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Clinton vs Trump or POTUS vs Congress?

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- November's election is about more than simply what U.S. voters choose for themselves. **The choice of U.S. President will mean changes in how global investors view U.S. assets and potentially the strength of trade and security arrangements across the world.** The latest national popular polls show a 5% national lead for Hillary Clinton over Donald Trump. Yet electoral-college-weighted polls show a massive electoral-college-vote lead for Clinton (341 vs 197). **As such, markets anticipate a "status quo" in the choice of U.S. president.**

- In contrast to Clinton's strong electoral lead, **Senate and House Congressional races show much stronger relative polling for sitting Republicans.** While polls may still change considerably, we see the high probability of divided government as the potentially undiscounted election prospect. Such a scenario carries both positive and negative possibilities looking forward, but may be initially positive for markets.

- There are uncertain transition costs and policy issues facing either Clinton or Trump. **Of the eleven post-World War II U.S. recessions, eight have overlapped a new president's first year in office.** Status quo economic policies under a Clinton presidency could reveal the same U.S. growth limitations of recent years. We see no easy path to raising long-term growth prospects sharply.

- **Unintended consequences**: The Mexican peso has been hammered by Trump's anti-NAFTA policy views this year. This has actually improved the competitiveness of Mexico's exports to the U.S. assuming current trade regimes remain in place.

- **More unintended consequences**: China's currency has slowly depreciated in the past year despite at times intense Chinese intervention to stem the decline. If China were designated a currency manipulator by the U.S. and threatened with trade sanctions as Trump has suggested, it might stop intervention in the currency market. A short, sharp Chinese yuan depreciation could take place, shocking world markets.

- Taken at face value, disruptions to trade – impacting both domestic production and activity abroad – appear to be the largest obvious economic risk if Trump's trade policies are put into effect. The status of unauthorized immigrants in industries such as agriculture and hospitality services also threaten disruption to U.S. activity. In contrast, some Trump tax and investment policies could stimulate U.S. growth.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NOT CDIC INSURED • NOT GOVERNMENT INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

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Summary conclusions:

- Based on electoral College-weighted polls rather than the popular vote, we see a high probability that Hillary Clinton wins the White House. Yet we also see a high likelihood that either the House, Senate, or both remain in Republican control. **While polls may still change considerably, we see a high probability of divided government, a potentially undiscounted election prospect.** Such a scenario carries both positive and negative possibilities, but may be initially positive for markets.

- **In essence, there's been a low correlation between Donald Trump's polling and that of Congressional Republicans. Since 1960, no new U.S. President has simultaneously won over a switch in control of the House of Representatives.** Moreover, even if Democrats won as many new House seats as they did in 2008, Republicans would still maintain control.

- If current polls are wrong, and Donald Trump wins the Presidency, we would expect an initial rise in U.S. Treasury yields tempered by global risk aversion. While the probability of fiscal stimulus would rise with a Trump presidency – and likely unified government in that event – we don't believe the U.S. dollar would perform as strongly as other "risk-off" and "fiscal stimulus" periods might imply. For political and security reasons, international capital might feel safer at home amid significant U.S.-policy uncertainty.

- The market tone resulting from a Clinton victory is unclear and would depend on the degree to which markets discount a "shock-free status quo result." While unlikely, a Democrat sweep of Congress might cause a pullback in markets on fresh policy uncertainty.

- As has often been the case with Democrats, President Obama inherited a depressed U.S. economy with low asset prices. His period in office since early 2009 has coincided with high asset price returns as a result. **If she became President, Clinton would instead inherit a late-cycle recovery and relatively high asset prices.**

- Assuming legislation can get passed, either the Clinton or Trump agenda would limit the relative attraction of municipal bonds. Trump through lower income tax rates, Clinton through more limited deductions. However, we expect municipal bonds to keep their core appeal.

- Equity implied volatility tends to spike 2% before U.S. presidential elections than quickly subside thereafter. The sole exception was the contested election of 2000.

- Equity sectors with a high international revenue share have correlated most closely to Clinton's poll results, while domestic sectors have correlated most closely to Trump's. We see risks that markets are too sanguine about infrastructure spending prospects which require bi-partisan support.

- China's relationship with the U.S. may be subject to change under either candidate. External threats to China's growth could have a large impact on China's trading partners in the region.

Overview: more than who "we" choose

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With thanks to Dominic Picarda

The coming end of U.S. President Barrack Obama's eight-year administration presents a substantial global uncertainty. And it is far from the only one of a purely political nature. The coming year's federal elections in Germany, the Presidential election in France, elections and referenda in a host of smaller countries could represent similar tests of the populist will against "establishment" political management. The present global order is arguably under siege already, and the extent to which it endures or frays could be decided in significant part by these democratic choices.

Digesting much popular financial analysis of "winners and losers" of a Clinton or Trump presidency, we are struck by how the focus tends to be solely upon the intentions of the two candidates, for example whether they favor solar or coal. For financial markets, however, more might be decided by the reactions of *others* around the world to the U.S. choice of president than by the candidates themselves.

Beyond the "headline" choice of president, the main question is the make-up of Congress. Yes, the two candidates' prospects could change substantially between now and November 8. However, the electoral-college weighted polls discussed in the section immediately below suggests a high probability of a Clinton presidency. For those who argue that the U.K.'s shock vote to quit the European Union demonstrates that politics is particularly unpredictable, there's certainly a case to be made. However, we believe it was largely the unwillingness of investors to believe opinion polls favoring 'Brexit' that led to the shock over the result.

What we believe the markets substantially do not appreciate is the low correlation of candidate Trump's electoral prospects with those of Congressional Republicans.

"Full status quo" of divided government means the chance of major breakthroughs in U.S. policy would be very modest. Yet the chance of major policy-led disruptions would also be minimal.

The very large Republican majority in the U.S. House of Representatives itself represents a substantial hurdle to unifying government under Democrats. The fact that a new U.S. President has not *immediately* coincided with a turn in the party controlling the House since 1960 offers statistical precedent for a continuation of the status quo of divided government. Beyond that, current polls suggest solid prospects for most sitting members of Congress with relatively little turnover indicated. This is despite the common wisdom that congressional candidates often ride to victory on the "coat tails" of a presidential contender from the same party. In essence, the present polling results suggest a weak level of association between the current Republican Congress and Trump.

What does this mean? Any change in U.S. leadership represents an economic challenge, often one that is under-rated by economists in our view. However, we are biased to expect a positive reaction in financial markets if there is a "full status quo" with a Democrat President and at least one Congressional chamber controlled by Republicans. Of course, such an outcome is far from certain, but appears likely in our view.

"Full status quo" means highly partisan actors would have to compromise to achieve anything. There is little policy common ground between current U.S. Democrats and Republicans. The chance of major breakthroughs in the direction of U.S. policy would be very modest. Yet the chance of major policy-led disruptions would also be minimal.

Forty U.S. States plus D.C. have voted for the same party's candidate in each of the last four presidential elections.

Clinton or Trump: election probability

As discussed in detail in the July edition of Quadrant *US Elections, Risk and Reward*, the probability of a Clinton or Trump presidency depends on the "winner-takes-all" Electoral College prospects of individual states. In the last four U.S. presidential elections, forty states as well as the District of Colombia have voted for the same party's candidate each time. In contrast, the other ten states' electors have switched party choice at least once, such that they are known as "swing states." The U.S. presidential choice is highly likely to be decided in this small group of states.

As **Figure 1** shows, the latest individual state polls put Clinton at 105 electoral votes compared to 11 for Trump in the historic swing-states[1]. Once all states are included, the polls suggest an electoral college vote count of 341 versus 197, an 73% advantage for Clinton and well above the 270 electoral votes required to win. This electoral college-weighted assessment contrasts markedly with the much closer polling of the national popular vote. The latest polls for the national popular vote puts Clinton on 42% support against 37% for Trump when both undecided voters and third-party candidates are included.

Of course, with more than two months of campaigning ahead, the stability of these poll results is far from certain. If there is movement, financial markets might become closely correlated to swing state poll results in the weeks leading up to election day on November 8.

Figure 1: Electoral college polls from current and past swing states

Historical swing states

Current Swing State Polling			
Percentage of Individuals Favouring Clinton vs Trump		Clinton %	Trump %
Colorado	9	46.3	35.0
Florida	29	44.3	41.6
Indiana	11	38.7	47.3
Iowa	6	41.5	42.3
Nevada	6	43.3	41.0
New Hampshire	4	45.0	35.7
New Mexico	5	40.5	32.0
North Carolina	15	45.5	43.8
Ohio	18	43.8	40.0
Virginia	13	45.7	40.7
Swing States		**99**	**17**
Total National Estimate		**341**	**197**

Sources: Citi Private Bank and RealClearPolitics as of September 6, 2016.

RealClearPolitics swing states

Current Swing State Polling			
Percentage of Individuals Favouring Clinton vs Trump		Clinton %	Trump %
Arizona	11	41.3	44.0
Georgia	16	42.7	44.3
Michigan	16	46.0	38.7
Nevada	6	43.3	41.0
North Carolina	15	45.5	43.8
Oregon	7	43.0	39.0
Virginia	13	45.7	40.7
Florida	29	44.3	41.6
Iowa	6	41.5	42.3
Montana	3	No polls.	
New Hampshire	4	45.0	35.7
Ohio	18	43.8	40.0
Pennsylvania	20	46.5	40.0
Wisconsin	10	45.0	39.7
Swing States		**138**	**33**
National Projection		**340**	**187**

Sources: Citi Private Bank and RealClearPolitics as of September 6, 2016.

1 We also include an alternative measure of the swing states from *Real Clear Politics* which shows fairly similar results.

Status quo or parts unknown?

Clinton's policy proposals look like shifts in nuance vs the "sea change" of her current and previous opponents.

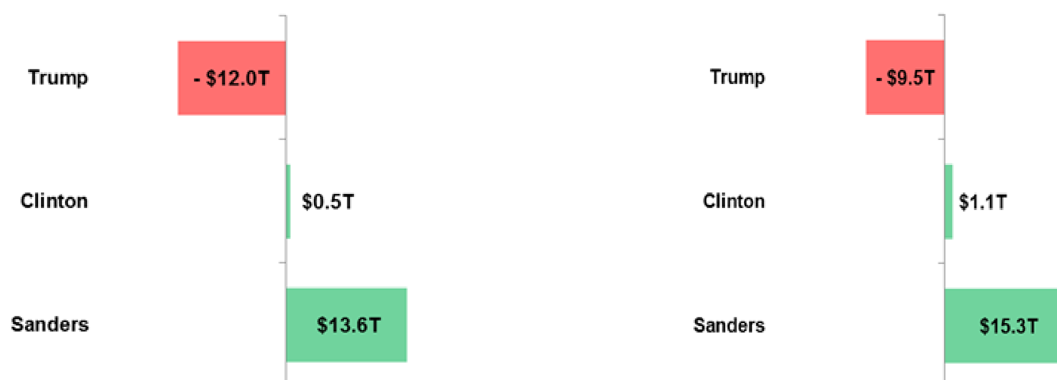
The "unknown unknowns" of a Trump administration are vast for many widely understood reasons. They include both those driven by the candidate – as he has no public record to assess – and if elected, his policy support within the coming new U.S. Congress. As we will discuss, the reaction abroad may prove critical.

Congressional uncertainties are high for a prospective Clinton presidency. Unlike President Obama's early first term, if elected, we believe she is likely to have to govern with less than the majority support of her party in both chambers of the U.S. Congress.

She is also unlikely to govern with a Democratic majority as did Obama early in his administration.

The relative lack of reaction in financial markets to the high apparent probability of a Clinton presidency may best be understood through **Figure 2** and **Figure 3**. They show the very limited scope of proposed fiscal changes by Clinton compared to her Democratic rival in the primary campaign, Bernie Sanders, or to Donald Trump. While there would be changes, when compared to Trump, Clinton represents a steady, largely "status quo" policy agenda. Her very detailed proposals seem to represent shifts in the nuance rather than a "sea change." Divided government and partisan rancor makes it even less likely that there would large policy changes in the following year.

Figure 2: Ten-year Federal revenue impact assumptions from two U.S. think-tanks. US$ Trillions.



Sources: Tax Policy Center and Tax Foundation as of August 22, 2016.
Note: The Tax Policy Center is considered a 'center' or 'center-left' analytical source while the Tax Foundation is considered a center-right analytical source. All forecasts are expressions of opinion and are subject to change without notice and are not intended as a guarantee of future events.

Figure 3: Campaign proposals with revenue impacts

Donald Trump

Personal Taxes
Lower Income Taxes, Fewer Brackets (10, 20 & 25%)
Exempt more income from taxes: Higher Standard Deductions ($25K/$50K)
Lower Business Income Tax
Repeal Alternative Minimum Tax (alternate tax system that limits value of deductions)
Repeal Estate and Gift Tax
Repeal Medicare Net investment surtax
Repeal Exclusion of Life Insurance Investment Income
Increase Phasout Rates for Personal Exemptions
Repeal select business tax expenditures
Limit certain tax expenditures to 10%

Corporate Taxes
Flat 15% Corporate Tax Rate
Repeal Corporate Alternative Minimum Tax
Require Foreign Corporation Income Repatriation
End Foreign Corporation Tax Deferal
Repeal Select Corporate Tax Expenditures

Total Revenue Change over 10-years	-$9.5T

Hillary Clinton

Personal Taxes
Limit Value of Certain Tax Expenditures to 28%
4% Surchange on Income Greater than $5M
"Buffet Rule" (mimimum 30% rate on incomes over $1 million)
Phase In Higher Long-Term Capital Gains Rates
Repeal Carried Interest, Mark Derivitieves to Market and Limit deferral in retirement accounts
Eliminate Fossil Fuel Tax Incentives
Create Incentives for Community Development and Infrastructure

Corporate Taxes
International Tax Reforms
Eliminate Fossil Fuel Tax Incentives
Create Incentives for Community Development and Infrastructure

Total Revenue Change over 10-years	+$1.1T

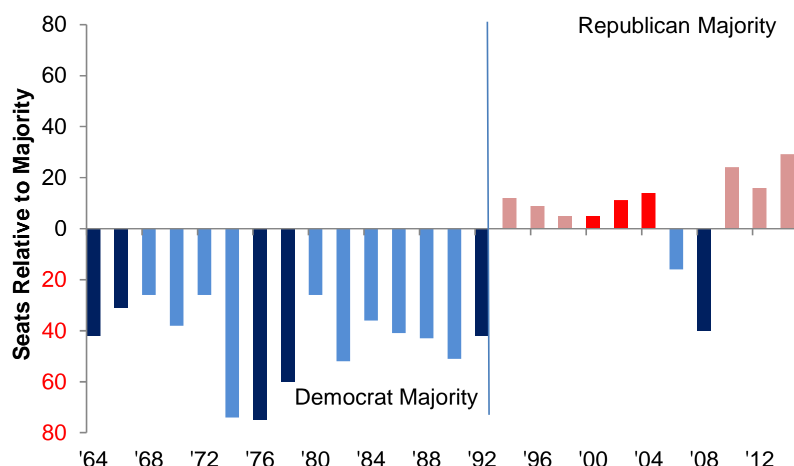
Sources: Tax Policy Center as of August 22, 2016. All forecasts are expressions of opinion and are subject to change without notice and are not intended as a guarantee of future events.

Congress: more likely to minimize than maximize impact

Importantly, the post-election reaction in financial markets may be decided by congressional results. The extent to which either candidate can achieve his or her aims depends upon unifying support across both houses of Congress. Such checks and balances - to the extent that they exist in the newly configured Congress - may argue for a more limited reaction in financial markets than “election fever” press coverage may imply. Yet congressional results are also more complex to assess and more unpredictable to forecast than the choice of president. This complexity contrasts significantly with the simple, binary Brexit referendum, for example.

We see a high probability that either the House, Senate or both will remain Republican if Clinton wins the White House.

Figure 4. Control of the House of Representatives Shifts Slowly



Source: House of Representatives and Citi Private Bank as of August 22, 2016.

Given that the present Republican majority in the House of Representatives is the largest since 1928 – 247 GOP members vs 188 Democrats – it would take a dramatic repudiation of Republicans to shift control in the coming House elections (see **Figure 4**). While that is possible, detailed polling on the Senate campaigns doesn't clarify that a change in control is certain (see **Figure 5** and **Figure 6**). While press reports have noted that Donald Trump has not attracted large political donations from the Republican establishment, this is not true of members of Congress - **Figure 7**.

Figure 5: Senate swing elections

State	Incumbent	Dem	Rep	Current	Poll Result	Change Implied
		Poll %				
AZ	John McCain	36	41	R	R	
CO	Michael Bennet	50	37	D	D	
FL	Marco Rubio	41	47	R	R	
IA	Chuck Grassley	41	49	R	R	
IL	Mark Kirk	No poll.		R		
IN	Daniel Coats*	48	41	R	D	+1 D
LA	David Vitter*	No poll.		R		
MO	Roy Blunt	No poll.		R		
NC	Richard Burr	45	44	R	D	+1 D
NH	Kelly Ayotte	45	44	R	D	+1 D
NV	Harry Reid*	41	41	D	R	+1 R
OH	Rob Portman	37	44	R	R	
PA	Patrick Toomey	42	41	R	D	+1 D
WI	Ron Johnson	51	40	R	D	+1 D

Current polling = 50 Republicans, 48 Democrats and 2 Independents in 2017 Senate.

The 2016 Senate = 54 Republicans, 44 Democrats and 2 Independents (Caucus with Democrats)

Source: RealClearPolitics.com and Citi Private Bank as of September 6, 2016.

Figure 6: Safe vs swing house elections

	Republicans	Democrats
Current Seats	**247**	**188**
Safe Seats	**221**	**181**
Competitive Seats	**26**	**7**
Projected Change	**-18**	**+18**
2017 House	**229**	**206**

Source: ElectionProjection.com and Citi Private Bank as of September 6, 2016.

Current polling data seem to suggest that the prospects for Donald Trump and for Republican members of Congress are not closely tied. The likelihood of a change in *both* the House and Senate to a Democrat majority could be just 10% to 20% in our view.

Figure 7. Presidential and party campaign finances

	Raised	Spent	Cash on Hand
Donald Trump	$128M	$90M	$38M
Hillary Clinton	$327M	$269M	$58M
Republican National Committee	$208M	$178M	$30M
Democratic National Committee	$152M	$149M	$3M

Source: Federal Election Commission and Citi Private Bank as of September 6, 2016.

In contrast, as **Figure 1** showed, the probability that Donald Trump wins the White House is significantly lower than national popular vote polls suggest. Yet if Trump does win the White House, the likelihood of maintaining Republican control in both chambers is quite high.

However, we see the probability of unified Republican government along with a majority of 60 Senate seats at less than 10%. This is the so-called "filibuster" proof majority that could be used to end legislative debate and move to immediate votes. Such a super-majority would mean powerful support for a new President in ordinary times. Yet one further consideration remains: the extent to which a Republican Congress would support a prospective Trump administration's agenda given widely reported policy differences, particularly on matters of trade and defense.

Summary: What to expect from Clinton

As noted, a Clinton presidency would represent policy continuity. The potential for imposition of the "Buffet Rule" would mean higher minimum taxes on tax-advantaged sources of income such as carried interest, municipal bond or common dividend income for the highest earning U.S. taxpayers – see Fixed Income section for details. This, of course, would require Congressional approval, which would at least be initially lacking. A potential financial transactions tax would also likely be discussed.

We consider security threats that arise during the new president's first year in office to be among the unexpected and undiscounted risks that have a higher-than-usual probability compared to other times.

Greater regulation of the pharmaceuticals sector, legislative pressure on low-wage paying employers and carbon-heavy industries would also be likely – see detailed section on page 17. Notably, in the way industries are regulated, a certain level of discretion exists that does not require legislative action.

Summary: What to expect from Trump

A Trump presidency could bring far larger changes. Fiscal policy easing would be fairly likely. While there would be some Congressional opposition to this, tax-cuts have historically been much easier to achieve legislatively than tax-hikes or spending-cuts. Fiscal easing without long-term entitlement reform would be at odds with long-term debt sustainability in the U.S., but should still be expected to strengthen economic growth at least over short periods.

In addition, while there are clear exceptions such as banking regulations, where policy proposals may raise – rather than reduce – uncertainty, it is reasonable to assume that de-regulation would encourage some level of increased business investment. However, this wouldn't be an impact felt in isolation.

In contrast to these potential positives, Trump's trade policy presents a substantial downside risk to the U.S. and world economy if carried out in line with campaign rhetoric. Unilateral tariffs – potentially in violation of existing trade treaties and possible retaliatory measures – would pose a significant risk of disrupting business outright. Domestic U.S. production would be compromised by the loss of imported parts. Well known consumer products such as iPhones – which are assembled in China, but have significant U.S. and international components and intellectual property value – could be subject to a disruptive trade dispute.

This would have ramifications beyond the real economy. While the U.S. current account deficit has fallen markedly from a decade ago, international actors could reduce their

inflows of capital to the U.S. if significant policies were introduced which were both hostile to trade and in conflict with the rule of law. These substantial uncertainties could raise risk premia on all U.S. assets and generate a global retreat from risk assets more generally.

Trump is on record as saying “I think we're sitting on an economic bubble. A financial bubble…on the verge of a "very massive recession." His campaign statements suggest little fear of providing a potential trigger.

Reaction abroad

Either Clinton or Trump could face immediate tests of their international stances in the early days of their presidencies. This may be more likely in the event of a Trump presidency as he has directly questioned defense alliances with South Korea, Japan and eastern European NATO members.

Away from security threats, questions of cooperation and cohesion will arise for the new President’s economic team. The U.S. strategic dialogue with China may take a different course even under a Clinton Presidency – see Asia section. The pending expiry of European economic sanctions against Russia on January 31, 2017 will likely see differing U.S. involvement depending on who wins.

New presidents, big challenges

Since 1920, first year U.S. Presidents saw recession three times more often than in other years.

While it would be wrong to imply a consistent pattern of causation, of the eleven post-World War II U.S. recessions, eight have overlapped a new President’s first year in office. Since 1920, recession periods during a new U.S. President’s first year have been three times as common as in other periods – Figure 8. In contrast, economists famously have difficulty forecasting recessions. Consensus forecasts have failed to anticipate any of the last six recessions a year in advance - Figure 9.

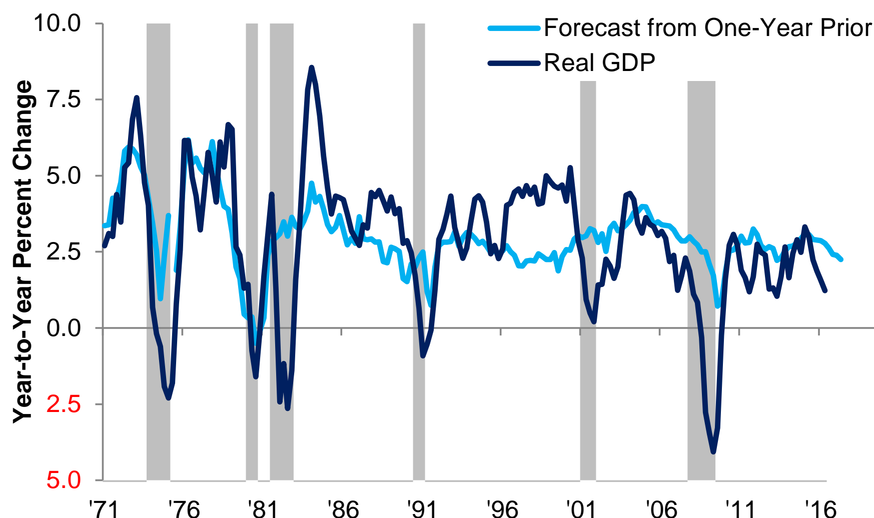
Figure 8. Recessions in the first year of a new President’s term

➡ Harding (shaded)	➡ *Coolidge* (shaded)	↓ Hoover (shaded)	➡ Roosevelt (shaded)
➡ *Truman* (shaded)	↓ Eisenhower (shaded)	➡ Kennedy (shaded)	*Johnson*
↓ Nixon (shaded)	➡ *Ford* (shaded)	Carter	↓ Reagan (shaded)
Bush	Clinton	↓ Bush II (shaded)	➡ Obama (shaded)

Recession	(shaded)	New Recession ↓	Republican
Replacement President	*Italics*	Continuing Recession ➡	Democrat

Source: Haver Analytics as of July 25, 2016.

Figure 9. Consensus economic forecasts and real GDP growth



Source: Haver Analytics as of August 23, 2016.

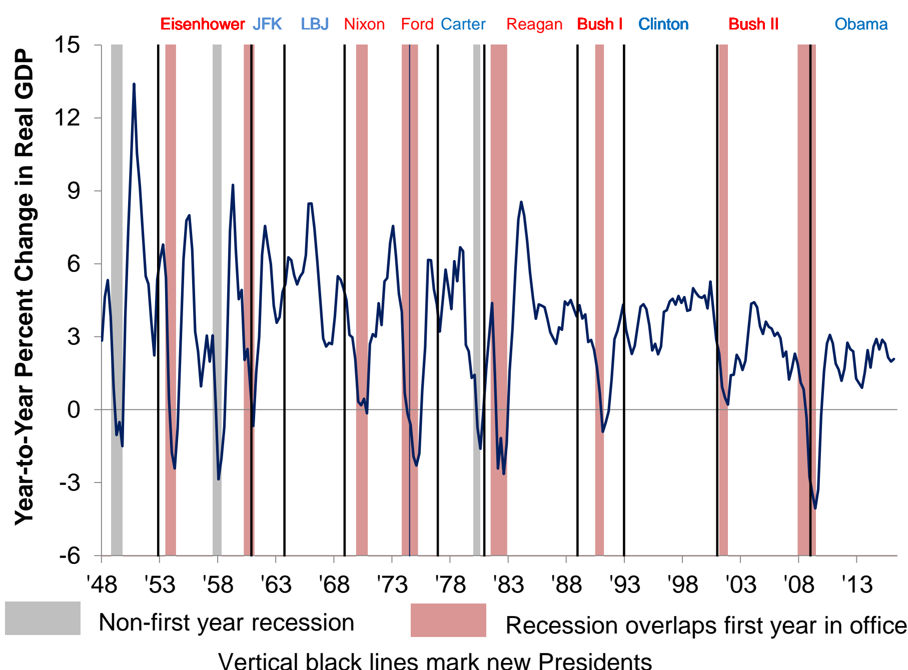
President Obama inherited a depressed economy and collapsed financial markets which allowed for 12% inflation-adjusted U.S. equity returns during his tenure.

As we noted in Outlook 2016, there's been an overlooked tendency for the U.S. electorate to choose Republican Presidents close to business-cycle peaks and Democrats when the U.S. economy has been depressed and ripe for recovery (see Outlandish Outcomes in Outlook 2016). This and some contrary examples, such as Reagan's presidency, appear to explain the stronger growth readings and higher historic average stock market returns under Democrat administrations (see Figure 12). In contrast, Clinton would not inherit an economy or asset markets similarly depressed.

The next U.S. President will not inherit a similar starting point for market performance.

For reasons unrelated to politics or policy, we see the next U.S. President as highly unlikely to see inflation-adjusted stock returns match the 12% annualized pace seen in President Obama's tenure in office to-date.

Figure 10. Eight of the eleven post-World War II recessions overlapped a new President's first year in office



Source: Haver Analytics as of July 25, 2016.

Figure 11. Eight of the eleven post-World War II recessions overlapped a new President's first year in office

Party	President	Innauguration Date	Recession Periods	First Year Recession Overlap?	Comment
D	Truman	Apr 1945	1 Nov 48-Oct49	No	
R	Eisenhower	Jan 1953	2 Jul 1953-May 54	Yes	
			3 Aug 57-Apr 58	No	
D	Kennedy	Jan 1961	4 Apr 60-Feb 61	Yes	Begins during prior admin.
D	Johnson	Nov 1963			
R	Nixon	Jan 1969	5 Dec 69-Nov 70	Yes	
R	Ford	Aug 1974	6 Nov 73-Mar 75	Yes	Spans appointment.
D	Carter	Jan 1977	7 Jan-80-Jul 80	Yes	Ends prior to Reagan's election.
R	Reagan	Jan 1981	8 Jul 81-Nov 82	Yes	
R	GHW Bush	Jan 1989	9 Jul 90-Mar 91	No	
D	Clinton	Jan 1993			
R	GW Bush	Jan 2001	10 Mar-2001-Nov 200'	Yes	
			11 Dec 2007-		
D	Obama	Jan 2009	--Jun 2009	Yes	Begins during prior admin.

Source: Haver Analytics as of July 25, 2016.

Figure 12. Annualized real S&P 500 total return and GDP growth by Presidential term

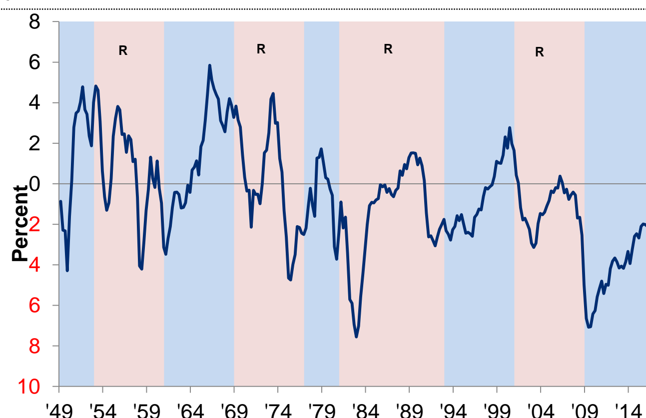
	Annualized Real S&P 500 Total Return (%)	Annualized Real GDP Growth (%)	Party
Truman	9.7	4.8	D
Eisenhower	13.3	2.5	R
Kennedy	9.9	5.3	D
Johnson	7.9	5.1	D
Nixon/Ford	-2.1	2.7	R
Carter	1.3	3.2	D
Reagan	9.4	3.6	R
Bush	11.0	2.2	R
Clinton	14.2	3.8	D
Bush II	-5.3	1.8	R
Obama*	12.4	1.7	D

*Obama result is through 2Q 2016.

Republican Weighted Average	4.6	2.6	
Democrat Weighted Average	10.1	3.7	

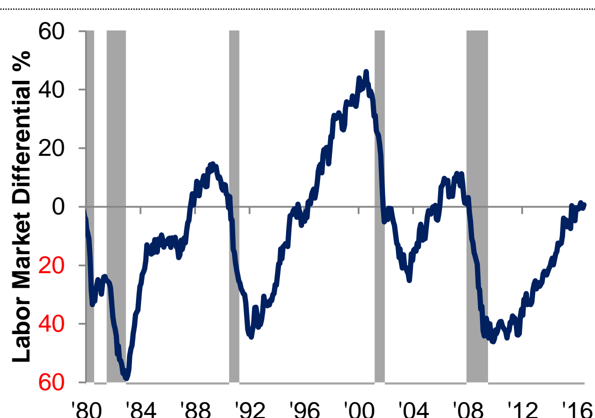
Source: Haver Analytics as of July 22, 2016. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results.

Figure 13: U.S. "output gap" and presidential party in power



Source: Haver Analytics as of July 25, 2016.

Figure 14: Consumer Rating of Labor Market: Net % consumers reporting jobs are easy to get minus hard to find



Source: Haver Analytics as of August 22, 2016.

Implications for fixed income

Fixed Income Strategy:
Kris Xippolitos

- A Hillary Clinton administration would likely represent a continuation of the status quo for fixed income markets. Treasury yields would remain low, corporate and emerging debt markets would remain well supported.

- A Donald Trump administration is more likely to be disruptive for bonds. Initially, Treasury rates might increase upon macro risk concerns. U.S. TIPS (Treasury Inflation Protected Securities) breakeven spreads could widen if foreign imports fell and U.S. consumer prices rose.

- An increase in Treasury borrowing to fund aggressive fiscal stimulus – as proposed by Trump – is bearish for long-term Treasury debt, although the Federal debt-ceiling would pose challenges to such borrowing.

- Recession risk under Trump is the largest concern for corporate credit, as spreads would likely widen, especially in U.S. high yield markets.

- Historically, changes in the U.S. tax code have had material effects on the U.S. municipal bond market. In the past, changes in tax rates have impacted the degree of tax-exempt demand and their yields ratios relative to U.S. Treasuries.

- Both Clinton and Trump are proposing tax plans which may ultimately be negative for U.S. municipal bond holders. While Trump favors income and corporate tax cuts, Clinton has proposed limits on itemized deductions.

- Ultimately, the implementation of new tax policies are likely to be politically challenging, and we still expect U.S. municipal bonds to remain a core value and key holding for many US investors.

U.S. election impacts on fixed income

Our baseline assumption for November is a Democratic president once again, combined with a Republican Congress in at least one chamber. As such, we are not likely to see much of a change in most U.S. fixed income markets. Political gridlock would minimize much of Ms. Clinton's agenda, the Fed would remain unscathed and the status quo would be left intact. Treasury yields would remain low and corporate credit and emerging market debt would continue to benefit from quantitative easing in Europe and Japan, as well as from the persistent search for higher yields.

On the other hand, a Trump victory could have numerous fixed income impacts. Similar to the reaction after the U.K. voted to quit the European Union, we'd expect the initial shock to push U.S. Treasury rates lower and corporate and emerging-market debt spreads wider. If Trump's trade policies reduce foreign imports, U.S. consumer prices could rise, pushing TIPS breakeven spreads wider.

Trump's fiscal proposals are also relatively aggressive, and imply greater government borrowing. Though Federal debt-ceiling limitations could restrict the size of any major stimulus package, Democrats are unlikely to use a potential government shutdown as leverage against such a rise. The resulting increase in Treasury supply would clearly be

a bearish factor for long-term yields. Subsequently, if Trump's initiatives are considered successful, corporate credit spreads could also tighten. However, total returns would likely be diminished by rising Treasury yields.

The larger risk for corporate debt under a Trump administration is a potential recession catalysed by trade shocks. In this scenario, yield spreads – especially in high yield debt – could widen dramatically. Of course, the European Central Bank or the Bank of England may be forced to intensify their existing corporate bond buying programs, consequently supporting non U.S. markets.

Clinton's potential effects on the U.S. municipal market

Clinton's plan capping tax deductions could eliminate much of the benefit from any rise in tax rates for the relative value of municipal bonds.

Historically, changes in the U.S. tax code have had material effects on the U.S. municipal bond market. In the past, changes in tax rates have impacted tax-exempt demand and yield ratios relative to U.S. Treasuries. Looking at Clinton's proposed tax plans, there are several opposing factors which ultimately may be negative for municipal bond investors.

In its current form, the Clinton plan proposes to retain the existing tax brackets on ordinary income, which includes a maximum tax bracket of 39.6%. However, effective income tax rates will be supplemented by changes in AMT (Alternative Minimum Tax) or include an additional surtax, depending on the level of income earned.

More specifically, taxpayers who earn more than $1 million annually would be subject to the "Buffett Rule", or a minimum effective tax rate of 30%. Furthermore, the highest income earners - those earning above $5 million a year – would be faced with an additional 4% surtax, raising these taxpayers' overall tax rate to 43.6%. Including the 3.8% Medicare surtax from Obamacare – which isn't expected to be repealed under Clinton – the highest effective tax rate would be raised to 47.4%.

While higher taxes are bullish for U.S. municipals given their income tax exemption, Ms. Clinton is also proposing a cap on all itemized deductions at 28%. It is unclear whether tax-exempt interest would be included, although the notion would be bearish for U.S. municipals, as tax-exempt demand would decline and bond yields and state borrowing costs would rise.

It is also likely Clinton would try to re-introduce the Build America Bonds Program, or other types of taxable muni bonds that carry federal subsidies. In essence, the government would still provide a subsidy to local governments, just in the form of coupon assistance, rather than as tax exemptions. As such, any lost demand from local borrowers could be replaced by taxable buyers, who would still likely be suffering from a glut of higher-yielding alternatives.

Trump's potential effects on the U.S. municipal market

Trump doesn't necessarily offer a better outlook for municipal investors. Having lately retreated from even more aggressive tax-reduction plans, Trump is now proposing to reduce the number of tax brackets from seven to three, with the highest tax bracket lowered to 33% (note, this is above the 25% that has been analysed in Figure 3). Trump also proposes decreases in tax-exempt deductions, albeit less far-reaching decreases then Clinton.

A large cut in corporate tax rates, if enacted, would limit corporate demand for municipal debt as an income shield.

While a cut in tax rates alone is bearish for tax-exempt bond investors, Trump's plan also proposes a reduction in the corporate tax rate from 35% to 15%. If enacted, demand for tax-exempt bonds would drop significantly from banks and insurance companies, and yield ratios relative to taxable bonds would soar. Of course, higher yield levels could eventually be welcomed by investors who may have previously overlooked the asset class, acting as a backstop and possibly mitigating any severe sell-off.

Like Clinton, Trump also has ambitious plans for infrastructure spending. Unfortunately, not much detail has been provided to explain the impact this could have on the municipal bond market. Few specifics on spending programs or spending cuts have been introduced. That said, lower demand and higher yields also implies higher borrowing costs for state and local issuers. As such, revisiting federally subsidized taxable municipal bond programs (BABS) could provide a political solution.

Bottom line

The tax agenda for both parties will at least marginally diminish the incentives for tax-exempt municipal bond investors. However, actual implementation of these policies can be challenging. The likelihood of a Democratic President and a Republican-controlled Congress, and the ensuing gridlock that could follow, would make Clinton's proposals for tax hikes and deduction limits difficult to achieve.

Moreover, any changes in policy that would raise the borrowing costs of state and local issuers appear inconsistent with politicians' eagerness for higher infrastructure spending. Of course, the politics surrounding infrastructure spending tend play out over longer periods of time than the election cycle. In our view, U.S. municipal bonds will likely remain an important financial engine for the U.S. economy, and a core fixed income holding for high-income U.S. investors.

Figure 15. U.S. Presidential Implications for Fixed Income Markets

Asset class	Hillary	Trump
US rates	**Nuetral** - Status quo would keep current macro environment intact; slow growth, slow Fed, lower for longer	**Positive (near-term)** - risk-off event feeds flight to quality; over the longer term, fiscal spending could pressure long-term rates higher
IG credit	**Positive** - current rate environment intact; lower for longer drives reach for yield; spreads nuetral to slightly tighter	**Negative** - spreads would likely widen from overall risk-aversion and potential trade impacts; Performance likely mitigated by rally in UST
HY credit	**Positive** - Lower for longer drives reach for yield; Higher oil prices benefits energy further; spreads tighter	**Negative** - risk off would drive outflows and wider spreads; would not benefit from lower US rates; likely market over-reaction to drive dislocations and longer-term opportunities
US munis	**Negative** - Higher top line tax rates and surtaxes may be limited by caps on itemized deductions; spreads widen	**Negative** - lower tax rates would be negative for tax-exempt buyers; yields would rise and spreads widen

Source: Citi Private Bank, August 2016.

Implications for North America

North America Investment Strategy:

Chris Dhanraj
Malcolm Spittler

- The U.S. Elections are likely to have a modest market impact at the macro level – i.e. a Hillary Clinton win combined with divided government should be seen more favorably as a 'status-quo' outcome. A Donald Trump win would instead likely trigger significant volatility across markets. In either case though, investors should expect larger moves at the sector or industry level.

- Overlaying current polling statistics to sector performance, we find that sectors that are most sensitive to an improving likelihood of a Clinton win are more internationally-oriented while those sectors that are more domestically-focused track a Trump victory.

- Examining the impact of fiscal stimulus on specific industries, we find that while both Clinton and Trump platforms propose fiscal stimulus, the likelihood of a Clinton win combined with a Republican Congress is likely to create an impasse that prevents significant sector-level benefits. However, a Trump win with a Republican Congress should result in fiscal stimulus that would primarily benefit the infrastructure and consumer discretionary industries.

- Concerning non-fiscal policies, a Trump win could have negative impact on hospitality-related industries (owing to anti-immigration policies) and on technology (which benefits the most from international trade). A Clinton win would be positive for these sectors, although beware the impact of industries such as financials and coal, which may suffer in a stricter regulatory environment.

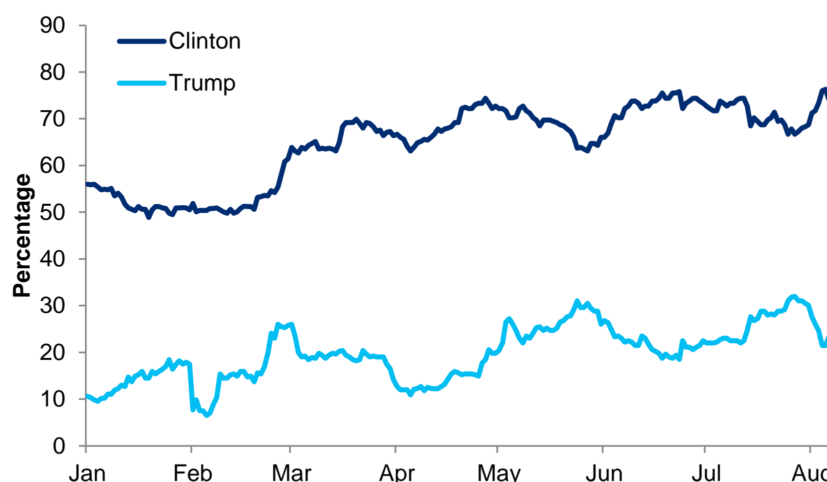
Favored and unfavored sectors

Financial markets may have priced in a high likelihood of a Clinton victory, but the surprise results from the U.K.'s Brexit vote in June should dissuade them from complete complacency. In this section, we will look closely at some potential industry consequences of both candidates' policies.

As noted in prior sections, a Clinton win would be viewed favorably by markets as the status-quo result, similar to a continuation of the present situation. Certainly, Clinton's policies have many similarities to those of the current Obama administration. That said, there are some key differences. Moreover, investors should understand that a Clinton win also comes with the high likelihood of Republicans keeping control of at least one chamber of Congress. As a result, partisan gridlock is likely to continue and cause any policy changes to be limited.

In contrast, Trump's policies are much further from the current status quo, and would likely spark much more financial-market volatility. However, national polls and election probability markets are pricing in a greater-than-70% chance of a Clinton win (Figure 16 below). However, the populist surge that led to the U.K.'s shock decision to quit European Union is a reminder of the potential for electoral surprises. A repeat of such an unexpected outcome in the U.S. in November could result in a strong and correlated sell-off across U.S. and global assets as investors' expectations are reset.

Figure 16. Implied probabilities of each candidate winning



Source: Bloomberg as of July 2016.

U.S. election impact on industries – what's being priced in

We examine how particular market segments have varied with the two campaign's polling prospects.

In trying to determine the potential market impacts, it is clear that certain industries could be more impacted than others. However, much of the financial media's analysis to date has centered on the thematic implications of the candidate statements. For example, it has been argued that a Clinton win would be negative for coal and positive for solar companies. By contrast, a Trump win is perceived as likely to be adverse for immigration-dependent sectors such as hotels and restaurants, while positive for infrastructure companies.

These types of conclusions are interesting, but offer limited value. While there have been hundreds of articles written on the link between Trump's prospects and the fate of the coal industry, few have noted that the last coal company quietly left the S&P 500 in March, and has a single-B credit rating. Nor have most articles noted that the assault on coal has come less from regulation and restriction than from the fracking-related boom in natural gas.

As well as trying to forecast potential industry impacts given the candidates' statements, we also take another approach. Specifically, we compare the changes in the market-implied probability of a Clinton or Trump victory using election probability markets. We examine how these moves correlate with changes in sub-sector prices relative to the broader S&P 500.

The results are interesting. Those sectors that have been most sensitive to the improving likelihood of a Clinton win tend to generate substantial revenue from international operations, and often have substantial cross-border production models. Whereas sectors that have been most positively correlated to the prospects for a Trump victory derive the vast majority of their revenue from domestic sources.

Are markets too optimistic about the prospects for a rise in future infrastructure spending which would take bi-partisanship?

It appears that investors are not yet focusing exclusively on the potential industry impact of U.S. elections but are still making sector-selection decisions based on other macro catalysts. This can be seen by the fact that despite the rising probability of a Clinton win, the sector most positively correlated with Clinton's prospects – communications equipment, up 14% year-to-date through 5 August 2016 – is lagging the sector most positively correlated with Trump's prospects, which is construction materials, up 34% year-to-date. Perhaps this is because of widespread, likely excessively optimistic views that either candidate will succeed in boosting infrastructure spending. As noted, this could take a breaking of partisan gridlock.

Figure 17: Sensitivity of sectors to changes in Candidate popularity ratings

Clinton	Correlation	US Revenue Share	Trump	Correlation	US Revenue Share
Communications Equipment	25%	57%	Construction Materials	37%	99%
Metal & Glass Containers	24%	47%	Commercial Services & Supplies	19%	82%
Household Durables	21%	69%	Food Distributors	17%	89%
Auto Components	21%	41%	Diversified Financials Services	16%	79%
Industrial Conglomerates	18%	45%	Specialty Retail	16%	91%

Source: Bloomberg, FactSet as of August 2016.

Looking ahead – the impact of fiscal policy on industries

As noted in the introduction, a Clinton victory could drive just a small net fiscal difference if her policies were enacted. Revenue increases would be driven by new limits on deductions; a proposal to enact the so-called "Buffett rule" – requiring taxpayers who earn more than $1 million a year to pay a minimum tax-rate of 30%, as well as a proposed 4% surtax on those with adjusted gross incomes (AGI) above $5 million. These would result in relatively little overall change in revenues, however. Any proposal to increase fiscal spending – such as by way of infrastructure programs – would be difficult to achieve, unless the U.S. elections also shift Congressional control from Republicans to Democrats or if there were a broader agreement with Republicans. The latter is a possibility, and the willingness of Clinton and House Republicans to reach compromise will be a key focus. Overall, however, the probable limits on fiscal action suggest little direct industry impact.

A Trump Presidency would have a much more significant fiscal impact and therefore consequences for sectors. Trump has advocated cutting taxes, increasing spending and balancing the budget, although only at most two out of these three can be achieved simultaneously. Recently, he has backed away from rhetoric about balancing the budget while noting the extraordinarily low borrowing costs that the Federal government could exploit.

Many of Trump's policies could have the positive effect of fiscal stimulus and would serve to boost economic activity in the short run. Given the low cost of government borrowing and the poor state of US infrastructure, this stimulus would likely make its way into the economy through first-order consumption effects and knock-on secondary effects from efficiency gains arising from much-needed improvements to roads, bridges, trains and other key infrastructure. However, it is not clear whether the "supply side" benefits of such spending would outpace the greater impact they would have on demand and the economy's scarce capacity seven years deep into recovery. History

suggests infrastructure spending as an intentional stimulus is usually quite poorly timed.[3]

If Trump were to win the election and the Congress remained under Republican control, allowing him an easier path to push through fiscal spending, we should expect to see positive impacts on the infrastructure and consumer discretionary sectors – the latter as take-home pay for some Americans would increase due to his net tax cuts. Of course, such spending would come at a cost. As noted earlier in this paper, both conservative and liberal think-tank tax analysis agree that Donald Trump's tax plans would reduce revenue by roughly $11 trillion over the next decade resulting in higher interest costs or a "crowding out" of private borrowers.

Figure 18: Broad Economic Impact of Trump policies

Policy	Broad Economic Impact
Lower Taxes	Boost Economic Activity
Increased Infrastructure	Boost Economic Activity
More Military	Boost Economic Activity
Balance Budget	Not compatible with other goals

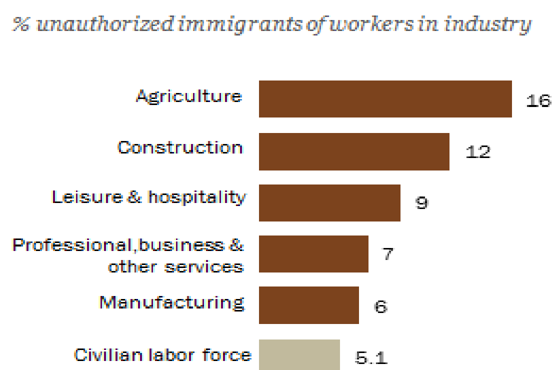
Source: Citi Private Bank, OCIS, as of August 2016.

Non-fiscal policy impacts on industries

Outside of fiscal policy, there are quite a few domestic industries that would be impacted by the choice of the next U.S. President. One of the most divisive has been the differences between both candidates on immigration. While Clinton has promised to introduce legislation within her first 100 days in office to create a path to citizenship for millions of people in the U.S. living illegally, Trump has taken the opposite approach with tough anti-immigration policies. Of late, he has made comments suggesting a compromise in approach. However, his primary-campaign promises of deporting illegal immigrants would have negative impacts on industries such as agriculture, which comprise an estimated 16% of jobs, construction (12%), and leisure and hospitality (9%). Note that construction is often seen as a beneficiary of Trump policy due to his statements on improving the nation's infrastructure.

3 Please see "Event Study: Both Pain and Gain in U.S. Fiscal Tightening," Steven Wieting and Shawn Snyder July 19, 2012. https://www.citivelocity.com/t/eppublic/yXre

Figure 19: Industries with High Shares of Unauthorized Immigrants, 2012



Source: Pew Research Center - December 2013. Updated March 2015.

Figure 20: H-1B Applicants by Occupation and Unemployment Rate

Occupational Category	All Beneficiaries		Initial Employment		Continuing Employment	
	FY2013 Number	FY2014 Number	FY2013 Number	FY2014 Number	FY2013 Number	FY2014 Number
Occupation known	**100**	**100**	**100**	**100**	**100**	**100**
Computer-related occupations	59.8	64.5	62.3	65.1	57.9	63.9
Occupations in Architecture, Engineering, and Surveying	9.6	9.2	9.1	8.6	10.0	9.6
Occupations in Administrative Specializations	6.5	6.0	6.6	5.9	7.2	6.0
Occupations in Education	7.1	5.9	7.0	6.8	76.5	5.4
Occupations in Medicine and Health	6.0	4.9	4.4	4.0	7.3	5.4
Occupations in Mathematics and Physical Sciences	1.8	1.8	1.9	1.8	1.8	1.7
Managers and Officials N.E.C.*	2.0	1.7	1.6	1.4	2.3	2.0
Occupations in Life Sciences	1.8	1.5	2.0	1.7	1.7	1.4
Occupations in Social Sciences	1.4	1.2	1.4	1.3	1.3	1.2
Miscellaneous Professional, Technical, and Managerial	1.4	1.2	1.3	1.0	1.4	1.3
Occupations in Art	0.9	0.8	0.9	0.8	0.9	0.8
Occupations in Law and Jurisprudence	0.3	0.3	0.4	0.4	0.3	0.3
Occupations in Writing	0.3	0.2	0.3	0.2	0.2	0.2
Miscellaneous	0.2	0.1	0.2	0.1	0.2	0.1
Occupations in Entertainment and Recreation	0.1	0.1	0.1	0.1	0.1	0.0
Occupations in Museum, Library, & Archival Sciences	0.1	0.1	0.1	0.1	0.1	0.0
Occupations in Religion and Theology	0.0	0.0	0.0	0.0	0.0	0.0
Sales Promotion Occupations	0.0	0.0	0.1	0.0	0.0	0.0
Occupation unknown	**---0.7---**	**---0.6---**	**------0.6**	**------0.6**	**---0.7---**	**---0.6---**

Notes: Occupations ranked based on FY 2014 data.
Sum of the percent may not add to 100 due to rounding.
Percentages shown in the table are based on the total number of petitions approved with known occupations.
*N.E.C. indicates not elsewhere classified.

Source: Heritage Foundation calculations based on data from the U.S. Department of Labor, July 2016.

However, immigration policies do not only affect industries that use the most unauthorized immigrant labor. Trump has also vowed to end the H-1B visa program, which grants temporary visas to skilled workers. Industries which garner the most applications will be negatively affected by the loss of skilled labor, specifically the technology, industrial and financial sectors.

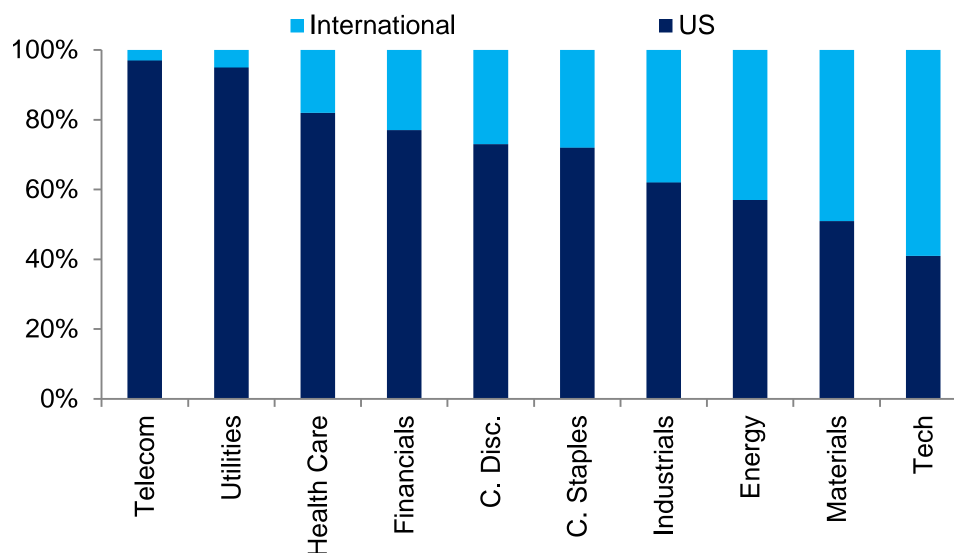
Does the U.S. economy have capacity to handle fiscal stimulus so late in a recovery?

Another potential impact would be the change in the U.S.'s relationship with China from a Trump Presidency. One of Trump's main policy proposals is to "bring China to the bargaining table by immediately declaring it a currency manipulator." This claim has generated popular support in U.S. regions associated with weakened manufacturing. As discussed on page 28, the Chinese currency may in fact weaken on such tactics and serve to boost Chinese manufacturing competitiveness. Additionally, the stronger dollar would cut into corporate revenues earned in China, where growing consumer demand has made China the single largest non-domestic source of revenue for the S&P 500 at 5%.

Another Trump policy to lower the corporate tax rate from 35% to 25% and to declare a tax holiday to encourage repatriation of cash held abroad could also have unintended consequences. Note that with $1.6 trillion of U.S. corporate wealth estimated to be held offshore, a significant inflow of this amount back into dollars would have the unintended consequence of boosting the value of the U.S. dollar, further hampering trade competitiveness.

Notably, the sector that benefits most from international trade – technology, which generates 10% of its revenue as a sector from China – would be hurt the most from the resulting dollar strength impact of repatriation – see Figure 21 below.

Figure 21: Domestic vs. International Revenue Exposure by S&P 500 Sector



Source: Bloomberg as of August 2016.

Below is a summary of various non-fiscal policies and the likely industry winners or losers under a Trump Presidency.

Figure 22: Summary of non-fiscal policies and likely industry winners under Trump Presidency

Policy	Winners	Reason
Compelling Mexico to Pay for the Wall	Materials, Construction	Construction of the wall
Healthcare Reform	Hospitals, Pharmaceuticals, Health Insurers, Financials	Could benefit from higher prices, as Obamacare has slowed price increases. Removing the ban on the sale of health insurance across state lines would likely lead to a wave of M&A as the industry consolidated.
Reforming US-China Trade Relationship		
Reform Veterans Administration	Hospitals, Pharmaceuticals	Allow competition with VA to care for veterans

Source: Citi Private Bank, OCIS as of August 2016.

Figure 23: Summary of non-fiscal policies and likely industry losers under Trump Presidency

Policy	Losers	Reason
Compelling Mexico to Pay for the Wall	Financial Services,	New "Know Your Customer" regulations for wire-transfers.
	Automobiles, Electronic Manufacturers, Oil Refiners, Chemical Manufacturers	Most trade with Mexico is "Round Trip" trade, where parts are shipped to US companies and assembled at US owned factories before returning.
Healthcare Reform	Health Insurers	Price transparency requirements would limit the ability of insurance companies negotiation preferential deals for their customers.
	Hospitals, Pharmaceuticals	Lower demand, due to decreased access.
	Consumer Discretionary, Consumer Staples	Higher healthcare prices would cut into consumer budgets.
Reforming US-China Trade Relationship	Technology, Manufacturing	US owned companies would have more difficulty manufacturing abroad. Increased uncertainty.
	Agriculture, Materials	US exports to China would be hurt by stronger U.S. dollar.
Reform Veterans Administration		
Immigration Reform	Construction, Agriculture, Hospitality, Food Services	Sectors that employ low skilled labor will have costs increased.
	Financial Services, Information Technology	Tightening requirements for heavy employers with H-1B Visas.

Source: Citi Private Bank, OCIS as of August 2016.

Mexico with a U.S. President Trump

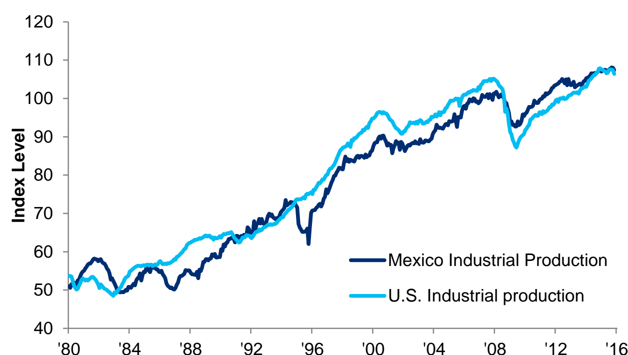
Latin America Investment Strategy:
Jorge Amato

- Mexico is the Latin American country that is at risk of the greatest disruptions from an intensification of U.S. protectionist policies, as suggested by Donald Trump's campaign rhetoric.
- The transmission mechanism for the Mexican economy to adjust to new trade terms is via the exchange rate. The Mexican peso might have already priced in less favorable terms of trade, but these are difficult to assess, meaning that more volatility may lie ahead.
- Despite the protectionist rhetoric, there is a good chance U.S. political checks and balances would result in a much less aggressive actual policies, which could have more marginal impacts on Mexico than the market is currently pricing.
- Broader trade regimes like the World Trade Organization (WTO) could also limit Trump's scope to implement protectionist measures.
- In the event of such measures, we would expect Mexico's policymakers to react decisively by providing liquidity as well as trying to curtail excess peso volatility.

Republican nominee Donald Trump has not minced words on immigration and global trade. Mexico has been one of the most prominent targets of his statements.

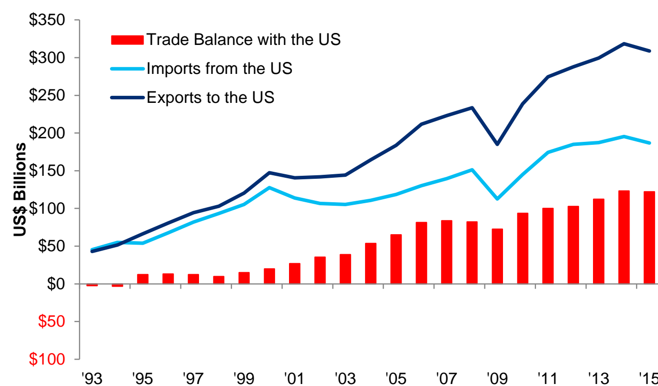
Mexico's economy has historically been linked to that of the U.S. Since the 1994 signing of the North American Free Trade Agreement (NAFTA), these links have strengthened further still. Since then both Mexico and the U.S. – as well as Canada, NAFTA's third member – have benefited from this agreement mainly via increase in trade, which has nearly tripled between the three.

Figure 24: Mexican industrial production tracks that of the U.S.



Source: Bloomberg as of August 2016.

Figure 25: Trade balance with the U.S. has been increasing since NAFTA



Source: Haver Analytics as of August 2016. Note: Annual data.

Trump has said that he would either renegotiate or withdraw from NAFTA. Article 2205 of NAFTA allows withdrawal from the agreement six months after providing notice. Presumably, he would need to gather congressional support to do this. Even were he able to convince U.S. lawmakers to withdraw, the U.S. would likely be constrained by World Trade Organization (WTO) requirements as to the imposition of new import tariffs.

Trump has argued that he would raise tariffs on U.S. imports from Mexico from 0% to 35%. According to Citi Research economists, the average-bound tariffs imposed by the WTO are now at 3.5% for all goods and 3.2% for non-agricultural goods. Another approach a Trump administration might pursue to impose higher tariffs would be to implement specific trade barriers and anti-dumping measures.

Most of the trade between U.S. and Mexico occurs by way of vertically integrated production networks arranged on a regional basis and across the border. Out of $278 billion of U.S. imports from Mexico, 65% or $180bn were "related-party trade" – mostly intra-firm transactions – according to U.S. Chamber of Commerce data and Citi Research. This is the highest amount among all U.S. trade partners. Anti-dumping measures would sever these links and U.S. firms would be severely affected, making this a measure with high economic and political costs for both countries.

Notes:

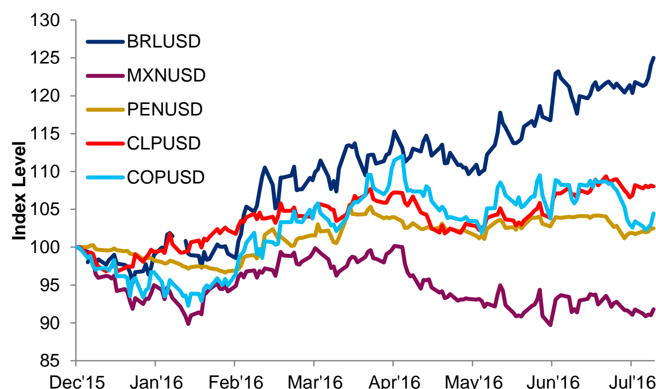
- *Most Favored Nation – is a principle stating that under the WTO agreements, countries cannot normally discriminate between trading partners. Granting someone a special tariff means you have to do it for all other WTO members. This principle is also the 1st article of the General Agreement on Tariffs and Trade GATT, 1947), which governs trade on all goods. NAFTA is an allowed exception to the MFN clause as it sets up free trade agreements that apply only to goods traded within the group members.*
- *WTO – World Trade Organization. The U.S. has been a member since its inception in 1995.*
- *On the average weighted tariff: About 99.9% of U.S. agricultural imports from Mexico enter duty-free. The MFN tariff for these goods is 6.4%. 100% non-agricultural imports from Mexico enter duty-free and the applicable MFN tariff is 1.9%. 93% of U.S. imports from Mexico are non-agricultural.*

Finally, assuming that Trump was not able to undo NAFTA and/or any anti-dumping measures failed to work, he might try procedural protectionism, which is the use of cumbersome legal or regulatory procedures to restrict the flow of trade with Mexico. But even implementing these measures would presumably require some type of implicit political support.

How would uncertainty revolving around trade relationships impact Mexico?

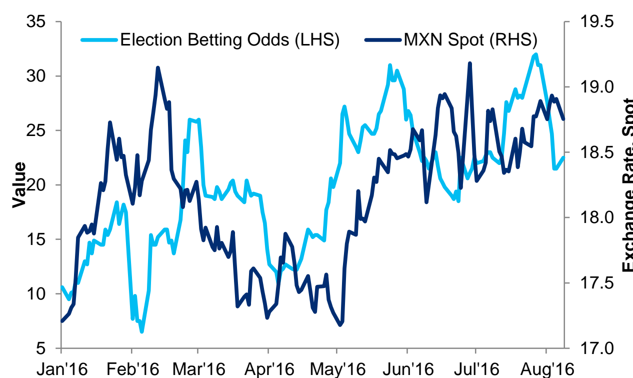
The transmission mechanism through which markets price the risk of a Trump presidency is – and would continue to be – the exchange rate. The Mexican peso is currently the only major Latin American currency trading at a lower level than at the start of the year, down roughly 8%. Moreover, there seems to be a strong relationship between Trump's perceived odds of victory and the weakness in the peso.

Figure 26: Latam Currencies year-to-date performance vs US Dollar



Source: Bloomberg, as of August 5, 2016. Note: 12/31/2015 = 100. 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. Past performance is no guarantee of future results.

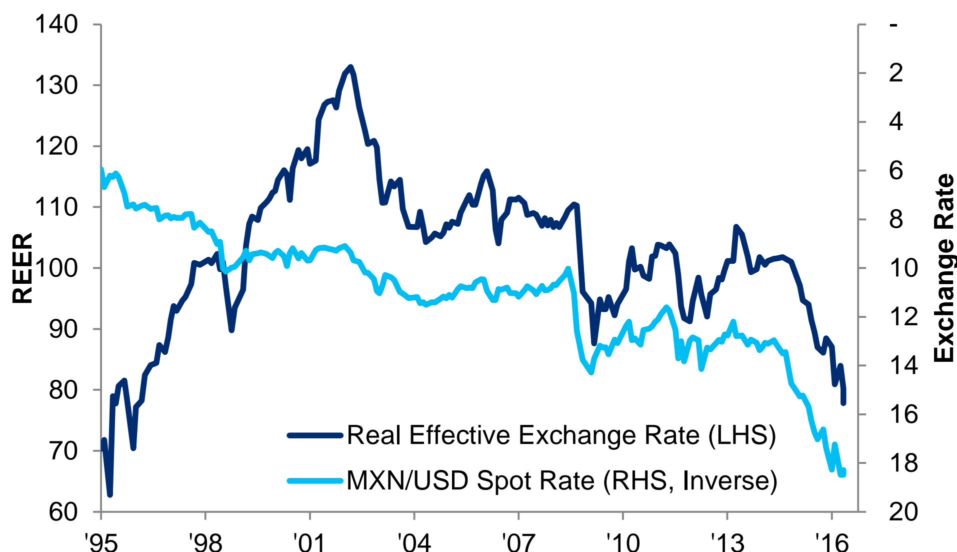
Figure 27: The Mexican peso has been reacting to Trump victory odds



Source: Bloomberg as of August 8, 2016.

At the moment, the peso's depreciation would appear excessive in both nominal and real terms when compared to historical levels. The problem is that this might be a fair statement assuming the current set of trade rules and agreements apply, but not necessarily otherwise. It is highly uncertain what the equilibrium exchange rate should be were the U.S. to withdraw from or change NAFTA terms, or to attempt to apply anti-dumping measures, or engage in procedural protectionism.

Figure 28: Mexico REER vs. Peso/USD Exchange Rate



Source: Bloomberg, as of August 2016. Note: Monthly data through to July 2016. Note: Real Effective Exchange Rate is the weighted average of a country's currency relative to an index or basket of other major currencies adjusted for the effects of inflation.

There has been significant Mexican peso weakening in 2016 on the prospect of a Trump victory. If NAFTA is broken, the downside would be more severe. However, the highest probability is that the peso has been unduly sold off and will rally on a Clinton victory.

Given that the perceived risk and major uncertainty revolves around trade, it is reasonable to expect investors express their concerns via a depreciation of the currency. The challenge, however, is to model a fair value exchange rate without having a reference for what the impact on the external accounts could be. This implies that the currency is likely to weaken further if Trump's odds improved, overshoot significantly in the event of a Trump victory and probably weaken even more when the new administration began talking about trade. Ultimately, how far the market exchange rate will trade from a new equilibrium exchange rate will be a function of the potential changes in the terms of trade between the U.S. and Mexico, making it very difficult at the moment to have a fundamental view on the currency. Investors might therefore potentially expect significant initial peso downside from current levels if Trump wins, which might subsequently prove to be an overshoot in the medium term.

What could be possible policy reactions from the Mexican administration?

Policymakers are well aware of the dangers and uncertainty stemming from a potential Trump victory in the November elections. It may be that Mexico's central bank would take discretionary action to intervene in the currency markets in order to soothe investor anxiety, as well as potentially hiking rates further or announcing foreign-currency swap lines. This type of liquidity support would be extremely important, as the private sector has already been pressuring the currency as a result of hedging demand. Signals of further support from multilateral agencies, like the Flexible Credit Line with the International Monetary Fund, could also be among the additional policy options.

Asia Investment Strategy:
Ken Peng

Implications for Asia if Trump Wins

Currency
- Higher odds of sharp Chinese yuan depreciation
- Spill-over to competitor and supplier currencies

Trade
- Labelling China as a "currency manipulator" is likely aimed at supporting targeted trade policies
- Countries that supply China may also be hurt, many of which are key U.S. strategic allies in the region

Geopolitics
- If Trump reduces the U.S.'s high-cost military presence abroad, then the South China Sea could become more vulnerable

China has expended significant savings keeping its currency from depreciating more sharply. External sources of weakening for China, such as new U.S. trade barrriers, could move China to the sidelines with significant negative repurcussions for others.

While both candidates are likely to adopt some degree of policies aimed at "bringing jobs home", Trump appears willing to go much further with protectionist measures. Therefore, we must analyse change in the event of a Trump victory. China is the source of the U.S.'s biggest bilateral trade deficit – more than half of the total – and is likely to face the lion's share of any targeted trade policies.

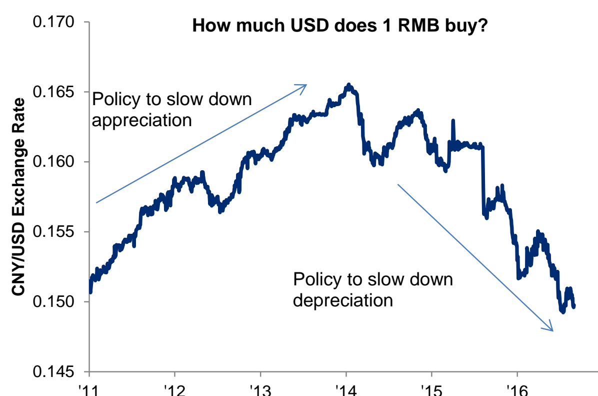
One of Trump's key commitments is to name China a "currency manipulator" if he is elected. This is likely to have the unintended consequence of instigating sharp depreciation in the Chinese yuan.

The yuan has been in a downtrend since 2014. It had appreciated sharply over the previous four years despite a marked deterioration in China's economic fundamentals. This has prompted investors to short the currency actively and eventually prompted Chinese authorities last year to let it become more freely traded, with market forces playing more of a role.

In the past year, however, the authorities' interventions to strengthen the yuan have been frequent. This is because the partial liberalization of its trading regime last year caused global financial markets to panic over the potential deflationary forces that a cheaper yuan may unleash - **Figure 29**. If U.S. trade policy becomes so restrictive as to damage China's already weakened economy, there would be a greater incentive for China to free up the yuan even more or to undertake a large, one-time devaluation to ease pressures on the economy. If the yuan devalued abruptly, the currencies of many of China's competitors and suppliers may fall even further - **Figure 30**.

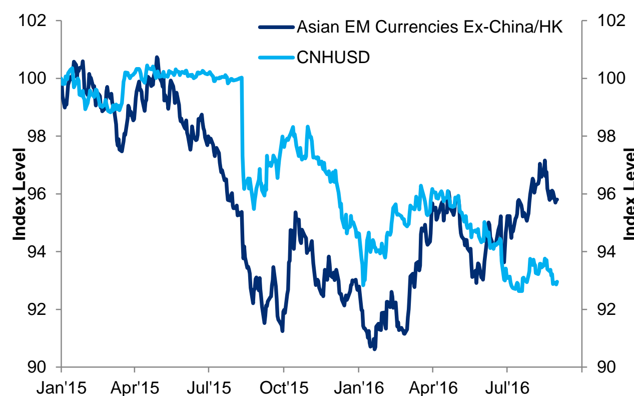
So, why bother naming China a manipulator? Doing so could be politically popular and provide cover for executing punitive trade policies. This is not new, however. China was named a manipulator in 1994 a label that was not removed until 2012. During that period, China managed to join the World Trade Organization and became the world's manufacturing hub. U.S.-China trade ballooned and the two countries set up the Strategic and Economic Dialogue to improve bilateral communications. So the designation itself is not as relevant as the policies that would follow it.

Figure 29: Prior years of undervaluation and policies to slow down appreciation have reversed for the yuan



Source: Bloomberg, as of August 8, 2016

Figure 30: During periods of sharp yuan depreciation, other regional currencies have done worse



Source: Bloomberg, as of August 8, 2016

Note: Indexed, End 2014=100.

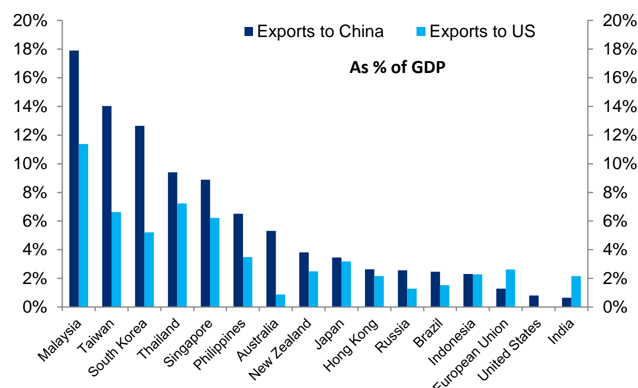
A possible fall in Chinese imports would damage many regional economies.

And what might be the impact of a weaker yuan? While it would provide little lift to headline exports, it could hit imports much harder because of the shrinkage in import processing trade – **Figure 31**. Many of China's regional peers are exposed to China's processing supply chain. And some of the most vulnerable economies are key U.S. strategic allies in the region – **Figure 32**.

Figure 31: China's processing imports are collapsing

Source: China Customs, as of July 2016

Figure 32: Most Asian economies have greater export exposure to China than to the US, partly due to the processing trade



Source: IMF, as of 2015

Economic difficulties can spill over to the political sphere, especially if U.S. shifts to towards isolationism in this region. Such a shift is more likely under Trump, given his comments about withdrawing from the North Atlantic Treaty Organization (NATO) and saving costs on U.S. military commitments abroad. Even then, Asia should be low on Trump's cut-list since South Korea and Japan largely cover the cost of local U.S. military presences. But Southeast Asia may be considered as a costly expense. By contrast, a Clinton presidency may see a continuation of the U.S.'s pivot towards Asia, which she helped to formulate as Secretary of State.

A reduced U.S. military presence in Asia could ease the immediate risks of a U.S.-China confrontation, although the benefits would likely to be offset by potential trade conflicts between the two and move conflict point to others in the region. Trump's isolationism might boost China's regional influence and its activities in the South China Sea. It would likely leave North Asian matters in bilateral or trilateral relationships among China, Japan and South Korea. Meanwhile, North Korea might become even more militarily assertive.

Implications for Europe on a Trump win

EMEA Investment Strategy:
Jeffrey Sacks

- Less U.S. military intervention in Europe could exacerbate refugee crisis
- Europe's needs steady US growth and predictable U.S. trade policy
- A Trump victory could fan European anti-establishment sentiment

The post-war rebuilding of Europe was heavily dependent on the active role of the U.S. as designer and leader of the multilateral system of institutions, rules and alliances. Partly as a result of this, Europe has enjoyed growth over many decades. A Donald Trump presidency would put this at risk in several ways.

Confidence in NATO is an important underpinning of European stability.

First, one of the Europe's institutional underpinnings – the North Atlantic Treaty Organization (NATO) – has relied on the agreement that all members would defend each other as and when necessary. Donald Trump recently stated that he might not defend his NATO allies in the event of aggression from Russia. This statement was surprising and caused some European uncertainty, even though it is by no means certain that it would be a concrete U.S. policy even if Trump won. The continued role of the U.S. in helping to uphold global security matters hugely for Europe.

Second, were a Trump administration to lead to a more inward-looking U.S. foreign policy, less spending on the military, and less intervention in overseas trouble-spots, then Europe could be negatively impacted. In particular, given that the Middle East is so fragile and unstable, there would be a risk of more weak states just across Europe's borders. That in turn would almost certainly exacerbate the migration and refugee crisis that Europe is already struggling to manage. The immigration issue has already had a critical influence on the U.K. public's vote to leave the European Union (EU). It is likely to weigh on voters' attitudes during the 2017 elections in France and Germany. Right-wing populist parties have been gaining support across Europe, including in France and Germany, mainly due to a rising impact of immigration. A more insular U.S. under a Trump presidency would encourage that trend indirectly.

Third, European confidence indicators for businesses and consumers are already under the microscope. This is because of rising levels of terrorism. The U.K.'s EU withdrawal vote shook investor confidence even though we are yet to see the full extent of the confidence fall in the official data. A Trump victory could shake confidence further. This matters because the European growth outlook is still weak, dependent on on-going monetary support from the European Central Bank, so a sharp decline in confidence could threaten the economic upturn.

Fourth, European political fragmentation has also seen an increase in anti-establishment sentiment. Society is polarizing, with a growing feeling among many that the central bank measures since the global financial crisis of 2007-09 have not benefited them as much as the measures have supported the holders of assets. This was a factor in the thinking of many of anti-EU voters in the U.K., even though the referendum question was specific to the U.K.'s EU membership. The vote to withdraw was therefore partly a protest vote against the establishment. If Trump wins it could be partly for similar reasons, fanning anti-establishment flames.

Fifth, a Trump presidency would likely be protectionist. While this would exacerbate an already-weak global trade cycle, the effects would hurt Europe at a vulnerable moment in its economic cycle, as well as from a political perspective, given there are increasing strains within the European Union.

Volatility: when and how to hedge (and when not to)

North America Investment Strategy:
Christopher Dhanraj

The current market set-up: hedge known, upcoming risks

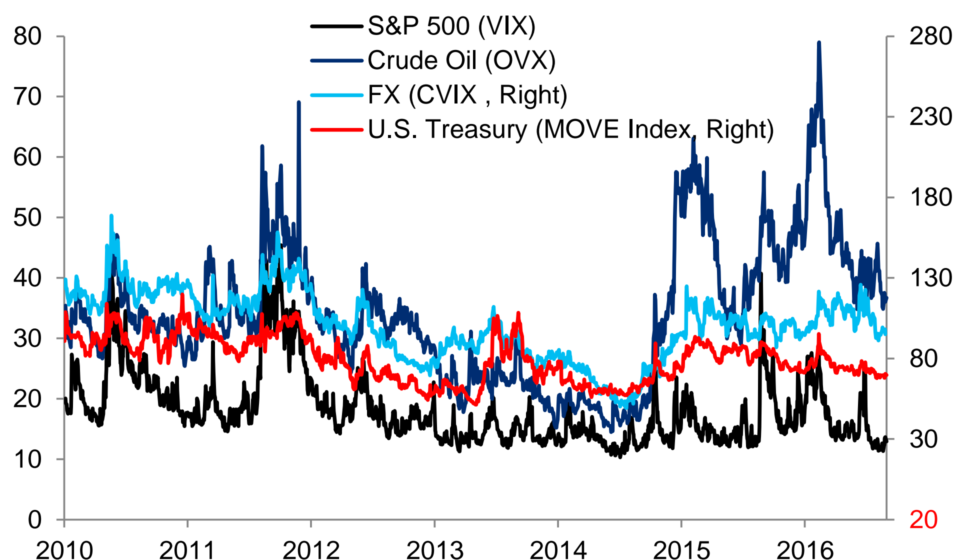
It may be less than three months until the day of the vote, but investors are only now starting to consider the potential impacts of the U.S. election on their portfolios. The good news is that volatility experienced just after June's Brexit vote has quickly subsided, allowing investors to purchase potential portfolio hedges at some of the cheapest price levels this year. The challenge for investors lies in understanding that not all asset class hedges cost the same. In fact, it may be worth using equity hedges to protect both equity and multi-asset portfolios and avoid more expensive commodity and currency hedges.

Implied volatility in U.S. equities is near a 10-year low just one month after Brexit.

In the past year, global macroeconomic forces have driven the markets and the cost of portfolio hedges across asset classes. Figure 33 shows that much of 2015 and 2016 have been dominated by crude oil's collapse and subsequent rebound, resulting in heightened volatility for this commodity. Currency volatility has slowly begun to creep higher as central bank policies have begun to diverge, with the market pricing in higher rates for the U.S. and lower rates for Europe and Japan. Interestingly, the one asset class that has remained relatively sedate is equities, particularly U.S. equities.

U.S. equity volatility – represented by the VIX Index – recently approached 10-year lows just one month after the U.K.'s shock 'Brexit' vote. (This rapid return to normality was because many investors quickly sell volatility when it spikes in order to generate more yield).

Figure 33: Implied Volatility for Various Asset Classes (U.S. Equity, Crude Oil, Foreign Exchange and U.S. Interest Rates)



Source: Bloomberg, Haver Analytics as of August 29, 2016. Note: VIX Index measures the implied volatility on S&P 500 Index options, OVX Index measures the implied volatility of crude oil prices, CVIX Index measures the implied volatility of currency markets and MOVE Index measures the implied volatility of U.S. Treasury options. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

In past U.S. elections other than 2000's contested outcome, implied volatility rose two months before the vote and fell soon after.

Investors have increasingly looked to the U.S. equity volatility market not only because of its relative cheapness but also for its ample liquidity and flexible trading hours. (As of June 2014, VIX futures and options trade 24 hours a day, 5 days a week). In fact, U.S. equity volatility ranks attractively when compared with the relatively rich cost of hedging other equity markets (see Figure 34).

Figure 34: Implied Volatility for Various International Markets and U.S. Bonds

Volatility	Level	1D	1M	1Y	YTD
US Equity volatility	13	-2.5%	-11.7%	3.8%	-28.4%
EU Equity volatility	23	-0.7%	-8.3%	23.4%	3.5%
JP Equity volatility	25	4.0%	-8.1%	42.0%	27.3%
EM Equity volatility	21	-2.2%	-8.9%	-11.0%	-10.4%
US Treasury volatility	68	6.6%	-8.7%	-10.4%	0.0%

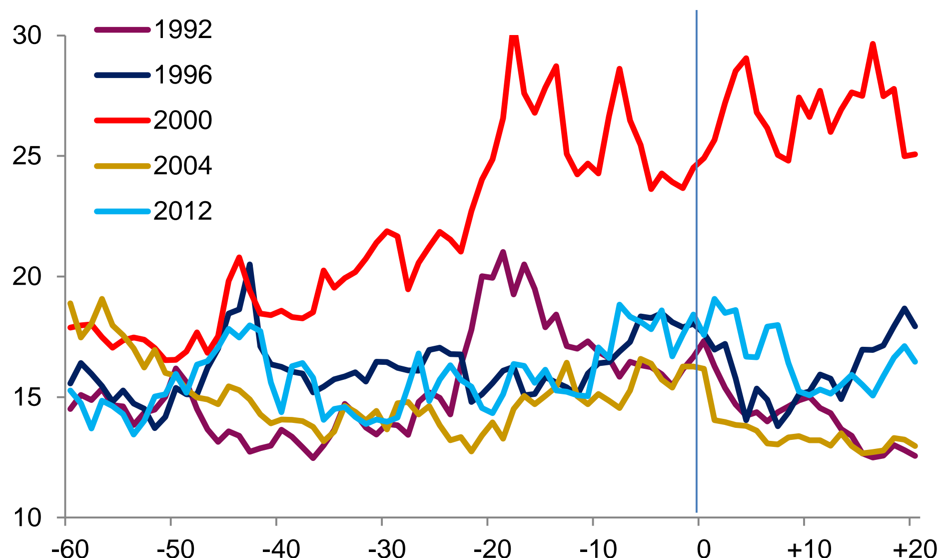
Source: Bloomberg as of August 3, 2016. There can be no assurance that these market conditions will remain in the future. Past performance does not guarantee future results. Actual results may differ materially from the forecasts/estimates. Views, opinions, trends and prices expressed are subject to change without prior notice and are expressed solely as a general market commentary and do not constitute investment advice or a guarantee of returns.

When considering what to do with volatility in their portfolios, investors should look to hedge in the market with potentially the lowest volatility – that is, U.S. equities. Volatility in other equity markets – Europe, Japan and Emerging Markets – should be used to generate income or offset hedging costs, in comparison.

As to implementing a portfolio hedge, investors should consider a tenor that extends until just after the 8 November 2016 election date so as to cover this event and any possible surprise outcome. The purpose of the hedge would be to allow investors to stay fully invested and be able to weather any unexpected volatility that may occur. A cheap hedge means that a "status quo" outcome – that is, a Clinton presidency but with a Republican Congress – would result in the hedging strategy's expiry with only a minor loss in the cost of such insurance from downside risk.

In four out of the past five presidential elections, heightened volatility has tended to occur two months ahead of the vote. However, it has also then subsided to more normal levels soon thereafter. (The 2000 election was somewhat different given the uncertainty created by the contested outcome, which ultimately resulted in George W Bush beating Al Gore by just one electoral vote.)

Figure 35: VIX rises in the days ahead of the election and falls subsequently



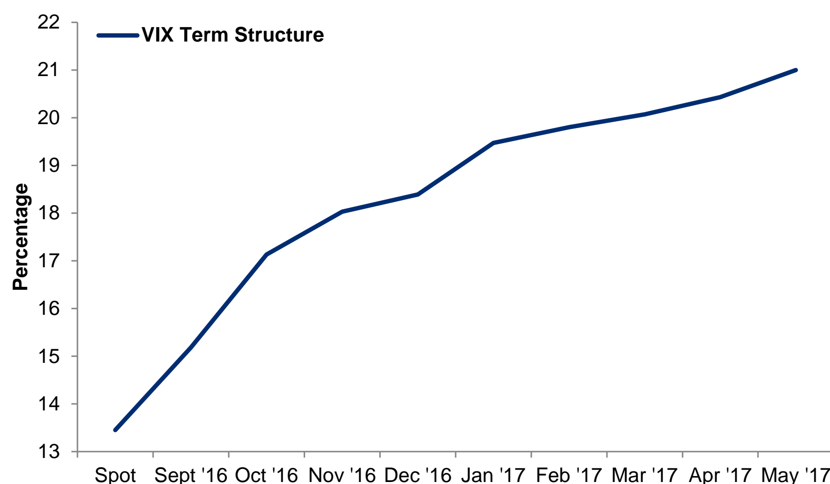
Source: Bloomberg as of August 6, 2016. Note: VIX Index measures the implied volatility of S&P 500 Index options. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

There is no sign in the term structure of volatility that investors are hedging ahead of the U.S. elections.

The key takeaway is that investors should consider the next month for putting hedges in place to shield the downside on U.S. equity positions before volatility may begin to trend higher, and limit the tenor to just after polling day, so as to avoid overpaying for this hedge.

Interestingly, the present election is following a similar pattern to previous ones in terms of the timing and volatility levels. As we are still outside the two-month window ahead of the election where volatility tends to rise, the current price of a hedge through mid-November is still relatively cheap. Indeed, looking at the term structure of volatility in the U.S. equity market, it remains fairly smoothly upwardly-sloping. Any stress would show up as a “kink” in the curve around the November maturity. So, the lack of such an aberration implies that investors are not actively targeting the election as a potential stress- point for buying a hedge.

Figure 36: Term Structure of VIX Index



Source: Bloomberg as of August 28, 2016. Note: VIX Index measures the implied volatility of S&P 500 Index options. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Shielding against "all loss" in equities is far less economical than hedging against a catastrophic loss.

Looking at the relative cost of hedging for an underlying U.S. equity portfolio through November 18 2016 – the first listed date that includes the election date – it is noteworthy that an investor willing to incur a 10% loss before insuring against any further downside would spend two-thirds less than an investor wanting potential protection against any loss at all.[5]

While it is advisable for investors to hedge downside portfolio risk where the cost of doing so is attractive relative to the potential loss incurred, it is important to monitor when the cost of hedging becomes too expensive. An example of this is in the fixed income market, particularly as it concerns international investors looking to hedge currency risk when buying U.S. Treasuries.

One consequence of the drop in global interest rates outside of the United States is the large foreign buying of U.S. Treasuries. In particular, the post-Great Recession period since 2009 has accelerated these inflows, to the point where over half of U.S. Treasury auctions in the past one year have been comprised of foreign buyers.

However, investors should be aware that the rising cost of hedging currency risk can detract from the case for buying much higher U.S. yields. For example, a Japanese investor planning to purchase U.S. 10-year notes must first convert Japanese yen (JPY) into U.S. Dollars. The annualized cost as of July 31 2016 to convert yen into dollars was 1.58%, reducing what appears to be a 1.64% yield differential to a mere 0.06% after currency conversion. Clearly, the rising cost of hedging Japanese currency risk makes doing so relatively unattractive.

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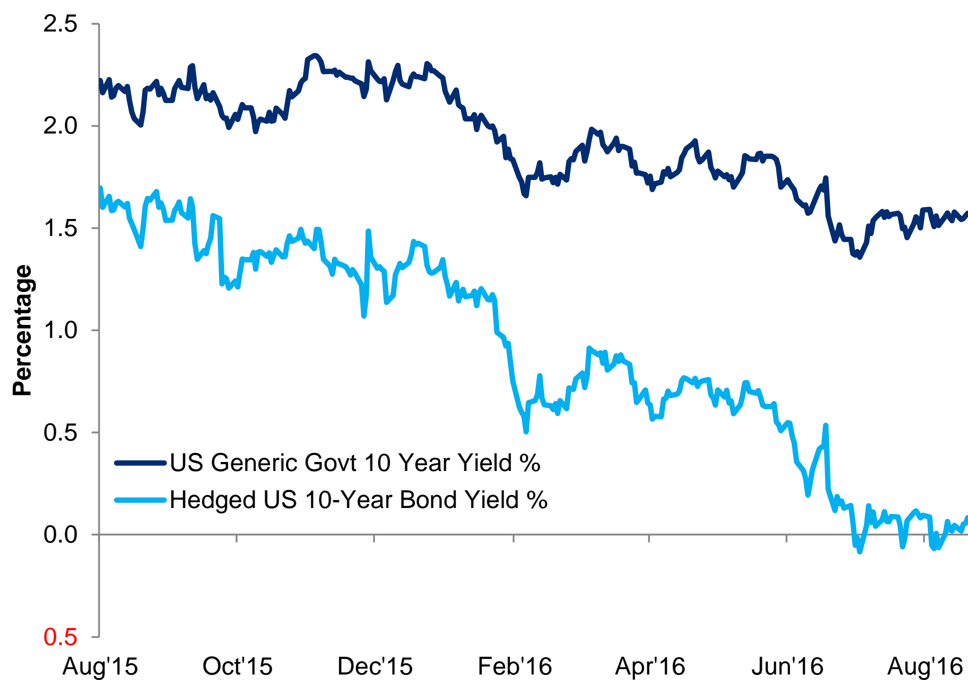
5 Specifically, the cost of potential protection against any fall in the S&P 500 is 2.9%, a cost that drops to 1% to protect against a greater-than-10% move lower. For investors willing to give up more than 5% of current upside and protect against a greater-than-a-10% move lower, the cost drops to 0.3% of notional spent.)

Figure 37: Japanese investors investing in US Treasuries earn only 0.06% after currency conversion from JPY into USD



Source: Bloomberg as of August 28, 2016.

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Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

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