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MACRO MORNING BRIEFING

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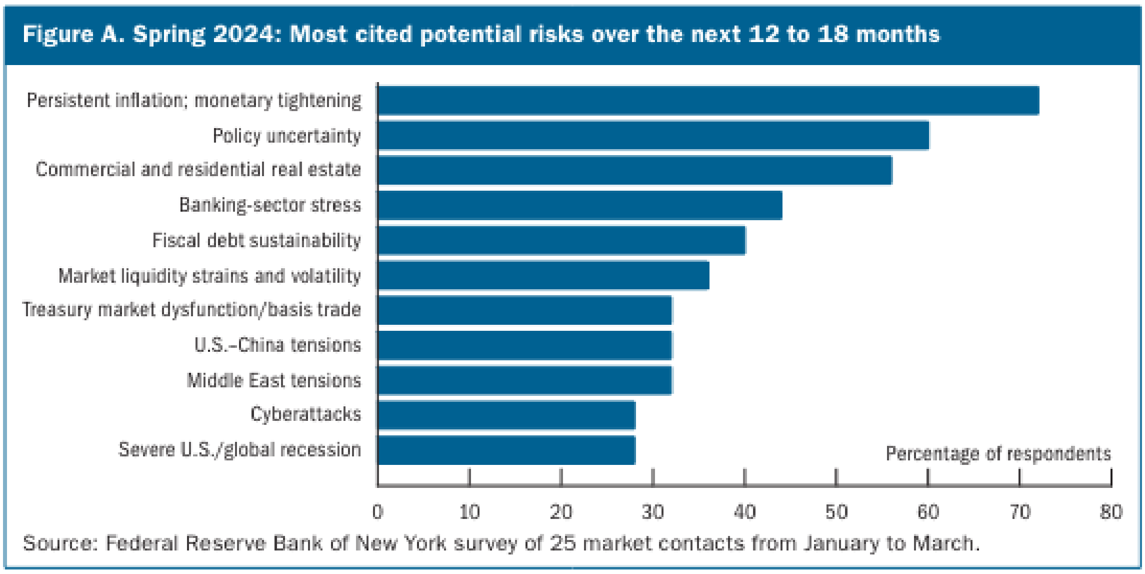
The US Elections & Risks Across Markets

Markets are already pricing in some US election-related risks, even with the vote still months away and the first debate between Democrat President Joe Biden and presumptive Republican nominee Donald Trump not until June 27. Who gets elected president, and to Congress, is still very much up in the air. For example, some polls suggest Trump is leading in so-called swing states, which pundits construe as Trump likely to win the election but lose the popular vote. The House is expected to swing to the Democrats by 10 seats, while the Senate goes to the Republicans by a 1-2 seat majority. The risk of a gridlocked government has traditionally been good for stocks – it typically means no new taxes, no new regulations and, generally, the status quo. However, markets have diverse pricing for what may lie ahead across assets.

- USD downside risk in the election appears underpriced and underappreciated. The tail risk of higher bond yields as debt burdens rise is also notable. Higher price-to-earnings ratios in stocks look unsustainable.
- Election years are generally positive for equities and bonds, but **over time economic growth and inflation matter more**. Policy shifts by the Federal Reserve during the election season are common. Regardless of the outcome, elections generate volatility – but normally in October-November. This time, however, we think the volatility tail could extend through January 2025.
- Polls have become less powerful predictors of outcomes since the two big surprises in 2016 – the UK's Brexit vote in June and Trump's election as president five months later. The best polling award goes to 538 – they have a notable record – but the risk of not accurately assessing election probabilities raises risk overall. What does show up in polling is the biggest concern of voters – the cost of living. The business community similarly sees inflation and policy the biggest risks – what is interesting here is the rise of the US election and policy shifts that follow as the next big issue after inflation/Fed policy.

Exhibit #1: FRB NY Potential Risks Survey

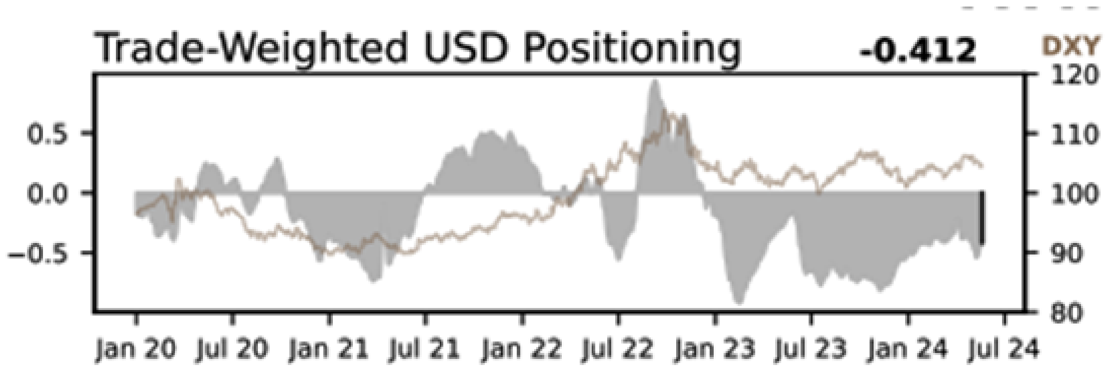


Source: Federal Reserve Board of Governors, BNY Mellon

Exhibit #1 above is an extract from the Fed's April 2024 Financial Stability Report. The second-highest ranked potential risk category, 'Policy uncertainty', includes "...policy uncertainty associated with the U.S. elections in November" (FSR, p. 47). We think this is notable and important because it leapfrogged into the second-place position occupied by 'Commercial and residential real estate' in the prior survey.

The flow of money into the US has stalled in part because of the election, but also in part because of 'value' perceived elsewhere. But iFlow data makes clear that USD positioning in G10 is only modestly short, compared to the outflows to October 2023. Fear of a US recession and/or of a more significant pullback in US growth and investments may bear the blame. Even now, investors want diversity from 'US exceptionalism'. The difference between this US election and other recent ones is stark differences between Biden and Trump. The rise of the extremes in US politics has been one notable shift in the last decade. The US public remains divided and confused. Markets are viewing 2024 as a referendum on 'US exceptionalism' and the USD may reflect this risk – already we have seen commodities rally sharply with gold at record highs. The outlook for the dollar against other fiat currencies is mixed. The roles of growth and inflation and monetary policy in driving FX markets still matters more than politics – particularly in EUR and GBP. The risk:reward from our iFlow indicators suggests an odd shift up in USD correlation to both stocks and bonds. This clashes with the push for diversification and the renewed 'value' push globally.

Exhibit #2: USD Positioning Short But Room For More



Source: Bloomberg, BNY Mellon

While the common ground in the US and other democracies in 2024 has issues about immigration and housing affordability, the lean towards more domestic, nationalistic policies with more private-government efforts to create strategic advances in Green and AI is also notable. All these will come at a cost, either through higher inflation and lower productivity or further fiscal spending in a world increasingly concerned about debt. We offer five other big issues in the election.

Issues at risk in the election:

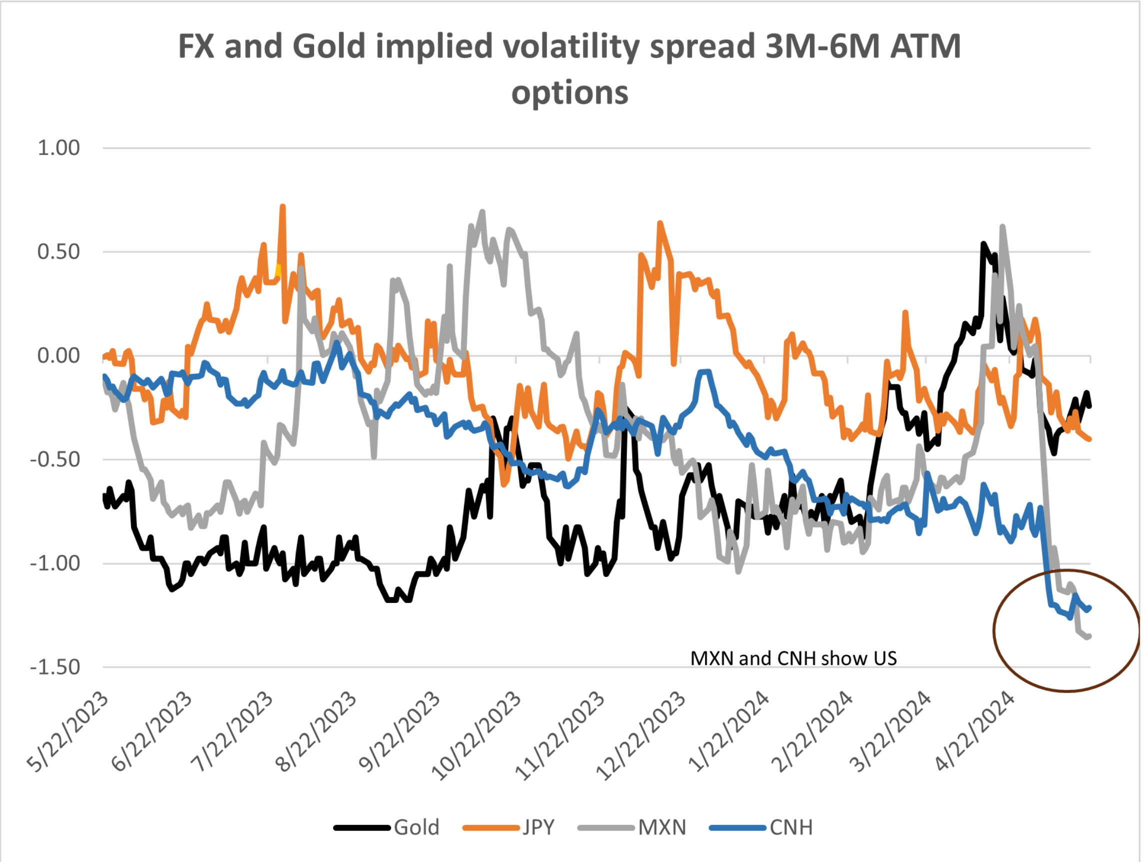
- **Clean energy investments**. Trump has vowed to expand US oil drilling and Biden just put tariffs on China EVs – both will have carbon implications for the Green transition targets of 2050. The role of 2030 and 2050 targets and what it means for US spending is clearly in play.
- **Fiscal deficit**. Neither party is fiscally responsible. A post-election risk in 2025 is in the debt burden and the cost of servicing it, which becomes more complicated by the tax shifts already in play. US debt service as a percent of GDP is seen rising to 6% in 2025, up from 3% in 2024.
- **Foreign Policy - nation first focus**. Both Biden and Trump have policies that are more nationalistic and less global. The world is worried about China/Russia alliances changing the world order from democracies to autocracies. There is also plenty of doubt about US support for both Ukraine and Israel longer term. Geopolitical risks are clear.
- **Political risks drive the real economy.** For investors and corporations, the risks are about cost of capital, global footprint, innovation and technology access, friend-shoring. These will likely accelerate as rates and stocks move on the vote, similarly.
- **Deep fakes and AI are going to be part of all 2024 elections.** AI is part of the underbelly for the voting world in 2024 as fake news and social campaigns push negative outcomes. Potential examples: robocalls with fake voices telling voters not to go to polls, famous actors pushing candidates that are not their

actual choice, and recordings about taxing beer or banning betting. The risk of more regulation on technology would likely follow.

The playbook from 2016 is part of the trading plan for the 2024 US election. Focus has been on Mexico and China policy shifts should Trump win, while a Biden victory is seen as meaning the status quo. The risk of USD weakness to spur a more mercantilist national economy has support on both sides of the aisle.

iFlow data shows an interesting shift in the last two weeks: the role of the USD in correlations to flows. A weaker USD was usually a necessary condition for higher global shares, but this has flipped. FX is now the cheapest hedge for equity and bond risks; there are several November-expiry option trades to consider. Bonds also have interesting opportunities in pricing election risks and the main issues.

Exhibit #3: FX 3M vs. 6M Options Show US Election Risks



Source: Bloomberg, BNY Mellon

All the 3M vs. 6M ATM FX options spreads that were narrow in Q1 have moved wider since. Part of that reflects April turn in risk and rates, but some of it is also about the US election as a Trump vs. Biden contest became clear.

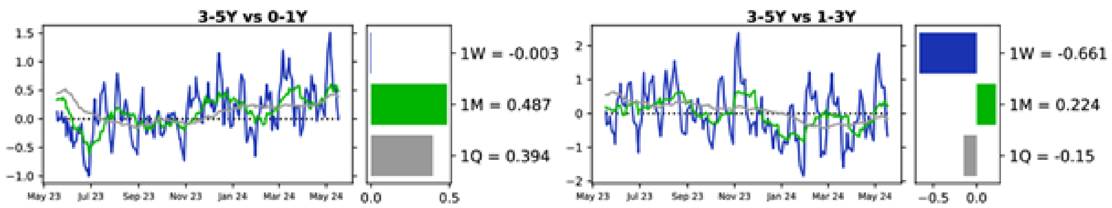
- JPY 3M vs. 6M ATM options show almost 50bp to the election – Bank of Japan policy and JPY intervention are part of the story.
- Offshore CNH 3M vs. 6M ATM FX options show nearly a 1.5% spread. Clearly, China is part of the election risk, and this is picked up in the Tik-Tok issue and

the US's imposition of tariffs on China EVs.

- MXN 3M vs. 6M ATM options have a 1.35% spread, even with Mexico's June 2 election risk ahead. This also highlights Mexico as a factor in the US election, with immigration and illegal drugs hot button topics.

US Treasury flows per iFlow suggest giving up on the FOMC trade of choice that dominated from January – Fed 'higher for longer' is no longer leading to a sharp recession so 2y selling vs. 5y buying has reversed. The other trade is selling 1y vs. buying 3y, where the optionality around the Fed and fiscal risk premiums shows up. What's going on in both of those spreads is an election risk call, too. Post-election risk starts in January 2025 with the debt ceiling, continues with the corporate tax cut roll off, and then moves onto regulation and regular budget battles. The role of the US election is clearly having an early impact on the short end of the US curve.

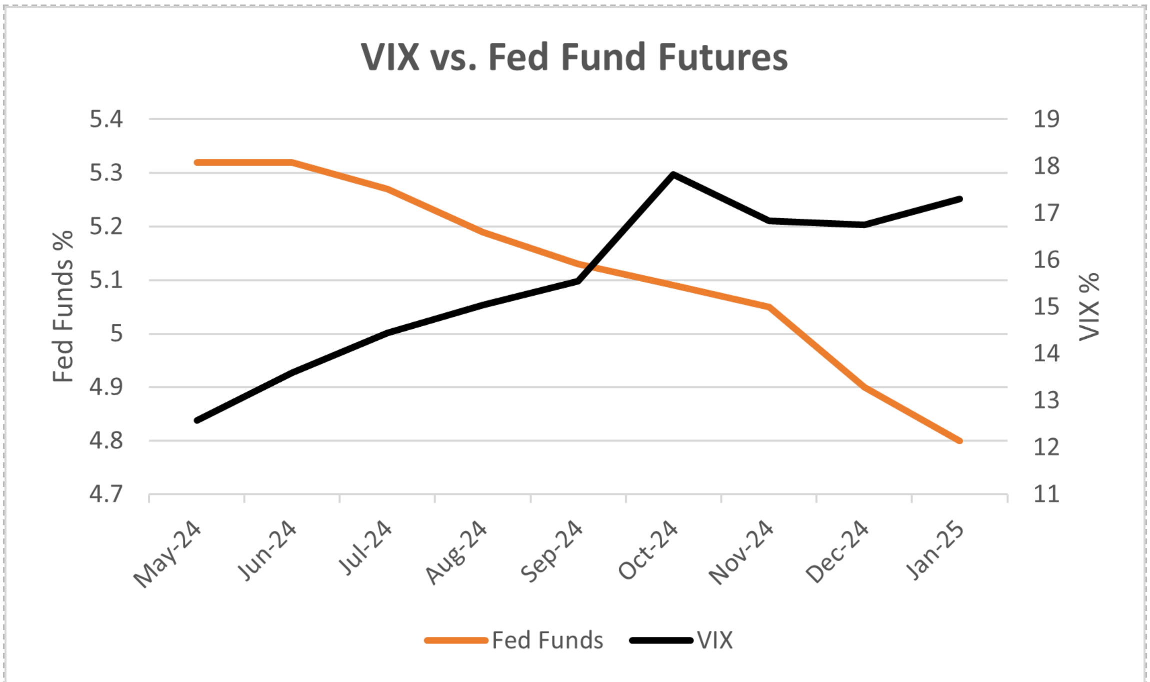
Exhibit #4:US Short-End Fixed Curves Suggest Election Shift



Source: iflow, BNY Mellon

Exhibit #5 below shows VIX futures (an election spike of 2% to the curve) as well as expectations for Fed rate cuts (starting in September). Dissecting equity risk around the US election is clearly a 1-month story but tail risks suggest some further troubles.

Exhibit #5: VIX Reflects More Election Risk

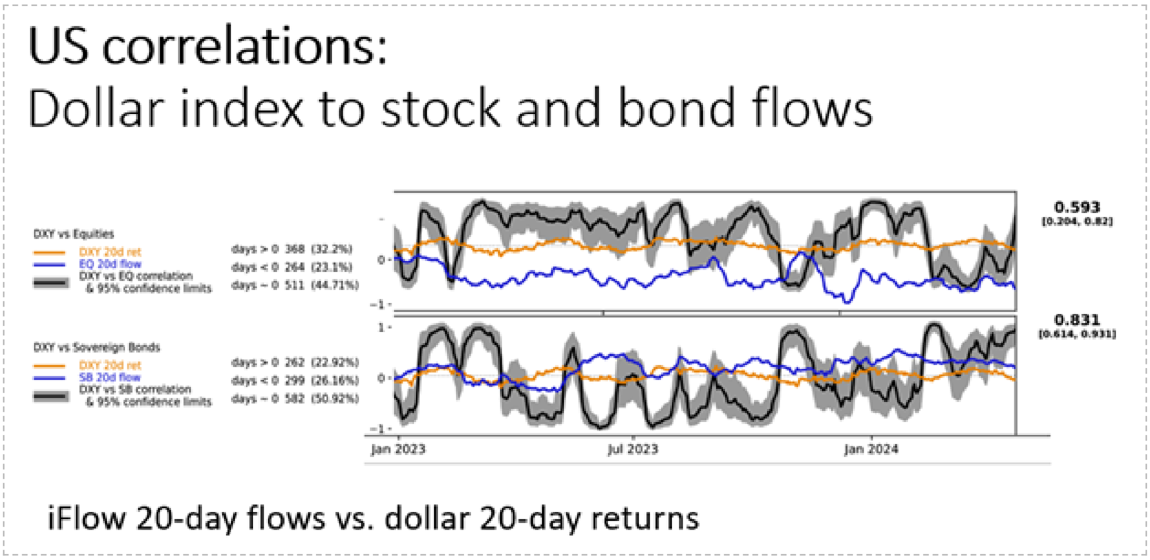


Source: Bloomberg, BNY Mellon

Bottom Line:

There's been an interesting shift in the role of the USD in market correlations. Contrary to the previous trend, where a weaker USD was a necessary condition for higher global shares, the pattern seems to have reversed. Currently, FX markets are emerging as the most cost-effective hedge for equity and bond market risks. The USD, in its current state, is the cheapest hedge for risk trading around the US election – but this could change as the vote draws nearer. The strategies from 2016 are being revisited for 2024, with focus on potential policy shifts related to Mexico and China in the event of a Trump win, while a Biden victory is seen as a continuation of the status quo. However, it is clear that the coming months will be a rollercoaster for financial markets. Buckle in for what is likely to be a wild ride.

Exhibit #6: Correlations Are Shifting



Source: iFlow, BNY Mellon

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