Election Looming Over Near-Term USD Outlook

The US presidential election has kicked into high gear with the candidates participating in the first of three televised debates last night; the outcome of these high-profile events will certainly help shape expectations around who is likely to win in November. But there are other election issues at stake beyond the White House; here we consider three scenarios which appear to be the most likely of the possible outcomes of the race for the presidency, Senate and the House and the impact on markets.

A little over a month ago, we issued a note highlighting the USD's tendency to rise in the latter part of the calendar year with that trend amplified and brought forward in years in which US presidential elections are held, with gains usually starting in late August or early September. Since the start of September, the DXY has risen by about 1.5% at writing (after peaking around +4.2% last week).

The rebound in the USD follows an extended run lower since the middle of the year; the USD slide has coincided with President Trump's struggles in the polls which gives the appearance of FX markets taking a bearish view of the USD's outlook in the event of a Biden win. Meanwhile, the US stock market has tended to appreciate strongly in the past few months, regardless of the President's poor polling form which might suggest a degree of investor comfort with the idea of a Biden win.

This is all a bit too simplistic, however, and it is clear that the one common factor behind the USD slide and the gains in US equity markets over the past few months is the aggressive monetary policy easing unleashed by the Fed in response to the pandemic—as well as an overall faster-than-expected economic recovery. The USD rebound that has developed over the past 2-3 weeks likely reflects a somewhat oversold condition and investors lightening up on USD shorts ahead of the election.

We think there are three main scenarios which cover the more probable outcomes in the November elections (in no particular order):

1. President Trump wins the White House while the Republicans retain the Senate and the Democrats retain the House.

2. Former VP Biden wins the White House while the Democrats take the Senate and retain the House.

3. Former VP Biden wins the White House while the Republicans retain the Senate and the Democrats retain the House.

Scenario one reflects the status quo but may be challenging for risk assets as the prospect of rapid movement towards additional fiscal stimulus would look weak. The President may be encouraged to pursue aggressive trade policies—particularly against China and the EU—which might add to headwinds for risk assets and impact US business uncertainty. We think the USD may continue strengthening in the short run under this scenario—though gains would likely reflect risk aversion and a further squeeze on short USD positions before giving way to longer run weakness on the USD's loss of its yield and growth advantages. The global economy should also continue its ascent—albeit on a slower trajectory owing to heightened US-China tensions—which should boost commodity prices and related currencies.

Scenario two may be supportive of market sentiment; a Democratic sweep should herald quick action on fiscal relief and help lift risk assets. It may also lessen the risk of election litigation. Markets may be concerned by Biden's tax policies but the administration's priority is likely to be the economy rather than rebalancing fiscal policy. A roll-back of Trump's tax cuts or an increase in capital gains taxes may not come until the latter part of Biden's 2021-25 term. On the flip side, Biden's

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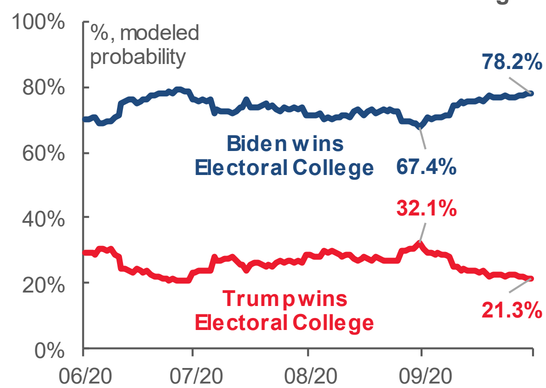
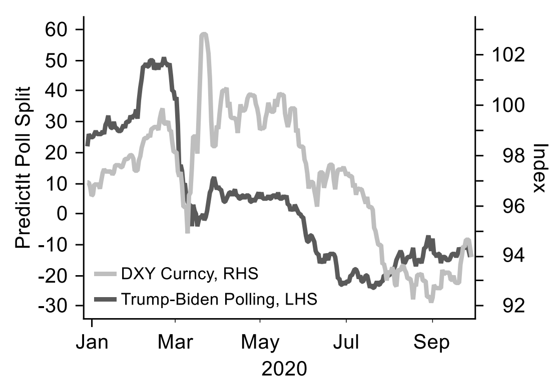
FiveThirtyEight Models Give Biden Close to Four-in-Five Chance of Winning



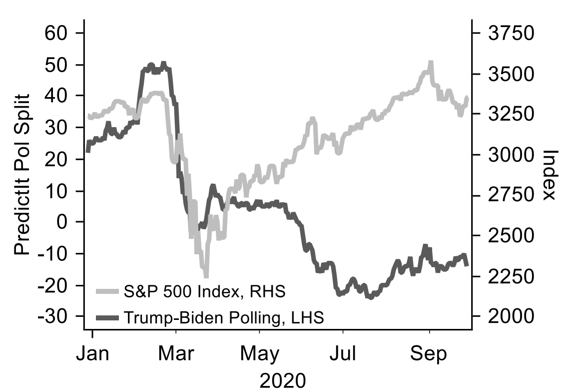
Source: FiveThirtyEight, Scotiabank FICC Strategy.

USD Sags Alongside Trump Polling ...



Source: Macrobond, Scotiabank FICC Strategy

... But Stocks Ignore Trump Lag



Source: Macrobond, Scotiabank FICC Strategy government spending policy would likely be more effective for economic growth in the medium-to-long run than Trump's. The USD may soften somewhat under scenario two amid reduced domestic and international political risks—although note that US-China frictions go beyond trade policy—but more responsible and focused fiscal policy may be more supportive for US growth and the USD in the longer run.

Scenario three may lead to a high degree of currency volatility in the short-run but ultimately be slightly supportive of risk assets; a Biden win should see trade tensions rolled back to some extent while the divided Congress will be a check on possible would-be material changes to tax policies that may act against equity markets. A move to normalize trade and security relationships should also boost business confidence and investment. However, near-term concerns would revolve around how quickly Congress could agree on fiscal measures to boost growth and, perhaps more especially in the election's immediate aftermath, whether Republicans/Trump litigate the outcome. A legal challenge to the election result would lift risk aversion and broader market volatility with the USD (counterintuitively) benefitting from short-term domestic mayhem against its risk-sensitive pairs—until the election is finally declared in Biden's favour. In the longer-run, however, a divided Congress would likely result in the return of foot-dragging disputes over spending and revenues that may see extended government shutdowns.

While we are considering the impact of the election on markets and the economy, the impact of the economy on the election should not be ignored. Research indicates that since the 1930s, the incumbent has not been re-elected if the US economy has experienced a recession in the two years prior to the vote. This tilts the risks towards scenarios two or three.

We think the election impact on FX markets may be relatively short-lived (although a contested outcome would clearly prolong uncertainty perhaps into the New Year). Near-to-medium term USD gains are still likely to give way to longer run USD losses as we move into Q1 2021 since the over-arching issue for the USD will remain relatively weaker domestic growth prospects and lower domestic yields. Investors are liable to fade a 2-4% rally in the USD around the election as Q1 develops.