EM TACTICAL FOCUS

US ELECTION: A ROADMAP FOR EM BOND INVESTORS

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The main political event of 2024 is fast approaching. We take a closer look at how the US election might impact Emerging Market Debt (EMD) returns. We believe a Harris victory would be the most favourable outcome. However, the impact of various election scenarios will vary considerably across EMD segments. A Trump presidency is expected to make hard currency EMD outperform, while a Harris victory is expected to put local currency debt in the driver's seat. Due to low duration and low correlation to global risk factors, EM Frontier markets offer an attractive opportunity to diversify away from US election risks.

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US Election: High uncertainty, high impact

Trump or Harris? Either way, a change is coming in the White House with profound near-term impact on financial markets. EM fixed income will be no exception. Understandably, the market narrative is increasingly being dominated by the US which increasingly looks like a coin toss. Trump and Harris are running neck-and-neck in national polls. Betting markets [1]have swung in favour of a Trump victory. It is beyond our competence to make any qualified guess on the election result. Rather, the aim is to help EM bond investors navigating through the fog of political uncertainty over the coming weeks and months. We provide an election roadmap mapping the most relevant outcomes, key transmission channels worth monitoring and how it filters through to EMD returns.

So how will the different election outcomes impact EM fixed income? To start with, let's first have a look at what we believe are the most likely election results to consider. Especially from a fiscal perspective, the composition of the Congress is equally relevant as the presidential race, itself. For simplicity, we focus on three election outcomes on Nov. 5. and what they mean for EMD returns over a tactical horizon:

1. Harris wins, Congress is split between Republicans, Democrats
2. Trump wins, Congress is split between Republicans and Democrats
3. Trump wins, Republican majority in both the House of Representatives and the Senate ("Republican sweep")

A Democratic sweep has been left out of the analysis. At the time of writing, there seems to be a high hurdle for Democrats to win both the race to the White House, the Senate (highest hurdle) and the House of Representatives. Betting markets attach a 43% probability to a Republican sweep, whereas a Democratic sweep carries a 14% probability according to Polymarket (see footnote). Consequently, we choose to limit our analysis to the three scenarios listed above.

Mapping election scenarios & transmission channels

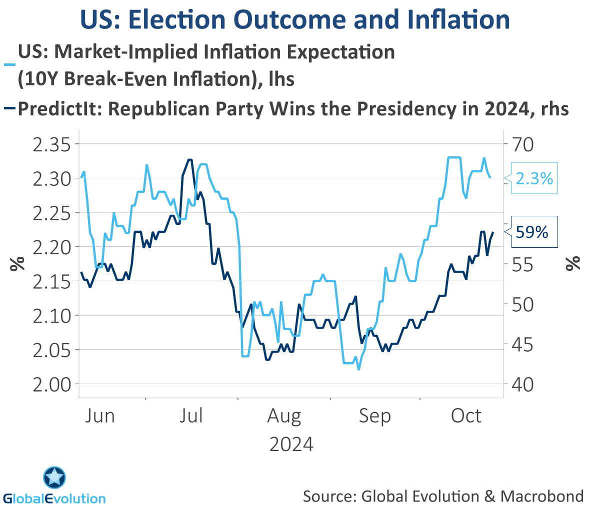
In order to assess the market impact and how EM bond returns are likely to respond, three policy areas are particularly important in shaping market participant's perception of the various election outcomes. It almost goes without saying that other

[1] See .e.g. Polymarket | Balance of Power: 2024 Election and 2024 Presidential Election Predictions & Odds | Who will be the next president? Betting markets are being used to show where results are trending but are not indicative of actual results.

areas like e.g. energy policy or international security policy could impact markets as well. However, the policy areas below should by far be most impactful from an EMD perspective. A word of caution is warranted, though: at this point in time, very little is known in terms of concrete measures or initiatives from both candidates within these areas. Consequently, this report delivers an assessment of *what policies markets expect from each candidate rather than a subjective view of what the candidates end up actually implementing.* After all, the former will define the short-term market reaction to any given election outcome, which is the focus of this report.

Trade policy: Neither Harris nor Trump are doves when it comes to trade. But whereas Harris is set to stick to the status quo, Trump has flagged his ambition to raise tariffs substantially if he comes to power with a universal tariff of 10% and up to 60% for selected Chinese imports, see also our previous note on Trump's trade policy here. Also, Trump intends to use tariffs as a negotiation tool according to his aides. Altogether, trade policy is set to become more protectionist and a greater source of volatility under a Trump presidency, even without taking 2nd round effects in the shape of other countries tit-for-tat reaction into account. A Trump victory should therefore strengthen the US Dollar as it would limit US demand for products from the rest of the world. In addition, higher tariffs will increase inflation risks in the US, contributing to upward pressure on US yields. While not completely derailing the Fed's rate cutting cycle, Trump's trade policy has the potential to at least reduce the amount of rate cuts. Both Dollar strength and upside risk to US rates imply tighter monetary conditions than under a Harris-led White House. Add to this a negative real economic impact from a reduced EM exports to the US, it becomes a safe bet that a Trump presidency could be seen as negative from an EMD perspective. A Harris victory, on the other hand, would most likely imply a continuation of current policies, implying a more neutral impact from trade policy on EM bonds. Given the large degree of presidential power when it comes to trade policy, the composition of the Congress matters less than e.g. in a fiscal context.

Fiscal policy: Neither candidate is likely to turn his back on the fiscal largesse of the post pandemic years. In other words, the risk to the budget deficit, currently running around 6% of GDP, remains biased to the upside. The main question therefore becomes who will be more expansionary. The key question from a fiscal perspective is whether Congress will be split between Democrats and Republicans or controlled by one party, only. The President's room for fiscal maneuver is limited without the backing from Congress. Under a split congress, there will be little difference between fiscal trajectories as Congress would be able to block meaningful fiscal initiatives. High deficits would prevail together with reoccurring periods of uncertainty and liquidity bottlenecks around debt ceiling negotiations. All else being equal, any election outcome with a split congress should be seen as neutral from a market perspective. A Republican sweep scenario, on the other hand, would change the fiscal trajectory substantially. Trump would get green light to open the fiscal floodgates through tax cuts. Deficits are likely to rise. Fiscal concerns and inflation risk would drive US interest rates higher, potentially surpassing previous cycle highs. Some of these dynamics are already unfolding (see chart below).



While the US Dollar would be biased stronger, the appreciation potential should be limited by debt sustainability concerns. The net result would be reinvigorated monetary headwinds globally, hurting EM assets. While we have so far ignored a democratic sweep scenario, it would most likely look similar from a fiscal perspective, causing US yields to climb, as well. The USD appreciation should be less pronounced, though, as the fiscal expansion primarily would come in the shape of higher expenses and less via tax reductions, benefitting US assets less than a Republican sweep.

Immigration: While both fiscal and trade policy aspects have the potential to impact markets immediately, immigration is a long-term factor. There is an ongoing debate about how much immigration has boosted labour supply in the US, but a significant positive impact is beyond much doubt. Given Trumps ambition to strongly curb immigration, the net-flow of immigrants is expected to decrease substantially if Republicans take the White House. This would limit US labour force growth, creating an upside risk to wage inflation amid an already tight labour market. From an immigration standpoint, a Trump victory is therefore seen as the most inflationary outcome. This adds to the monetary tightening triggered by Trump's trade policies.

Both candidates push an inflationary agenda. However, a Trump presidency should be seen as more inflationary and creates higher demand for US assets amid his appetite for lower corporate taxes. Another key difference is that inflation risks stemming from Trumps agenda are driven by supply side dynamics (immigration, tariffs), whereas Harris agenda tilts inflation risks towards the demand side. So, a Trump victory's impact on inflation would be viewed as more long-lasting, pulling growth potential lower, as well. The following table summarizes market's interpretation of election outcomes in terms of trade policy, fiscal policy and immigration.

	Harris wins & split Congress	Trump wins & split Congress	Trump wins & Republican Sweep
Trade Policy	Tariffs unchanged.	Tariffs increase	Tariffs increase
Fiscal Policy	Budget deficits widen moderately	Budget deficits widen moderately	Budget deficits widens significantly
Immigration	Net-flow declines moderately	Net-flow declines	Net-flow declines

Cut to the chase: 3 key take-aways

How do these policy scenarios translate into EMD returns? We take a two-step approach to address this question. First, we assess the impact on the US Dollar and US 10-year yields. These two metrics should give a good sense of how overall EM risk appetite will react. In the second step, the changes in these price metrics are used as input to our entropy pooling model, which identifies similar US rate and Dollar environments. Attaching higher weights to these episodes, the model generates modified return expectations for the main EM fixed income segments, shown in the table below.

	Harris wins & split Congress	Trump wins & split Congress	Trump wins & Republican Sweep
EM Risk Appetite	↑	↓	↓↓
	3-month returns		
Local Currency EMD	2.4%	-0.8%	-5.3%
Hard Currency EMD	1.6%	1.0%	-4.5%
EM Corporate Debt	1.1%	1.8%	-2.7%

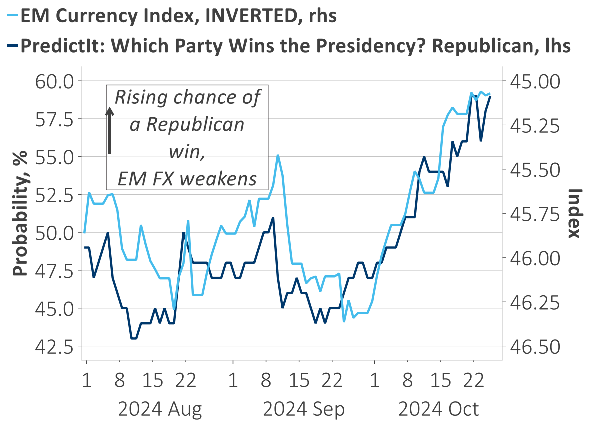
Three conclusions stand out. Firstly, a Republican sweep would be the most negative short-term scenario for EM bonds, resulting in negative returns across the board, see table above. Significant headwinds from higher US yields on the back of fiscal deficit concerns would have a negative impact on hard currency EM bonds. At the same time, a stronger US Dollar driven by US protectionism and tax cuts benefits US corporate earnings (at least as a first-round effect) would undermine local currency EM debt returns. While we largely ignore the Democratic sweep scenario, it would trigger expectations of a fiscal expansion, driving US yields higher and EMD returns into negative territory. However, protectionism would be less of a concern, resulting in milder EM bond drawdowns than a Republican sweep.

Secondly, EM fixed income should thrive if Harris wins the White House race. By-and-large markets would view such a scenario as the status quo of key policies prevailing. Tariffs should be kept largely unchanged and budget deficits widen only marginally as a split congress would limit Harris' fiscal wiggle-room. Add to this that the market already has priced a large chunk of the so-called "Trump trade", EM bond investors should expect some relief.

Thirdly, both kind of Trump victories (split congress and Republican sweep) favour EM hard currency bonds over local currency bonds, with US Dollar strength being the common feature. Fiscal expansion and higher tariffs create inflation risks and upward pressure on US yields. Fed's rate cutting cycle would be short-lived. Corporate tax cuts and deregulation causes US assets to be sought after, creating Dollar demand. Vice-versa, local currency EMD is set to outperform if Harris wins the presidential election, as tariffs are expected to be kept largely unchanged and corporate taxes could increase, limiting Dollar upside.

How to position: Buy the rumour, sell the fact?
Having mapped election scenarios, policy transmission channels as well as quantified their market impact, a key question to ask is what scenario markets are pricing at the current juncture. US yields have been rising, the US Dollar is on a tear (see chart below), EM bond returns are in the red in October. Comparing with our estimates of the short-term market impact of the main election scenarios, this suggests that the market is pricing a scenario somewhere between a Trump victory with a split congress and a Republican Sweep. The upshot is that a Harris victory would bring short-term relief to EM bonds.

Politics & FX

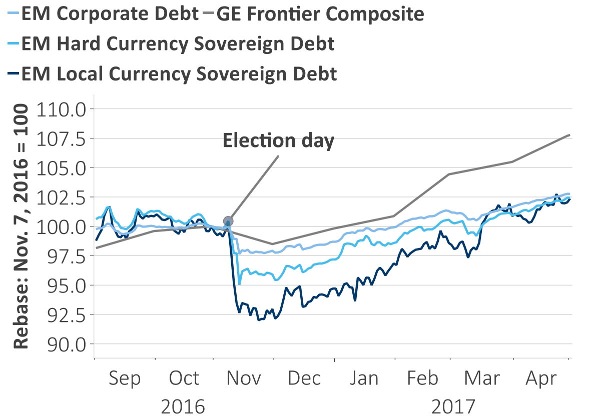


Source: Global Evolution, Macrobond and Bloomberg

So, markets seem to front run a Trump victory, potentially triggering a "buy the rumour, sell the fact" dynamic in the immediate aftermath of the election. A Trump win - somewhat counterintuitively - could therefore lead to a decline in yields and the US Dollar in the *immediate* aftermath of the election. The risk to the estimated returns in the two Trump victory scenarios is probably to the upside. Finally – absent the non-negligible scenario of a contested election – the sheer fact that uncertainty decreases after Nov. 5th could also cause the initial market reaction to tilt more positively than indicated by the above table.

So how to position amid overwhelming election uncertainty? The optimal allocation is obviously highly dependent on the subjective probabilities attached to each election scenario. At this stage we resist the temptation of guessing election results, moving our EMD asset allocation between hard, local and corporate debt closer to neutral. All being said, outside the main EMD segments, Frontier Markets provides a somewhat overlooked diversification opportunity. In fact, Frontier Markets should perform well under most election scenarios, shielding against political risks. Frontier Markets are less correlated with global risk factors compared to the main EM bond indices. Case in point, the initial drawdown around the 2016 US election relatively muted in Frontier Markets (chart below). Even during periods of rising rates, the asset class has shown outstanding risk-reward prospects, significantly outperforming other fixed income segments. In other words, particularly in a sweep scenario, EM Frontier Markets should be well positioned to cope with rising US yields.

2016 US Election: EM Fixed Income Returns



Source: Global Evolution, Macrobond and Bloomberg

When the fog lifts
Finally, it is worth recalling the 2016 election. Although the reaction in Emerging Market fixed income was negative in the immediate aftermath of the election, the subsequent months turned out to be positive for Emerging Market bonds. Hence, we emphasize that the above analysis centers around the short-term impact of the election (3 months). Longer-term, global macro fundamentals will be the dominant driver of EMD returns. As we see recession odds decline and monetary conditions ease, these fundamentals provide fertile ground for EM fixed income and a come-back of EM local currency bonds once the fog around the US elections has lifted. Ultimately, culminating election uncertainty might therefore provide an attractive entry point for EM bond investors.

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