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Does the US Election Even Matter? Thoughts on Politics, Fed Policy, and Portfolios

Markets seemed immune to election news early in the year, but the changing political landscape could have bigger implications.

In the first half of 2024, the impending US election and the Federal Reserve's (Fed) decision to delay rate cuts certainly made headlines. At times, though, markets hardly seemed to notice. As we move into the second half of 2024, investors are still grappling with some big questions about the policy path ahead and the impact of the election. To help, Head of Wellington's Multi-Asset Strategy Adam Berger and Wellington's Macro Strategist Mike Medeiros discussed the interest-rate outlook, some of the most critical election issues, and the asset-allocation implications.

Insight from sub-adviser, Wellington Management

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Interest Rate Outlook

Adam: Mike, let's start with monetary policy, which you, as a member of Wellington's Global Macro Strategy Group and Global Bond Team, spend a lot of time thinking about. What's your take on the interest-rate environment in the US?

Mike: I look at interest rates through two lenses. The first is structural, and it's based on my 12-24-month outlook for slower-moving factors such as trend growth in the economy, the average inflation rate, inflation volatility, and fiscal policy. Currently, those factors together suggest that while we've had a pretty material sell-off in the bond market over the last three years, it's not done yet. In fact, to get inflation down to 2% on a sustainable basis, I think we need an even greater level of restrictiveness from the bond market, with the 10-year Treasury yield closer to 6% or 7%. For me, that will be a very important anchor point to watch for in the battle against inflation over the next one to two years.

The second lens I use when it comes to interest rates is the cyclical backdrop. I'm always looking for alignment between structure and cycle, which is when markets tend to trend. When we don't have alignment, markets tend to be more rangebound. That's exactly what we've seen in the bond market over the last 18 months—it's been a wide, violent range because those structural forces are in place but there are cyclical headwinds. Growth is below trend, the unemployment rate is up more than half a percent off the trough, and inflation, while still elevated, is easing. Looking at the Fed's forecast through the end of this year, I think unemployment will end up higher than their 4% projection, I'd say closer to 4.5%. I also think their inflation forecast of 2.8% for the core Personal Consumption Expenditures (PCE) Index[1] may be too high.

Since the 10-year yield peaked at 5% about nine months ago, the bond market has been more engaged with these cyclical headwinds. It's been consistent with a soft landing, and I think that's still coming through. To clear some of the cyclical valuation gaps for the bond market, that would be consistent with 10-year yields closer to 3.75%. So, I think we'll still have that tension in the short term, between now and the election, which means yields will likely continue to grind lower. But I'm very much still watching for that alignment between structure and cycle, so that we can position portfolios for it when the time comes.

Key Points

- The bond market has been subjected to a misalignment between structure and cycle for the last 18 months, and we may see this tension remain in the short term.
- Differing approaches between parties to fiscal and trade policy, immigration, and regulation mean the election could have significant implications on the economy and markets.
- Timing could look very different after this election cycle as the structural backdrop is inflationary, term premium has started to rise in the bond market, and government debt has risen by trillions of dollars.

Adam: What will you be watching for in the second half of the year when it comes to the Fed's next steps?

Mike: For the Fed, it's really about their dual mandate. I think the bar for a dovish outcome relative to their current forecast is pretty low. The Fed forecasted just one rate cut in its updated projections at the June Federal Open Market Committee meeting. In the scenario I described earlier, in which core inflation is closer to 2.5% and the unemployment rate is closer to 4.5%, I'd expect the Fed to cut rates two to three times this year and the market to price in more cuts for 2025. But the outlook for rates could be altered meaningfully by the election outcome.

Elections are enormously important to the economy, particularly as it relates to fiscal policy.

Economic Impact of the Election

Adam: That's a good segue to the election. I sometimes hear from investors that elections haven't mattered much for the economy or markets, historically speaking. Do you think this one matters?

Mike: Yes, I'm completely on the other side of that argument. Elections are enormously important, particularly as it relates to fiscal policy. From a bond-market perspective, even midterm elections are critical. The bond bear markets of 1994, 2018, and 2022 ended within a week or so of the midterm elections, and all three of those elections represented shifts from full control by one party to divided government. Bond markets tend to love divided government and hate full control because of the fiscal implications.

So, I think the 2024 election could have significant implications, and I would highlight four key areas where there's a real contrast between the parties:

1. **Fiscal policy** – The plans put forward by both parties would materially increase the deficit and public debt. Under former President Donald Trump's plan, the deficit would increase by about $4 to $5 trillion over the next decade. If we assume Vice President Kamala Harris will have a similar plan to President Joe Biden's, the deficit would increase by about $3.5 trillion. So, there are no signs of fiscal responsibility, but Trump's plan would have the greater impact as a result of the tax provisions.
2. **Trade policy** – Under Harris, I would expect trade policy to be largely unchanged. Biden didn't alter any of Trump's tariffs or more protectionist measures, but he didn't propose new ones either. Trump has been very clear about an increase in tariffs: 10% across the board, including Canada and Mexico, with higher tariffs on some select goods and countries, particularly China. That would represent a material acceleration in protectionist trade policy, and all else equal, would add about a percentage point to core PCE next year—materially above the Fed's forecast.
3. **Immigration** – Immigration has surged over the last nine months. I think it's been very important in driving a soft landing by improving the supply side of the economy. I think immigration has actually peaked over the last few months and will continue to come down. Again, there's a clear contrast between the candidates, with no major changes likely under Harris but significant immigration restrictions and even deportations under Trump.
4. **Regulation** – Under Biden, regulations increased over the last four years, and I think we could expect more of the same under Harris. Meanwhile, Trump has proposed a very significant deregulatory environment across all aspects of government.

Adam: Taking all of the proposed policies into account, how would you expect the economy and interest rates to be affected?

Mike: All else equal, Trump's plan could lead to higher short-term growth but also much higher short- and medium-term inflation because of the trade, immigration, and fiscal proposals relative to Harris. If we see a Trump victory and a Republican sweep, I think we could see a reduction in the gaps between cyclical and structural valuation measures in a matter of months. And with a Harris victory, the market may start to price weaker growth as a result of the fiscal drag from the expected $2 trillion tax increase.

I think this means that the election could be a binary event for the bond market and the interest-rate outlook in 2025 and 2026. In other words, I'd expect a Trump victory and a Republican sweep to bring higher interest rates—perhaps 6% within six months—and a Harris victory and a Democratic sweep to bring lower interest rates.

We can debate the details and timing of the market reaction, however. The market consensus is that a Republican sweep could be very similar to what we saw in 2016, when bond yields rose but it was good for risk assets[2] as well. I'd take the other side: Over a longer horizon, I don't think that will be the ultimate reaction, largely because I think the world's a lot different than it was eight years ago. The structural backdrop has shifted to become more inflationary than disinflationary. The term premium[3] has started to rise in the bond market. Government debt has risen by trillions of dollars, and the market will be more sensitive to that going forward. I can envision a shorter period of time in which the reaction is similar to 2016, but given the backdrop I just described, I'm very skeptical about the longevity of that reaction.

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Adam: In terms of trying to gauge the election outcome, what are some of the key factors you're focused on, whether in the polling or the advantages held by each candidate?

Mike: Prior to Biden's decision to drop out, one of the remarkable things was the stability of Trump's lead in the swing states. His lead had been narrow and within the margin of error, but he had been leading in all seven of those states: Arizona, Georgia, Michigan, Nevada, North Carolina, Pennsylvania, and Wisconsin. The race has tightened considerably since VP Harris replaced President Biden as the Democratic nominee.

Relative to Biden, I think swing-state voters viewed Trump as a better steward of the economy, immigration, and trade, as well as foreign policy and national security. Inflation is another issue that's weighing in Trump's favor.

As an investor, I'm unrounding the core Consumer Price Index[4] each month to see whether it rose by a high 0.1% or a low 0.2%. But the average American doesn't think "inflation has come down from 6% to 3%." They think in price-level terms, and, on that basis, inflation is likely to remain a challenging issue for Democrats, even if we get a continued deceleration in inflation between now and the election.

As for Harris, I think there are two main issues working in her favor: stewardship of democracy and concerns around women's reproductive rights. The Democrats outperformed in the midterm elections and every special election since Roe v. Wade was overturned. I would also expect Harris to focus on some of the government investment programs implemented over the past four years, including the Inflation Reduction Act, the bipartisan infrastructure bill, and the CHIPS Act.

All that said, it's hard to have a lot of conviction in the outcome at this point given the high percentage of voters in the electorate who dislike both candidates. So those voters will ultimately be the key swing factor that determines the winner. The Senate is a little more straightforward: The Democrats have a very unfavorable map, and the Republicans either need to pick up two seats in the Senate if they lose the White House or one seat if they win the White House. With the House of Representatives, my bias in presidential election years is that it will tend to go toward the presidential winner, and I think that could be the case this time around.

Asset-Allocation Implications

Adam: Let me close with a few asset-allocation takeaways to consider.

- **Consider a wider range of interest-rate outcomes** – There's a tendency to focus on the here and now with markets, which, as Mike said, have been range-bound recently. The idea that we could have yields of 6%–7% is probably not on the radar for many investors, but I think it should be in the range of scenarios they're thinking about.
- **Have a plan to hedge portfolios if a more persistent inflationary regime is dawning** – Managing through an inflationary regime often requires a very different asset allocation, but one that may not be compelling if inflation doesn't come through. As I've noted before, investors may want to consider a glidepath or a checklist of sorts that allows for gradually tilting a portfolio as signs of higher inflation emerge over time. Planning for that today, before inflation rises, could make a lot of sense and doesn't necessarily require moving much capital around.
- **Find ways to be more nimble** – In a world with more volatility and uncertainty, investors may want to seek opportunities to be more nimble in portfolios. This could include global-macro hedge funds, tactical asset allocation strategies, or more tactical hedging when risk premiums[5] appear to be rising.
- **Stress test for a world of different stock/bond correlations** – With central banks potentially facing an extended battle with inflation, perhaps over several years or more, investors may want to stress test portfolios for less stable stock/bond correlations. We've had a long period dominated by negative stock/bond correlations, but I wouldn't assume that'll be the case going forward.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] Personal Consumption Expenditures Index (PCE) is a measure of the spending on goods and services by people in the US as determined by the US Bureau of Economic Analysis.

[2] Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

[3] The term premium is the amount by which the yield on a long-term bond is greater than the yield on shorter-term bonds. This premium reflects the amount investors expect to be compensated for lending for longer periods.

[4] Core CPI, or the Consumer Price Index, is defined by the Bureau of Labor Statistics as a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services excluding food and energy prices

[5] A risk premium is the investment return an asset is expected to yield in excess of the risk-free rate of return.

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