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PONDERING THE PRESIDENTIAL ELECTION

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The fast-approaching U.S. election has all the makings of a classic given its tightness and the yawning policy divide separating the two candidates. In this report, we take an evidence-based approach that lays out the likely election outcome on November 8th, the potential economic implications of each candidate's platform, and ultimately the financial market repercussions.

Following the first presidential debate, it appears that Democratic nominee Hillary Clinton retains a palpable but not insurmountable lead in the race for the White House, and as such is the probable victor. In this scenario, the economic implications would be broadly neutral relative to the existing trajectory, and the market implications would be slightly positive.

In comparison, Republican nominee Donald Trump remains a conceivable if somewhat less likely victor, and proposes a plethora of short-term economic stimulus that would theoretically elevate economic growth in the years immediately following the election. However, his anti-trade and anti-immigration policies would likely more than offset this tailwind over the medium run, resulting in a diminished economic endpoint. When paired with the additional policy uncertainty that a Trump presidency would bring, the stock market appears more favourably disposed toward a Clinton victory than a Trump win.

Of course, much of the financial market's verdict will depend on the composition of Congress and the extent to which the new president actually delivers on their platform. Let us evaluate all of these factors.

Gauging presidential odds

National political polls point to a close race, but not a dead heat. The average of these polls argues that Clinton leads by around 2 percentage points over Trump – less than the 2 to 4 percentage point advantage that prevailed for most of the past month, or the 5 to 7 percentage point gap that temporarily opened up after the Democratic convention. We suspect this will again widen slightly given several metrics arguing that Clinton was perceived to have outdueled Trump in the first presidential debate on September 26th, but that is mere conjecture for now and there remain two more debates.

A quirk of the U.S. electoral system – the fact that, in most states, the recipient of the majority of a state's popular vote receives the entire allocation of that state's electoral college votes – means that only a handful of states are close enough to really merit watching. Notably, the odds recently tipped from Clinton to Trump in the swing states of Florida, Ohio, North Carolina and Nevada. The acclaimed political analyst Nate Silver of fivethirtyeight.com now calculates that Clinton is on track for 272 electoral votes versus 266 for Trump. This is agonizingly close, with the difference representing nothing more than a single mid-sized state. With over a month remaining, this election is hardly settled.

Betting markets have generally taken a more serene view of the election outcome. They argue that a Clinton victory was once as high as an 80% probability in August, rested at more like 60% before the first debate, and now sits at a reasonably comfortable 70% likelihood (Exhibit 1). Thus, markets believe that Clinton is more than twice as likely to win as Trump. All the same, this means Trump has an entirely conceivable 30% chance of winning.

How to reconcile this 40 percentage point probability gap with the mere 2 percentage point gap in the polls? There is no contradiction: if we knew with certainty that Clinton would maintain her 2 percentage point gap right through the election, this would actually merit a 100% chance of victory. In general, the likelihood of victory is much higher than any gap in the polls. The market's assigned 30% chance of a Trump victory represents the possibility that the voting intentions of American voters change in his favour by the election, or that the existing polls are undercounting his supporters.

We are inclined to argue that the race is a bit closer than popularly imagined, with perhaps a 65% Clinton probability versus a 35% chance for Trump. One reason for this is the fact that the fraction of undecided voters (18%) is a remarkable three times higher than at the equivalent point of the 2012 election. These undecideds could alight just about anywhere.

This view is also motivated by the fact that it is necessary to go well beyond the polls in considering the electability of each candidate (Exhibit 2). Among the more notable factors in Trump's favour, the U.K. Brexit vote demonstrates a significant populist resurgence, there are a number of reasons why Trump supporters may be undercounted in the polls, and Clinton is being forced to grapple with a range of concerns including her health and her use of a private email server. On the other hand, Clinton still has a lead in the polls, possesses a big financial and organizational advantage and enjoys the unreserved support of her own party apparatus.

The broader political landscape

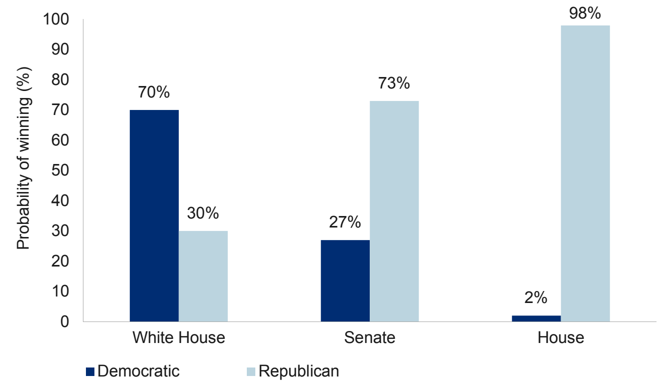
We have focused so far on the likely presidential victor. But the election is about more than that: the entire House of Representatives and a third of the Senate will also be chosen on election day.

Referring back to Exhibit 1, it is clear that the single most likely outcome is actually the status quo – a Democratic president paired with a Republican Congress. In this scenario, nothing much changes. Clinton fits broadly into President Obama's centre-left mold and little legislation of any note would pass with the White House and Congress in opposition to one another.

However, the second most likely scenario is rather more consequential. This is a Trump victory paired with a Republican congress. Such a Republican sweep is a historically rare occurrence, and leaves considerable room for legislative action. In this scenario, one can envision a visible shift on a range of issues. Even here, though, one should not presume that the Republicans will redefine Washington from top to bottom. There are several tempering factors:

- Trump is ideologically different than most Congressional Republicans, limiting the degree of cooperation between the two.

Exhibit 1: U.S. election odds



Note: As of 9/27/2016. Source: pivit.io, RBC GAM

Exhibit 2: Clinton vs. Trump likelihood

Clinton pros	**Trump pros**
• Leading slightly in polls	• Brexit vote demonstrates populist uprising
• Economy healthy	• Trump supporters may be undercounted
• Financial advantage	• Trump has repeatedly exceeded expectations
• Organizational advantage	• Seems immune to scandal
• More moderate candidate tends to win	• Negative shock (economy, market, terrorism) would boost chances
• Poll drift tends to mean-revert	• Declining influence of traditional centrist media
• Electoral college format helps Democrats	• Low debate expectations
• Obama popular, is helping; so is husband	• Improved discipline with new campaign manager
Clinton cons	**Trump cons**
• "Not a natural politician"	• Alienates segments of population
• Historically, voters want new party after 2-termer	• Lacks Republican establishment support
• Must defend political record	• Disorganized campaign
• Issues: health, private emails, family foundation	• Free trade attitudes not actually in major decline
• Some states restricting voter rolls	
High uncertainty	
High undecideds increase range of possible outcomes (18% of voters versus 6% in 2012)	

Source: RBC GAM

- President Obama enjoyed a Democratic sweep for the first two years of his presidency. While this yielded a major stimulus package, bank reforms and the landmark Affordable Care Act, the Democrats failed to deliver on many other files, including immigration and tax reform. A big reason for this is that one needs 60+ seats in the Senate to truly control the proceedings (an almost impossible aspiration for this election), and House members rarely have the ability to "think big" because their two-year election cycle puts them in perpetual election mode.

Public policy ahead

Elections matter not because of the faces they elect but due to the public policy that results. As a pre-amble to a proper policy discussion, let us acknowledge three things.

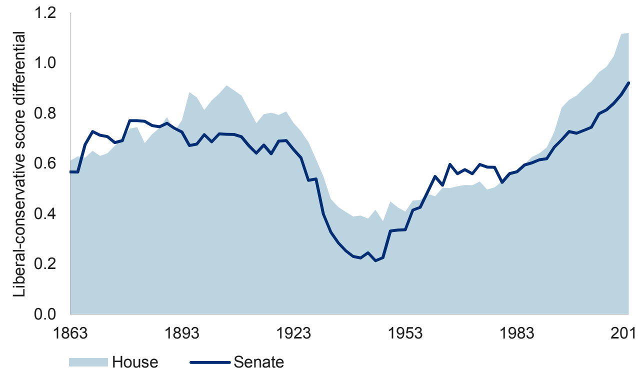
First, U.S. elections are theoretically becoming more consequential over time because the polarization between Democrats and Republicans has grown to truly historic proportions (Exhibit 3). Candidates now embody sharply different values and views.

Second, this particular election is especially consequential because it is not the usual format of a centre-left Democrat against a centre-right Republican for the presidency. Trump, in fact, manages to defy both the traditional centre-right and the newly popular, further-to-the-right Tea Party movement that populate the modern Republican Party. His views can best be described as populist with authoritarian leanings.

Third, and at the risk of reader whiplash, let us also recognize that political platforms rarely transform unmodified into public policy. They are usually watered down for a variety of reasons:

- Politicians tend to simplify and exaggerate their ideology during campaigns as a means of attracting their base and to get their point clearly across in a chaotic environment.
- Once in office, the necessity of compromise between the executive, legislative and judicial branches tends to soften or impede legislation.
- Any political directive must survive implementation through layers of policymakers and bureaucrats who tend to blunt the sharper edges of new policies.
- Some politicians feel a duty to govern on behalf of the entire country, not just the segment that elected them.

Exhibit 3. Congress at record level of partisanship



Note: Measured as the difference between median scores for the Democratic and Republican members in the House of Representatives and Senate. Source: Voteview.com, RBC GAM

Short-term economic implications

Let us now turn to the economic policy proposals of each candidate. To our eye, Trump represents the clear economic stimulus candidate, at least over the short run. His proposals include:

- A large infrastructure program
- Additional spending on the military, veterans, education and child care
- Significant corporate and individual tax cuts

While Trump proposes to pay for much of this via a one-third reduction in non-entitlement government spending, it is unlikely that government spending can be cut that radically, especially given the confines of his other promises. The resulting fiscal deficit represents a significant increase in economic stimulus, potentially on the order of 1-2 percentage points of additional growth in the short run.

Although Clinton proposes an increase in infrastructure spending and higher taxes on the extremely wealthy, her economic policies are not drastically different from those in operation today.

We should acknowledge that there is some debate around our assertion – a recent Moody's analysis suggests that both candidates have platforms that would boost economic growth by around 0.5ppt in 2017. Any disagreement would appear to revolve around whether to pay greater heed to Trump's promise to balance the budget or his spending and tax commitments. We are inclined to focus on the latter.

Of course, this extra fiscal stimulus would not be cost-free. The bipartisan Committee for a Responsible Federal Budget calculates that Trump's policies – if delivered unencumbered – would increase the U.S. debt load by a large 28 percentage points of GDP over the next decade. In contrast, Clinton's policies point to a tamer 9 percentage point increase in the public debt ratio (Exhibit 4). The status-quo fiscal trajectory – meaning no change in law – is also for a 9 percentage point increase in the debt ratio.

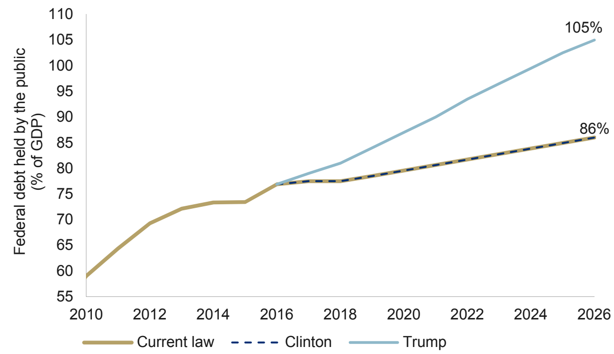
Medium-term economic implications

The economic situation reverses over the medium run (Exhibit 5). Over any period of more than a year or two, Clinton's policies appear more likely to deliver the superior economic performance. Again, Clinton's policies are fairly status quo. In contrast, Trump's musings on limiting free trade with China and Mexico, his distaste for new trade deals (though, in fairness, Clinton is also against the Trans-Pacific Partnership trade deal) and his less immigrant-friendly stance would all stand to reduce the speed limit of the U.S. economy.

Recent analysis by the nonpartisan Peterson Institute calculates that a full-blown trade war with China and Mexico would subtract a large 4 percentage points from U.S. GDP. This represents the equivalent of two years of lost economic growth. The study finds that even an abbreviated trade war would have damaging consequences. Providing further context, the aforementioned Moody's analysis argues that Clinton's economic platform would be superior to Trump's in 2018. To be clear, trade might not be impeded as much as these models assume given the vagaries of where authority lies to change trade laws and the tendency for public policy to be delivered in watered-down form. But it is a clear risk.

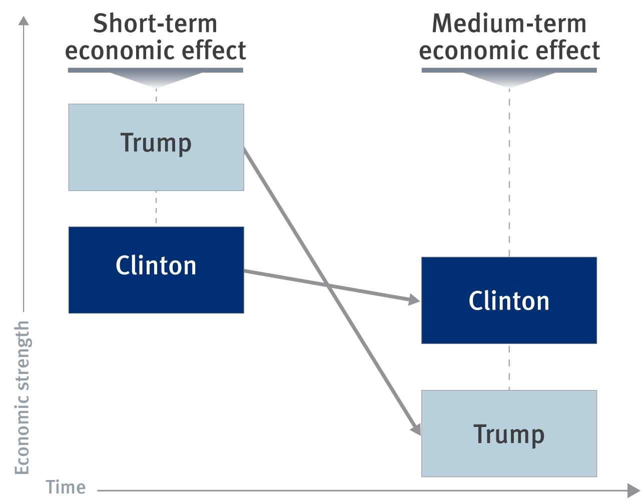
The analysis cannot quite end there, as to Trump's credit he talks of eliminating red tape – a subject on which he would likely find common ground with his Republican partners in Congress. Similarly, one must not completely discount the second-order dynamics of his proposal for lower taxes and faster short-term growth, as these could prove capable of creating a favourable tailwind of optimism that adds to medium-term growth. But a sober analysis nevertheless suggests that his anti-globalization stance would more than undermine these green shoots.

Exhibit 4: Projected debt higher under Trump



Note: Estimates by CRFB. Source: St. Louis Fed, CRFB, RBC GAM

Exhibit 5: Economic implications of U.S. election



Source: RBC GAM

Foreign policy

Foreign policy has only an indirect effect on economic growth, but it is nevertheless relevant to our analysis for two reasons. First, regardless of the impediments put up by Congress on other matters, presidents enjoy a considerable amount of discretion in the conduct of foreign policy. Thus, a candidate's foreign policy platform has a better chance of implementation than most other proposals and so deserves serious attention. Second, foreign policy can have an economic and financial market effect to the extent that it materially alters military spending or dramatically changes the perception of geopolitical risk in the world.

Clinton is arguably a bit more militarily hawkish than President Obama, though not to an extreme degree. Trump is much harder to read. Much of what he says rings of isolationism, such as the argument that other NATO members should carry their own weight in the world's security affairs. This, as an aside, squares well with his inward-leaning views on trade and immigration. However, Trump also talks about expanding the size of the U.S. military and going after ISIS. Meanwhile, his tentatively warm relationship with Russia would appear to represent a departure from the recent U.S. stance. It is hard to square the circle of these various proposals. As such, it is perhaps safest to say that the perception of geopolitical uncertainty would likely rise were Trump elected to the presidency.

Financial market response

Unavoidably, this paper now enters an even more speculative realm. We must first imagine the victor of the election, then the public policies they would manage to implement, and finally the reaction of financial markets to these new policies. Naturally, there is considerable room for error along the way.

We break the analysis down into two segments. The first is the economically-motivated market reaction. The second is the historical market reaction.

Economically-motivated market reaction

The main debate for the stock market is whether to dwell more on Trump's short-term economic positives or his medium-term economic negatives. Based on the market's ebb and flow in response to political polls over the past few months, it would appear that Trump's medium-term economic negatives are dominating the evaluation. We are inclined to agree – the medium-term negatives of his platform look set to be at least twice as powerful as the short-term positive. As a further support for the market's interpretation, let us recognize that Trump represents the greater "unknown" given his lack of political background and views that deviate palpably from existing policy. Markets shy away from uncertainty. In contrast, Clinton represents a much more familiar and better understood option, particularly given the high likelihood that the House of Representatives would stymie her bolder plans.

It is worth noting that financial markets do not necessarily prefer the status quo *because* it represents the "best" possible policy. They may simply prefer it because it would

CANADIAN ECONOMIC IMPLICATIONS

A quick word on the Canadian economic implications from the U.S. election. We see three main effects.

First, the economic linkage between the U.S. and Canada is powerful. All else equal, this means that Trump might also be a short-term positive for the Canadian economy and a medium-term negative. Clinton changes the equation less.

Second, Trump is in favour of the Keystone XL pipeline. We loosely figure that such a pipeline would be worth as much as $4 billion per year for the Canadian economy. This is an attractive feature of a Trump victory, though the president has only limited say over such matters. Recall that President Obama was also in favour of Keystone XL but did not succeed in getting it passed. Trump's odds would be better given the possibility of a Republican triple crown, but still short of certainty.

Third, Trump has railed against NAFTA. Naturally, the threat of NAFTA's elimination is a major risk for Canada. There is considerable uncertainty around the magnitude of this risk. One question relates to whether the president has unilateral authority to achieve this outcome. Legal experts are divided. Congress would be unlikely to go along. Another element is the extent to which NAFTA would be dismantled. Some have noted that the elimination of NAFTA might not be so bad for Canada as the Canada-United States Free Trade Agreement of 1988 preceded NAFTA, and it seems conceivable that this would come back into force upon the expiry of NAFTA. Thus, Canada's access to U.S. markets might be less threatened than it first appears.

be costly to change their business practices in response to new legislation, and for that matter some of the biggest companies today are successful in part because of the particular policy idiosyncrasies in force today (tax credits, loop holes, byzantine regulations and all).

From a currency perspective, we ultimately suspect the better economic environment of a Clinton victory would push the U.S. dollar higher, with a Trump victory sending the dollar a bit lower. But there is no denying that Trump's plans to repatriate overseas earnings could induce a significant inflow into U.S. dollars, and for that matter any squeamishness about the considerable uncertainties resulting from a Trump victory could well induce a safe haven bid for the dollar. But we assume that the former effect dominates.

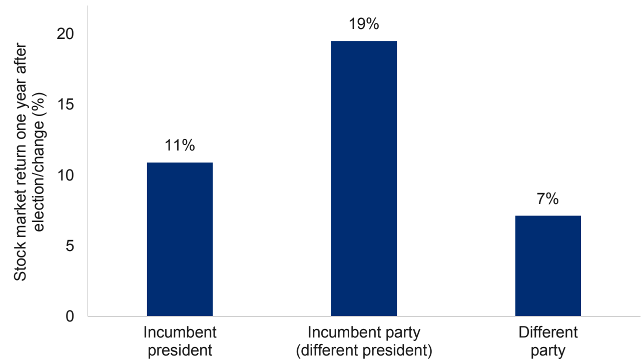
It is particularly difficult to gauge the logical reaction of the bond market to the election. In the end, our bias is that a Trump victory would induce slightly lower yields due to the weaker economic implications, perhaps tinged by a slight safe-haven bid. Clinton would have the opposite effect, presumably. Of course, it is never a one-way street: Trump's economic platform promises additional public debt and could result in additional short-term inflation – both bond bearish developments. Again, we lean toward the first interpretation – slightly higher yields under Clinton, slightly lower yields under Trump.

Evaluating the sector-based implications of each presidential candidate is beyond the scope of this report, but at a cursory level one could imagine health/medical and industrial companies favouring Clinton, and Trump conceivably favoured by financials (due to a promise to halt further financial regulation) and defense stocks.

Historical market reaction

Before venturing any further, it is crucial to understand that the upcoming analysis of how the stock market has historically fared in response to different political outcomes very likely suffers from a "small sample size" problem. In other words, there are so few historical episodes to look at that these conclusions may represent random noise. We only mention them because there is an insatiable demand for such analysis and so many of these signals happen to point in the same direction right now:

Exhibit 6: Markets historically prefer incumbent victory



Note: Average return of S&P500 one year after an election or change of president due to death or resignation from 1928 onwards.
Source: Bloomberg, RBC GAM

- **Clinton positive:** stock markets have historically performed better with Democrats in office.
- **Clinton positive:** stock markets generally prefer when the incumbent (or incumbent's party) is re-elected to the presidency (Exhibit 6).
- **Election positive:** when one examines how the stock market has traditionally performed under different party permutations across the White House, Senate and House of Representatives, it turns out that the three most likely outcomes for this election are also the three most favourable for stocks (Exhibit 7).
- **Year one neutral:** the stock market generally performs respectably in the first year of a new election cycle (though year two tends to be better).
- **Close election positive:** Some third-party analysis argues that the U.S. stock market tends to rally after unusually close elections. There is a theoretical justification: markets are happy when these types of elections are resolved because it means one less source of uncertainty in the world. The upcoming election fits the bill for "closeness." However, we should warn that this finding is highly sensitive to the specific time horizons used, making us dubious of the result.

For what it is worth, these historical trends tend to argue for a favourable stock market performance in the future, especially should prediction markets prove correct and Clinton wins the presidency.

Exhibit 7: Political permutations

President	Senate	House	Odds	Median S&P 2-year annualized returns
Democratic	Republican	Republican	50%	16%
Republican	Republican	Republican	21%	13%
Democratic	Democratic	Republican	19%	13%
Republican	Democratic	Republican	8%	-18%
Democratic	Republican	Democratic	1%	N/A
Republican	Republican	Democratic	0%	9%
Democratic	Democratic	Democratic	0%	9%
Republican	Democratic	Democratic	0%	8%

Highest probability events have greatest returns

Note: Returns measure annualized median 24-month percent change over the 2-year congressional term. Odds as at 9/27/2016. Data from 1961 to 2016.
Source: Pivit.io, RBC GAM

Bottom line

The bottom line is that the most likely scenario is a status-quo outcome: a Democratic president paired with a Republican Congress. As such, very little would change from a policy perspective, with perhaps the hope for a bit of additional infrastructure. The stock market response might range between nonchalance and mild happiness, with the U.S. dollar and bond yields edging upwards.

As a less likely alternative, Trump has a 30% chance of winning. This would be far more consequential from an economic and public policy perspective, because it would represent a new party in the White House, because his policies are further from the centre than Clinton, and because it would imply a Republican sweep of the presidency, Senate and House. In combination, these developments could induce a less favourable stock market response, with the U.S. dollar down and bonds rallying.

Let us conclude by stepping back from the fray for a moment. While public policies can easily swing in one direction or another over the span of an election cycle or two, the long arc of history – the time period that really matters to investors and society alike – generally reveals a capable and mostly steady hand at the wheel of U.S. public policy. When mistakes are made, they are usually undone by future politicians. Meanwhile, good decisions tend to be cemented ever more firmly into place.

This is not to say that the upcoming election is inconsequential, but rather that it is probably less important in the grand scheme than it currently looks. Financial markets can continue to rise over the long run thanks to the ingenuity and industry of workers, the relentless pace of technological advances and ultimately the rising standard of living of the world's people.

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