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MACRO MORNING BRIEFING

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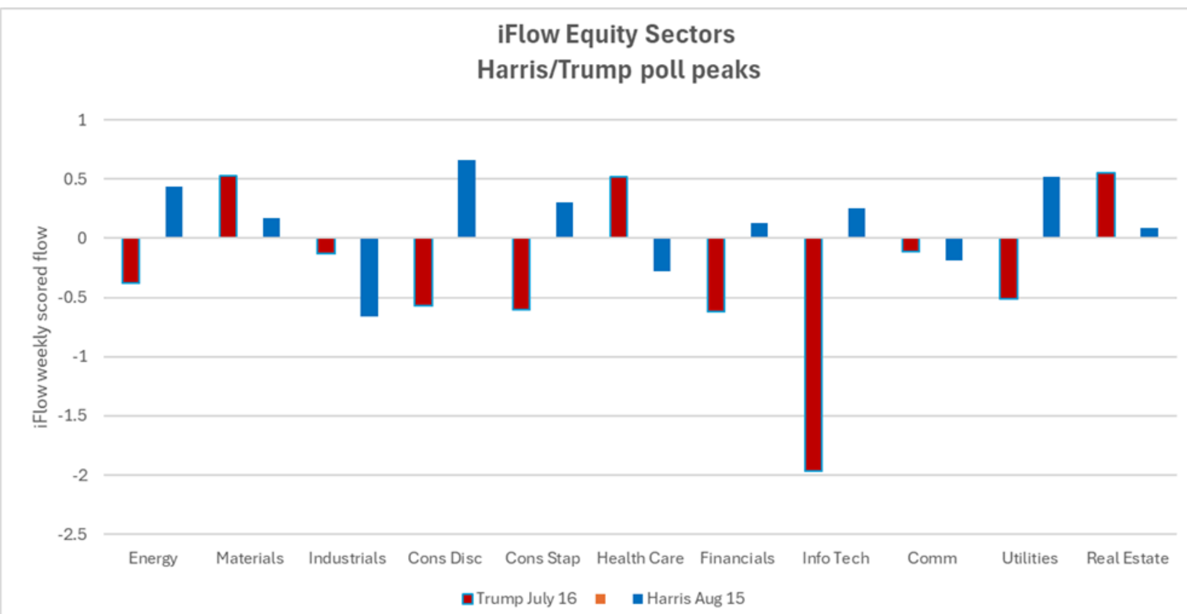
Defining US Election Risks with iFlow

- **The Trump trade appeared in markets on June 27** after the Trump-Biden debate – many see this as bond market negative, due to higher deficits, weaker USD due to trade tariffs and slightly positive equities due to deregulation. This is not what we see in the data.
- **The Harris trade took hold in mid-August around the Democratic National Convention** – many see this as a continuation of the Biden agenda, with higher government spending on tech, housing and foreign aid against higher corporate taxes. The result is a flatter US curve, stable USD and slightly negative equities.
- **The odds of the presidential election remain too close to call** – a state that has held since August, while the Senate has been consistently expected to lean toward the Republicans, with the House leaning to the Democrats. As a result, most investors are not focused on the uncertainty but are instead looking to the FOMC and other policy shifts.
- **iFlow data show that investors have a more nuanced set of divisions** over what each candidate means for equities – with tech, consumer discretionary, utilities and health care all at odds for a Trump or Harris win – beyond the usual energy, real estate, and utilities sector divides that many would expect. The curve in US rates is another mixed risk if you look at our iFlow data. Further, there is a notable split between domestic vs. international views on the US election.

The notable selling in the technology sector in July was based on idiosyncratic factors, from the rotational pressures of the NASDAQ to Russell 2000 trades to Q3 earnings setups for the “Magnificent Seven” stocks. So, any analysis of flows must consider this “beta.” Even with that factor, the notable lack of movement in some sectors and the lack of clarity over what a Republican or Democratic Congress would mean for the sectors supports the diversity of views over what a Trump or Harris presidency would mean for stocks.

As the chart in Exhibit #1 reveals, the flows by equity sector when Trump reached peak polling following the presidential debate shows investors see real estate, health care and materials all doing better with a Trump victory. On the other hand, Harris peak polling shows a notable uptick for consumer discretionary and utilities but a weaker industrial sector. There are differences between the two candidates in terms of flows at the peak across all the sectors, but these differences are not all statistically significant. Whether this split holds after November 5 will be interesting to watch, but using this as a barometer in addition to polling and betting platforms may be useful as well.

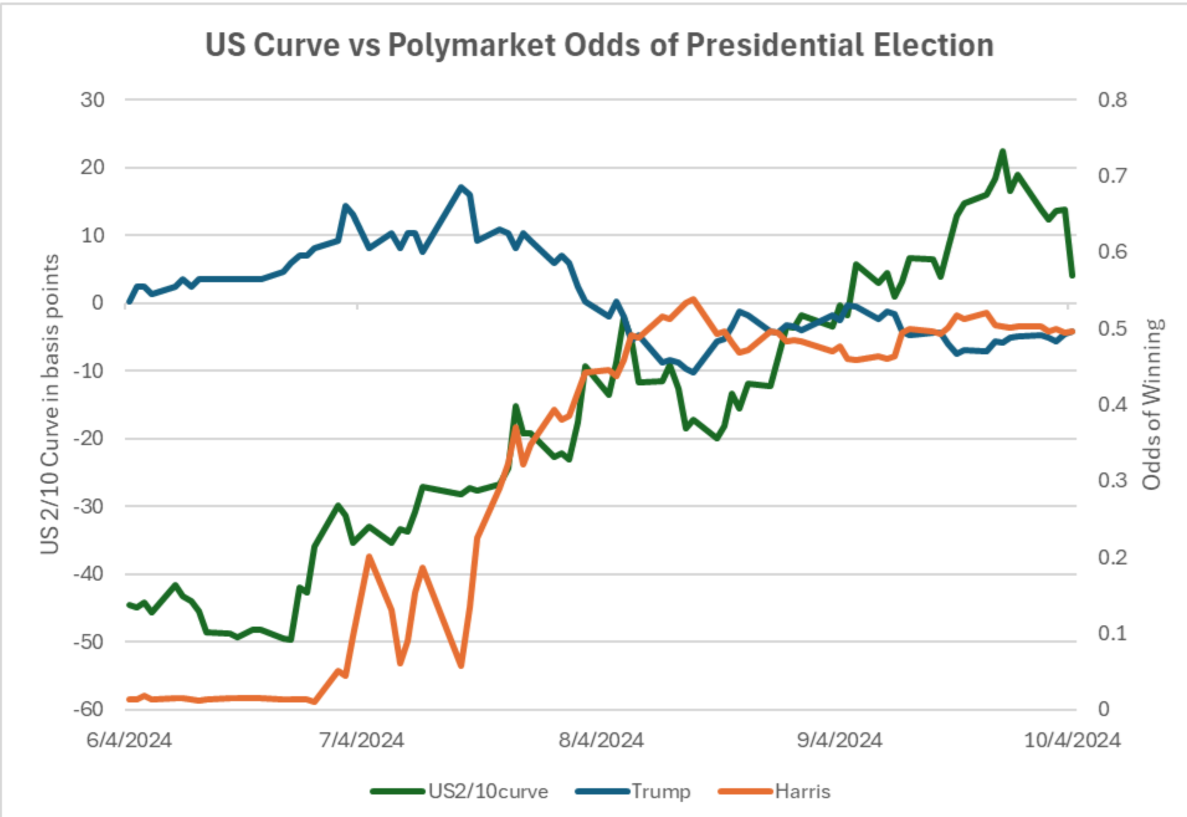
Exhibit #1: Equity Sectors Show Clear Biases for Trump vs. Harris



Source: iFlow, BNY

For bonds, the market has the noise of the FOMC, the September jumbo rate cut mixed with the weaker July unemployment report and the ongoing sag in consumer economic viewpoints depending on their party affiliation. We have highlighted how the consumer mood in the University of Michigan sentiment survey shows a clear bias based on party affiliation. This makes any forward-looking survey data less useful and leaves the election outcome as more important for a recalibration of mood. The certainty gained following the election will help calm markets and has traditionally led to a relief rally in risk assets. However, for bonds, this could be different. Fiscal concerns and the tightness of the races for Congress matter now. The most notable takeaway from iFlow data comes from international appetite for US bonds which declined following the Trump-Biden debate and has only recently returned after the FOMC easing. The risk for the post-election US bond market could be in term premiums and curve steepening.

Exhibit #2: US Election and 2Y/10Y Curve



Source: Bloomberg, Polymarket, BNY

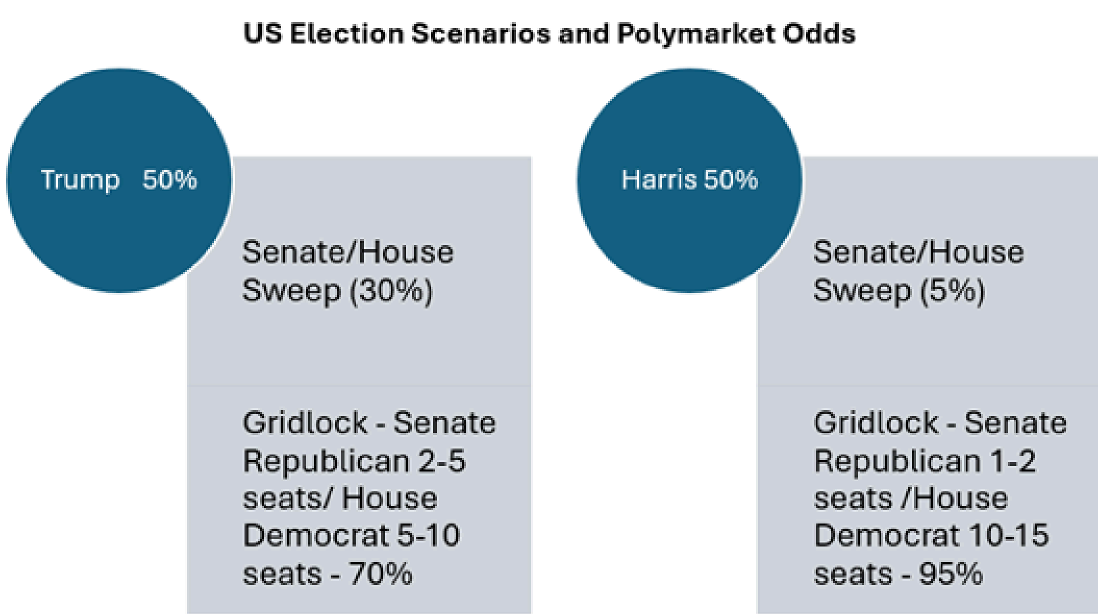
A scenario analysis of the US election – spelling out all the potential outcomes and probabilities of the election – has become a key part of market reaction to polls and betting platforms. The consensus call for the election – less than 30 days ahead of the vote – is that there will be gridlock. The presidential election may be too close to call, but the bias is for a Republican Senate and a Democratic House. This means that the budget and all fiscal matters will require a compromise between parties to work. The odds from Polymarket shown in Exhibit #3 also highlight the lack of pricing for a Democratic sweep at 5% when mathematically they should be 20%. This maybe a source of risk into the next week.

The first test of this will be the election itself – as the undiscussed risk of a close US election is uncertainty over the actual result on November 5 . There is a nonzero chance that the election results for the presidency, the Senate and the House will require recounts, legal challenges and, potentially, a vote in Congress to determine the winner.

The other notable point about the US election is the lack of "coattails" for either candidate. Democrats' chances of winning the House are based less on Harris's success and more on the seven Senate seats that are actually in contention. Similarly, the House, while currently Republican-held, is widely seen as flipping to the Democrats more because of state redistricting than because of any other factor.

The biggest determinant in the US election is turnout. Higher participation in key swing states will determine the US presidential outcome. While there are 38.8 million registered Republican voters, and 49 million Democratic voters – independent voters aligned with the Democrats give the party a 49% of the total 210 million voters, while Republicans have a 48% share. Independents are the second largest group of US voters, as many do not align with either of the two parties. This has made polling and politics more confusing in the last five US presidential elections.
The risk for any US election is in the state-by-state outcomes as they determine the Electoral College delegations. So, the concentration risk around the seven key swing states continues to be the key.

Exhibit #3: Gridlock Is the Consensus

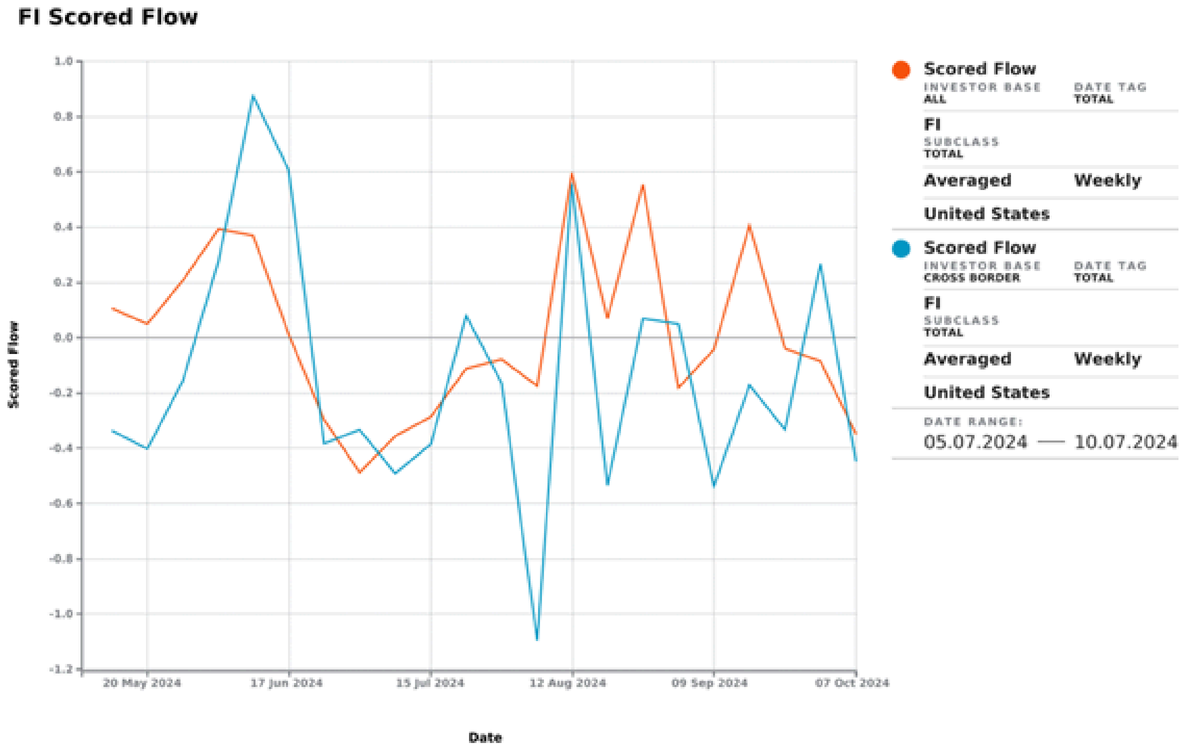


Source Polymarket, BNY

The role of fiscal policy in the US election has been less important to the national debate and far more a focus for international discussion. The US national debt is seen rising over the next ten years by a minimum of 10% of GDP to 125% and potentially as high as 155%. A number of think tanks have analyzed the deficit risks for both Trump and Harris with neither seen as balancing the US budget, although Trump is seen as the more uncertain and more likely larger deficit spender. The role of gridlock has been taken by many investors as a brake against the worst policy fears of each candidate should they win the presidency. This ignores the compounding risk of US debt as it grows without active intervention by Congress to contain it. The amount of money needed to service the national debt now exceeds the amount spent on Medicare spending or national defense. The risk of monetary policy not returning the terminal rate to 2% mixed with a higher term premium for US debt adds to concerns about funding US deficits in the years ahead. Cross-border flows point to the risk of the US election to US bond markets as shown in the Exhibit #4.

Bottom Line: The risk for markets around the US election does not yet feel fully priced. The bigger and more clearcut concerns over monetary policy and the Fed terminal rate overlayed by the S&P 500 earnings cloud some of the current pricing of election outcomes. As there is an urgency and end date to the process, the risk of the US election is likely to increase over the last two weeks of October. The role of Congress in the mix of election outcomes remains a significant longer-term concern and one that may drive prices faster should there be a shift in the consensus. The focus on different equity rotation trades could become important to how the market sees the election risks.

Exhibit #4: Cross-border Flows Are Not Buying US Debt Consistently



Source: iFlow, BNY

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