OCTOBER 2024

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STRATEGY FOCUS

US elections : background and potential market reaction

SOCIETE GENERALE
Private Banking

US elections: background and potential market reaction

SUMMARY

The presidential elections in the United States will take place on November 5. This note develops the exceptional economic context in which this event is taking place. It recalls the modus operandi of these elections as well as the programmes of the main candidates. Finally, it presents the potential short- and medium-term impacts on the financial markets.

Outperformance of the US economy (p.3)

The US economy has been growing strongly since the Covid crisis, having quickly made up for the losses of this crisis and widening the gap with developed economies. This outperformance can be explained by massive fiscal packages during the Covid crisis, sound private sector balance sheets, a low impact of the conflict in Ukraine and a rebound in productivity.

Twin deficits, the price to pay for the outperformance (p.4)

The flip side of this outperformance the sharp deterioration in the budget deficit and the current account balance. The fiscal deficit is expected to remain high in a context of large mandatory spending and likely loose fiscal policy over the next few years. The external deficit is also expected to remain high, in a context of strong demand for goods and a sharply rising cost of external debt.

A soft landing in 2025 (p. 5)

The US economy is expected to slow down in 2025 compared to the very strong pace of recent years. The slowdown would reflect a less dynamic labour market in terms of job creation and wage growth. Nevertheless, the Federal Reserve's rate cut cycle as well as the sound balance sheets of households and companies should allow the economy to make a successful soft landing.

Three elections in one with an uncertain outcome (p.6)

On Tuesday, November 5, the presidential and legislative elections will take place, with the entire House of Representatives and a third of the Senate at stake. Polls predict very tight results for the presidential election and the House of Representatives. This configuration is essential because a president depends on Congress to be able to implement his policies.

Harris vs Trump: Important differences but some common ground (p.7)

Despite a highly polarised campaign, the economic programmes of Kamala Harris and Donald Trump have several points in common: the pursuit of decoupling from China, the continuation of industrial policies and of fiscal easing to support the economy. The main differences on the economic front correspond to their international policies, where Trump is planning very significant tariff increases, regardless of the exporting country. The second difference is institutional, with Trump planning a stronger intervention on monetary policy.

Probably modest impact on the financial markets (p.8)

Historically, the outcome of the presidential elections has had little effect on financial markets. We believe that in the event of a divided government, the financial markets would remain indifferent. In the event of a large Democratic victory, it is likely that the equity markets could have a short negative reaction while in the event of a large Republican victory the equity markets could react positively. What happens next will depend on the inflationary effects of the policies put in place.

An economic exceptionalism

The US economy has posted a very strong economic performance since Covid. First, economic activity rebounded very quickly after the shock of the pandemic. Real GDP has returned to its pre-crisis level in just one year, compared to three years after the 2008 financial crisis. And since then, activity has continued to surprise with its dynamism, now well above the level expected by the consensus before the Covid shock. Real household income also performed well, quickly erasing the negative effects of Covid and inflation by returning to its pre-Covid crisis trend. Finally, the good performance of the US economy is also visible on the labour market, with an employment level that has returned to its pre-crisis level in one year and a historically low unemployment rate, close to 3%, in 2022.

A clear outperformance compared with other developed economies. The United States stands out very clearly from its peers. US GDP has grown by an average of 3% since the beginning of 2022, compared with 1.2% for the euro area, 0.8% for the United Kingdom and 0.9% for Japan. Another element that illustrates the exceptionalism of the US economy is that this strong growth was accompanied by a very strong increase in inflation in 2022/23, but that inflation ultimately remained more contained than in the rest of the developed economies and has already returned to a level close to the Federal reserve's (Fed) target.

Reason #1: very significant fiscal and monetary support. The support was both very rapid and substantial at the time of Covid. And since then, while monetary policy has largely tightened, fiscal support remains substantial, with for example the *Inflation Reduction Act (IRA)*. This is now reflected in dynamic investment, particularly in artificial intelligence and renewable energies.

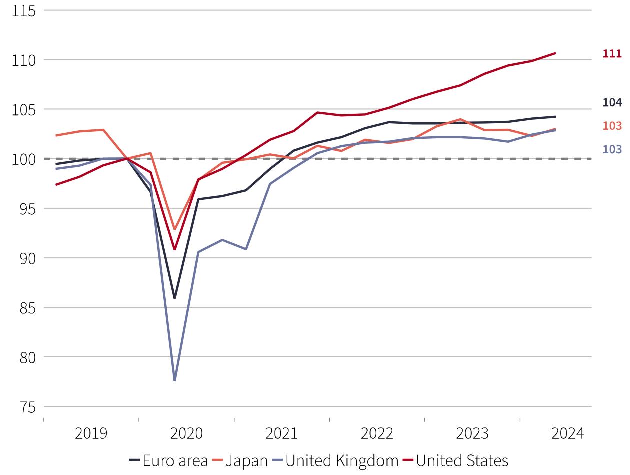
Reason #2: Sound households and businesses balance sheets. Households and businesses entered the Covid crisis with a moderate level of debt and abundant liquidity. They had also taken advantage of the advantageous monetary conditions to invest or refinance their debt at low and fixed interest rates, with extended maturities. In this way, when the Fed raised interest rates sharply, the impact on household and corporate balance sheets remained relatively limited, with companies even enjoying lower net interest rate payments. This has been a real support for consumption and investment.

Reason #3: an undeniable advantage in terms of energy. As the United States is a major producer of shale oil and gas, it has not suffered from the energy shock resulting from the war in Ukraine. They continue to benefit from significantly lower energy prices than in Europe, with an average increase in energy prices since 2014 of 14% in the United States compared to 26% in the euro area. At the same time, the United States has been showing strong growth in its renewable energy production in recent years.

Reason #4: Productivity outperformance. According to Mario Draghi's report on European competitiveness, productivity trends are the main reason Europe is lagging behind the United States. Indeed, the United States has better productivity, which can be explained by a combination of factors: strong innovation, favourable sectoral specialisation (new technologies), low energy prices, and a highly integrated single market.

Real GDP

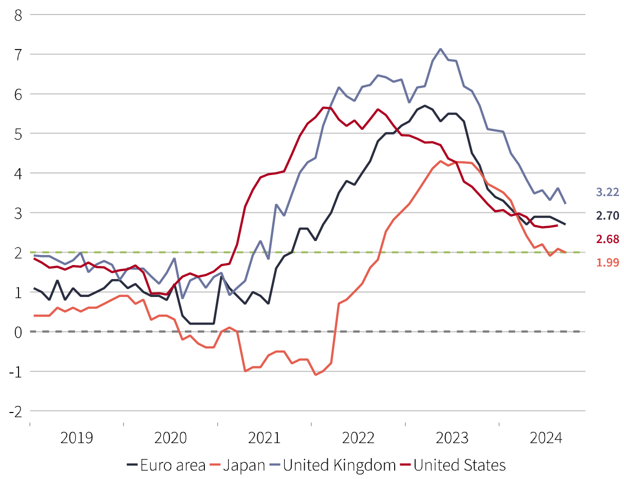
100=31/12/2019



Sources: Société Générale Investment Solutions, Macrobond, INSEE, DESTATIS, Eurostat, Istat, CAO, INE, ONS, BEA, StatCan, ABS 2024 Q2

Core inflation rate

% ch, year-on-year



Sources: Société Générale Investment Solutions, Macrobond, Eurostat, INSEE, DESTATIS, Istat, INE, BEA, ONS, SBJ 09/2024

Twin deficits: the flip side of the US outperformance

The performance of the US activity has had a negative counterpart: the significant deterioration of the twin deficits, namely of the public deficit and the current account deficit. The outlook for activity and the electoral programmes suggest that these deficits will remain high in the medium term.

The public deficit has been on a negative trend since 2016. First, the Trump administration passed the Tax Cuts and Jobs Act, which consisted of significant tax cuts on households and businesses, with no adjustment in terms of federal spending. This law expires in 2025 and the new administration will have to choose whether to extend these measures. Secondly, the Covid crisis support plans, put in place by the Trump and Biden administrations, have resulted in a very sharp deterioration in the deficit. Finally, once the temporary Covid measures ended, the Biden administration decided on further public support under the *IRA* keeping the budget deficit at a high level. In total, public debt increased from 106% of GDP in 2016 to 119% of GDP in 2023.

Without significant policy change, the budget deficit will remain high over the next few years. Indeed, on the expenditure side, mandatory expenditure dominates. More than half of the federal government's spending is on social security and health care and is expected to increase with the ageing of the population. A change in these expenditures would also require broad agreement in Congress, which seems unlikely given the current and future level of polarisation. The only tool that could be used remains a change in taxation, but this also seems unlikely to be considered after the elections, except in the event of an exogenous shock.

The current account deficit has also been on a negative trend over the last decade, i.e. all current transactions of the United States with the rest of the world, for two reasons.

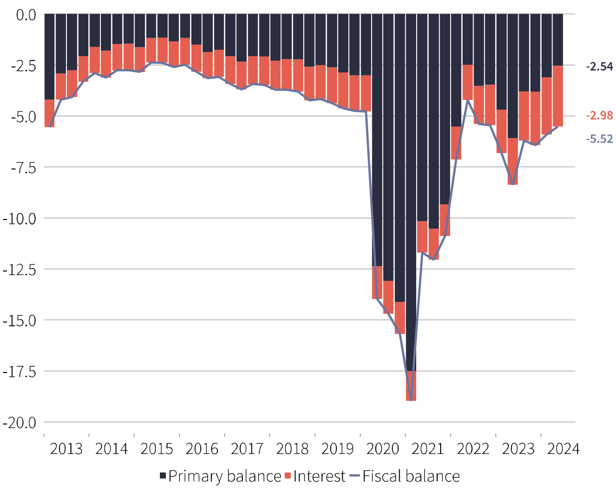
Reason #1: the deterioration of the trade deficit in goods and services, from USD 480 billions pre-Covid crisis to USD 807 billions in mid-2024. It is also very important to emphasise that in recent years the United States has become a net exporter of energy. The recent widening of the trade balance is now explained by the deficit in manufactured goods. This deficit thus illustrates the strength of American domestic demand, consumption and investment, as well as a strong dollar relative to the 2010s, and feeds the protectionist discourse that is reinforced during the election campaign.

Reason #2: The disappearance of the surplus from the investment income balance. The investment income balance consists of the difference between the income from financial assets held by Americans abroad and the cost of their liabilities held by non-residents. Despite high external debt, the U.S. investment income balance has been historically positive, reflecting highly profitable foreign investments and relatively cheap external financing, as U.S. interest rates have traditionally been low. This is also characteristic of the exorbitant privilege of the United States, which allows it to have a high tolerance for a high external debt. However, the recent sharp rise in interest rates, coupled with the rise in external debt, has resulted in a rapid rise in the cost of external liabilities, thus reducing one of the exorbitant privileges of the United States.

Looking ahead, the US current account deficit is expected to remain high, in a context where the United States is expected to maintain more dynamic demand than the other major economies.

Federal fiscal balance

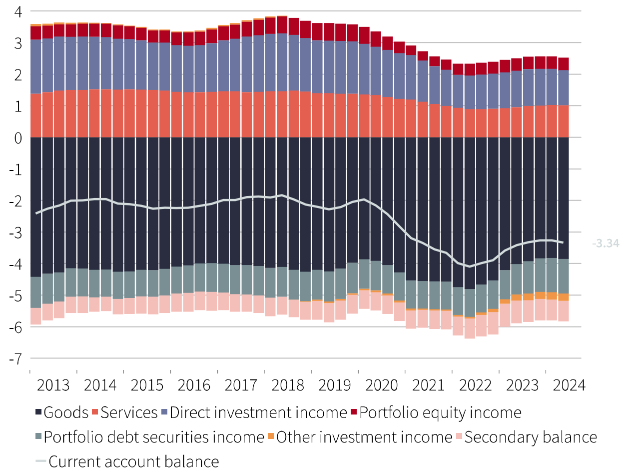
As % of GDP



Sources: Société Générale Investment Solutions, Macrobond, U.S. Treasury, BEA 2024 Q2

Current account balance and its main components

As % of GDP



Sources: Société Générale Investment Solutions, Macrobond, BEA 2024 Q2

US Elections

Towards a soft landing in 2025

The U.S. economy is expected to continue expanding in 2025, but would slow down to its potential growth rate, close to 2%. This slowdown would mainly reflect the gradual slowdown in the labour market, both in terms of job creation and wage growth.

A post-Covid tight labour market. The labour market was very unbalanced in 2022/23 with a very low unemployment rate of 3%, a large number of unfilled jobs and high employee mobility, leading to significant wage pressures. While these have been a real support for consumption, they have also been one of the causes of inflation in the United States.

An expected normalisation of the labour market would moderate the increase in purchasing power. Since the beginning of 2024, labour market imbalances have narrowed significantly. On the one hand, the unemployment rate rose gradually to just over 4% in September, above the Fed equilibrium level. This increase mainly reflects the growth of the working-age population rather than job losses. Nevertheless, several indicators show that while net job losses remain relatively low, it is more difficult for new entrants to the market to find a job. In the same line, the number of unfilled jobs has decreased and is at its 2019 level. All of these have resulted in a slowdown in wage growth and should therefore result in a moderation in household consumption compared to a very strong pace.

A slowdown that would remain moderated by several favourable factors. We believe that the slowdown in the labour market will be moderated by the start of the fall in interest rates, by a still accommodative fiscal policy and by still strong balance sheets of companies and households.

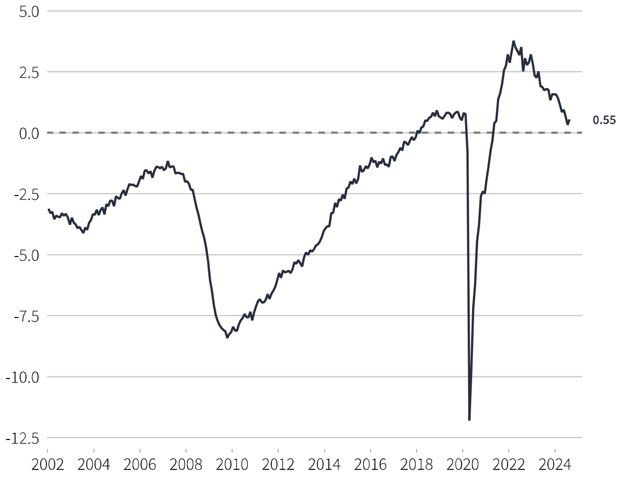
Monetary policy continues to ease. As part of its mandate of price stability and full employment, the Fed began an interest rate cut cycle in Q3 24 and is expected to continue in 2025 to a level close to 3%. While rate hikes have had a moderate effect on economic activity, lower rates should have a positive effect. Indeed, residential investment has been the "only" victim of the tightening of interest rates, posting negative growth since 2022. The rate cut cycle should revitalise the sector and support a soft landing for the economy.

The rate cut cycle should also benefit companies and investment, as they still have strong balance sheets and the outlook for investment in the new technology sector is still positive. In addition, corporate profit margins are close to their all-time high, maintaining good conditions in the labour market.

Finally, the extension of Trump's *Tax Cut and Jobs Act* and the *IRA* should maintain accommodative fiscal policy until at least 2025, supporting household disposable income and investment prospects.

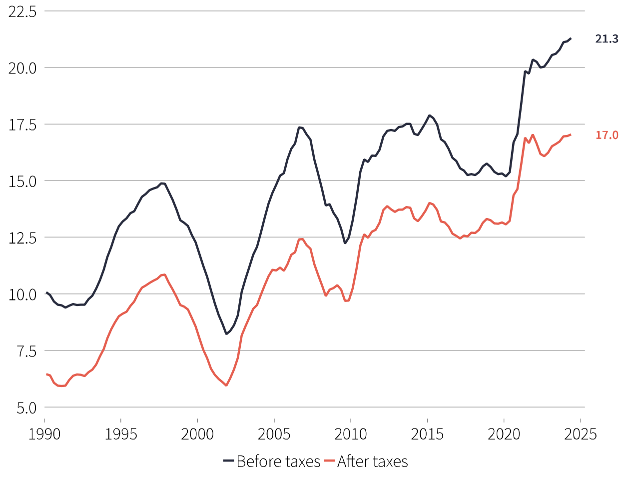
Labor demand and supply

Gap between employed population plus job openings and labor force, as % of labor force



Nonfinancial corporate profit rate

As % of nonfinancial corporate value added



Three elections at once

The specificities of the presidential election in the United States. On Tuesday, November 5, the presidential election will be held between Kamala Harris, current vice president, candidate of the Democratic Party and Donald Trump, candidate of the Republican Party. The election is by indirect suffrage, the winner will be the one who wins the election of the electoral college, i.e. at least 270 grand electors out of the 538. The number of electoral votes is determined by the population of each State. California, the most populous state, has 54 electoral votes while Alaska has only 3. The candidate who wins the popular vote of a state wins all of its electoral votes.

Too close to call. This particular configuration explains why the outcome is ultimately determined by a few key states, known as swing States. These states are characterised by a large number of electoral votes and a tendency to change "sides" from one election to the next. The polls in these swing states are within the margin of error and do not currently allow us to determine a winner, which confirms a very tight presidential election.

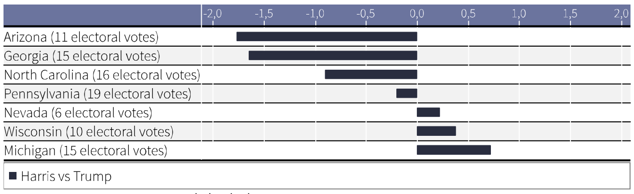
A risk of indecision for several weeks. In this context and given the experience of the last election where Trump did not admit defeat, it is very likely that the final result of the election will not be known on Wednesday, November 6. Moreover, in the event of a narrow victory for Harris, Trump could question the result of the election possibly up to the highest judicial levels.

In this configuration, here are the important dates:

- 5 November 2024: Presidential election
- 6 November – 11 December 2024: counting of votes by the States and issuance of election certificates by the Governors
- December 17, 2024: Meeting of the electoral college and voting according to the results of their state
- January 3, 2025: The new Congress takes office
- January 6: Certification of the Electoral College vote by the new Congress
- 20 January 2025: Inauguration of the new President.

Polls gap in key swing States

A positive spread means Harris is leading in the state poll, a negative gap means Trump is leading in the state poll



Société Générale Investment Solutions, Macrobond, FiveThirtyEight

The specifics of the U.S Congress elections. In parallel with the presidential election, the legislative elections will also take place on 5th November. During these elections, the entire House of Representatives and a third of the Senate will be renewed. The House of Representatives is renewed in its entirety every 2 years, while a third of the Senate is renewed every 2 years, the term of office of a Senator being 6 years.

Congress is decisive for economic policy decisions. For a law to be effectively passed and implemented, it needs a vote in the House of Representatives and the Senate, both houses having the same power. However, the Senate retains control over the appointment of members of the presidential cabinet and important positions in the Federal administration (judges of the federal courts). According to the U.S. Constitution, the Congress controls the Federal budget, authorising spending, revenue, and debt issuance. Moreover, it is also customary for the Congress to lead the economic agenda with the various bills proposed by these members.

The risks of a divided government. In the event of a divided government, i.e. with different political colour between the Houses of Congress and the President's party, situations of political deadlock are frequent. It is difficult for a president to implement his economic policy if he does not have the Congress' authorisation. This encourages episodes of government shutdown and debt ceiling drama. It is important to emphasise, however, that even in the event of a divided Congress, the President retains control over foreign policy and the ability to change tariffs on imported goods.

The House of Representatives is currently led by the Republicans, with a majority of 220 votes out of 435 while the Senate is led by the Democrats, with a majority of 50 Senators out of 100, the split vote being that of the vice president. Polls show the Democratic Party winning the House of Representatives, with only a narrow lead, and an almost certain victory for the Republican Party in the Senate.

The most likely configuration is that of a divided Government. The results of the polls are very uncertain but currently expect a presidency and a parliament of two different political colours. We can imagine a Trump victory with a Democratic House of Representatives or a Harris victory with a Republican Congress. However, even if the probability seems lower, we cannot rule out scenarios of a fully Republican government, or a Democratic dominance (even if the Senate would most likely remain Republican-dominant).

Harris vs Trump: important differences but also some important common ground

Common trends and points of divergence. Harris' and Trump's economic agendas show some common trends, such as economic policy toward China, the pursuit of industrial and energy independence policies, and the use of fiscal policy (via spending or tax cuts) as a means of maintaining resilient consumption and investment. On the other hand, from an institutional and foreign policy point of view, there are very clear differences between the two platforms.

Harris, an economic programme in the continuity of current policy. Her programme includes an increase in federal aid and tax credits for SMEs, first-time buyers and low-income households. On household taxation, Harris' platform does not foresee tax increases for households with an income of less than USD 400 000 but sets an increase in taxation for high incomes, with a minimum tax rate of 25% for households with assets above USD 100 million and the creation of a tax on unrealised financial capital gains. On corporate taxation, Harris' programme calls for an increase in the corporate tax rate from 21% to 28%.

Regarding industrial policy, Harris' programme also remains in line with Biden's strategy, with tax incentives for the production of strategic manufacturing goods on American territory. She would also continue the policy of reshoring but also of friend-shoring.

In terms of energy policy, Harris' programme heralds the extension of the IRA as a means of strengthening the country's energy independence. However, she is likely to maintain the status quo on fossil fuels. Indeed, despite a rhetoric theoretically unfavourable to fossil fuels, oil and gas production has increased significantly during Biden's presidency.

At the international level, Harris would favour the traditional alliances of the United States and continue tougher trade measures vis-à-vis China (tariffs, trade norms). Outside China, Harris does not plan to increase customs duties. In addition, Harris would maintain aid to Ukraine.

Finally, at the institutional level, Harris' election would mean the status quo, with the preservation of the independence of the Fed and Federal agencies.

Trump: Towards an enhanced version of his first term. Trump's programme provides for an extension of the tax cuts for households and businesses adopted during his first term, including a reduction in the corporate tax rate from 21% to 15%. For households, Trump's programme calls to maintain the tax cuts voted in 2017 as well as a reduction in tax pressure on social benefits.

Regarding industrial policy, Trump's programme provides for the pursuit of reindustrialisation policies, with tax incentives for the production of manufactured goods on American territory. Trump's programme, however, would emphasise reshoring more than friend-shoring.

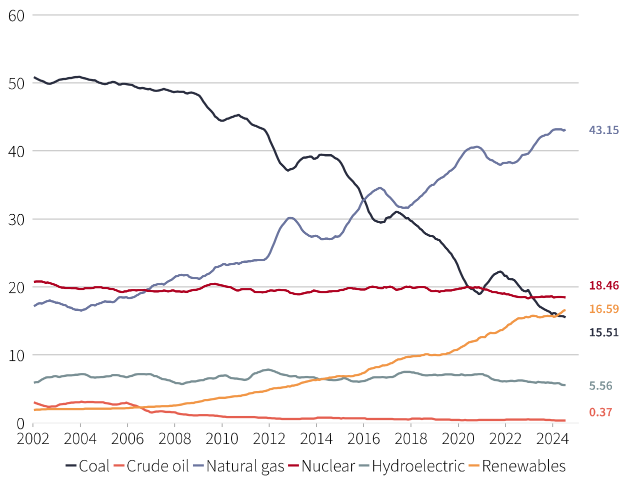
In terms of energy policy, Trump would also continue the policy of energy independence, with deregulation policies on fossil fuels. That said, it is likely that he will not go back on the incentives for renewable energies since they represent nearly 16% of electricity generation in the United States, that they imply job creation and that they are often located in Republican states.

At the international level, Trump would return to the policy of America First, i.e. a policy where only the interests of the United States would count regardless of the implications on traditional allies. It would maintain strong trade pressure on China, with an increase in customs duties to 60% for Chinese goods. Trump's agenda also includes higher tariffs on autos and other goods from other countries, including allies. Regarding the war in Ukraine, it is likely that with the return of Trump, the United States will significantly reduce its aid.

At the institutional level, the main change with Trump's election would be on the independence of institutions. While not written in his platform, Trump has said on many occasions that he would like to have a say on the Federal Reserve's policy. This loss of independence would also affect other federal agencies.

Sources of electricity generation

As % of total electricity mix



Sources: Société Générale Investment Solutions, Macrobond, EIA 07/2024

US Elections

How will the markets react?

Market outperformance in line with economic outperformance. US equity markets have also performed strongly since the 2010"s and are clearly outperforming other developed equity markets. This outperformance reflects the strong US economic performance, with strong corporate profit growth, as well as the importance of the new technology sector in US indices.

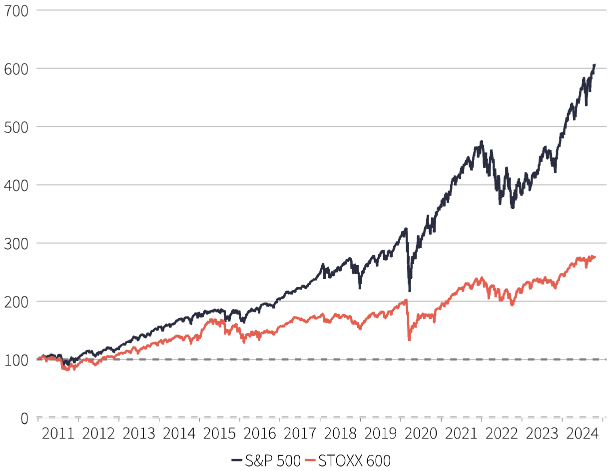
Historically, there has been little impact of elections on the markets. Statistical analysis of equity performance since 1980 at the time of the presidential elections shows a very small impact. Indeed, on average, the S&P500 equity index is stable 3 months before the presidential election and rises slightly afterwards. When Trump was elected in 2016, the S&P500 index initially remained stable before rising in the months that followed. During Biden's election, the S&P 500 index showed a much more volatile evolution before the election and recorded a sharp rise afterwards. However, this election was held during the Covid crisis and coincided with the release of the vaccine. As far as market developments are concerned, Trump's challenge to the election result remained a non-event for equity markets.

It seems to us that the elections will not have an impact on the markets, given historical observations, market developments and the likelihood of having a divided government between Democrats and Republicans. This scenario could be the most appreciated by equity market investors, as it would imply a political status quo and limit the risk of more radical decisions. In our view, such a situation would not have a significant effect on bond markets. In the event of a very close result and a contested election, we cannot rule out a few bouts of volatility.

A possible negative reaction from the equity markets in the event of a Democrat victory of the presidency and Congress, but the movement is expected to remain short-lived. This reaction would respond to investors' fears of an increase in the tax on corporate profits, the implementation of a tax on unrealised financial capital gains and the increase on the tax on high-net-worth individuals. **Harris' election could be positive for European and emerging markets outside China, however** because of its desire to preserve traditional alliances. Bond markets are unlikely to have a specific reaction, as such a configuration would imply the continuation of current policies.

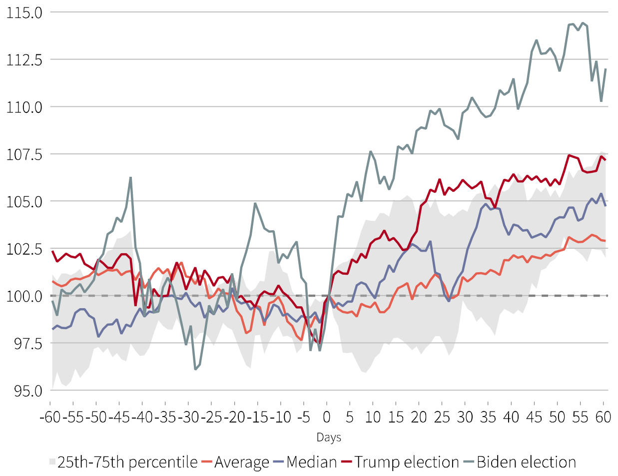
More heterogeneous movements in the event of a victory for the Republicans in the presidency and Congress. In this case, US equity markets could react positively in the short term given the general tax cut planned by his programmes. Nevertheless, Trump's desire to increase tariffs on imports regardless of their origin could resurface fears of a new inflationary surge and weigh on equity markets. It is likely that **European and emerging equity markets and currencies react negatively** to this will, with bearish pressure on their currencies. As such, in Europe, the United Kingdom, Italy and Germany are the economies that export the most to the US. In addition, in the medium term, equity markets could also react negatively if Trump intervenes in the Fed's decisions, as the Fed's independence is one of the pillars of the US economy. As for the bond markets, it is likely that the reaction will be negative, i.e. that the Treasury rate will rise, as Trump's programme is considered more inflationary (higher tariffs, zero immigration policy). This scenario, if realised, could call into question the Fed's rate cut cycle.

Total return indices in local currency
100=31/12/2016



Sources: Société Générale Investment Solutions, Macrobond, 21/10/2024

Evolution of the S&P 500 index around the presidential election date



Sources: Société Générale Investment Solutions, Macrobond, <Property Date not found.>

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