predicting outcomes, last week elevated Biden to an 82% probability of victory in the aftermath of the shambolic candidates' debate. Crucially it also has a 67% probability of the Democrat "Blue Wave" (with only a 1% chance of the Republicans sweeping the board).

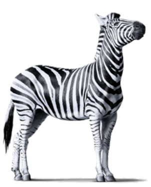
Are these predictions vaguely reliable? There is no doubt that pollsters have learned from previous mistakes, and are now much more granular in their assessment of different demographies. They are also well aware of the "shy Trump voter" who did not reveal him or herself in 2016 until entering the polling booth. Models, as we know, are just that, with all their inherent flaws and uncertainties, but they are best thing we have to go on and tend to be what markets price their expectations off.

If those are the possible outcomes, what about the path? Recent weeks have already proved that it's anything but a straight and narrow one. The death of liberal judge Ruth Bader Ginsburg opened up a whole new can of worms regarding the composition of the Supreme Court, with Trump immediately pressing to have his preferred, more conservative replacement, Amy Coney Barrett, elected to the bench.

Not only did this distract from the pressing issue of passing a new stimulus bill to support the economy, it also has big implications for future policy outcomes as well as, in some circumstances discussed in the final "duration" section, the election result itself.

The President's positive Covid test was another surprise ingredient thrown into the mix. I am not going to speculate on the health outcomes here. Suffice to say that we believe that the Constitution has sufficient clarity to mean that the election will take place as scheduled, whether it be with Trump leading his party, or Vice-President Mike Pence, or even another candidate.

Even so, it is almost inevitable that the next four weeks will throw us some more curve-balls, to use a baseball metaphor appropriate to the context. Who knows what new dirt will be dished up by



either side, although nothing really seems to stick at the moment. So much for the big revelation about Trump's taxes, for example. Remember, too, that the 2016 election might well have been swung in Trump's favour by the late revelation of an FBI investigation into Hillary Clinton's use of a private e-mail server. I think it would almost be more surprising if there were no surprises in the next month.

It is also worth bearing in mind that the fate of the presidential election will probably be settled by the results of as few as four states. The "electoral college" system places (some would argue) disproportionate power in the hands of the electors of certain smaller states. It's all very well for the Democrats to win California and New York at a canter, but the focus has to be on Wisconsin, Michigan and Pennsylvania, ostensibly the battlegrounds upon which Clinton lost the war in 2016 by very narrow margins. Of the bigger states, Florida will be the key one to watch.

Finally, what about the duration? This is where expectations are deviating most from the norm. Historical data since 1928 shows that volatility tends to rise in the months leading up to the election (for reasons outlined earlier) before normalising immediately thereafter. This time that is not the case. Volatility expectations, as defined by VIX Index futures, remain elevated through the end of the year and into January. This, at least from the perspective of markets, is evidence that there is the potential for a drawn-out process in which the result is not clear for weeks, as opposed to in the early hours of the fourth of November.

The last time this happened was in 2000, when there were multiple inconclusive recounts of the vote in Florida – remember "dimpled chads"? – until Al Gore finally conceded as late as 12th December. But this had required the intervention of the Supreme Court, which ruled only 5-4 in favour of passing the decision back to Florida's Supreme Court, which effectively ended the recounts. This could be why the composition of the Supreme Court is so important this year. George W. Bush was declared the winner having lost the popular vote, but winning Florida by a final margin of just 537 votes. Florida carries twenty-nine electoral college votes. Bush sneaked an electoral college majority of just two.

So what might happen this year? There are two key elements to focus on. First is the probable high percentage of early voting, thanks to people wanting to protect themselves from Covid and avoid potentially long socially-distanced queues on election day. You might think that this would speed up the process, but, in fact, it delays it owing to the need to process and then count ballots manually. Although some states allow for early processing, votes cannot be counted early for fear that they might be revealed and influence later voters.

Donald Trump has already made it abundantly clear that he regards mail-in votes as open to abuse and voter fraud, and so he has laid the foundations for complaint if the result looks as though it is going against him. Importantly, and not coincidentally, it also appears that Democrats are much more likely to mail-in votes. It is entirely possible that Trump could be in the lead in certain states based on votes cast on election day, but that the lead could be whittled away as mail-in ballot tallies are submitted. This happened to Bush in Florida in 2000. Trump would then do everything he could to discredit the mail-in ballots, and, of course, Biden would take the opposite tack. Cue weeks of clashes in the courts.

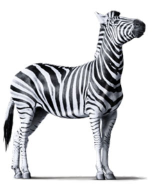
The other, and possibly more worrisome, threat is that Trump just refuses to leave even if he loses. This has to be a low probability risk owing to the Constitution, but it certainly isn't zero. Again, it would involve the courts, although who knows what pretexts might be invoked. The best that markets can hope for (political preferences notwithstanding) is an early landslide win for either candidate that makes any further dispute redundant.

Investors are looking back to 2000 for an example of what a delay might mean for equities. Then the S&P 500 fell more than 10% during the impasse. However, the market was in the throes of the bust

following the tech boom, and also the Federal Reserve was in the process of tightening rather than loosening policy.

Should we go down the path of a long delay, we will have to judge markets on their merits at that time. Even so, it's difficult to imagine them thriving amidst such uncertainty.

As promised, then, these are some of the key issues upon which to focus in the weeks ahead from an investment perspective. That doesn't actually mean that we are planning to make big portfolio shifts during the period. The truth is that whatever volatility is created we can be pretty sure that we will have a definitive result by inauguration day (20th January 2021), and we can get back to assessing more usual things. However, it is possible that markets, with their short-term focus, will offer us some attractive opportunities for the longer term, and we will be more than happy to take advantage of such opportunities if and when they arise.



Last week's Economic Highlights

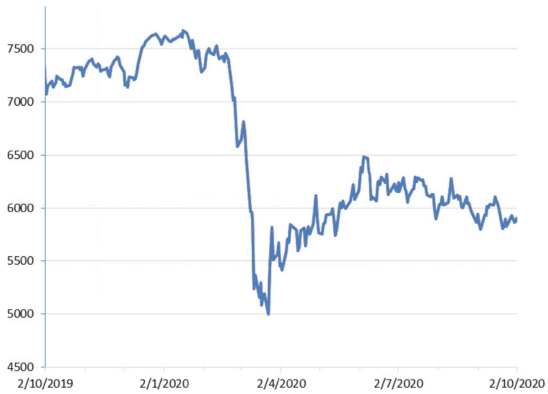
FTSE 100 Weekly Winners

Standard Life Aberdeen PLC	14.9%
ITV PLC	11.3%
DS Smith PLC	10.6%
Mondi PLC	10.3%
NatWest Group PLC	10.3%
Lloyds Banking Group PLC	10.0%
Legal & General Group PLC	10.0%

FTSE 100 Weekly Losers

Rolls-Royce Holdings PLC	-26.6%
DCC PLC	-9.4%
BP PLC	-8.1%
Royal Dutch Shell PLC Class A	-7.1%
Royal Dutch Shell PLC Class B	-7.0%
Ocado Group PLC	-5.7%
Avast PLC	-5.7%

FTSE 100 Index, Past 12 Months



Source:FactSet

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