Global Markets Analyst

The US Election—Debating the Asset Market Impacts (Wilson/Chang)

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- This year's US presidential election is still almost six months away. But the first debate, now scheduled to take place in less than a month (three months earlier than usual), may increase focus on the election and provide fresh clues as to how the market is viewing its impact on asset markets. Ahead of this, and the summer convention season, we update our views around the potential asset market impacts of the main election outcomes.
- We focus on the likely impacts from shifts in fiscal, tax, and trade policy. Unified government control is likely to generate the most positive fiscal impulse, while divided government is likely to lead to more fiscal restraint—but in all scenarios, the likely fiscal effects in each scenario are much smaller than in 2020, and so the market's potential reaction to proposed tariffs may be the biggest swing factor.
- At this stage, our baseline scenarios predict 1) a modest rally in equities, higher yields, and USD strength in a **Republican sweep**, 2) modest equity downside, higher yields, and USD weakness in a **Democratic sweep**, 3) modest equity downside, slightly higher yields, and USD strength in a **Trump with divided government** outcome, and 4) equities flattish, lower yields, and USD weakness in a **Biden with divided government** outcome.
- If fiscal proposals wind up being larger, or the market reacts more intensely to tariff proposals then these outcomes could be quite different. Other potential policy shifts that we do not explicitly consider here (geopolitical tail risks, Fed risks) may also broaden the asset impacts. Given the uncertainty around these reactions, a Republican sweep may not reliably follow the asset footprint seen in 2016.
- We still see a stronger USD as the most reliable impact of a potential Republican victory because it is the most consistent response to tariff risks. Higher yields are more likely in either "sweep" outcome than in divided government outcomes. Our baseline estimates do not make a strong case for hedging equity exposures, but there are scenarios that could generate more significant equity pressure. Because FX and rates impacts vary across different potential risk scenarios positioning for deep equity downside directly may still offer the most efficient protection for long risk portfolios.
- The challenge for positioning for or hedging against election outcomes is that the

election itself is still some time away. But market focus could pick up ahead of that point. Volatility in many parts of the market remains quite low by historic standards, and even lower still ahead of the October/November period. We think that presents opportunities to look at positioning for increased focus in the election through the summer and beyond.

The US Election—Debating the Asset Market Impacts

The US elections in November remain a major risk event for asset markets. Election Day is still nearly six months away, but we are now within three months of the conventions and of the period where polling data is likely to become more reliable. The first presidential debate is now scheduled for June 27th, well ahead of the usual September timeline. In both 2016 and 2020, the first debate provided one of the first broad market-moving events of the election cycle.

We outlined some early thoughts a few months back on the potential asset market impacts of different election outcomes. The election has still not yet been a major driver of markets, so direct clues as to how markets may respond remain limited. The upcoming debate is likely to be the first potential point for the market to reveal how it currently views the asset "footprint" of different election outcomes. Ahead of that point, we revisit our thinking here. Our Economics team recently set out more detailed views on the likely policy implications of the election. We use that analysis here to estimate an updated set of potential responses across major asset markets and highlight where uncertainty is particularly high.

In February, we highlighted five major policy areas that might drive asset market responses to the November election: fiscal policy; tax and regulation; trade policy; the Fed and immigration; and geopolitics. The last two are the most difficult to address concretely, so we focus here on quantifying the impact of the first three. Even in these areas, uncertainty around the impacts is high and it is easy to think of alternative reactions and asset-specific circumstances that a unified approach like ours will gloss over. But we think it is important to estimate the likely impacts as best we can and to refine them as new information becomes available.

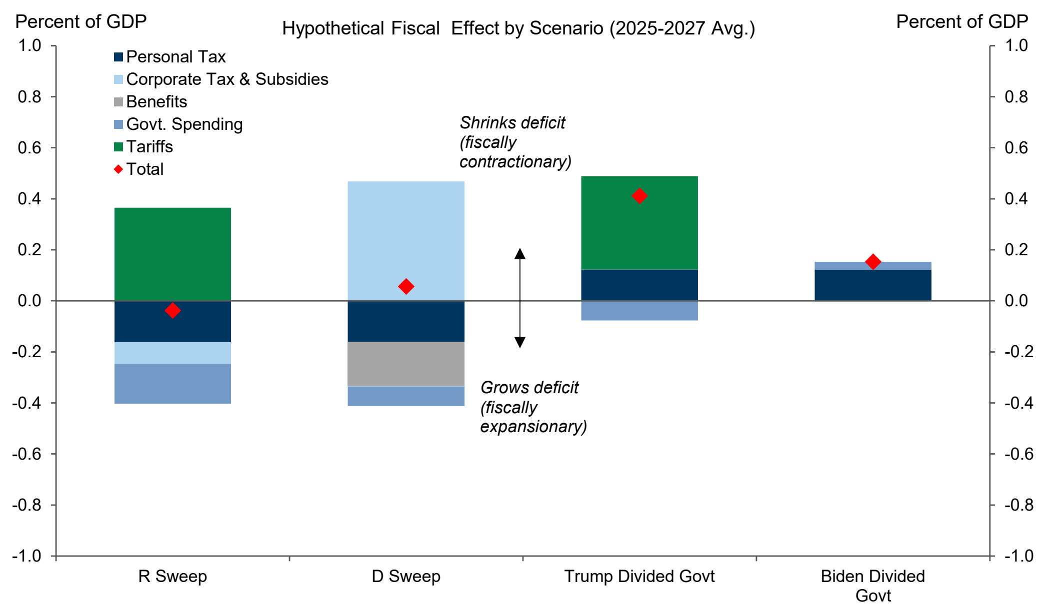
We still find that the most consistent implications across approaches are for the US Dollar, with a Trump victory likely to lead to a stronger Dollar through several potential channels. Equity and bond yield implications are more dependent on assumptions about how markets react to the prospect of potential large tariff increases in a Republican presidency, but there are conditions under which those markets might see substantial shifts too.

Fiscal and tax shifts more modest than in 2020

We start by considering the impact of the fiscal and tax agendas that our US economists currently expect in the four main election outcomes for the Presidency and Congress (Republican sweep; Democratic sweep; Trump with divided government; Biden with divided government).

Exhibit 1 shows the hypothetical fiscal effect in each scenario, including from the fiscal impact of potential tariff policies and use of the funds that they generate.[1] The largest shifts in fiscal policy occur in the two "sweep" scenarios, given the difficulty of implementing significant changes under divided government although we assume that tariff policy depends only on control of the Presidency. For the Republican sweep, this comes largely from the extension of expiring tax cuts and the assumption of additional tax cuts that offset new tariff revenue, while for the Democratic sweep higher corporate taxes are likely to be more than offset initially by an expanded Child Tax Credit. As we did for the 2020 election, we think about the potential fiscal impulse in terms of the upgrade or downgrade to growth expectations implied by Exhibit 1 and use our models to generate estimates of the impact of that growth shift on asset markets.[2]

Exhibit 1: The largest shifts in fiscal policy are most likely under unified government outcomes



Source: Goldman Sachs Global Investment Research

For tax and regulatory policy, we consider potential changes in terms of shifts to after-tax earnings and from there to equity prices. For a Democratic sweep, we consider the prospect of a corporate tax hike from 21% to 25% as the main proposal (Biden has proposed a 28% rate and other corporate policies but this could be too ambitious in a thinly divided Congress). While our central case is for no change in corporate tax rates in a Republican sweep, we see markets assigning some chance of a boost to corporate earnings from both potential corporate tax cuts and looser regulations. We assume that under a Trump presidency with divided government, the market still expects looser

[1] We have collapsed the two potential tariff scenarios from the original analysis into an equal-weighted version of those two alternatives, as only the election outcome itself is likely to be determined on Election Day.

[2] In 2020, inflation was below target and the unemployment rate was higher, so we assumed that shifts in the fiscal impulse did not generate an offsetting monetary policy response. With inflation still above target and the unemployment rate at historically low levels, we assume that now the Fed's policy path would shift to offset potential changes in the growth path. This dampens the impact of fiscal policy on equities and boost its impact on bond yields.

regulatory policy, but no corporate tax shifts.[3]

Exhibit 2 shows the estimated impact on the S&P 500, US 10-year yields and the trade-weighted US Dollar from these combined fiscal and tax shifts in the four scenarios. These estimates are quite small compared to our predictions in 2020, when the expected shifts in the fiscal impulse were much larger. Because it is the two "sweep" scenarios where the fiscal impulse is most positive, those scenarios boost bond yields more, while the fiscal restraint from divided government pushes in the opposite direction. The impact of potential tax and regulatory changes mitigates the potential tailwinds from the boost to growth to equity markets in a Democratic sweep and boosts them in the Republican sweep scenario.

Asset markets could obviously move more sharply if fiscal and tax policies become more ambitious as policy platforms firm up. Markets might also react more significantly to proposals for meaningful fiscal expansion if those proposals fueled focus on the sustainability of public debt or interacted with concerns about potential subordination of the Fed.

Exhibit 2: Fiscal and tax shifts imply quite modest moves in major assets

Estimated Asset Impacts From Fiscal + Tax/Regulatory Shifts				
	R Sweep	D Sweep	Trump with Divided Govt	Biden with Divided Govt
Equities				
S&P 500	3.9%	-4.3%	0.2%	-1.0%
FX				
EUR/USD	-0.1%	-0.1%	0.1%	0.1%
AUD/USD	0.2%	0.3%	-0.2%	-0.2%
JPY/USD	-0.7%	-1.3%	0.9%	0.9%
MXN/USD	0.2%	0.4%	-0.3%	-0.3%
CNH/USD	0.0%	-0.1%	0.1%	0.1%
CAD/USD	0.2%	0.3%	-0.2%	-0.2%
GS USD TWI	-0.01%	-0.01%	0.01%	0.01%
Rates				
UST 10Y	12bp	23bp	-16bp	-15bp

Source: Goldman Sachs Global Investment Research

The tariff "wild card"

The scenarios in Exhibit 2 incorporate the direct fiscal implications of potential tariff changes, but they do not incorporate the wider impact of those policies. Tariffs are not equivalent to other taxes in terms of their FX implications, so it is important to overlay estimates of the broader impact of tariff proposals on the fiscal and tax-driven estimates above. Tariffs have meaningful impacts on short-term inflation paths; and they affect

3 Specifically, we assume that the market sees the combined impact of tax and regulations under a Republican sweep as equivalent to a 50% chance of a cut in the corporate tax rate from 21% to 15%, roughly evenly divided between the two.

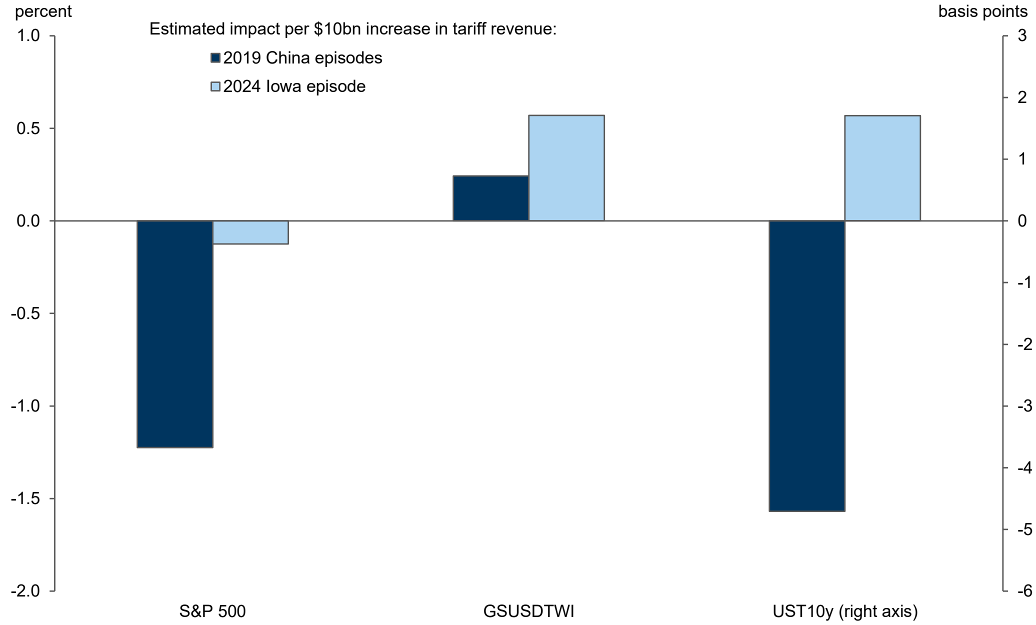
profitability and increase uncertainty for companies who depend on imported inputs or who supply into markets where retaliation is a possibility.

However, it is challenging to estimate the potential market reaction the prospect of tariffs. The market reaction to the US tariffs imposed on China in 2018 and 2019, which we used as a guide in the 2020 election, might be one potential road-map. Those episodes tended to push the USD stronger, but also triggered substantial equity sell-offs which helped to pull bond yields lower. Arguably the use of tariffs then was more of a shock than it is now, and the market impact of those narrower tariffs (vs. the broader tariffs proposed now) may have also included the risk of further trade escalation that could be less likely to be priced now if large upfront tariffs are already on the agenda. The magnitude of the equity market impacts of China tariff episodes (and the rotation away from cyclical stocks that we saw) was also consistent with much larger downward revisions to GDP growth than conventional estimates of the impact of tariffs on growth would have implied and how the economy behaved in 2019 after tariffs were imposed.[4] So the risk is that the markets now views those moves shifts as an overreaction, especially in the current context.

We have also used the market reaction to the Iowa caucuses this year as a more recent potential indicator of asset impacts. Exhibit 3 compares the estimated impact on equities, bond yields and the USD per $10bn of tariff increases from this Iowa approach to the China episode approach. While both approaches predict a strengthening in the USD, the estimated impact on equities is much smaller using the Iowa sample, and the Iowa episode also generates estimates of higher, not lower, bond yields from tariffs. The post-Iowa pattern has the advantage that it takes place in the current policy context, but the disadvantage of relying heavily on scaling up a single episode where trade policy differences were only indirectly implied by the outcomes.

[4] This is to some degree a more general puzzle. Equities fall much more sharply during recessions than the hit to discounted earnings imply, for instance. And while the tightening in financial conditions that results may then generate a substantial drag on growth, the logic there is somewhat circular.

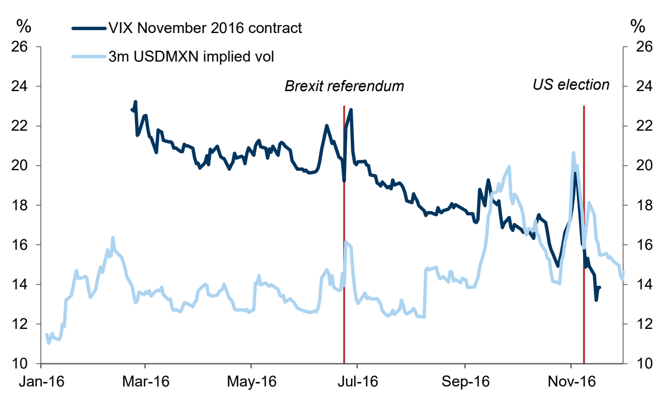
Exhibit 3: Post-Iowa and China 2018-19 reactions show similar responses in FX, but differences in rates and equities



Source: Goldman Sachs Global Investment Research

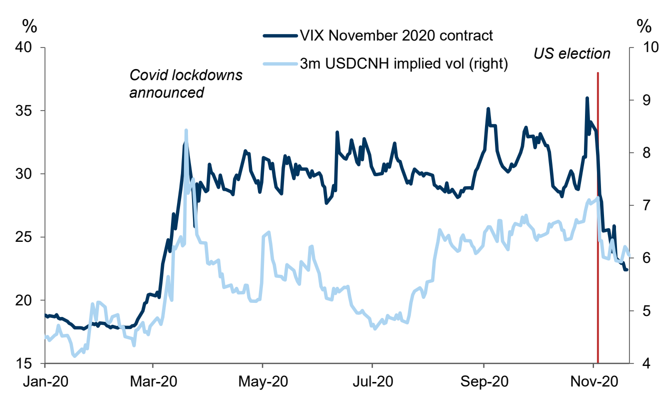
Even beyond uncertainties around the best methodology, the market impact also depends on the probability that the market assigns to both the likelihood of tariffs and the magnitude of those potential tariffs, specifically whether more dramatic tariff proposals are a gambit or a concrete policy plan. Experience in past elections, including both the focus on MXN in 2016 and CNH in 2020, also suggests that markets may not focus on these kinds of policy proposals until closer to the election when their salience increases. These issues potentially apply to all policy proposals, but we think are more pronounced with respect to tariffs.

Exhibit 4: In 2016, the election did not move macro markets much until September



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 5: In 2020, election impacts became visible in the summer and more clearly in the fall.



Source: Bloomberg, Goldman Sachs Global Investment Research

Varying these assumptions has a meaningful impact on the potential outcomes. Our bias is to think that the shock of tariff impacts on risk assets will be smaller than it was during the China trade war. We also think that without a large downgrade to risk assets, yields are more likely to move higher than lower, particularly given the current inflation and policy context. But the potential range of outcomes around the impact of tariffs is large.

Asset market shifts in the four scenarios

Exhibit 2 shows "baseline" scenarios that combines potential impacts from fiscal policy, tax and regulatory shifts, and tariff proposals. Here, we assume the post-Iowa reactions to tariffs for equities and rates. For FX, where the impact of tariffs is similar across approaches, we scale the size of the USD TWI reactions to the China episodes since they come from a much larger sample, but use the post-Iowa *pattern* of FX reactions, which we think are a better guide than the China-centric reactions of 2018-2019. We assume that the market is only partially priced for trade policy risks and will increase its weight on those as the election approaches, as in recent elections. As Exhibit 6 shows, different assumptions about the impact and pricing of trade policy might lead to quite different estimated impacts, particularly for equities and rates.

Exhibit 6: Larger (and less certain) asset market shifts in the four scenarios when including potential tariff reactions

Baseline Estimates From Fiscal, Tax, and Trade Policy Shifts				
	R Sweep	D Sweep	Trump with Divided Govt	Biden with Divided Govt
Equities				
S&P 500	2.0%	-3.7%	-1.6%	-0.4%
FX				
EUR/USD	-4.0%	1.2%	-3.9%	1.4%
AUD/USD	-4.5%	1.9%	-4.9%	1.3%
JPY/USD	-5.1%	0.2%	-3.6%	2.4%
MXN/USD	-5.6%	2.4%	-6.1%	1.6%
CNH/USD	-2.7%	0.8%	-2.6%	0.9%
CAD/USD	-1.9%	1.0%	-2.3%	0.5%
GS USD TWI	3.6%	-1.2%	3.6%	-1.2%
Rates				
UST 10Y	37bp	14bp	10bp	-24bp

Source: Goldman Sachs Global Investment Research

Summarizing across the main scenarios:

1. **Republican sweep.** Our baseline scenario predicts a modest rally in equities (fiscal and tax boosts offset by tariff-related worry), yield upside and appreciation in the trade-weighted USD. The main risk to that comes from a larger negative reaction to potential tariffs that would weigh on equities and bond yields.
2. **Democratic sweep.** Our baseline scenario predicts modest equity downside (a fiscal boost and some modest tariff relief outweighed by corporate tax risks), modest USD depreciation and higher yields. If there was more substantial relief from avoiding potential new tariffs, this would lead to more positive equity

outcomes and reinforce the upward shift in yields and the potential depreciation for the USD. A larger anticipated fiscal impulse would counter the tendency for USD weakness.

3. **Trump with divided government.** Our baseline scenario predicts modest equity downside (modest fiscal restraint and tariff risks but some regulatory easing), slightly higher yields and meaningful USD upside (though less than in the sweep case, without the fiscal boost). If the market reacted more intensely to potential tariffs, alongside the prospect of fiscal restraint, this scenario could have the largest downside for equities and yields.
4. **Biden with divided government.** Our baseline scenario is that this mix creates a flattish outcome for equities as fiscal restraint is balanced by modest relief from corporate tax and tariff risks; yields would be expected to fall; and the USD should weaken (both from fiscal restraint and tariff relief). As with a Democratic sweep, the main alternative to this baseline is if relief from avoiding new tariffs was larger than expected, which would add to equity upside and USD downside, and could potentially push yields higher instead of lower.

Market implications—outside USD, tariff uncertainty a dominant factor

We expect to learn more in coming months about the possible policy landscape but also about clues to the market reaction to those shifts. Although the uncertainty around these estimates remains high, at this stage we draw the following conclusions for markets:

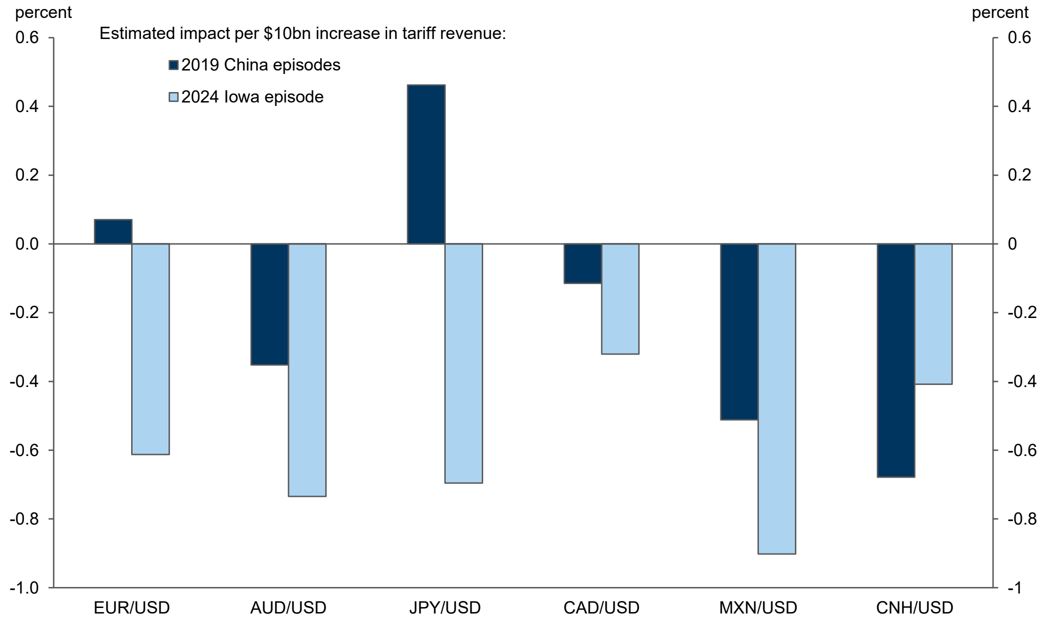
1. **Shifts in fiscal and tax policy alone are likely to have a relatively modest effect on asset prices, though those impacts will likely be larger in sweeps than divided government.** Equity impacts could be larger if there is more hope of bigger corporate tax shifts, while yield shifts could be larger if the market sees fiscal expansion plans as a broader threat to debt sustainability. But the scope for asset markets to move on the likely fiscal impulses alone currently looks smaller than in 2016 or 2020. Because the Fed is more likely to adjust policy in response to shifts in the growth and inflation landscape than in 2016 and 2020, yields may move relatively more than equities compared to those episodes.
2. **The market reaction to tariff proposals is the biggest potential swing factor in asset markets.** Specifically, it will matter how much weight the market puts on the chance of increased tariffs becoming policy, and how much it worries about the risks that those tariffs create to growth and profitability. A more negative reaction is the biggest risk to the conventional view that a Republican sweep could push equities and bond yields higher as it did in 2016. And if fear of tariffs proves more intense, then the scope for relief in a Democratic victory would also rise.
3. **We still see a stronger USD as the most reliable impact of a potential Republican victory because a stronger USD is the most consistent response to tariff risks**. We would expect USD strength against a broader range of major currencies than in the 2018-2019 China tariff episodes, though a stronger negative risk reaction to tariffs could mitigate any strength against less cyclical currencies (i.e. safe havens). The degree to which the USD strengthens will vary, however,

depending on the extent to which the market believes that tariff proposals as large and imminent. Pressure for appreciation will also depend on the judgments that markets make about how tariffs will be passed on to consumers; the elasticity of demand for the products that are targeted; and the risks of retaliation. The counterpart to these risks is that a Democratic victory could lead to some USD weakness, particularly if tariff risks are well -priced going into the election.

4. **Bond yields are more likely to rise in the two "sweep" outcomes than in divided government outcomes.** But they would rise more in a Republican sweep if the equity market reaction to tariff policies was benign and more in a Democratic sweep if fear of tariff policy impact going into the election was high. For equities, the most challenging scenario may be a version of a "Trump with divided government" outcome, in which markets react negatively to tariff proposals without any offsetting fiscal or tax boosts. More positive outcomes could come from a Republican sweep (fiscal boost, tax/regulatory cuts) with a more benign response to tariff proposals, or a "Biden with divided government" outcome (no corporate tax increases) in which relief from tariff fears is large.

5. **Other potential policy shifts may broaden the asset impacts**. We do not explicitly consider the tail risks from geopolitics or a more aggressive attempt to influence Fed policy. We think the first of these reinforces the case for owning upside tails in oil and gold. The second might add to the case for upward pressure on bond yields in a Republican sweep and could put downward pressure on the USD if it becomes a large enough source of concern. The combination of upside risk to oil prices, fiscal policy, and tariffs also pushes towards higher inflation pricing in these scenarios. US policy shifts, particularly in trade and international policy, may also have significant impact on growth and asset market performance in other countries in other countries, including Europe and China, which we hope to be able to quantify more accurately in the future.

Exhibit 7: Post-Iowa response suggests a broader-based USD appreciation versus China trade war



Source: Goldman Sachs Global Investment Research

Watching the debate

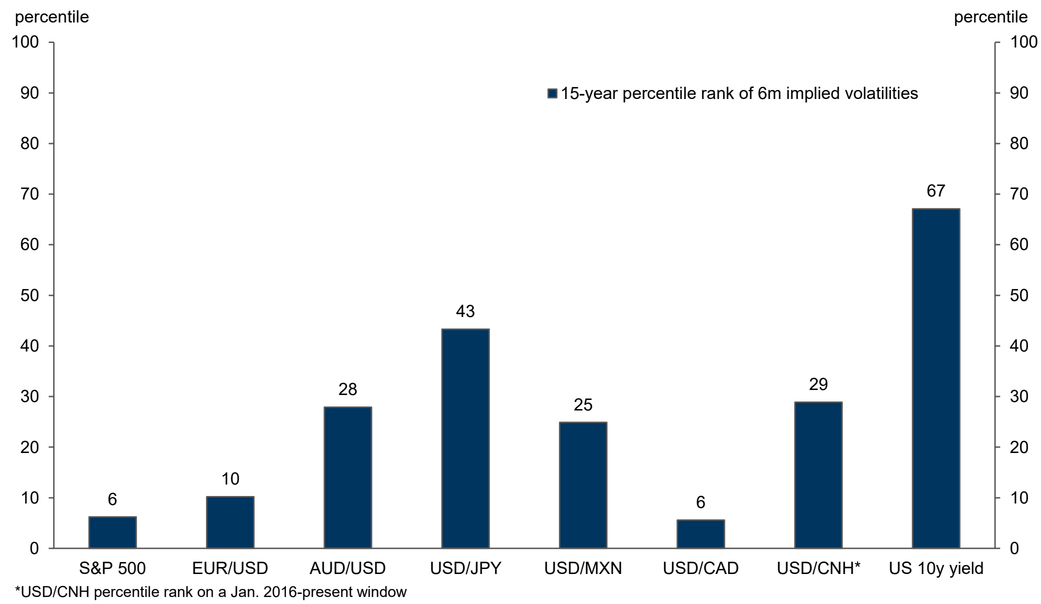
In terms of opportunities at the current juncture, USD upside continues to screen well to position for a Republican victory both in terms of both the size of moves relative to implied volatility and the robustness of the likely response to different assumptions. But we think it makes sense to retain an open mind about potential asset reactions and will be guided by any clues from the first debate on June 27th.

Our baseline estimates do not create a strong case for hedging equity exposures, but a strong reaction to tariff risks or a refocusing on debt sustainability issues in the face of fiscal expansion might generate more significant equity pressure. The challenge is that the correlation structure across assets is different in these cases. The risk of positioning for higher yields as a hedge is that a strong risk-off reaction to tariffs could push yields lower as it did in 2019. USD strength is a more reliable way to "cheapen" equity downside, but the case is clearest against riskier currencies where correlations savings are smallest. As a result, positioning for deep equity downside directly may still offer the most efficient protection for long risk portfolios.

The challenge for positioning for or hedging against election outcomes is that the election is still nearly six months away. Although Election Day itself is understandably usually the point at which the largest shifts in election probabilities take place, market focus may pick up well ahead of that point. We saw significant shifts in parts of the asset complex between July and October in 2016 and 2020 in response to election-related moves. The June 27th debate is a clear obvious potential source of market focus, given how those episodes have led to shifts in prediction market probabilities and asset markets in the past, and many parts of the market still appear to be pricing low volatility through that period.

It is also striking both that 6-month implied volatility—which encompasses the election—remains quite low by historic standards (Exhibit 8); and that there is a pronounced kink in volatility curves around the election date, which means that implied volatility ahead of October/November is even lower still. We think that presents opportunities to look at positioning for increased focus in the election through the summer, if not beyond.

Exhibit 8: Implied volatility is still quite low in many assets through the election period



Source: Goldman Sachs, Goldman Sachs Global Investment Research

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