November surprises

What to expect, as we head into the homestretch of another U.S. electoral nailbiter

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IN A NUTSHELL

– Contrary to what we thought might happen before the summer, U.S. equity markets have been taking political events in their strides.
– We don't think this has all that much to do with changing probabilities or hopes for what either of the two major candidates might do if elected.
– Instead, we think it's quite consistent with our base cases of this particular election being less consequential than widely anticipated.
– After a nasty campaign, investors should prepare for gridlock in Washington, with not too much policy variation around the edges of plausible outcomes.
– Events and reality unfolding in any new administration's early months tend to do more to shape policy than campaign promises.
– Still, chances of election-day suprises appear unusually large this time around.

Into the homestretch of an electoral nailbiter

Back in 2016, we pointed to plenty of uncertainties in our election watch that year and marveled: "All this sounds like a recipe for uncertainty of the sort that might cause market jitters. Instead, the S&P 500 is trading near all-time highs!"

Well, the more things change, the more they stay the same. For watchers of U.S. politics, there has been plenty to be excited about all summer, from the withdrawal of Joe Biden from the race and the swift ascent of Kamala Harris to the pick of first-term Ohio Senator J.D. Vance as Republican vice-presidential nominee. Not to mention a second assassination attempt on and a rather underwhelming debate performance by former President Donald Trump, amongst several other moments where his age seemed to show. The net result, though, is that quality-adjusted polling averages have if anything gotten even tighter both nationally and in key states, perhaps hinting at Trump's appeal to voters just tuning in.

It was not that hard to guess in advance that this election season would be full of twists and turns, leaving seasoned observers on tenterhooks until the very end. Back in June, we thought that, from a market perspective, this could create opportunities along the way, if markets got unnerved and temporarily ended up overpricing political risks. It was one of those instances when getting the politics right was the easy task – the harder one is often anticipating market reactions if and when a plausible set of events materializes.

Contrary to what we thought might happen before the summer, U.S. equity markets have been taking events in their strides. Unlike many pundits including some market commentators, we don't think this has all that much to do with changing probabilities or hopes for what either of the two major candidates might do if elected. Instead, we think it's quite consistent with our base cases of this particular election being less consequential than widely anticipated, compared to, for example, earnings dynamics at sector level. The set of base-case outcomes is outlined in Section 1. Section 2 describes what surprises investors should nevertheless be ready for in the days, weeks and months that follow the vote – and which ones appear a bit overrated in terms of investor attention. This special concludes by setting this election in a longer-term context, by looking at how 2024 could nevertheless end up boosting U.S. national prosperity.

1 / After a nasty campaign, prepare for gridlock

1.1 Narrowly divided chambers of Congress likely to trim presidential campaign promises

We continue to think that for investors, it makes sense to focus on gridlock and divided government of various stripes, as the range of base cases most worthy of their attention. This is most obvious if we start by considering Congress, specifically the House of Representatives.

Currently, Republicans are in control, by a razor fine majority. Along with most handicappers, we would expect another closely divided House, with Democrats as narrow favorites to be in the majority.[1] Democrats have led in quality-adjusted generic Congressional ballot polling averages quite consistently during the last three months. Redistricting following the 2020 census, as well as changing electoral coalitions of both major parties should, according to these polling averages, translate into taking Democrats to House victory – especially if Kamala Harris wins the popular vote nationally.

Matters are quite a bit more complicated for the Senate, and not only because the next vice president would cast the tie-breaking vote in case of a 50/50 split. Due to what looks like a very unfavorable Senate map, Democrats would need quite a few upset victories to avoid losing their Senate majority. Another possibility is that neither party ends up securely in control. Nebraska independent candidate Dan Osborn, who has run a surprisingly strong challenge to Republican incumbent Deb Fischer, for example, has pledged that he won't caucus with either party if elected.[2]

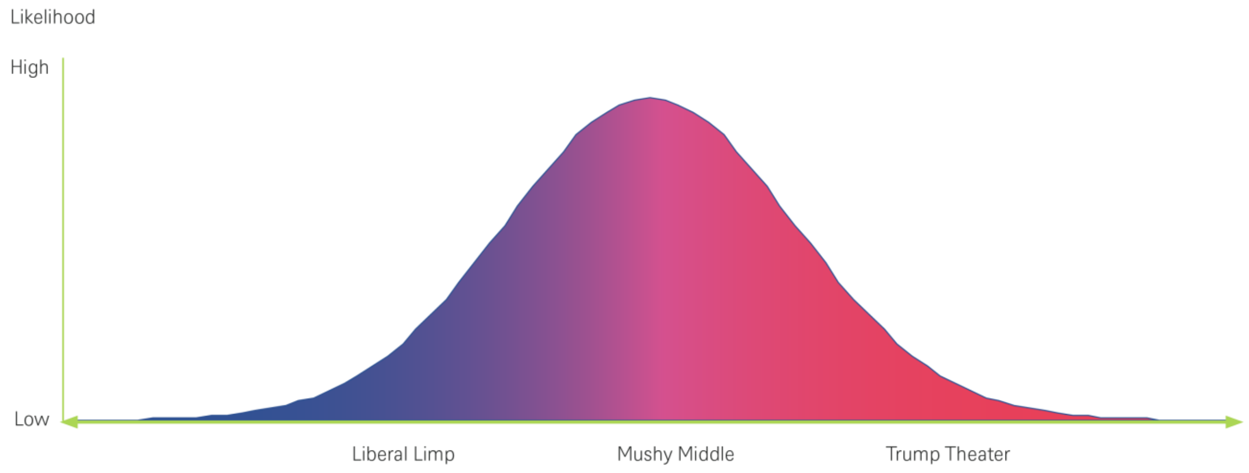
Nevertheless, we would caution that Senate surprises tend to fairly frequently offset each other in terms of the national picture. Big, uncorrelated polling misses at the level of state Senate races have historically been quite common. Highly candidate- and state-specific factors can also reshape dynamics late in the cycle.[3] It is worth keeping in mind that the Senate majority has gone its own way plenty of times before. There are already signs of a revival in voters' willingness to split their tickets – as the jargon goes – in 2024 by voting for one side for the Senate while favoring the other party's candidate for the presidency and House races.

1.2 Probabilistically many scenarios around what we described as the "Mushy Middle"

For the purposes of scenario planning, we would nevertheless point out that the differences in policy outcomes for investors need not be all that big, barring such a large polling error producing larger-than-expected Congressional majorities for either side. As long as House and Senate majorities are narrow, we would not expect either a Harris or Trump presidency to be all that significant in legislative terms.

Back in June, we described these as middle instances within a probability distribution, capturing all the outcomes that look fairly plausible, while ignoring the more unlikely outcomes at either extreme. Alongside a "Mushy Middle," requiring downright bipartisan compromises due to divided control of Congress and/or the presidency, we described the two adjacent scenarios as "Liberal Limp" and "Trump Theater."

Stylized probability range of plausible outcomes



Source: DWS Investment GmbH as of 10/24/24

Under the former scenario, we would continue to expect any Democratic sweep to be relatively inconsequential and also short-lived (leading to the loss of one or both chambers in the 2026 mid-terms). Given an even greater reliance on centrist House Members and Senators, as well as already stretched government finances, a Harris administration would probably struggle to finance such costly campaign promises as expanding the child tax credit, providing more generous support for first-time home buyers and eliminating taxes on tips.

The same holds, arguably even more so, for a Republican sweep, especially if Trump were to win again only through the vagaries of the Electoral College. Do not get us wrong, another Trump presidency would likely bring plenty of day-to-day drama for market participants to watch, but its legislative legacy would probably not go much beyond extending most of the Trump tax cuts. This is because, in this scenario, Republican majorities would be narrow and Congressional delegations divided, making it hard to get much done, even leaving aside potential hostile market and voter reactions if and when they seemed on the verge of passing legislation.[4]

Moreover, tax cuts for wealthy households and corporations are increasingly at odds with the new working-class coalition Republicans have been relying on for – relatively rare – electoral victories ever since 2016. Without a sharper reversal on "taxing the wealthy," there would be a significant opening for populist alternatives – and one or two upsets in this cycle, such as an Osborn victory or near victory in Nebraska, might well suffice to bring home that message to Congressional Republicans.

Most of all, investors should remember that Joe Biden's ability to pass consequential laws in 2021 and 2022, despite very narrow majorities, was very unusual, and probably owed a lot to an understanding of how to cobble together Congressional compromises over many decades. Neither Harris nor Trump (as well as their running mates, as far as the Senate is concerned) can point to anywhere near as much experience.[5] Unable to run again in 2028, another Trump administration is likely to be severely constrained by tight majorities in Congress as well as Republican fractures, to an even larger extent than was the case from 2017 to 2018.

Not to mention the law. To be sure, tariffs and other trade measures have increasingly become a bipartisan pursuit, especially with regards to China. Given that Congress has the power to set tariff policy under the U.S. Constitution, however, the direct impact of another Trump term even on trade should not be overstated.[6] Especially if and when some of the negative consequences mainstream economics would predict of Trump's tariff plans were to materialize, sufficient numbers of Congressional Republicans would presumably feel compelled to act.

1.3 The race for the White House and market implications of plausible scenarios

What then, about 2024's marque event – the race for the White House? We will keep this brief, not least as you have probably read more than enough horse-race coverage already. For investors, though, three points are worth keeping in mind.
First, swing-state polling can be subject to big, only partially correlated misses – and even what really counted as the pivotal state(s) in any given U.S. presidential election contest can only be determined with hindsight. The same holds for estimates of how small or large an advantage either side might have in the Electoral College.[7]

Second, events and reality unfolding in any new administration's early months tend to do more to shape policy than campaign promises. And third, chances of polling misses of some sort are actually unusually large this time around for the presidential contest, due to some methodologically questionable choices by many pollsters.[8]

All this should lead to reasonably well-behaved market reactions in the days following election day; or potentially weeks or months if things get very tight in either the Senate or the House (though this seems less likely, as we argue in the next section, for the presidency). For equity markets in particular, we would think that even a Republican sweep might see anxiety about trade policies and higher interest rates mixed with relief and tax-cutting hopes. However, some sectors would no doubt benefit from the removal of election-related uncertainty. For example, both sides have pledged to boost spending on technology and encouraging innovation, while anything short of an overwhelming Democratic victory might boost sentiment towards healthcare stocks.

The main exception we would highlight from a market perspective would be a Harris win so unexpected and decisive as to enable Democrats to not just win the House but also hold the Senate. Harris would then claim that she and Democrats had a mandate and quickly try to move forward her agenda. It is worth keeping in mind that Senate Democrats, led by Majority Leader Chuck Schumer (D-NY) have threatened for years to further restrict or altogether abolish the filibuster. This parliamentary procedure allows one or more Senators to delay or entirely prevent a vote on many legislative proposals, provided there is no super majority in favor (currently 60 out of 100 Senators).

Changing those rules would in principle be possible through a simple majority. Two Senators adamantly opposed to such a change in the current Congress are retiring, namely Democrat-turned-independent Senators Joe Manchin of West Virginia and Kyrsten Sinema of Arizona. A third Senator open to reform but not to elimination of the filibuster is Montana's Jon Tester, already mentioned above.[9]

It is very hard to see Democrats holding the majority in the Senate if Tester loses in Montana, but for markets, mere but serious post-election talk of abolishing the filibuster could come as a shock, as it would have big, potential implications from healthcare policy to tax policy. The precise effects in terms of actual legislative changes are hard to gauge. Take prescription drug costs, for example. Apart from a specific pledge to "extend the $35 cap on insulin and $2,000 cap on out-of-pocket costs to all Americans, not just seniors," the Harris campaign website mentions vague plans to accelerate the speed of Medicare prescription drug negotiations and "increase competition and demand transparency in the health care industry."[10]
On taxes, pressure on individual Republican Senators (under a new, less experienced minority leader) might prove immense, moreover, to compromise on corporate tax rates or taxes on wealthy households, perhaps in return for the filibuster to nominally survive. And after the strong run U.S. equities have had, it may not take much of a disappointment on future U.S. tax policies to cause some market jitters.

2 / Expecting the unexpected, including a quick result

2.1 What other November surprises investors should be ready for

Of course, one of the reasons market reactions to looming political events are often hard to predict in advance is that humans – including experts and market participants – are quite bad at thinking probabilistically, especially if what is about to happen has few immediate precedents in recent memory.[11]

Take, for example, the idea that because polling currently suggests a tight race, the end result will necessarily be just as tight. This is based on poll-driven, probabilistic models, which have shown close to 50/50 probability splits for Harris and Trump throughout much of the campaign. But, at least when they are properly done, the same type of simulations that produce very tight win probabilities (based on current polling) also suggest that this will not necessarily translate into tight Electoral College margins. If many polls turn out to be wrong in similar directions and magnitudes, either because of the typical movements in polls between now and election day or because of regionally correlated polling errors come election day, the same models tend to imply there is something like a 50% chance of an Electoral College landslide.[12]

In part, that reflects some of the underlying modelling assumptions. Unlike plenty of countries we cover, the U.S. has pretty good polling and some excellent polling aggregators and modelers, partly because there is a lot of historical data. As a result, it has become an article of faith to "NEVER" try to guess the direction and magnitude of polling errors come election day (compared to current averages). We tend to be a little more open-minded on this and would more heavily rely on the patterns seen in the most recent electoral events involving the similar electoral coalitions (notably, as far as the U.S. is concerned, the last two mid-terms, as well as the 2020 presidential election). It is worth keeping in mind that an election being a toss-up ahead of the vote in a series of winner-takes-it-all contests such as the Electoral College is perfectly consistent with a final result turning out lopsided under most reasonable modelling assumptions.

For investors, this means preparing for this election not necessarily turning into a nailbiter. Whatever your take on the underlying dynamics of the race, be prepared for results becoming clear either very quickly – or very slowly. If the Electoral College math does come down to just one or two swing states, it could take a few days at least to get clarity, especially if either Pennsylvania or Wisconsin are among the close states that turn out to matter.[13]

By contrast, some of the outcomes pundits and some investors tend to spend undue amounts of attention on range from exceedingly to very unlikely. For example, no candidate getting 270 electoral votes, with both Trump and Harris tied at 269, requires some pretty odd combinations of state-level victories. Somewhat less improbable but still very unlikely, are scenarios of one or more decisive states being so tight as to require automatic recounts by state law (typically mandated when results are within 0.5 percentage points apart). However, these types of outcomes are altogether more plausible when it comes to the Senate or individual House races. So, investors should also be prepared for the race for the White House being decided fairly quickly, with Congressional control still in the balance.

3 / Conclusion

In this paper, we have argued that it makes sense for investors to focus on gridlock and divided government of various stripes. We have explained why we would not expect either a Harris or Trump presidency to be all that significant in legislative terms. We pointed out how tax cuts for wealthy households and corporations are increasingly at odds with the new, working-class coalition Republicans have been relying on for – relatively rare – electoral victories and explained which November surprises investors should be prepared for.

All this has led us to suggest why our base case sees this particular election as being less consequential than many think, at least in the short term as measured in months and years. In the long term though, it appears to be quite consequential already, not least at making U.S. governance institutions more inclusive, by, for example, both sides paying closer attention to voters and places left behind in recent decades.

The other week, the Royal Swedish Academy of Sciences decided to award the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2024 to Daron Acemoglu, Simon Johnson and James Robinson. All three moved to the U.S. as adults and won for their work on how institutions are formed and affect the prosperity between nations.[14]

Amidst fears and increasingly apocalyptic warnings by U.S. partisans of both sides, this work seems like a suitable counterpoint for investors to consider.[15] For one thing, it makes it clear that institutions and institutional legacies tend to be quite sticky. For another, one of the core arguments of Acemoglu, Johnson and Robinson has long been that for institutions to encourage investment in human and physical capital, these institutions need to be inclusive, in terms of widely sharing prosperity, rather than extractive (with a small group of insiders able to exploit the rest of society).

Seen in those terms, it perhaps becomes easier to assess the last eight years of U.S. politics, and the bitter divides we will no doubt see come election day, also as a sign of institutional renewal – especially, as we would quite expect, if accompanied by another presidential election with unusually large voter turnout.

Footnotes

[1] For a handy overview of different forecasts, see 270toWin, © 2024 Electoral Ventures LLC. For the House, we would signal out The Economist's model among poll-driven, quantitative forecasts as the most suitable one to keep an eye on.
[2] See, for example, Roll Call, Oct. 15, 2024, "Happening in Plains sight: A competitive Nebraska Senate race -Independent Dan Osborn barnstorms the state, scrambling partisan dynamics."
[3] To take just two obvious such wildcards, consider Larry Hogan's popularity as a former Republican Maryland governor in an increasingly blue state. Or Democrat Jon Tester in Montana, where it would not be entirely surprising to potentially see diminishing returns of what look like unprecedented amounts of spending in such as sparsely populated state on behalf of his Republican opponent. See, for example, New York Times, Oct. 15, 2024, "The Hard Truth About Montana and Jon Tester's Senate Race" And any large, regionally or nationally correlated polling error could put plenty of other states potentially in play, including Ohio, Michigan and Wisconsin among Democratic Senate incumbents, as well as Texas and Florida on the Republican side.
[4] See, for example, The Economist, Sept. 30, 2024, "A world without trade-offs: Harris's and Trump's economic plans both promise utopia. High spending, low taxes–and don't worry about the deficit" and The Economist, Jul. 11, 2024, "Halting his charge: Trumponomics would not be as bad as most expect. Opposition would come from all angles"
[5] However, Tim Walz would probably benefit from having represented Minnesota's 1st congressional district from 2007 to 2019.
[6] The Peterson Institute for International Economics, Sept. 3, 2024, "Trump II Tariffs: Who said he could do that?"
[7] We note with interest the recent, lively debate, among U.S. election watchers on this. See in particular, Nate Cohn, New York Times, Sept. 25, 2024, "Once Seen as Ironclad, Looks to Be Fading: A review of the evidence that Donald Trump's advantage relative to the national popular vote has declined significantly." and Nate Silver, Silver Bulletin, Sept. 26, 2024, "Pigs fly. Hell freezes over. The Electoral College favors ... Democrats? This scenario is not very likely – but probably worth a bet at 300:1."
[8] See in particular, Nate Cohn, Sept. 27, 2024, "The Problem With a Crowd of New Online Polls: They've become cheap to produce but they underperform the competition, falling short of their original promise." and Oct. 6, 2024, "How One Polling Decision Is Leading to Two Distinct Stories of the Election: A methodological choice has created divergent paths of polling results. Is this election more like 2020 or 2022?"
[9] For further background, see, for example, USA Today, Sept. 26, 2024 "Will Congress change its rules for abortion protections and voting rights? What to know" and Congressional Research Service, Apr. 7, 2024 "Filibusters and Cloture in the Senate"
[10] See their document: A new way forward for the middle class: A Plan to Lower Costs and Create an Opportunity Economy
[11] See, for example, Keith Stanovich (2011), "Rationality and the Reflective Mind", Oxford University Press
[12] In Nate Silver's model – the one with the longest and strongest track record – the two most frequent outcomes involve either Trump or Harris sweeping Arizona, Georgia, Michigan, Nevada, North Carolina, Pennsylvania and Wisconsin. Together, just these two extreme scenarios cover 40% of outcomes! Adding just the three next most likely instances of either Harris or Trump winning 6 out of 7, and typically about 50% of outcomes. See Silver Bulletin, Oct. 20, 2024 update, "Silver Bulletin 2024 presidential election forecast" and also Nate Silver, Sept. 29, 2024, "The 128 paths to the White House: From the Sun Belt to the Rust Belt, which maps are most likely?"
[13] In both, poll workers won't be allowed to begin opening and processing mail-in ballots before Election Day. For a useful overview of state rules on ballot processing and counting, see National Conference of State Legislatures, Sept. 23, 2024, "Table 16: When Absentee/Mail Ballot Processing and Counting Can Begin". In terms of current decision desk planning at Fox News, also see: Breitbart, Oct. 21, 2024, "Head of Fox News Decision Desk Foresees Delay of 4 Days for Presidential Election Results: Four days after Election Day is the over/under for when Fox News will likely declare a presidential election winner, Arnon Mishkin, the head of the network's decision desk, said."
[14] The Economist, Oct. 14, 2024, „An economics Nobel for work on why nations succeed and fail Daron Acemoglu, Simon Johnson and James Robinson tackled the most important question of all."
[15] For a very accessible introduction to much of their thinking, see James A. Robinson and Daron Acemoglu (2012) "Why Nations Fail: The Origins of Power, Prosperity and Poverty" Crown Business

Glossary

The Democratic Party (Democrats) is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

The Electoral College is the body which elects the President and the Vice President of the United States. It is composed of electors from each state equal to that state's representation in Congress.

The United States House of Representatives is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

The Republican Party (Republicans), also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

The United States Senate is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six year, overlapping terms in their respective state.

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as of 10/24/24; 103314_1 (10/2024)