BLACKROCK®

Markets Brace for Historic U.S. Election

Kate Moore
Chief Equity Strategist,
BlackRock Investment Institute

It's been said – and shown – that markets hate uncertainty. And elections, by definition, engender just that. The 2016 presidential election stands out in this regard. It features two unpopular contenders, vast policy differences and rancor not only between parties, but within the GOP. Yet markets maintained decorum leading into Labor Day, a pivotal point when the campaigns generally heat up. What could this election mean for markets? BlackRock's Chief Equity Strategist Kate Moore weighs in.

What do you make of the candidates' policies?

At this point, the candidates' policy platforms are miles apart. Greater clarity and also revisions are expected from both as they make a push to attract independent and undecided voters as Nov. 8 nears.

Generally speaking, Democrat Hillary Clinton is focused on income inequality with lower enthusiasm for free trade than the current administration. Republican Donald Trump's policies are less clear with protectionist and anti-immigration overtones, presenting markets with some questions about his economic agenda.

One thing the candidates seem to agree on: more fiscal stimulus. Both support higher infrastructure spending, but propose to finance this investment differently. We could see corporate tax reform under either, including the repatriation of some of the roughly $2 trillion in profits held abroad.

What do you see for stocks as Nov. 8 nears?

Equity volatility should rise from current levels, which are at historic lows – especially for an election year. (See chart on next page.) Investors tend to reduce risk and pull money out of equity funds in the month before presidential elections, a trend seen in the past four cycles.

Uncertainty is weighing on corporate behavior already: Capital spending is lackluster and many companies are shying away from providing long-term guidance. This is playing out globally in a flight to perceived equity "safe havens" such as U.S. stocks, particularly quality companies and high yielders.

But the election will not be the only driver of equity prices over the next few months: monetary policy, global growth and third-quarter earnings results will all play a big part in determining market direction.

What should we expect from stocks post-Election Day?

Any market softness in the weeks leading up to the decision could reverse once uncertainty wanes. We are also likely to see sector and industry differentiation depending on the outcome of the vote and the priorities of the new president.

Infrastructure spending, which is favored by both candidates, is likely to target highways, mass transit and airports. Some U.S. construction and materials stocks have already rallied in anticipation. This outperformance may be premature, as new fiscal programs will take quarters to impact earnings.

U.S. financials and health care, which make up roughly one-third of the U.S. stock market, could both face long-term headwinds. Clinton favors more intense regulation of Wall Street and has criticized abusive pricing practices by drug companies. Both candidates have been critical of free trade. This means little chance of any new trade agreements and possible headwinds for companies that derive a large proportion of income from global trade. U.S. companies with a higher percentage of domestic earnings, particularly small caps, could outperform.

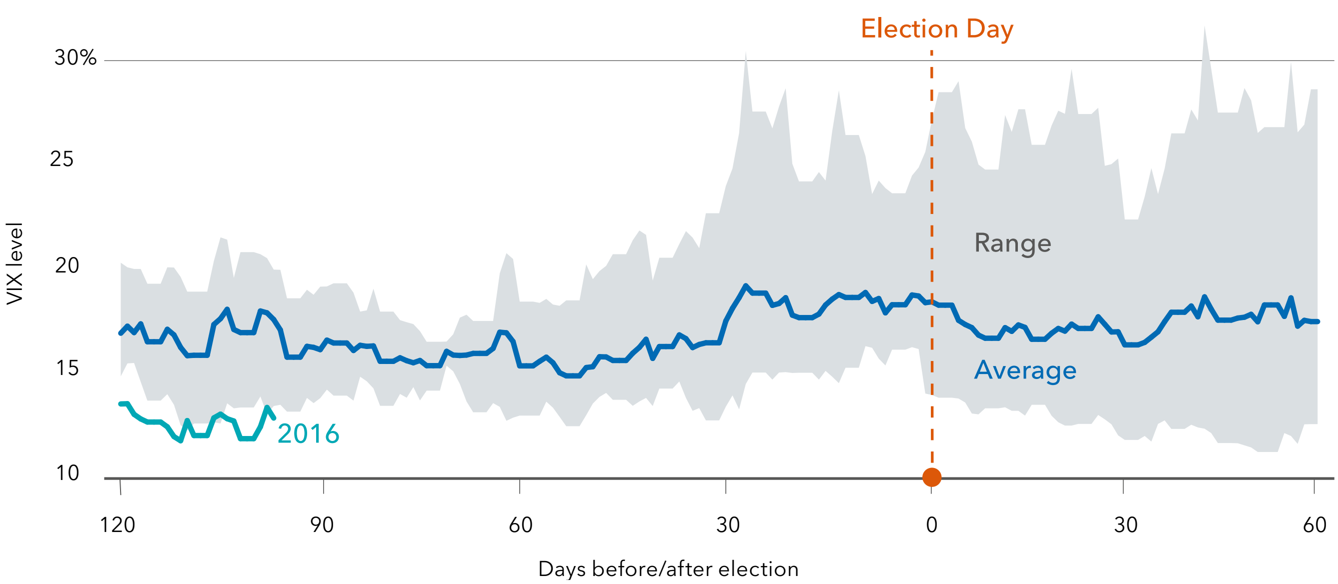
What about bonds?

Leading up to the election, we could see stocks and other risk assets struggle and "safe-haven" assets such as Treasuries attract inflows. But valuations in some of these assets are already stretched. For that reason, gold (rather than Treasuries) may be a better hedge against uncertainty.

That said, we could see yields drift higher if the Republican takes office due to potentially looser fiscal policies. Increased fiscal spending under either candidate should lead to a modest rise in interest rates, boosting the U.S. dollar. A key draw of municipal bonds – tax-exempt interest income – would lose some luster under Trump's promised income tax cuts. Clinton's higher taxes for top earners would be a positive for

Volatility Tends to Pick Up as Election Day Nears

Equity volatility around U.S. elections, 1992-2016



Sources: BlackRock Investment Institute, Thomson Reuters, August 2016. Notes: The blue line shows the average VIX levels around U.S. presidential elections from 1992 to 2012. The VIX represents expectations of 30-day volatility calculated from S&P 500 options. The shaded area shows the VIX's trading range in the periods, while the teal line shows the actual VIX this year. The analysis excludes the 2008 elections due to the impact of the global financial crisis.

munis – barring a cap on tax exemption. Infrastructure spending, however, could offset these negatives because state budgets would improve due to increased economic activity.

We see U.S. corporate bonds following the trend of equities, although corporate profit repatriation would likely trigger more dividend payouts and share buybacks.

Where do you expect the vote to go?

While many polls show a high probability of a Clinton win, it is still early. We have spent a lot of time analyzing the polls, official statements and data to prepare for any outcome. The Brexit referendum in June and previous UK votes have shown the pitfalls of polls and prediction markets. The race could be tighter.

The outcomes in Congress are important as well. Democrats could gain control of the Senate by taking just five of the 34 seats up for grabs. Of note, the recent voter tendency to stick to a single party when in the voting booth could mean the Senate goes to the party of the new president. The House seems likely to remain Republican. Democrats would need to win almost all of the 40 seats in play to assume a majority. Ultimately, however, history shows us that the party in the White House has little statistically significant effect on market returns.

My advice to investors is to remain focused on your goals and on building a well-diversified portfolio that can weather all seasons, political and otherwise.

Want to know more?

blackrock.com

Prepared by BlackRock Investments, LLC, member FINRA.

007033C-USWA-0916 / USR-10284 LA-1579

BLACKROCK®