SanJac Alpha

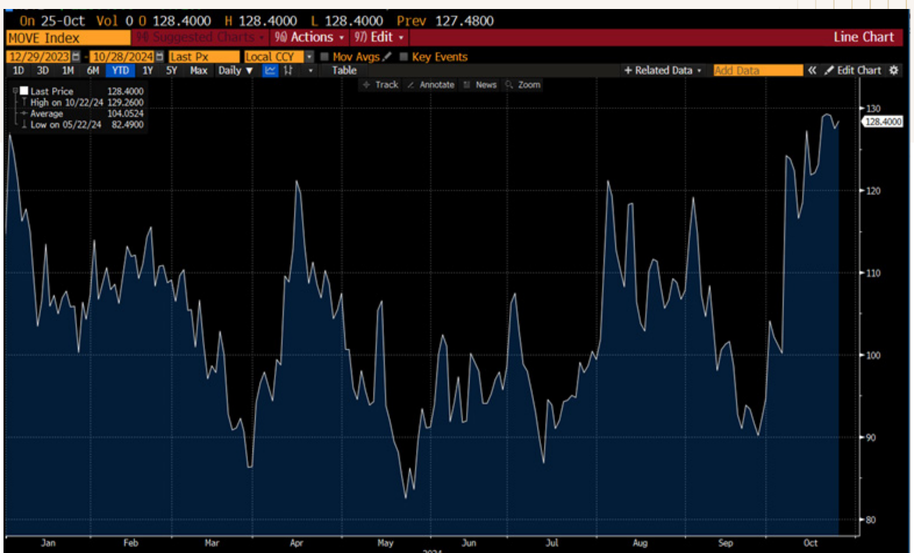
2024 Election Preview Special

Market Uncertainty

The upcoming U.S. presidential election between Kamala Harris and Donald Trump is causing significant market uncertainty. The MOVE index[1] (which measures Treasury market volatility) is at year-to-date highs, as expected before a major election. Current polling shows a dead heat between the candidates, with Trump having slight momentum in recent weeks. While betting markets favor Trump, these may be less reliable predictors than polls. The analysis suggests the race will be very close, with a slight edge to Trump winning the Electoral College.

As the U.S. presidential election approaches, financial markets are exhibiting heightened sensitivity to potential outcomes. The contest between Vice President Kamala Harris and former President Donald Trump presents distinct economic policy trajectories, each with implications for bonds and interest rates.

The MOVE index of the bond market, which measures the volatility of the at-the-money[2] one-month options in US treasuries, is at the year-to-date high. This is expected as the U.S. election, a major binary event[3], is one week away. Regardless of the outcome, it's likely volatility will subside from the highs once the election is determined.



Source: Bloomberg

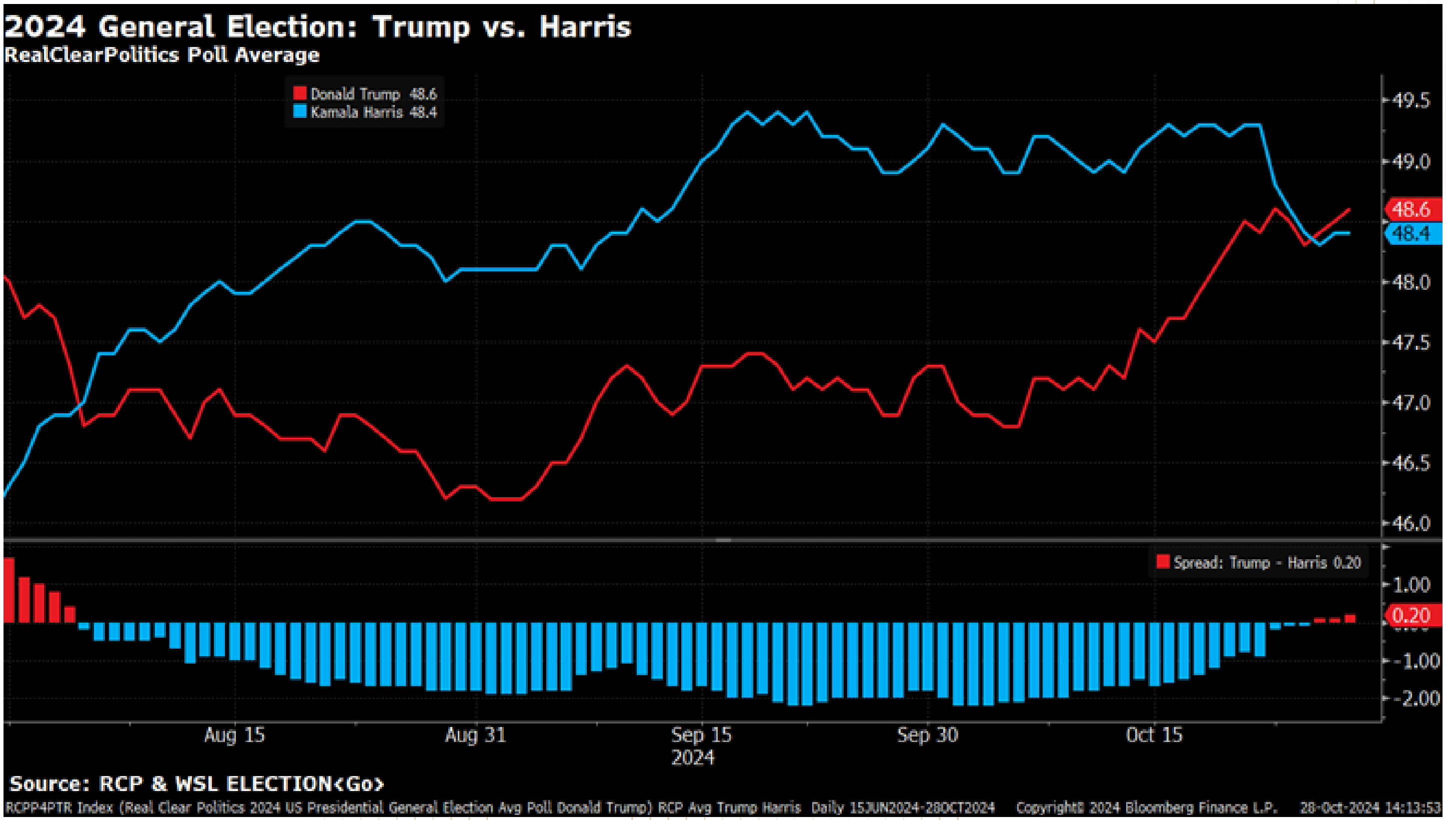
Keep in mind that any MOVE reading above 80 is considered high versus long term trends, so note that even this year's local minimums are still considered volatile. Fortunately, we know the risk but not the outcome—a true 'known unknown'—which allows for strategic positioning and risk management.

Historically, election cycles bring uncertainty, but the current environment—with persistent inflationary forces, a less certain Fed rate cut path, geopolitical volatility and an economy balancing on a fine line between growth and contraction—has added complexity. We continue to project above trend volatility in the MOVE index well into 2025 and beyond.

The current state of the polling, momentum and betting/prediction markets

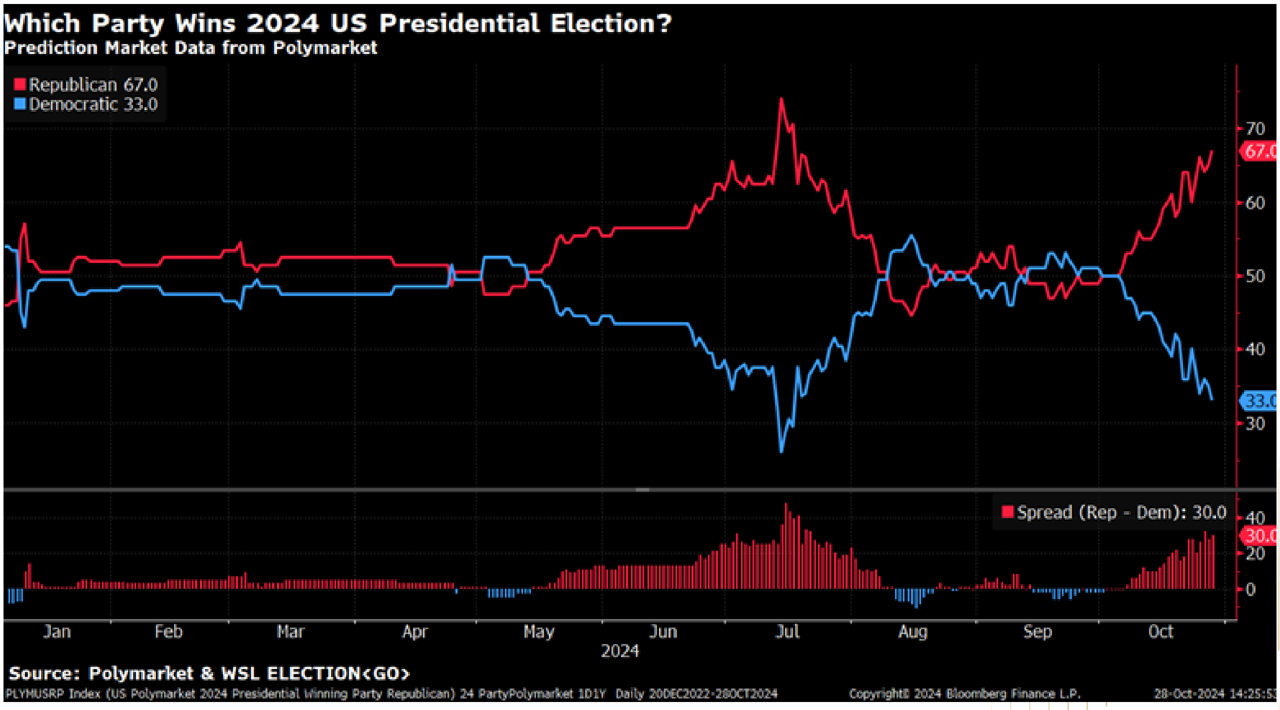
The polling markets show the candidates are in a dead heat race well inside the margin of error as represented by the latest Real Clear Politics Poll shown in the following graph:

While RCP does appear to show momentum in the past few weeks favoring Trump over Harris, it is important to keep in mind that polls have consistently shown a max spread between the candidates of 3 points, which most pollsters agree is still within margin of error for polls.



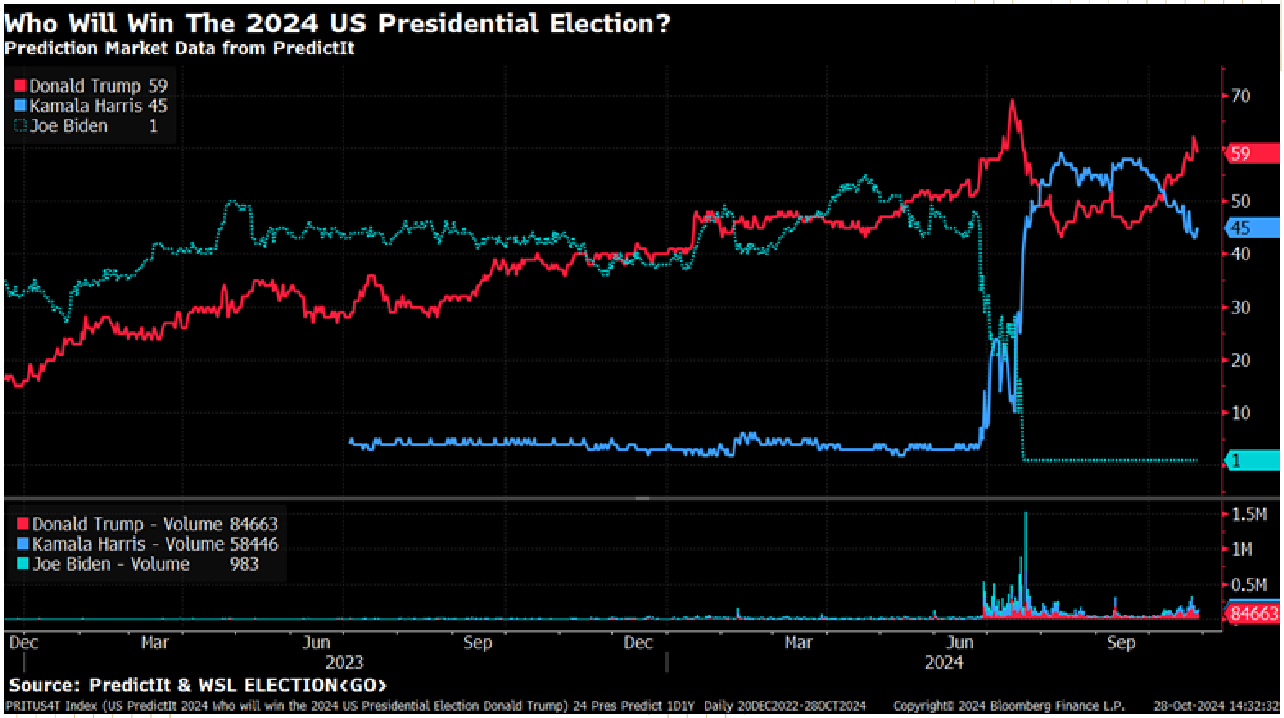
Source: RXP & WSL Election <Go>

Using Polymarket, a non-US but most liquid betting market, shows a marked increase in the probability of a Trump presidency.



Source: Polymarket & WSL Election <Go>

Using Predict-It, a US-based, but less liquid betting market, shows a similar trend but smaller lead for Trump.



Source: PredictIt & WSL Election <Go>

Our observations of both of these metrics as useful indicators are as follows:

Polls are not perfect, and have been inadequate in the last two presidential elections, but we believe they are still the best predictive tool available to gauge real voter intentions. Additionally, pollsters have learned lessons from the 2016 and 2020 elections to continuously improve the psychology of their questions. It was noted that the 2022 midterms saw polls make a comeback in their accuracy. Still, Trump is objectively outperforming his polls of 2016 (which showed him a 3 point underdog into his victory) and 2020 (which showed him a 6-point underdog into his defeat). In a too-close-to-call polling dead-heat we believe this does favor Trump.

As to the betting markets, and similar wisdom-of-the-crowds predictive techniques, we view these with caution as predictors of voter intentions. The case for them is that they are picking up an efficient real-time market that takes into account all available information. The other argument is that these are real investors placing real money on the line and much as sports betting lines are uncanny in their ability to predict game spreads, so may betting markets predict elections. Our case is that they are simply the average of certain people who have a disposition to betting on outcomes. We read the betting markets more as convention of wisdom as to what people think may happen, rather than a predictor of what may actually happen. We think they matter, and as a truly decentralized blockchain-based market, gives some valuable up to minute insights otherwise not captured elsewhere. They did, however, predict a red-wave in the mid-term congressional races in 2022 incorrectly, and as Trump generally under polls to his advantage, he seems to be far over-represented in the betting markets.

Conclusion: The race is likely to be very close – but with an edge to Trump winning the Electoral College.

How are rate markets expected to react?

Perhaps ironically, the markets tend to prefer a mixed government, where Harris or Trump may win but must contend with an opposition party controlling either the Senate or House of Representatives. We see this both as a most likely outcome, and as an antidote to high volatility in the rate markets.

As of today, based simply on the number of uncontested seats, the Republicans have a favorable path to 51 in the Senate and based on a strong polling and betting market indications, the Democrats have a favorable path to regain the House of Representatives.

As we pointed out in a previous market update, we projected that above trend inflation and a better-than-expected economy would drive Fed policy over the next few months. We believe this explains why several rate cuts have been removed from the Fed rate cut path as recalibration is less likely to take as many to get to neutral.

If either party wins a sweep of the presidency, House and Senate, we believe the market will price in a higher inflation expectation and rates will rise markedly in response. If there is a mixed congress to oppose the president (either candidate) we believe the rate market will view this favorably. We will maintain our call for a steepening of the curve, based on the Fed's muted yet persistent move toward a less restrictive posture. Barring a significant surprise in inflation readings the Fed path alone should deliver a bull steepening effect and we do believe that rates, especially near the 2-3 yr. points will calm and ratchet downward as the inflation-fear trade unwinds. Additionally, as equity markets trade near all-time highs, opportunities may arise for rotation back to bonds, with equity pricing potentially becoming untenable for some value investors.

Obviously there are a multitude of knock-on effects to either Trump or Harris winning the presidency, including the president's control over foreign policy (affecting commodity pricing), tariffs (impacting CPI), and border policy (influencing employment). This makes the upcoming election a historically significant event for markets.

Final Thoughts

As we approach Election Day, we maintain a very defensive stance against rapid rate moves post-election. We believe a barbelled approach in a roughly 60/40 blend of shorter dated treasuries out to 3 years vs investment grade credit positioned in the value segment of BBB[4]-A[5] with preference for mortgages which are at YTD highs in basis spread. This allocation allows credit and low-duration holdings to buffer against wild rate swings while seeking to capture ample carry on the front end of the flat rate curve and, in our view, an excellent risk-adjusted spread in IG credit and mortgages.

[1] **MOVE Index** - The Merrill Lynch Option Volatility Estimate (MOVE) Index reflects the level of volatility in US Treasury futures.

[2] **At the money (ATM) -** a situation where an option's strike price is identical to the price of the underlying security.

[3] **Binary event** - any sudden development which can dramatically move the market as a whole or a specific underlying.

[4,5] **Credit ratings** are used to determine which investments are less likely to default and yield a solid return.**BBB Credit Rating** - low expectation of default; business or economic factors could adversely affect the company; **A Credit Rating** - low default risk; slightly more vulnerable to business or economic factors.

[6]**Basis Spreads** - premiums and discounts on one side of a basis swap that make the swap into a fair transaction. The spread relates to the first two reference interest rates assigned.