Citi Global Wealth Investments

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US Election: Looking for Risks Hiding in Plain Sight

Key Takeaways

- The last US President to preside over a net decline in US equities was George W. Bush. His second term ended in January 2009, just after the sub-prime mortgage collapse, a crisis his administration had a limited role in creating. Investors appear to ascribe too much power to US presidents to drive the economy and returns – at least while "checks and balances" remain.
- With this in mind, we can see some downside risks for the US economy and markets if either of the two major US candidates drive through their party's full platform unchecked.
- Investors have reason to fear a large rise in US tariffs, even as the impact of 2018 tariff increases were remarkably muted. "Mass deportations" could be an even more disruptive policy depending on their extent and implementation. One irony may be that Democrat policies toward immigration could be more positive for business profits and less supportive for lower income workers (all else constant).

Potential Portfolio Implications

- President Biden's decision to leave the race has lowered investor certainty of a "red sweep." The chance that Congress and the White House will be unified under one party – to either cut taxes or spend unchecked – has been reduced.
- We loathe making portfolio shifts based on unreliable polling data. Given a history of rising market volatility in the summer before US Presidential elections, short-term hedging costs for portfolios remain attractive.
- We remain concerned that US firms producing goods in China for export to the US have vulnerabilities. Some are the largest American companies. Profitable US small and mid-cap growth companies – with greater domestic exposure – might help diversify this risk.
- Still like the Magnificent 7? The largest US tech-related shares fell about 11% since July 10, but are still up 45% over the past year. Since July 10 the S&P 400 and 600 growth indices have risen 1% and 6%, respectively.

Hold on to Your Seats, It's Election Time Again

Events of the past two weekends have shocked the world. A US President (current or former) was shot for the first time in 43 years. Moreover, the attack came while Donald Trump, the former US President, was campaigning for reelection. Joe Biden, the sitting US President, decided not to seek reelection with a little more than three months left before election day. The latter event has shifted much of the election narrative, raising uncertainty as markets now view the race as more competitive with Vice President Kamala Harris running in Biden's place (see **FIGURE 1**).

As we've said before (please see our CIO Bulletin of June 22), investors will have to live without knowing the US election outcome with any certainty. Congressional results are even less predictable. While there are multiple factors to consider, these events fit a historic pattern of rising volatility – and less robust market confidence – in the run-up to the election result (see **FIGURE 2**). Subsequently, some level of clarity will re-emerge.

FIGURE 1: PredictIt probability of Democrat or Republican presidential win

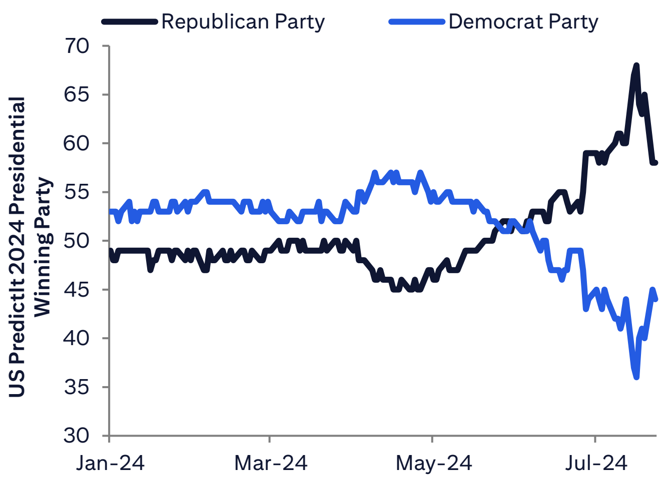
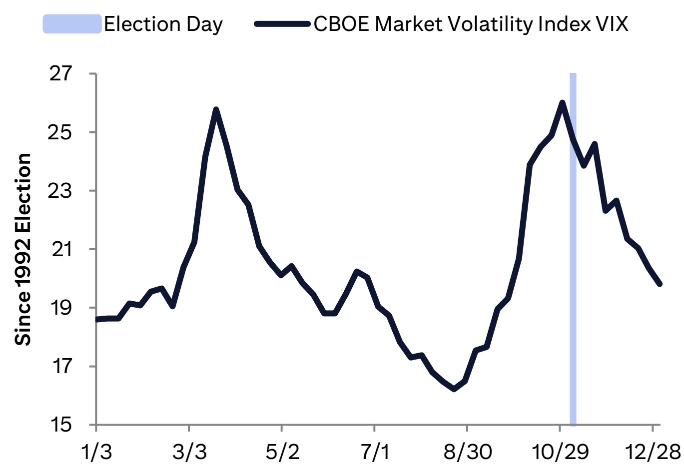


FIGURE 2: S&P 500 implied volatility average during election years since 1992



Source: Bloomberg as of July 23, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Of course, the rhetoric on both sides is likely to swing towards the apocalyptic. Patient investors might be comforted by the fact that US Presidents take far more credit for economic outcomes and market returns than they deserve. The last US President to preside over a negative return for US equities during his tenure was George W. Bush. He had the misfortune of ending his administration in January 2009, two months before the historic bear market of 2008-2009 reached a bottom. The housing boom and sub-prime mortgage bust wasn't arrested by his administration, but it wasn't wholly his creation either (see **APPENDIX 1** at the end of this report).

Investors also often underestimate the ability of the economy to adapt to change. Europe's adaptation to a historically-severe energy supply disruption from Russia is just one recent example. We believe the anticipation of new US tariffs is already impacting trading patterns in a similar attempt to adapt. With that said, we can't help but worry that some risks are hiding in plain sight if certain policies become a reality.

Immigration Policy Implications

While both candidates highlight the importance of slowing the large migrant populations moving north, the rhetoric is starkly different. Former President Trump cites a straightforward rationale to protect American jobs and bolster national security. This is contrasted with a more moderate approach from Harris who is interested in a path to citizenship, reinstatement of DACA (impacting children brought illegally to the US), and mitigation of the underlying causes of mass migrations from Central and South America.

These two policies have different implications for labor markets, business profits, and real economic growth. The strong immigration restrictions of former President Trump would likely help maintain some of the wage gains at the lower end of the education/skill spectrum in the US. In contrast, the more immigration-friendly policies of Vice President Harris would likely put more negative pressure on wages at the lower end of the spectrum (Democrat administrations have generally attempted to mitigate this with proposals to increases the federal minimum wage. State-level data generally suggest a negative impact on business costs and employment).

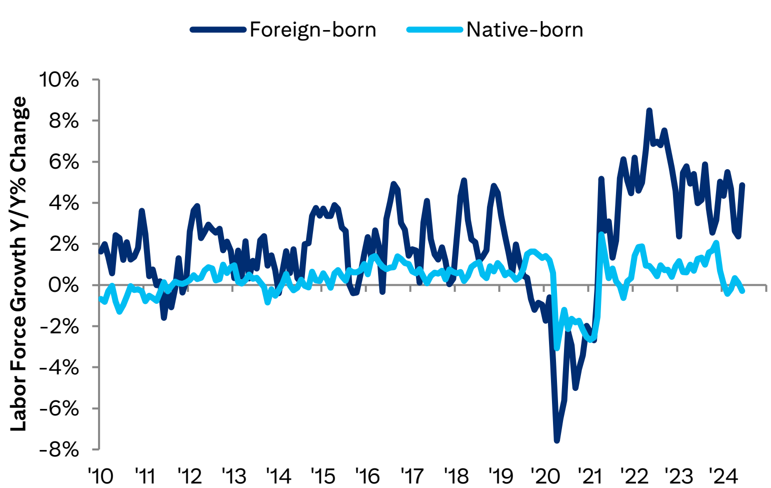
Given the aging population in the US and much of the developed world, immigration is generally viewed by economists as highly favorable for economic growth in richer economies. In fact, the recent period of stronger-than-expected US labor force growth was at least partially explained by the post-Covid surge in immigration (see **FIGURE 3**). Population growth is one of the most reliable long run drivers of economic growth as well as equity returns.

According to the Pew Research Center in 2016[1], immigrant Americans were more likely to have less than a high school education as well as more likely to have a graduate degree than native born Americans. This shows that "immigrants" are far from a homogenous group. Similarly, the US economy has differing needs for both low and high-skilled workers.

We would note that immigrants tend to add a great deal of dynamism to the economy. The American Immigration Council highlighted that as of 2023, roughly 45% of Fortune 500 companies were founded either by an immigrant or the child of an immigrant. This is despite immigrants only accounting for about 14% of the population[2].

The US's ability to attract skilled immigrants is also critically important for addressing long run fiscal challenges. The high level of US government debt that is driven by age-triggered entitlements is far easier to address with a growing rather than shrinking workforce.

FIGURE 3: Native-born vs foreign-born US labor force growth



Source: Haver Analytics as of July 16, 2024.

[1] Pew Research Center, "Education levels of U.S. immigrants are on the rise," September 14, 2018.
[2] United States Census Bureau, "The Foreign-Born Population in the United States: 2022," April 2024.

Trade Policy

Trump's trade policies, particularly his tariff strategy against China, aim to protect domestic industries from foreign competition. While these tariffs were designed to rebalance trade relationships and support American manufacturing, they also risk inflating import costs and, consequently, consumer prices. Biden/Harris sustained these policies, though generally under the umbrella of national security.

We are somewhat more sanguine on tariff risks than the headline threats imply. Despite significant tariff hikes during Trump's first term, inflation remained in check until the COVID-19 pandemic disrupted global supply chains (see **FIGURE 4**).

The narrative that tariffs directly cause inflation is overly simplistic; the real economic effects are mediated by a host of factors. Nonetheless, the scale of the proposed tariff – 60% on Chinese goods imports and 10% for the rest of the world – would be unprecedented in modern times. The recent experience of producers passing price hikes on to consumers during the pandemic raises the probability of a larger impact than 2018. This makes Trump's tariff strategy riskier for markets in our view.

As discussed in last week's CIO Bulletin, US firms may also face a larger market impact from trade retaliation given their stronger share price performance of late (see **FIGURE 5**). In fact, some of the US stock market's strongest performers of the last year – large cap firms in semiconductors and smart phones – appear to be at greatest risk from tariffs and retaliation.

FIGURE 4: US CPI and tariff collections year-over-year %

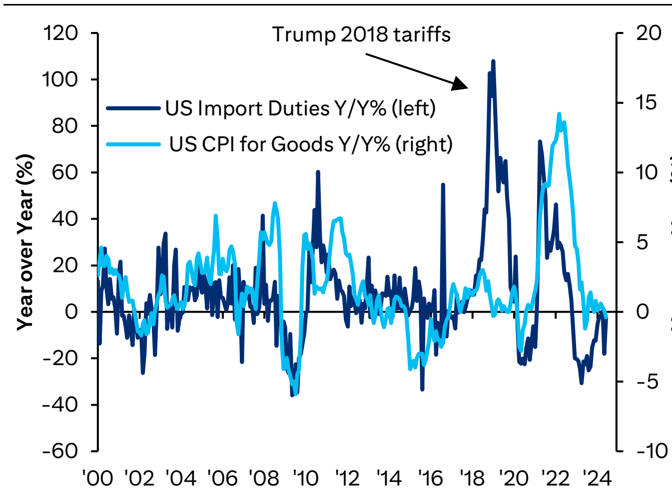
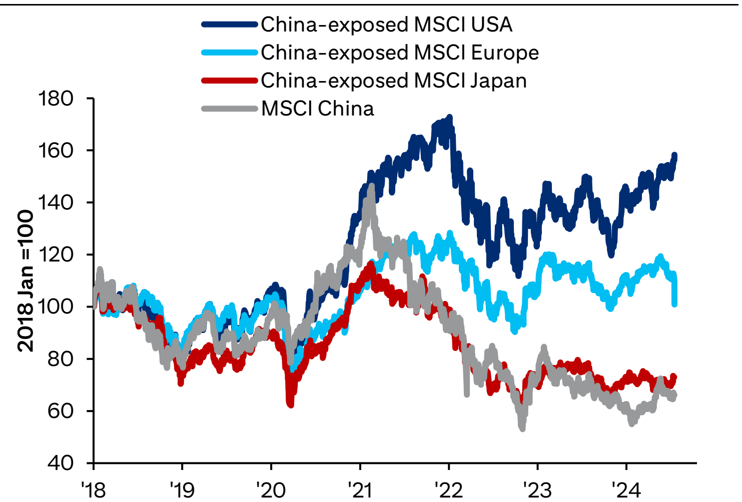


FIGURE 5: Equities of US firms operating in China vs other regions



Source: Bloomberg and Haver Analytics as of July 23, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Among the trade war-sensitive firms is one of only three US firms to exceed a $3 trillion valuation. For reasons unrelated to the US election, we've favored diversification in equity portfolios including overweights in US small and mid-cap growth shares with historically moderate valuations (see **FIGURE 6**). These firms happen to have lower global trade exposure. In the past three weeks, US small cap growth shares have risen 5.9% while the "Magnificent 7" have fallen 11.8%. These smaller firms also derive greater shares of their revenues from inside the US economy. They are generally less vulnerable to retaliatory tariffs (see **FIGURE 7**).

FIGURE 6: S&P 400, 600, 500 Growth trailing P/E

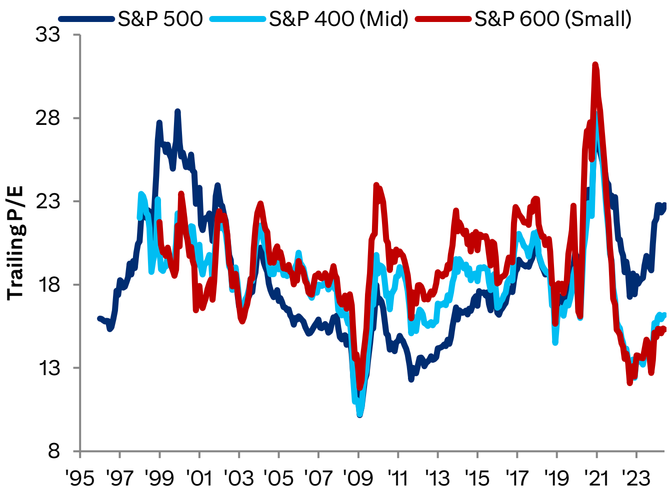
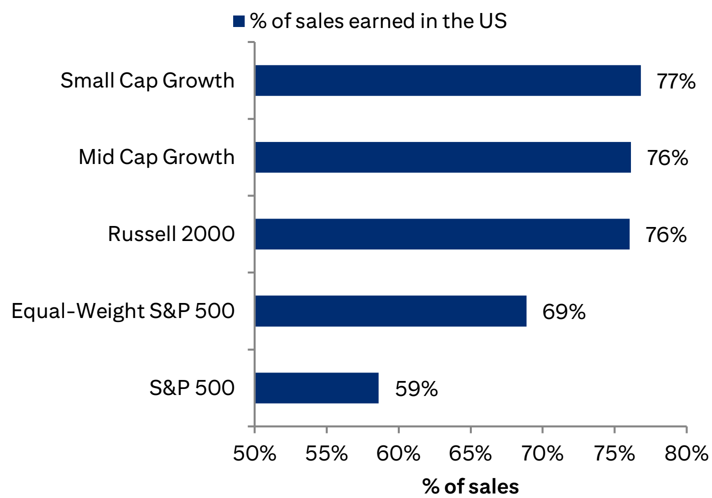


FIGURE 7: Share of sales earned in the US among large and small cap indices



Source: OCIS and Bloomberg as of July 25, 2024. Small cap growth proxy is S&P 600 Growth index, Mid cap growth proxy is S&P 400 Growth index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Kamala Harris is by no means advocating free trade. Like Biden, she might be accused of attempting to use trade limitations as a tactical tool, hoping to achieve protections for labor and environmental standards in trade agreements. In pure economic terms, we see the US corporate sector profiting the most from broadly free trade. The largest corporations in the US are highly globalized, with roughly 41% of the revenue of the S&P 500 coming from outside the US. More difficult to measure, they are great beneficiaries of global supply chains when generating US revenue.

As noted, firms were remarkably adept at finding routes to avoid the large-scale tariff increases under the first Trump administration. While our concerns are elevated, we see impediments to the kind of destructive trade barriers that would actually stymie the US economy.

Technology and Chip Manufacturing

Which candidate will keep the US and wider world safer from conflict is far beyond our scope of discussion here. Yet raised within the scope of security, we consider the issues of technology safety and supply of chips.

On this subject, nominally both candidates are similar, as they have expressed concerns about the ethical implications and safety of artificial intelligence and have called for regulatory frameworks to manage AI development. But a key distinction between the two candidates is likely to be on the handling of the challenging geopolitical issue of Taiwan autonomy. According to the Boston Consulting Group, more than 60% of computer chips sold in the US are either manufactured or designed in Taiwan[3]. And while both candidates are strongly advocating onshoring chip production, realistically the timeframe for those developments is unlikely to be fast enough to function as a safety valve if tensions between the US and China on the status of Taiwan continue to grow.

[3] Boston Consulting Group, "Strengthening the Global Semiconductor Supply Chain in an Uncertain Era," April 1, 2021.

Key Takeaway: Much of the optimism around AI-related equities is dependent on a highly tense geopolitical situation. It's safe to say that direct conflict regarding the status of Taiwan is unlikely to have many, if any, market winners. Chip security poses a small but severe threat to the world economy and many of the current darlings of the US equity market.

Portfolios to Outlast Partisan Conflict

Conclusion: It is unlikely that there will be a clear-cut stock market favorite candidate. Instead, some sectors and subsectors will be favored with a win by one candidate or the other. With the poor track record of polling and political forecasters in recent years along with election surprises in France, India, and Mexico in the last few months, we would emphasize a durable and diversified portfolio designed to thrive in any potential political environment rather than attempting to forecast the US election (please see our latest Quadrant for our full asset allocation guidance).

Appendix

APPENDIX 1: Market and economic indicators of US Presidents since World War II

	Annualized Real S&P 500 Total Return (%)	Annualized Real GDP Growth (%)	Unemployment Rate At Start Of Term (%)	Annualized Real Trade Weighted Dollar Change (%)
Truman	9.7	4.7		
Eisenhower	13.3	2.5	2.8	
Kennedy	9.9	5.3	6.3	
Johnson	7.9	5.1	5.5	
Nixon/Ford	-2.1	2.7	3.4	
Carter	1.3	3.2	7.8	-1.1
Reagan	9.4	3.6	7.4	-0.1
Bush	11.0	2.2	5.3	0.0
Clinton	14.2	3.8	7.4	2.3
Bush II	-5.3	1.9	3.9	-1.6
Obama	12.7	2.0	6.9	1.5
Trump	13.9	1.8	4.8	-1.4
Biden*	7.3	3.0	6.7	3.7
*Biden figures are through Q2 2024				
Republican Weighted Average	5.5	0.0	5.8	-0.8
Democrat Weighted Average	9.9	0.1	5.5	1.7

Source: Bloomberg as of July 23, 2024. Note: weighted average assigns each data point importance based on its weight in the underlying data set, contributing to the final average. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
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- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
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