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Weekly Briefing

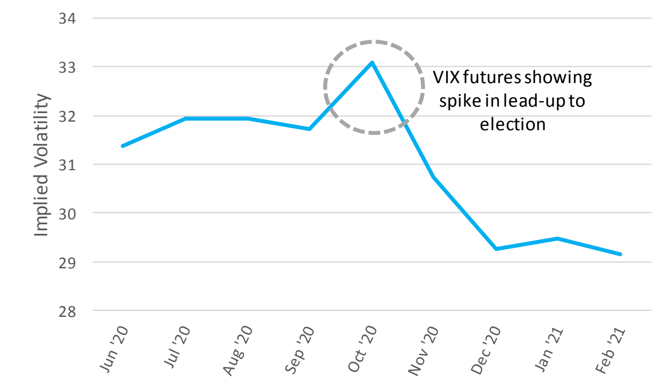
SKYView: 2020 US Presidential Election

Risk assets have been volatile over the last several days, with 2020 US election concerns once again rising to the fore. In addition to recessionary conditions and climbing COVID-19 cases amidst a tenuous economic re-opening, investors must now incorporate a wider range of potential election outcomes given a precipitous fall in prediction market odds of an incumbent victory. In this *Weekly Briefing*, we discuss factors influencing investor sentiment, examine updated polls following an uptick in trade tensions and civil unrest, and consider how differing policy priorities among Republicans and Democrats may impact various segments of the high yield market.

Prediction markets and more traditional polling data point toward a close race, with a post-coronavirus reopening and signs of an economic recovery presumed necessities for a successful Trump re-election bid. Further clouding the election picture is a wave of civil unrest across the country, perhaps the worst seen in decades. Unsurprisingly, investors expect an uptick in market volatility closer to the November 3, 2020 general election date (left chart below). Additionally, a recent survey conducted by RBC Capital Markets (right chart below) found that the 2020 US election is now the dominant driver of investor worries and ranks second in a list of events that would likely cause a pullback in US equity markets.

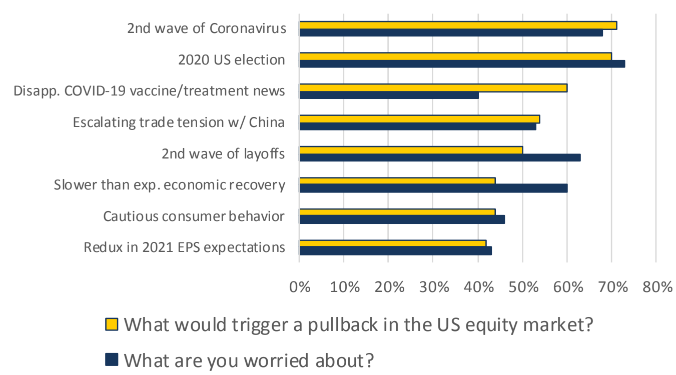
VIX Futures Imply Election Volatility

data at June 23, 2020



RBC Survey: 2020 Elections Cause for Concern

June 2020 investor survey

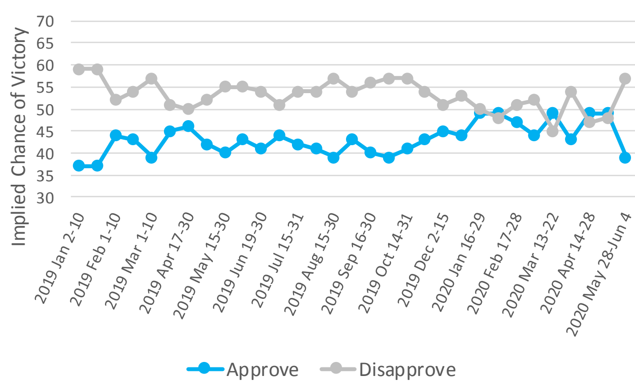


Source: SKY Harbor, RBC Capital Markets, Reuters, Bloomberg

A strong economy and US-China trade progress caused President Trump's approval rating to modestly increase between Q4'19 and January 2020, ultimately hitting 50% for the first time since August 2018. However, his perceived (mis)handling of both the coronavirus outbreak and, later, nationwide protests following the death of George Floyd quickly reversed what had been an upward trend. Over the last three weeks, former Vice President Biden - who formally clinched the Democratic nomination in early June - has expanded his lead over the incumbent according to prediction markets.

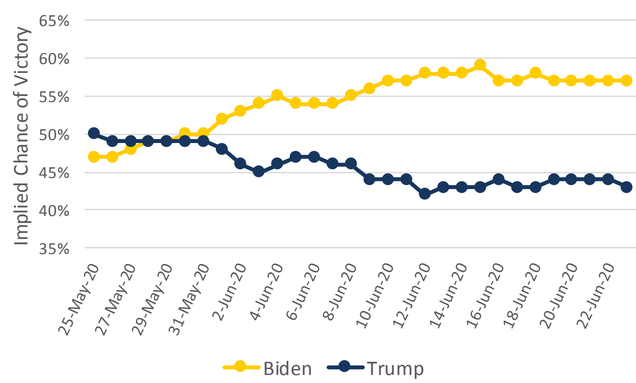
Trump Approval Rating Declined Sharply Late May / Early June

data at June 23, 2020



Biden Has Expanded Lead in Recent Polls

data at June 23, 2020

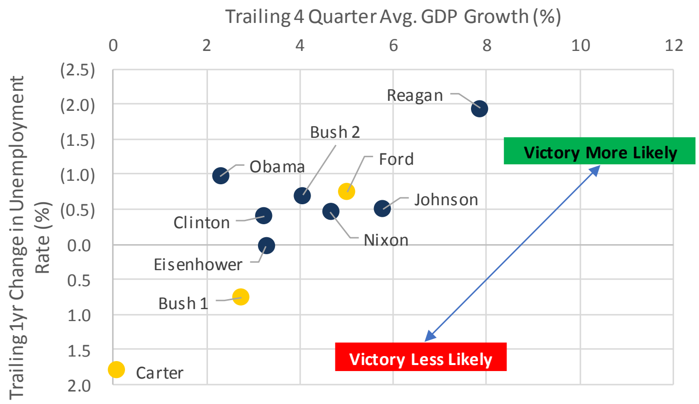


Source: SKY Harbor, Gallup, PredictIt.org

To better gauge Trump's likelihood of success in November, we looked back at all instances since 1956 when an incumbent sought re-election. Though admittedly far from a robust data set (10 observations), we do find evidence to suggest that changes in the unemployment rate and average quarterly GDP growth (we measure both in the 12 months leading up to an election) appear key factors in the decision-making process of the electorate (Ford seems to be an outlier). This data, along with differing perceptions of candidate strengths (Biden more trusted on healthcare, Trump more trusted on the economy), gives further credence to the notion that a successful re-opening of the economy could be the deciding factor for Americans as they head toward the polls in November.

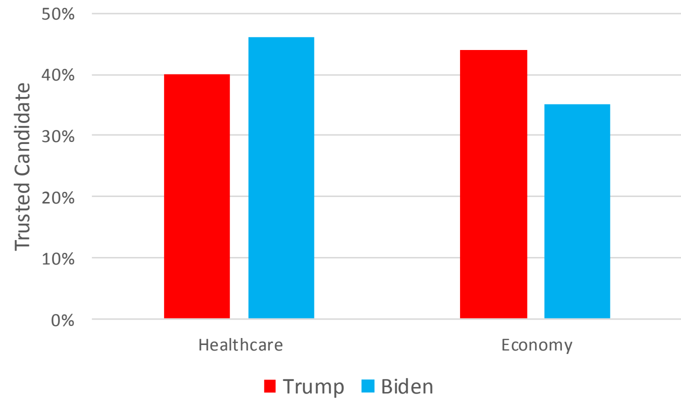
Strength of Economy Impacts Incumbent Chances of Success

blue dots denote incumbent victory, orange denotes incumbent loss



Evolution of COVID-19 Paramount Given Candidate Strengths

POLITCO/Morning Consult Poll: Who do you trust more to handle the following issues?



Source: SKY Harbor, Bureau of Economic Analysis, Federal Reserve Bank of St. Louis, Bloomberg, POLITICO/Morning Consult, Morgan Stanley

In an effort to simplify potential election day outcomes, we present a scenario analysis below segmented into two broad groups – divided government and unified government – and then nuance one step further by simulating both slim party victories and sweeps. Under the US system of separation of powers, it is logical to assume a greater likelihood of broad/sweeping changes in a unified government scenario, as both the executive and legislative branches are (presumably) aligned with regard to priorities. The opposite is true of divided governments, which often result in policy gridlock for all but bipartisan issues. At present, Republicans maintain a narrow majority in the Senate, while Democrats maintain a narrow majority in the House of Representatives, all of which make the range of possible November election outcomes more disperse.

According to prediction markets through the time of writing this piece (June 25, 2020) – which take into account trends associated with individual seats up for election in November – scenarios that what we label “Dem Sweep” and “Slim Biden Victory” score most probable, while our scenario “Rep Sweep” scores least probable.

US Government Scenario Analysis

at present, "Dem Sweep" and "Slim Biden Victory" most likely, "Rep Sweep" least likely

	Divided Government		Unified Government	
	Slim Trump Victory	Slim Biden Victory	Dem Sweep	Rep Sweep
White House	Republican	Democrat	Democrat	Republican
Senate	Republican	Republican	Democrat	Republican
House	Democrat	Democrat	Democrat	Republican

Source: SKY Harbor, Morgan Stanley, PredictIt.org

Unified Governments Could Lead to Greater Change

potential initiatives under Dem or Rep unified government

Democrats	Rollback of 2017 corporate tax cuts (went from 35% to 21%)
	Rollback of individual tax cuts (top rate went from 39.6% to 37%); could go higher
	Expand healthcare coverage / benefits
	Funding for climate changes
Republicans	Additional tax cuts, perhaps Tax Cuts and Jobs Act (TCJA) 2.0
	Infrastructure plan

Issues likely to garner the most attention in this election season include healthcare, taxes, regulations, trade, and immigration. With regard to healthcare, a “Slim Trump Victory” probably results in maintaining the status quo, as Republicans likely won’t have the numbers to attempt another repeal of the Affordable Care Act (ACA). A “Rep Sweep” could entice Trump to seek a further reduction in government involvement in the healthcare system, but prediction markets put the odds of a GOP White House, Senate, and House very low. Biden is expected to protect the ACA and will likely attempt to expand coverage, though a Medicare-for-all plan pushed by Sen. Bernie Sanders is likely off the table. Biden has also hinted at reversing Trump corporate and individual tax cuts, with higher earners likely to be the most negatively impacted. Republicans would likely extend the Tax Cuts and Jobs Act (TCJA), preserving, among other things, the reduction in corporate taxes (from 35% to 21%), and could push for a second round of cuts. From a regulatory standpoint, Trump has already rolled back the Clean Power Plan supported by President Obama and has committed to the withdrawal from the Paris Climate Agreement. If Biden is elected, he is likely to rejoin the Paris Climate Agreement, and has previously stated his intention to target net-zero emissions by 2050. Financial system oversight and regulation is likely to be stepped up under a Democrat victory, and re-implementation of Glass-Steagall appears possible. With regard to Energy, regulations will likely be relaxed further under Republicans, while Democrats have raised the idea of preventing fracking on federal lands. Both parties claim to be committed to a firm approach with regard to China and trade relations, though popular thinking is that Trump is more likely to strike a hard-line tone.

Key Candidate Issues That May Impact US High Yield Sector Positioning

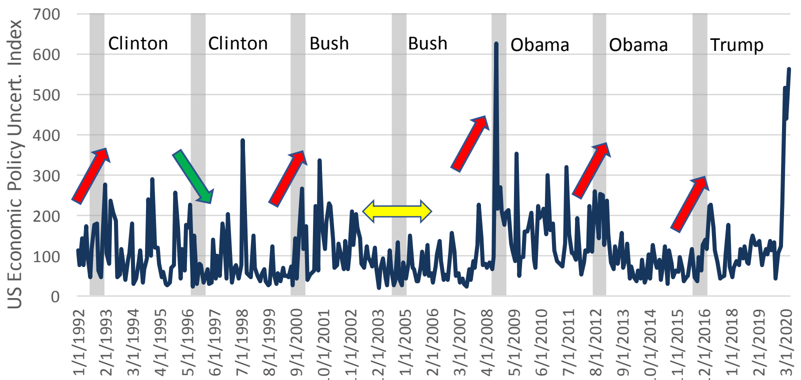
	Trump	Biden
Healthcare	Will likely continue to reduce government involvement	Plans to protect ACA and expand Medicare / public options
Taxes	Likely to extend Tax Cuts & Jobs Act (TCJA)	Likely to push for higher corp. and upper-tax-bracket individual rates
	Could push for tax cuts 2.0	Could eliminate SALT cap
Regulations	Rolled back Pres. Obama's Clean Power Plan	Has stated intention to target net-zero emissions by 2050
	Committed to withdraw from Paris Climate Agreement	Committed to rejoining Paris Climate Agreement
	Lower oversight in general	Greater oversight of financial services/markets and tech
Trade	Committed to a more firm appoach to China	Also committed to a more firm appoach to China
Immigration	Tougher border security; more stringent immigration	Pathway to citizenship for undocumented workers

Source: SKY Harbor, Morgan Stanley

Given the vast differences in politics and ideology between President Trump and former Vice President Biden, we think an increase in the policy uncertainty index is likely to occur, particularly if unified government under a “Dem Sweep” remains a credible scenario. As we have discussed in the past, the US Economic Policy Uncertainty Index has proven to be positively correlated with US high yield spreads over time. The index - which tracks newspaper publications for key words like "economy," "uncertainty," "legislation," "deficit," "regulation," and other factors related to policy changes – has historically risen during presidential election years (5 of the last 7). Below, we highlight the direction of policy uncertainty readings in the four months immediately before and after the last seven presidential elections. Upon further statistical analysis, we find a higher degree of correlation – and, therefore, greater implied sensitivity to rising uncertainty – in cyclical vs. defensive sectors, large vs. small issues, intermediate (4 to 6) duration vs. short duration (0 to 2) bonds, and B-rated securities vs. BB and CCC (for this, we think CCC largely trade based on idiosyncratic factors, while BBs are more insulated from volatility, thus making single-Bs most sensitive to policy uncertainty on the ratings spectrum).

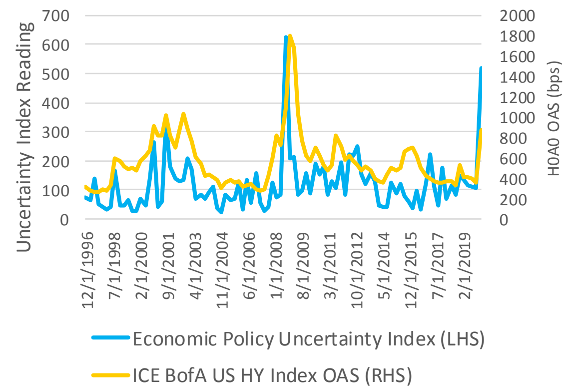
US Elections Likely to Increase Economic Policy Uncertainty (EPU)

monthly data, shaded areas represent the period 4 months prior to and immediately after elections



EPU Positively Correlated to US High Yield (H0A0) OAS

quarterly data

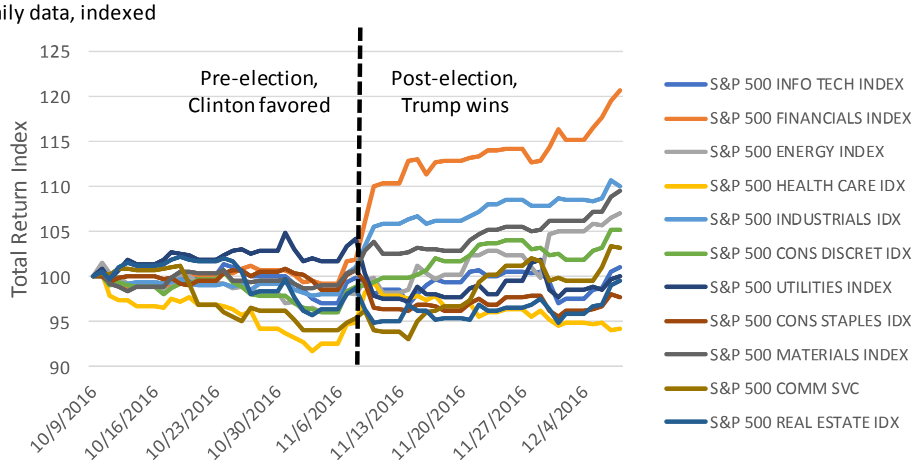


Source: SKY Harbor, Baker, Bloom & Davis, Bloomberg, ICE BofA Indices

Deciphering sector winners and losers has proven to be a more difficult task, but we believe the framework presented below provides a reasonable starting point for the 2020 election. In the last presidential race, former Sen. Hillary Clinton enjoyed a consistent advantage – often several points or more - over Donald Trump in polls published during the month leading up to election day (November 8, 2016). With this in mind, we can reasonably assume that most investors positioned their portfolios for a Clinton inauguration, thus necessitating an investment thesis re-set following Trump's surprise victory. As such, we compared S&P 500 sector performance in the month leading up to and the month following the general election. After beta-adjusting sector returns relative to the S&P 500 Index, market fluctuations imply Energy, Consumer Discretionary, Financials, Industrials, and Materials as likely beneficiaries of a Trump victory, while Energy and Healthcare are likely at-risk should Biden prevail.

US Equity Performance Around 2016 Election

daily data, indexed



Beta-Adjusted Sector Implications

S&P 500 sector returns 1 month pre and post-election

Trump Victory	**Biden Victory**
Presumed Winners	Presumed Losers
Energy Consumer Discretionary Financials Industrials Materials	Energy Healthcare

Source: SKY Harbor, Standard & Poor's, Bloomberg

The view on Healthcare remains in flux given sensitivity to an admittedly large range of election outcomes, but we attempt to further frame the discussion below by breaking the sector down into industry constituents. Healthcare Facilities, the largest subset of Healthcare (41% by face value), appears to have been negatively impacted by the implementation of the ACA. As demonstrated below, EBITDA margins - generated using an equal-weighted average of industry constituents with public financials – declined after initial ACA implementation in March 2010. Additionally, we would note that these constituents rank among the larger competitors in the space and were theoretically better positioned to handle insurance coverage expansion. A study conducted by Navigant[1] analyzed 104 health systems (~ 47% of US hospitals, including small / private facilities, most of which reside outside of our index) and showed that system operating margins dropped by nearly 39% in the two full years following ACA coverage expansion. In our view, Healthcare Facilities could potentially be winners in a "Rep Sweep" should the ACA be repealed, though our enthusiasm is limited by prediction market implications that such an outcome is becoming increasingly unlikely. More likely, however, is the prospect of a "Dem Sweep," which could further pressure facility margins upon ACA expansion.

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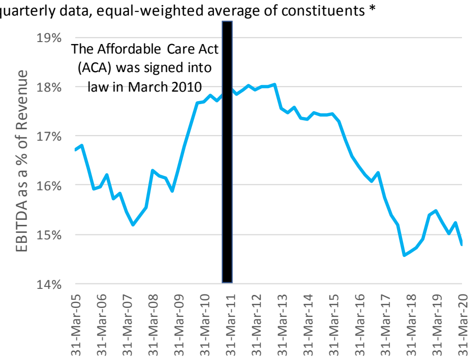
[1] https://guidehouse.com/-/media/www/site/insights/healthcare/2018/hsfinancialanalysisinfo.pdf

Additionally, we remain mindful of the precarious position Pharmaceutical industry constituents (22% of the Healthcare sector, the second largest industry) are in given the potential for bipartisan support of reducing drug prices. While politicians appear unwilling to attack pharmaceutical makers amidst the coronavirus pandemic, the risk could return after a vaccine comes to market. To highlight the tenuous nature of the industry, we present below (far right chart) the negative impact a tweet by Hillary Clinton had on the S&P 500 Pharmaceuticals ETF in 2015 ("Price gouging like this in the specialty drug market is outrageous. Tomorrow I'll lay out a plant to take it on. -H").

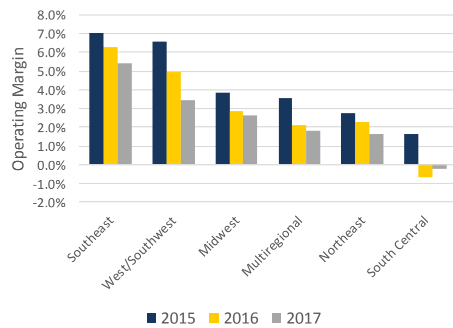
HY Healthcare Facility EBITDA Margins Down Post ACA

quarterly data, equal-weighted average of constituents *



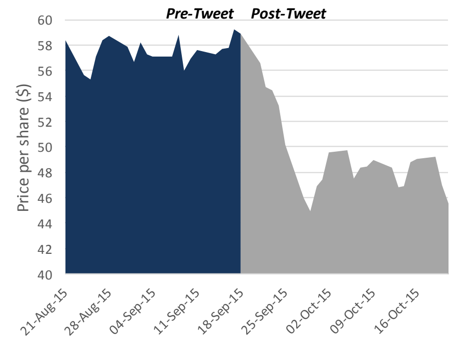
Impact More Severe After Including Smaller Systems

Navigant analysis of 104 health systems (47% of US hospitals)



Hillary Clinton Tweet Shows Risk to Drug Pricing

Price of SPDR S&P Pharmaceuticals ETF



*Healthcare Facility EBITDA margins calculated using an equal-weighted average of public industry constituents with at least 15 years of financial history; our data set includes Community Health, Encompass Health, HCA, Mednax, Select Medical, and Tenet Healthcare

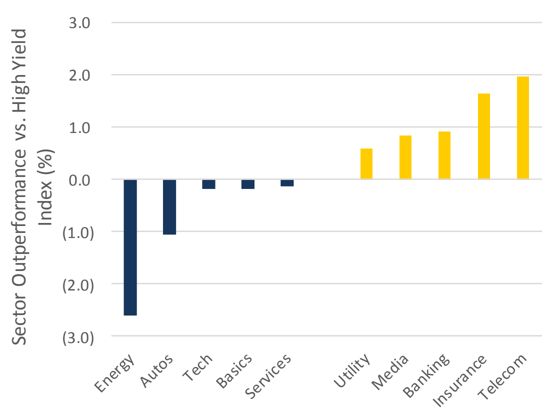
Source: SKY Harbor, ICE BofA Indices, Capital IQ, Bloomberg, Navigant, Twitter, company filings

Trade war escalation remains a significant risk on the horizon, with rhetoric ascribing blame for the coronavirus pandemic threatening to reverse all progress to date. Despite President Trump's insistence that the preliminary phase deal with China remains "fully intact" (minutes after top trade advisor Peter Navarro claimed it was "over"), market jitters have yet to subside. In an effort to isolate areas most at risk from a re-escalation of tensions, we analyzed sector returns relative to the ICE BofA US High Yield Index (H0A0) in May 2019, arguably the most significant period of trade uncertainty (it involved several provocative tweets and a failed trade delegation trip to Washington, and ended with each side instituting 25% tariffs on $200bn worth of goods). That month, Energy, Autos, Tech, Basics, and Services suffered the worst performance, while Telecom, Insurance, Banking, Media, and Utilities demonstrated the greatest resilience (left chart below).

As an alternative method, we also compared changes in the value of the Australian dollar to changes in industry-level spreads over time. The largest buyer of its commodities and representing its largest market for exports, Australia is highly tied to the well-being of China, and the AUD has tended to rise and fall in response to China's growth outlook (which is certainly impacted by trade negotiations with the US). As demonstrated below, commodity, tech, and auto industries are likely to be sensitive to evolving US-China trade tensions, while restaurants, insurance, telecom and medical products should be less impacted.

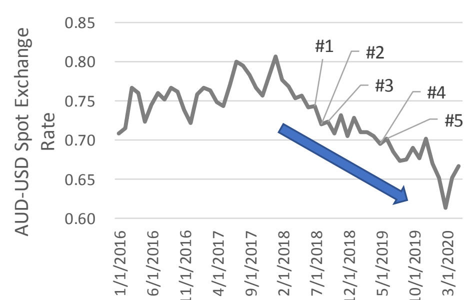
Sector Performance During May '19 Trade War Escalation

total returns in May 2019, sector less index



Australian Dollar a Proxy for US/China Trade Risk

monthly AUD data, tariff overlay



#1 = July 2018 tariffs (US $34bn, China $34bn)
#2 = August 2018 tariffs (US $16bn, China $16bn)
#3 = September 2018 tariffs (US $200bn @10%, China $200bn @10%)
#4 = May 2019 tariffs (US $200bn @25%)
#5 = June 2019 tariffs (China $60bn @25%)

AUD and Industry OAS Correlations

monthly data, January 2018 to May 2020

Most Sensitive to Trade War Tensions	
Energy - Exploration & Production	(0.81)
Automakers	(0.79)
Oil Field Equipment & Services	(0.78)
Tech Hardware & Equipment	(0.76)
Steel Producers/Products	(0.75)
Metals/Mining Excluding Steel	(0.74)
Least Sensitive to Trade War Tensions	
Restaurants	(0.33)
Multi-Line Insurance	(0.24)
Telecom - Wireless	(0.17)
Media Content	0.01
Cable & Satellite TV	0.11
Medical Products	0.15

Source: SKY Harbor, ICE BofA Indices, Bloomberg

In conclusion, we remain mindful that election results are not always accurately captured by polling data, but we see opportunities and risks for issues investors appear to have incorrectly valued relative to their cohort given the set of potential outcomes. Additionally, we recognize that healthcare and energy positioning will likely be a key factor in performance over the coming quarters due to their large size, above market yield (energy), and the profound impact differing party agendas are likely to have on the longer-term operating potential of sector constituents.

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