CIO autumn update:

US election: themes and implications

Foreword

Sonja Laud
Chief Investment Officer

Many of the themes at the heart of the US election, and other political developments elsewhere in the world, are of immense importance to investors.

Since our last update, investors have gained some clarity on monetary policy, with major developed market central banks kicking off easing cycles. But the outcome of the US election, another key macro driver, has become much more uncertain.

The presidential race was upended during a few weeks of extraordinary political drama, in which Kamala Harris replaced Joe Biden as the Democratic candidate, dashing expectations of a Republican victory. The current vice president will now face off against Donald Trump, the former president, in the vote on 5 November.

"The broader backdrop is one of an increasingly multi-polar world, unsettled by technological advances, demographic challenges and geopolitical strife."

2024 | CIO autumn update

Markets – at least at a headline index level – seem relatively relaxed about the race. We think that may change as the candidates enter the home stretch. The convulsions across the investment landscape of early August point to the underlying fragility in risk assets we noted earlier this year, especially because many valuations remain lofty.

That's why this publication, to which teams across L&G's Asset Management division have contributed, is focused on the implications for investors of the race to the White House, both near term and long term. We discuss:

- How different election outcomes might impact US assets
- Positioning for a 'Harris trade'
- Four key questions over the impact of tariffs on inflation and growth

We also weigh how a number of key elections over the coming months might shape the investment landscape; the impact the US election could have on clean energy investment; and the potential challenges and opportunities within private markets posed by deglobalisation.

Market pricing

There are important parallels between this election and others that have taken place elsewhere around the world.

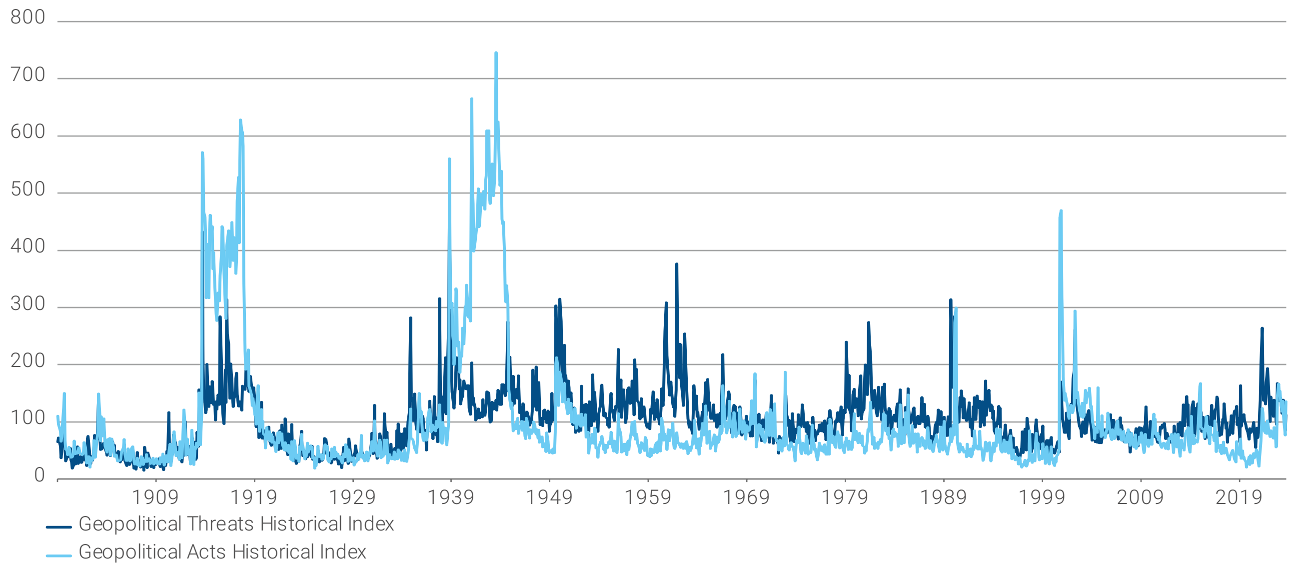
For example, some of the topics dominating the campaign are very much part of the political discourse in Europe – including inequality and immigration, on which large numbers of voters appear to be expressing frustration. This helps to explain the rise of parties such as Alternative for Germany, Reform in the UK and Marine Le Pen's National Rally in France.

The broader backdrop is one of an increasingly multi-polar world, unsettled by technological advances, demographic challenges and geopolitical strife.

These underlying themes are of immense importance to investors. As noted in our research, they impact the outlook for growth and inflation – and the attendant policy responses. Some of them, not least geopolitical tensions, are incredibly difficult to position around or hedge against. This explains why markets do not appear to be pricing in the risks stemming from conflicts that are already under way, such as those in Ukraine and the Middle East.

As a result, we believe it's critical to conduct regular scenario analysis in order to think through potential implications. We also think this makes diversification* more important than ever, to help withstand a range of economic scenarios – and mitigate the impact of any single market event.

Geopolitical Risk Index



***It should be noted that diversification is no guarantee against a loss in a declining market.**

Source: LGIM, Macrobond as at 15 May 2024. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

Economics

Gauging the impact of tariffs under Trump

While there is near-uniform opinion among economists that tariffs raise inflation and reduce growth, key questions remain.

Tim Drayson
Head of Economics

One of the biggest policy differences between the presidential candidates is trade; at stake is the speed of deglobalisation.

The Democrats will probably maintain a tough stance on China, with existing tariffs unlikely to be rolled back. The Republican agenda appears more radical. Trump has not been specific, but at times during the campaign he has mentioned a 60% rate on all goods from China and a 10% rate on all other imports. Reducing the overall trade deficit and boosting US manufacturing seems to be the goal.

The initial rounds of tariffs on China have almost halved the bilateral goods deficit as a share of GDP. But there has been little impact on the overall goods trade deficit as it has mainly encouraged trade diversion. Some of this is Chinese-manufactured goods being transferred and then sold out of third countries such as Vietnam, but it also represents new supply chains developing in countries more aligned with US interests (friendshoring in Mexico).

Four key questions

Economists rarely agree, but there is near-uniform opinion that tariffs raise inflation and reduce growth – and the risk of recession grows non-linearly as the scope and magnitude of tariffs broadens. There are many questions to resolve, including:

1. The level of tariffs to be introduced and on what products is not currently clear. There would likely be intense lobbying from retailers to prevent tariffs. In the event of a Trump administration, we would watch the key appointments carefully. These would likely influence the policy stance. In the first wave, the Trump administration was careful to avoid China tariffs directly on consumer goods where the inflation impact and squeeze on real consumption would likely be larger.

2. There are various protectionist mechanisms available to the president that do not require Congressional approval. But the extent of the authority is not clear. Our view is using the various trade and tariffs acts legitimately would merely slow rather than prevent the imposition of tariffs.

3. How will the rest of the world respond? The greater the retaliation, the bigger the hit to US exports and global growth.

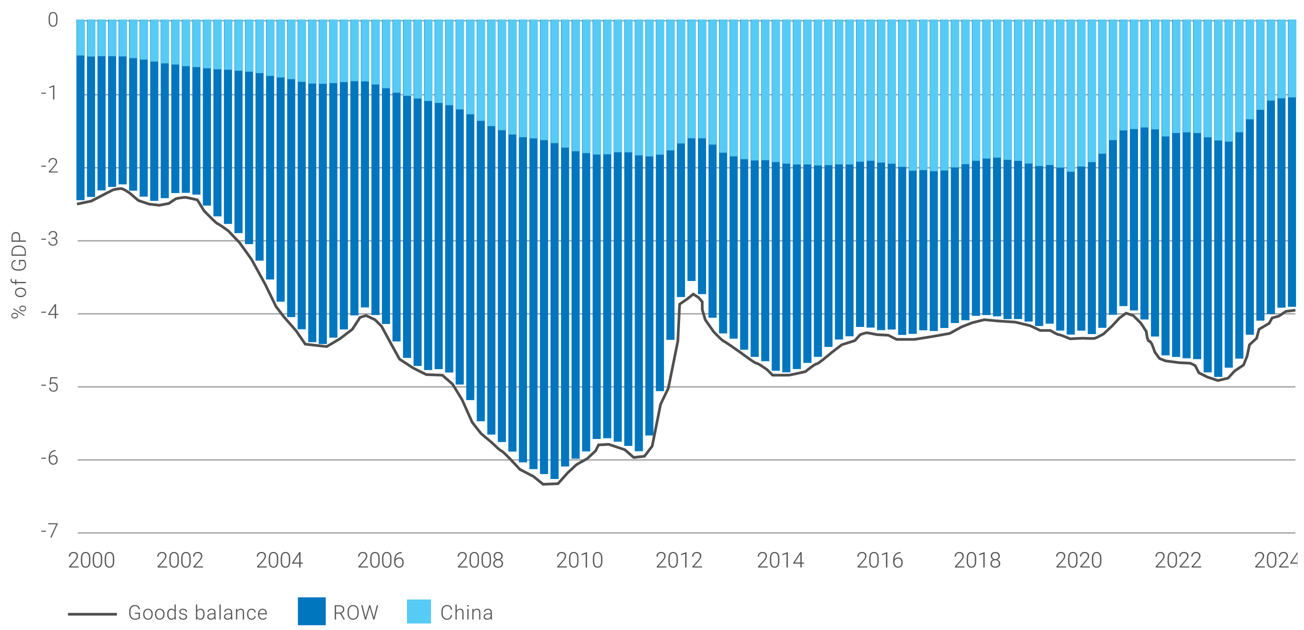
4. Finally, how would financial markets react? Trump has implied one reason for tariffs is to force other countries to revalue their exchange rates. But economic theory suggests the dollar is likely to appreciate in response to US tariffs. The dollar could also get a bid due to its perceived safe-haven quality, despite US policy being the cause of the hit to global growth. In our view, the equity market and credit reaction to aggressive use of tariffs would likely be negative, even if the tariff revenue is used to partly fund an extension of the tax cuts due to expire over the next two years.

"Economists rarely agree, but there is near-uniform opinion that tariffs raise inflation and reduce growth."

The impact on US rates is ambiguous and would also hinge on the wider market reaction. A strong dollar would mitigate the upward pressure on US prices from tariffs, while a global trade war would have a chilling effect on business investment and inflation.

Consensus seems to be that any tariff increases would be targeted and limited. If Trump follows through on the campaign rhetoric mentioned above, this raises the effective tariff rate on US imports to near 20%. In this scenario, we calculate the level of US core inflation could rise around 200 basis points. This would complicate the ability of the US Federal Reserve to respond to the shock, though if it triggers a global recession, which is plausible, the central bank would likely cut rates.

US goods balance



Source: Macrobond, as at 1 September.

Asset Allocation

Fragile markets vs. political risk

We believe periodic market disruptions are increasingly probable in late cycle. Enter the US election.

Emiel van den Heiligenberg
Head of Asset Allocation

Chris Jeffery
Head of Macro Strategy

The US presidential election is possibly the key macro driver for the rest of the year. In our experience in dealing with the market impact of these geopolitical events, it is dangerous to assume we can predict the outcome.

As we've seen in the past few months, the best made forecasts can be thrown out by "events, dear boy, events", as a former UK prime minister put it. At the time of writing, Kamala Harris is leading the race by a narrow margin. The bias in the electoral college means that she probably needs to be around 4% ahead on the national popular vote to win. A handful of swing states will sway the election.

An important difference between the two candidates is their attitudes towards international trade, where the presidency has significant executive discretion to impose higher tariffs. (For more on this, see Tim's piece.)

On fiscal policy, the probability of a Democratic or Republican sweep of the White House and Congress is important. If that does not happen, we would expect fiscal stalemate to exert a drag on the economy in 2025. The Democrats have an uphill battle in the Senate, as they are defending twice as many seats as their opponents. But our US colleagues regularly urge us not to underestimate the likelihood of a sweep, with split-ticket voting in the US increasingly rare.

In the table below, we have sketched out the markets moves we expect in different scenarios. A Trump sweep would likely bring a return of tariffs as a policy instrument alongside tax cuts: in our view, bad news for US Treasuries, non-US markets and consumer staples; good news for energy and the US dollar.

A Harris sweep would probably reverse the Trump tax cuts and increase spending on social and environmental priorities. We think that would be somewhat negative for US equities, better for non-US markets and push yields up. Without tariffs in the mix, the fixed income effect is likely to be more muted than under a Trump sweep. If the government ends up divided, then fiscal policy becomes less easy to get through Congress.

		Equities	Yields	$	Favoured sectors	Least prefered sectors
Kamala Harris	United government	-	+	=	Emerging markets Autos	Energy
	Divided government	+	--	-	Consumer staples Emerging markets	
Donald Trump	United government	+	++	+	Financials Energy	Emerging markets Autos
	Divided government	--	=	=		Emerging markets

Source: LGIM as at September 2024. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

This story will continue to ebb and flow until election day (and maybe, unfortunately, beyond). Throughout this period, our focus will be identifying the themes that the market is latching onto, rather than pinning our colours to the mast of an expected outcome.

Dissecting the summer squall

Early August brought extreme market turbulence: the VIX (often called the market's 'fear index') jumped to levels rarely seen outside economic panics, credit spreads spiked, risk-off currencies rallied and yields fell. However, most of those market moves reversed as quickly as they unfolded.

What was going on: a low-liquidity, mid-summer squall or something more serious? Our answer is a bit of both.

To be clear, we were not anticipating this specific set of risks to crystallise when it did. But the volatility was in line with our thesis that markets are vulnerable to bad news and periodic disruptions as we get deeper into late cycle. The market narrative has shifted from slowing inflation as the main positive focus to worries about slower growth. Any disappointing macro data can bring the risk of a hard economic landing into sharp focus.

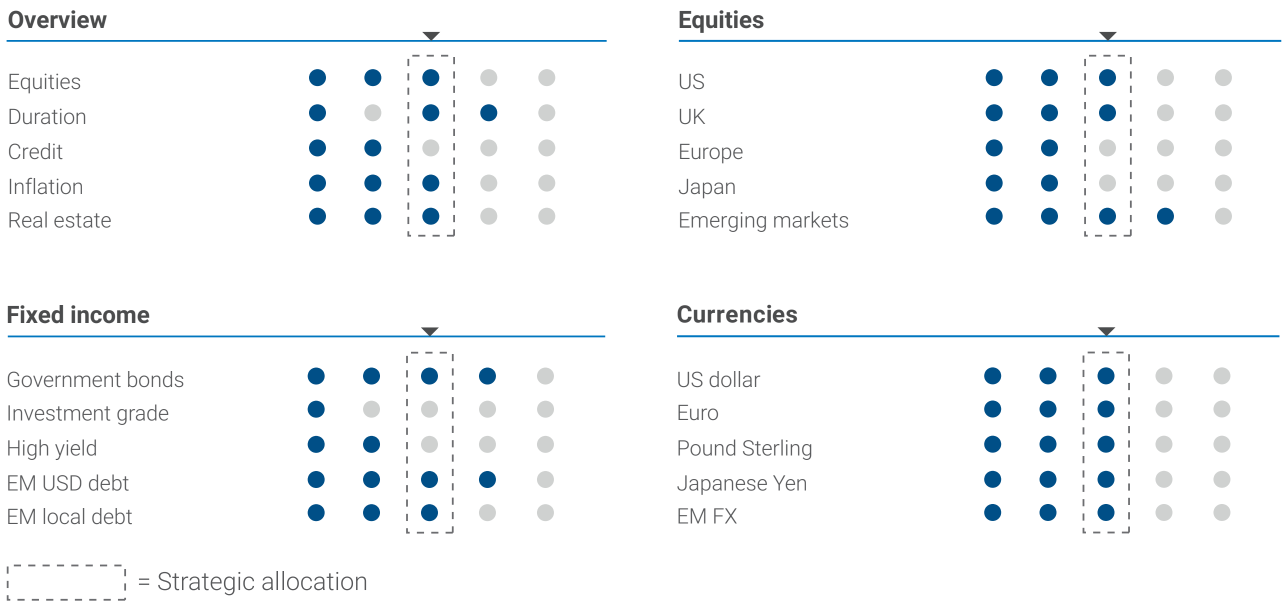
In the wake of the turbulence, it was striking that government bond yields remained significantly lower than in the second quarter. The market was saying that looser monetary policy over the medium term is the necessary condition for an ongoing expansion.

We believe the sudden selloff was indicative of how uniformly investors had bought into a benign economic outlook. The build-up of similar positions, most notably in high-yielding emerging market currencies, created a vulnerability. Some, but not all, of this froth has now been removed by the injection of volatility.

There was also a noticeable change in how assets interacted during this episode. Selling across equities and credits was accompanied by a strong rally of perceived safe-haven assets, such as government bonds. Unlike the broad-based, inflation-induced selloff in 2022 that dragged both equities and bond returns lower – kryptonite for multi-asset portfolios – this more classical growth-driven selloff saw government bonds cushion the blow by moving in the opposite direction. We believe that with the increased focus on economic growth risks, this negative correlation between bond and equity returns will be sustained.

Taking all this together, we remain neutral equities, and express our cautiousness by being underweight credit and long duration. We have taken some profit in the recent fall of interest rates, but still think there is more to come in terms of lower real yields.

Our key asset allocation views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of September 2024. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. Regional equity views should be read in conjunction with the overall equity view. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Active Fixed Income

Never mind the ballots

The muted reaction to this November's election may not last.

Jason Shoup
CIO, LGIM America, and
Co-Head of Global Fixed Income

"The potential for November's election to create significant market volatility increases should the outcome be a sweep by either party."

After a summer where it has been anything but politics as usual in the US, the race for the White House is back to being a veritable coin flip. At a high level, risk markets have seemingly yet to take much notice of the pre-election gyrations, although there are signs of sector rotations and reflation trades beneath the surface.

However, the muted reaction may not last. Against a backdrop of slowing economic growth and an impending fiscal cliff, the upcoming election is poised to be especially important for markets, particularly if the result is a sweep by one party.

In one sense, not much has changed over the past three months. In the period since Kamala Harris became the presumptive Democratic nominee, both polling and prediction markets have shifted significantly in her party's favour. However, over a longer timeframe, the odds for various outcomes (Republican sweep, Democratic sweep, or divided government) remain largely unchanged from June – before the first presidential debate, when Joe Biden was still leading the Democratic campaign.

Not surprisingly, most of the market's focus has been on a second 'Trump trade', with many economists and strategists publishing detailed views on his trade, immigration and tax-cut proposals.

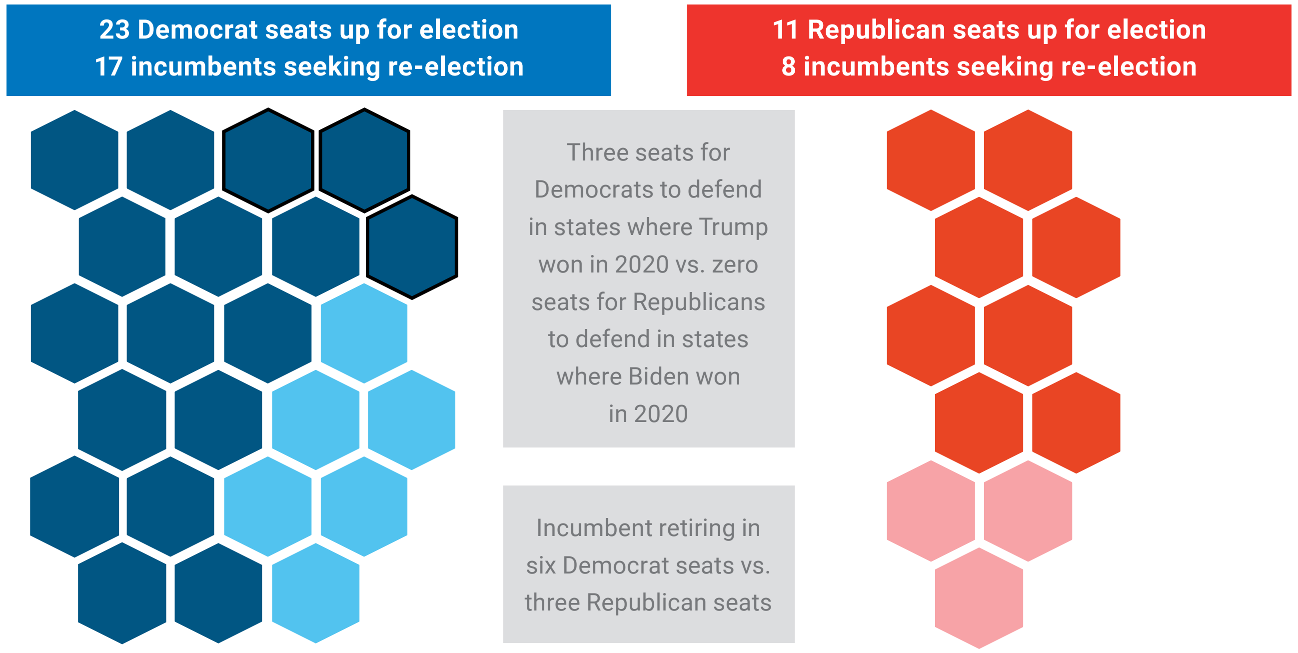
The Harris trade

In comparison, there has been relatively little attention on a corresponding 'Harris trade', with investors likely assuming a continuation of the Biden agenda should she prevail. However, that could be a mistake given that Harris has not fully outlined her policy platform. The one policy Harris has recently promoted – taxing unrealised capital gains for the 'ultra wealthy' – indicates she is willing to depart from the programme of the previous administration.

The government's budget deficit is a central issue in American politics. However, it may not be much affected by either a Trump or Harris trade. Neither candidate has expressed a preference for fiscal austerity: Harris is advocating for higher social spending, while Trump is expected to push for an extension and possible expansion of the Tax Cuts and Jobs Act, which is set to expire in 2025.

As a result, the potential for November's election to create significant market volatility increases should the outcome be a sweep by either party – an outcome that appears more likely than not, given the long-term decline in split-ticket voting and the observed correlation in polling errors. Furthermore, there is every reason to think the next administration will find it easier to pass more partisan legislation as the willingness to eliminate the Senate filibuster has increased alongside a steady decline in the numbers of centrist members such as Senators Sinema of Arizona and Manchin of West Virginia.

Senate map heavily favours Republicans in 2024



Source: https://www.senate.gov/senators/Class_I.htm; as at August 2024.

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

A tough in-tray

Whoever wins, the next president will likely face a growing set of challenges next year. Immigration has slowed significantly over the summer; both candidates now advocate for stricter border enforcement. Politics aside, fewer immigrants will create headwinds for consumer demand and labour supply. Meanwhile, the next president will also find it difficult to replicate the fiscal tailwind created by the Inflation Reduction Act and CHIPs Act.

Regardless of the election outcome, 2025 is shaping up to be a more challenging year for the US economy than 2024 has been. Markets may be taking a sanguine attitude to the political events to come, but all the ingredients are present to produce the same sort of cross-asset volatility experienced in 2016 – but with far less certainty over which direction risk assets might move.

Private Markets

Deglobalisation: potential amid pitfalls

Weakening global cooperation creates macroeconomic pressures, but also some select opportunities within private markets.

Lushan Sun
Private Credit Research Manager

We use the term 'deglobalisation' to describe a waning global integration of trade, capital flows, people, intellectual property and cooperation. The Russia-Ukraine conflict, plans to reduce immigration in Europe, and geopolitical tensions between the US and China are all prominent examples of catalysts supporting this trend.

In our view, a diverging world creates structural headwinds for some vulnerable sectors. It also provides opportunity for investment in new infrastructure as governments increasingly look inward.

An inflatable globe

Deglobalisation will likely, in our opinion, create inflationary pressures. Consider pushes to lower immigration in the US. Recent academic research[1] has shown that much of the country's post-pandemic job growth has been attributable to new immigrants. Curbing migration, therefore, may limit the size of the domestic workforce, driving up wages and thus inflation.

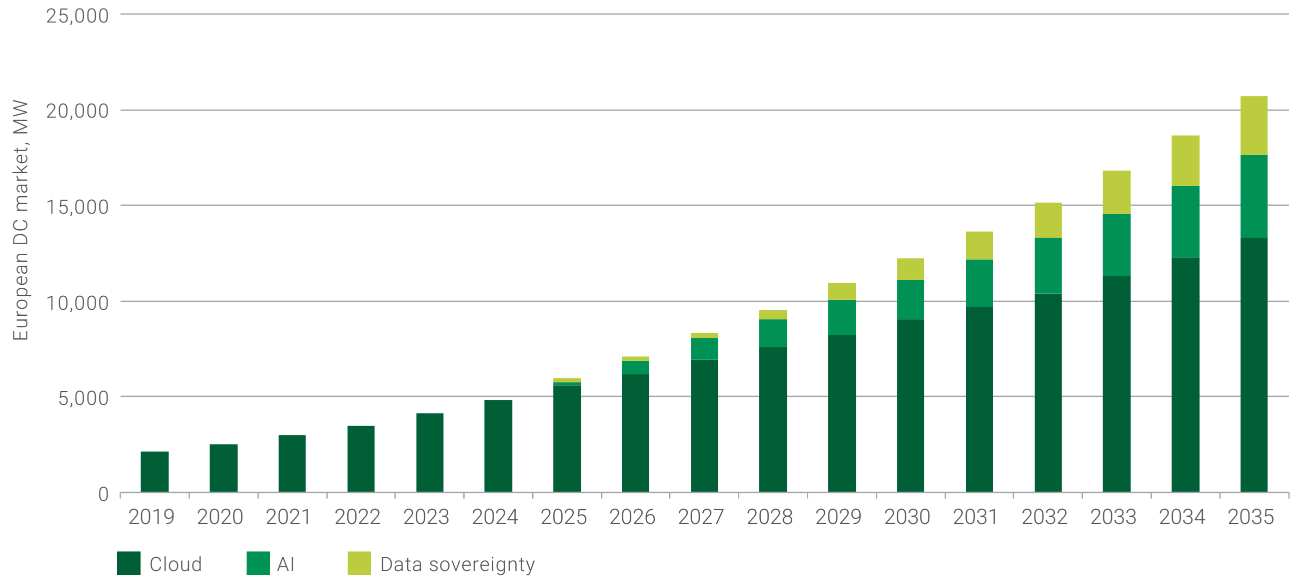
From a private markets standpoint, our view is that parts of the commercial real estate market are potentially vulnerable in the face of stricter immigration curbs. The office sector may see a hit to demand – a reduction in the international flow of talented employees may have a knock-on effect for corporate economics and the overall vibrancy of inner-city business districts.

It's also our view that higher-education institutions – frequent users of private credit – could face pressure as the number of international students wanes amid persistent deglobalisation. There's a real estate implication here too, with student housing often reliant on overseas students.

1. Source: The Brookings Institute, Net immigration estimates help make sense of the pace of the employment, March 2024

"A diverging world creates structural headwinds for some vulnerable sectors."

Data sovereignty to boost data centre demand in the long term



Source: Morgan Stanley Research, as at February 2024.

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Riding the tailwinds

Like many trends, however, deglobalisation also brings its opportunities. Disruption to supply chains, for example, may encourage investment in new technologies and infrastructure as the US and European countries seek a lesser dependence on China.

We believe the industrial real estate space could benefit here. Recent history has shown that where there are frictions in supply chains (such as those caused by Brexit or the pandemic) companies require greater storage as they switch from a 'just in time' to 'just in case' approach.

Another area to look out for is digital infrastructure as data security and sovereignty become increasingly concerning amid simmering geopolitical tensions. Demand for domestic data centre assets and interconnecting infrastructure will increase over the coming years, in our view. We think this, together with the increased digitalisation of social and economic life, should provide a tailwind to digital infrastructure assets.

Challenging assumptions

Taken together, these factors underscore the importance of reviewing the exposure of private markets portfolios against the attendant risks and opportunities. We favour a granular exercise – potentially down to the asset level – to fully capture the multi-faceted nature of deglobalisation.

The shift to a multipolar world order also, in our view, leads to changing correlations across markets and divergent policy responses. Investors need to test whether their existing risk and return assumptions still hold today.

Index & ETFs

Why the election won't decide the fate of clean energy investment

Clean energy policies or monetary easing could provide near-term tailwinds, but we believe the underlying economics will remain the real driver of progress.

Aanand Venkatramanan
Head of ETFs, EMEA

Michael Stewart
Head of Pooled Index Strategy

The starkly divided political landscape in the US might suggest continued investment into renewable energy hangs in the balance. We don't believe that's the case for one simple reason: economics.

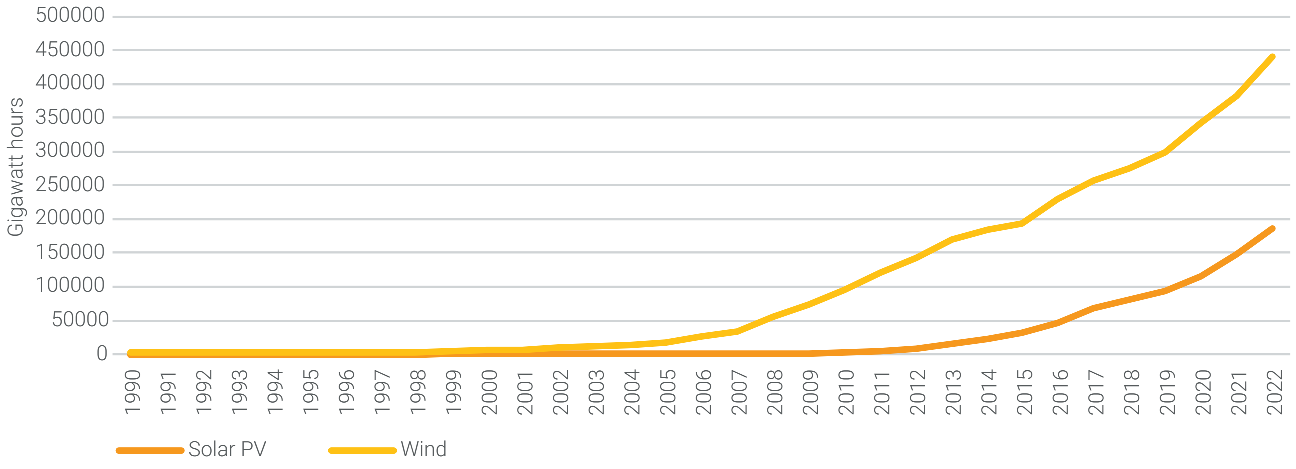
A Democrat win would promise a continuation of the potent legislative support for clean energy investment provided by the 2021 Bipartisan Infrastructure Law, the 2022 CHIPS and Science Act, and the 2022 Inflation Reduction Act. This would benefit the industry, driving capital via federal investment, loans and tax credits.

But what if the Republicans win?

Trump has made no secret of his antipathy towards renewables and his support for domestic fossil fuels.[2] Were he to win, we might therefore expect to see a similar reversal of US climate policy to that witnessed under the previous Trump administration, which culminated in the country's withdrawal from the Paris Agreement in 2017.

Given the rhetoric of Trump's first term, investors may be surprised to learn that the amount of electricity in the US provided by wind (onshore and offshore) and solar actually rose every year during Trump's presidency, with what was at the time record levels of generation seen across both (see chart).

Electricity generation by source, United States, 1990-2022



Source: Energy Statistics Data Browser – Data Tools - IEA, accessed 10 September 2024

2. Source: https://www.reuters.com/world/us/trump-would-axe-biden-clean-power-rules-speed-power-plant-approvals-campaign-2024-08-29/

Interest rates and financing costs

The cost of building new power-generation facilities is typically undertaken via a mixture of debt and equity. The power produced is then sold through power purchase agreements (PPAs).

While new PPAs incorporate higher funding costs brought about by the rise in interest rates, power producers with existing PPAs suffer lower margins in an environment of rising rates. That's because the receivables are fixed but payables (i.e. interest payments) can be variable. As a result, a higher cost of capital weighs on the energy sector just as it dampens activity throughout the wider economy.

While some governments have sought to offset the impact of higher rates on the energy transition with subsidies and the development of carbon markets, interest rates will continue to be a factor in the rate of investment in power-generation facilities, including renewables.

If rates fall as markets anticipate, this will provide a tailwind for clean energy producers with existing PPAs.

The economics of change

But beyond fluctuations in interest rates, a more fundamental shift in the economics of clean energy is transforming how the world gets its power.

Between 2010 and 2022, solar and wind power passed a crucial tipping point, becoming cost competitive with fossil fuels without the need for subsidies. Over this period, the global weighted average cost of electricity from solar fell 89%, making it almost a third less than the cheapest fossil fuel globally.[3]

The International Renewable Energy Agency estimated in 2022 that the renewable power deployed globally since 2000 saved an estimated US$521 billion in fuel costs in the electricity sector.[4]

Ultimately, we believe economics – not policy – provides the foundation for a clean energy future.

"Beyond fluctuations in interest rates, a more fundamental shift in the economics of clean energy is transforming how the world gets its power."

3. Source: Renewables Competitiveness Accelerates, Despite Cost Inflation (irena.org)
4. Source: ibid.

Solutions

Preserving funding levels as rates fall

With monetary easing cycles under way in developed economies and bonds once again providing potential insurance against equity risk, we believe that interest rate hedging could be key for DB schemes looking to maintain elevated funding levels.

Robert Pace
Senior Solutions Strategy Manager

Alex Mack
Head of Rates and Inflation

Funding levels[5] have continued to increase over the past year, with liability values helped by relatively range-bound yields and rallying equity markets and credit spreads boosting asset values.

On average, most pension funds are well hedged. However, within that average, individual pension funds may still be actively considering their level of hedging.

For some it could be an incremental increase to hedging (say 5% or 10%), while others could be considering their hedging basis in light of their long-term goals and whether to strengthen the basis.

Other schemes could be contemplating the hedging of a surplus, while some may simply not have increased their hedging yet given their goals and strategy, or because it has not been their top priority.

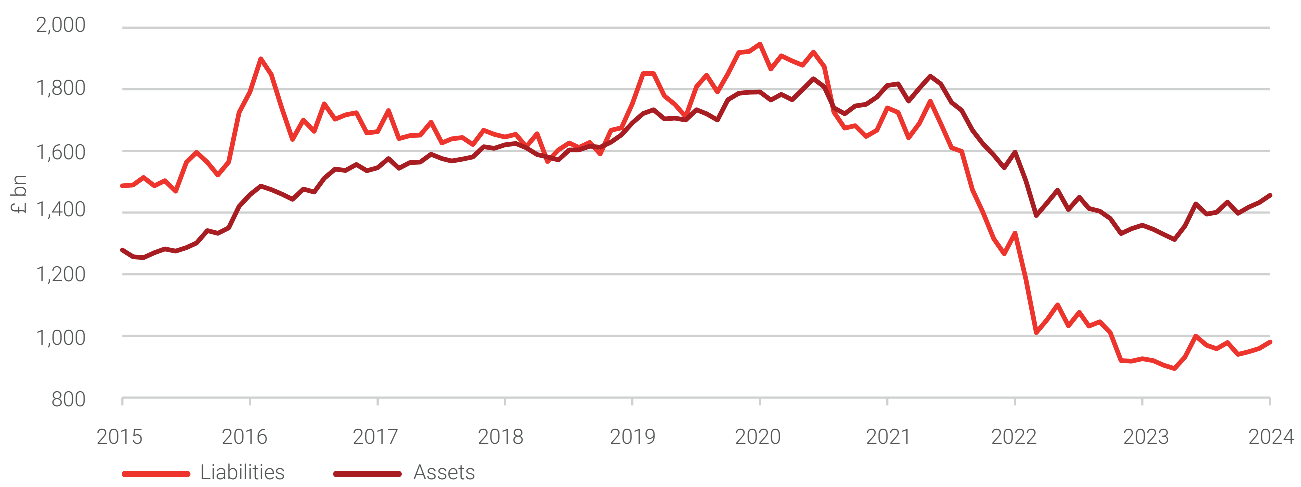
For those considering the current environment for rates (and inflation), our Rates and Inflation team believes that there is room for UK yields to fall from here, even though there are risks in both directions.

Ultimately, therefore, for pension schemes with lower leverage, we think this could potentially still be an attractive entry point to increase hedging levels.

Value of insurance goes up, price goes up

While much of this CIO update has a US election theme, it's worth acknowledging the recent period of political stability in the UK (for now). A diverse set of investor groups has bought 'all the gilts' to date, including a substantial increase from overseas investors. However, it's also important to acknowledge that the UK is a small fish in a big pond. Directionally, global forces dominate.

Asset values continuing to outstrip liability values



Source: PPF7800 Index, as at August 2024. **Past performance is not a guide to the future.**

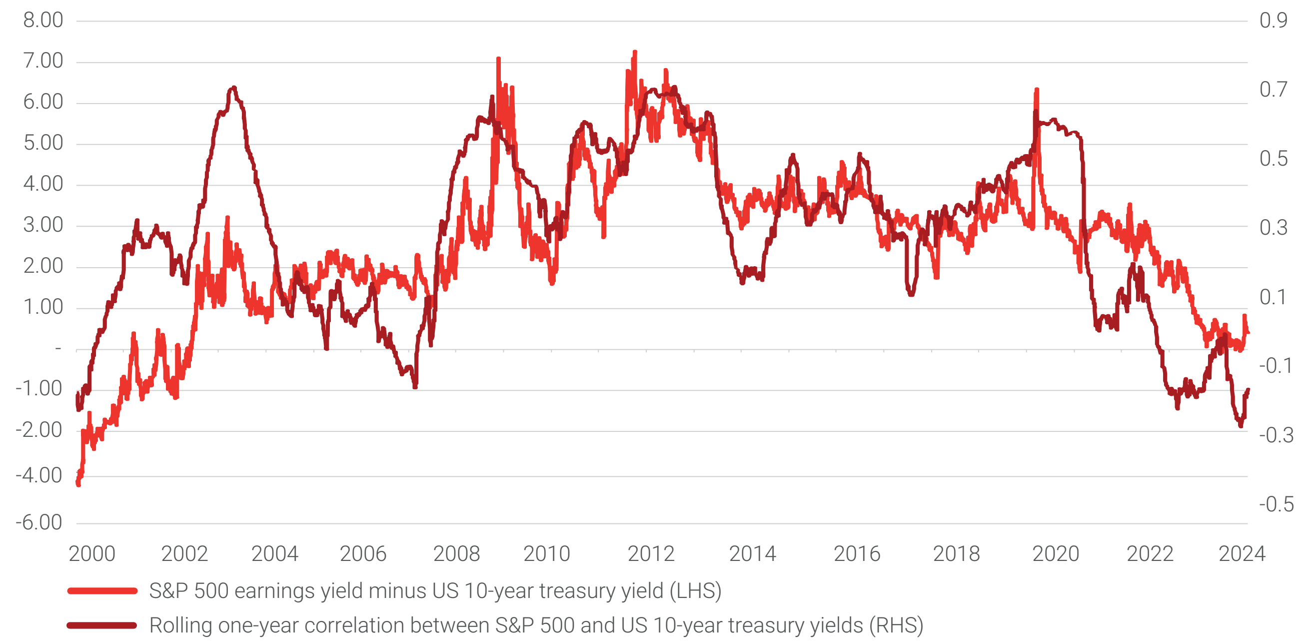
5. Source: PPF7800 Index

Inflation, particularly in the US, has declined in such a way that investors are no longer scared of high inflation. Against this backdrop, we think there's room for yields to fall as investors fall back in love with the potential insurance that bonds can provide. In our active funds, we remain overweight, positioned for lower yields.

If bonds act as insurance for equity drawdowns, it stands to reason that they should trade with a premium. We can see this in the following chart.

Comparing yield differentials with bond-equity correlations

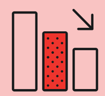
When the correlation between bonds and equity returns turns negative (when bonds offer good insurance for equity risk), yields on bonds tend to fall relative to yields on equities



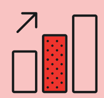
Source Bloomberg and LGIM analysis, as at August 2024. **Past performance is not a guide to the future.**

As we look towards year-end, with lots of lower-inflation data in the bank, we think it's hard for investors to get concerned about high inflation. We therefore believe there's plenty of scope for bonds yields to fall relative to equity yields, and so we continue to tilt our active portfolios towards being prepared for lower yields.

Let's contrast two periods in the chart:



Period 1: During the low-inflation period of 2000-2020, bonds generally provided good insurance during periods of equity drawdowns. As investors recognised this insurance value, bonds became more expensive relative to equities. In other words, the yield on bonds remained significantly below the yield on equities (earnings/price)



Period 2: As fear of high inflation picked up post-COVID, however, bonds provided poor insurance. In fact, bonds and equity market returns generally went up and down together.During this period, bonds cheapened relative to equities, or, put another way, the yield on bonds rose towards the yield on equities

Key risk
The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.

> "We think there's room for yields to fall as investors fall back in love with the potential insurance that bonds can provide."

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

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Key risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

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