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US Presidential Election Strategies

With the coming United States Presidential election on November 5th, we look at a few potential outcomes and what they could mean for the Canadian market. While Canada's bond (and stock) markets often follow closely behind those of the US due to strong economic ties, geopolitical risk is one area that can often cause large divergences. We examine, free of political rhetoric or partisan commentary, we hope, realistic possibilities in the 2024 election and their potential effects on Canadian interest rate markets.

One caveat to any analysis of election outcomes is, of course, that politicians promise a LOT and often don't or can't deliver on those promises even if they win office. Sometimes promised policy is ambiguous or even intentionally false but conflicting goals, geopolitical surprises and hostile opposition parties can render even well-intentioned policy goals impossible to achieve in reality.

Democrat Win

A Kamala Harris win would, inevitably, be something of a continuation of President Joe Biden's policies (despite campaign assurances otherwise), but of course with a Harris spin once she is in charge. As with both parties, deficit spending is a certainty with promises of a program of homebuyer downpayment assistance, a fund for local housing construction and an increase of the child tax credit among her platform promises. In addition, there would likely be more regulation, if not outright, then certainly more than her opponent would favor, which should result in fewer large mergers and acquisitions, and perhaps some student loan and health care debt relief. The cost of such policies, despite a higher proposed corporate tax rate than her Republican opponent, would be larger deficits than today, all else equal.

Although volatility is difficult to forecast, we feel certain that, over the course of a Harris administration, volatility of most asset classes would be lower than in a second Trump administration, if only due to a more coordinated announcement plan with the federal bureaucracy rather than a return to "policy by Twitter" that often prevailed in the first Trump administration. Further, with the independence of the Federal Reserve unquestioned in a Harris government, inflation expectations should be lower than they would be if the independence of the central bank was in doubt or policy rates became outright politicized.

Conclusion:

- Deficit spending despite higher corporate tax rates
- Less business-friendly government accompanied by relatively more regulation
- Fewer, lower, tariffs, more global friendly government
- Lower volatility in both equities and bonds
- Lower long-term treasury yields due to constrained inflation

Potential Canada Reaction Trades

Despite much discussion south of the border on the relative effects of the Democratic party versus Republican party economic effects, it appears a near certainty that a Harris win would be better for the economy of Canada. With a government friendlier to globalization, more accepting of tariff-free imports (i.e. our exports), and less critical of Canada's meagre defense spending all providing a boost to Canadian GDP relative to a Trump administration.

Bond market implications for Canada can vary but we speculate that a potentially strong Canadian economy should translate into a need to restrict monetary policy at some point in the medium term, rather than loosen policy as is currently implied at the front end of the yield curve.

One way to capitalize on this outcome may be a 2-10 flattener as future monetary easing is replaced with restrictive or neutral policy. The trade can be constructed in futures[1] as shown in Figure 1 and would result in profits if the Canadian 2-10 curve moved back to inverted levels due to tightening policy getting priced back into the front end of the yield curve.

FIGURE 1

20-10 Flattener via CGZ/CGB (11:2 ratio)

DV01 NEUTRAL POSITION	SECURITY	PRICE	CTD COUPON	MATURITY	DV01/100	DV01 NEUTRAL TOTAL DV01
-1,386	**CGZZ24**	104.91	4.00%	01-Aug-26	1.80	-25,005
279	**CGBZ24**	123.49	2.50%	01-Dec-32	8.96	25,006
	+11CGZ-2CGB	**907.03**				**1**

Source: Montréal Exchange

Republican Win

A Donald Trump win in 2024 also translates into deficit spending, potentially via lower taxes but also via replacement programs for healthcare services. Although more business friendly on the surface, the Republican plan to reduce regulation is combined with some kind of consumer level price controls, although the details of such a program and how it would work to constrain energy costs remain unclear. Additionally, despite a proposal for lower corporate and high-income earner tax rates, Trump has promised to "pay off" the $35 trillion US national debt. For bond investors, this is a difficult promise to take seriously as lower taxes, unless combined with lower spending, would normally translate into greater bond issuance and higher debt while the idea of paying off the national debt would imply vastly lower (net negative) bond issuance.

1 For more on spread trading using futures, including how the intra-group spreads (IGS) on MX work, please refer to "Trading Mechanics: Price versus Yield Spread" published by Montréal Exchange in March 2024.

In any case, a Trump administration should be a return to higher volatility as unscheduled announcements of policy move from official channels back to X (Twitter) or other social networks and the results of various criminal trials proceed or are blocked from proceeding by the appropriate courts. A likely resumption of tariffs as well as the introduction of uncertainty among US allies of the level of US commitment to existing alliances should all translate into higher volatility in this scenario.

The Trump win scenario should translate to higher inflation or at least higher inflation expectations, despite some aspects of consumer level price controls that the Republicans have proposed for energy and electricity, if they are introduced, as the former President seems intent on taking some control of monetary policy. One need only to observe other nations that lack entirely independent central banks (Turkey, Argentina, etc.) to ascertain that politicians at the helm of monetary policy translates, without question, into higher inflation outcomes. Even the hint, or threat, of interference that impedes the Federal Reserve from doing the unpopular task of tightening monetary policy some months in advance of an overheating economy, would presumably result in higher inflation outcomes via the expectations effect. Further, any mass deportation of immigrants is, for the most part, a disruption of the low-wage workforce in the USA which would also be inflationary, at least in theory.

Conclusion:

- Deficit spending via potentially lower corporate and high-income earner tax receipts.
- Business friendly government but with some form of mandated price controls
- Resumption of the tariffs that accompanied the first Trump administration
- Higher volatility may be accompanied by lower equity markets due to higher risk premia
- Higher bond yields due to higher inflation potential and bond issuance. Or not, depending on the details of the plan to eliminate the national debt.

Potential Canada Reaction Trades

One potential trade on a Trump win centers around the notion that central bank independence would be threatened under a second Trump administration. Scenarios where this results in lower inflation expectations are difficult to imagine so, all else equal, US inflation expectations and risk premia should rise relative to those in Canada where, presumably, there would be no change in the institutional norms surrounding monetary policy. The additional notion of a return to US import tariffs, especially punitive to the export-heavy Canadian economy, should result in lower GDP growth/economic activity in Canada relative to a win by a more globalization friendly government in our southern neighbour. Finally, US pressure could result in higher government spending on defense, a key Republican complaint about Canada and other allies, which may counteract a slower private sector and replace it with government spending (and higher bond issuance in Canada).

The above combined notions could result in a steeper US 2-5 curve where short term rates are held low for political reasons, which results in higher inflation expectations becoming incorporated at the 5-year point of the curve. Canada's central bank, while it might need to react to lower export levels, would presumably be targeting higher rates than politically motivated policy in the US and Canada would be experiencing lower growth and inflation expectations, resulting in a relatively flatter 2-5 curve in Canada.

One could construct a US 2-5 steepener and a Canada 2-5 flattener in futures quite easily. We show a $10,000 per CAD DV01 example in Figure 2, although other trade constructions could also be imagined which monetize the above ideas.

FIGURE 2

2-5 Flattener in CAD v. Steepener in UST

DV01 NEUTRAL POSITION	SECURITY	PRICE	CTD COUPON	CTD MATURITY	CONVERSION FACTOR	DV01/100 (LOCAL CURRENCY)	DV01 NEUTRAL TOTAL CAD DV01
-558	**CGZZ24**	104.910	4.000%	01-Aug-26	0.9687	1.8	-9,993
196	**CGFZ24**	114.550	3.500%	01-Sep-29	0.8979	5.1	10,001
193	**TUZ24**	103.453	4.625%	15-Sep-26	0.9774	3.7	10,016
-168	**FVZ24**	108.445	4.250%	28-Feb-29	0.9363	4.3	-9,998
							26

Source: Montréal Exchange, CME Group

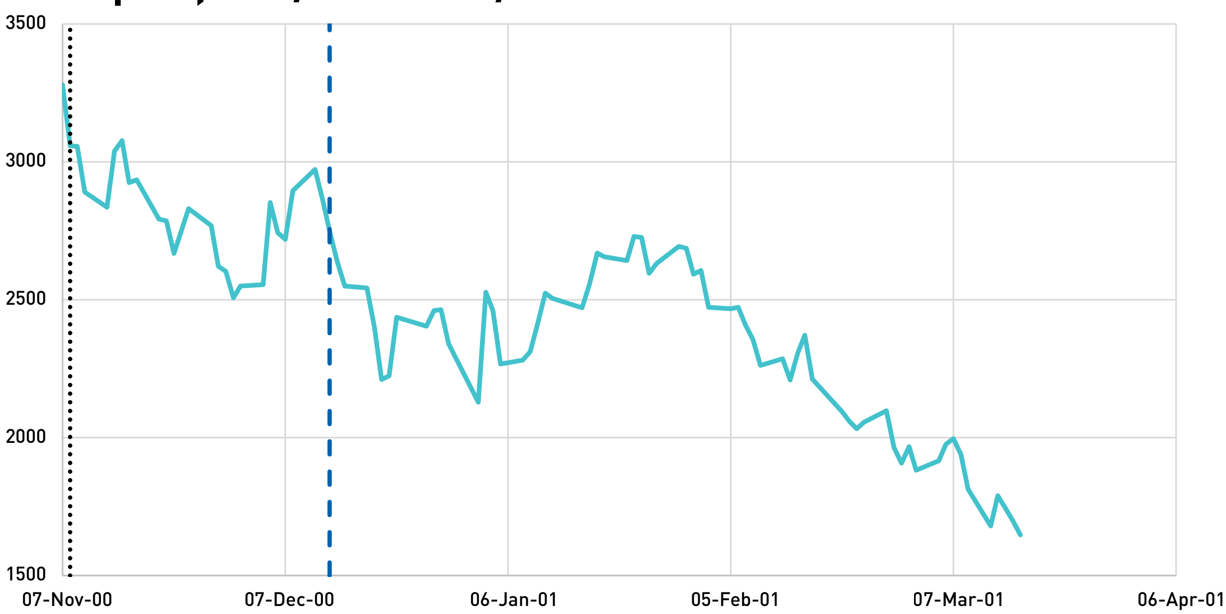
Undecided for N Days

Given the current polling, a possible outcome of the 2024 presidential election is a delay of multiple days or even weeks before a definitive outcome is announced, especially given the propensity for some candidates and their allies in the House of Representatives to refuse to acknowledge a defeat. In this scenario, which would have similarities to the 2000 Bush/Gore contest where no winner was determined for 36 agonizing days, there would almost certainly be many opportunities for nimble traders as various events like court cases, recounts, ratification of results, etc. unfold to determine the winner.

Unfortunately, the market reaction to the 2000 election, and the subsequent delay in announcing a winner, are unlikely to be much help since the stock and bond markets were in a situation of extreme volatility before the 2000 election, during the 36 days required to determine the winner, and for some months after due to the bear market and erosion of the original internet bubble. For instance, the NASDAQ-100 fell as much as 24% during the recounts and court battles over ballots in November and December 2000 but, after Bush was announced as the winner, the index fell a subsequent 40% over the next three months as shown in Figure 3. Perhaps some sort of statistical wizardry could attempt to isolate the effects of the bursting internet bubble from the election/administration uncertainty, but we doubt the confidence levels in such an analysis would be high enough to be useful.

FIGURE 3

Nasdaq-100, Nov7/00 to Mar15/01



In this scenario, traders are urged to exercise caution since the unknowns are truly unknown given the nature of the court challenges and counting of votes. Unlike in the general macro environment of trading, almost no interpretation of the known facts will likely assist in forecasting the next fact or event to transpire. However, all is not lost for speculative managers here as markets will most likely price nearly impossible outcomes which can be profitably monetized since the most extreme outcomes rarely come to fruition.

To be sure, this situation means volatility, implied and probably also realized, rises to a high level. Equities fall due to the increased uncertainty, and, while a winner is still undetermined, 10-year yields fall, in the US and also in Canada. Consumer confidence almost certainly must fall since confidence in the stability of the future economy will be low. While the equity and volatility scenarios hold for both US and Canadian markets, we always need to question in Canada whether "flight to quality" means buying Canadian bonds? In many cases it does but in a few it hasn't.

And, of course, it is always best to remember that the increased volatility, whether realized or implied, is due to uncertainty which all markets abhor. Once a winner is declared in the election, or one side has conceded defeat, reversion to normal is expected to be rapid.

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