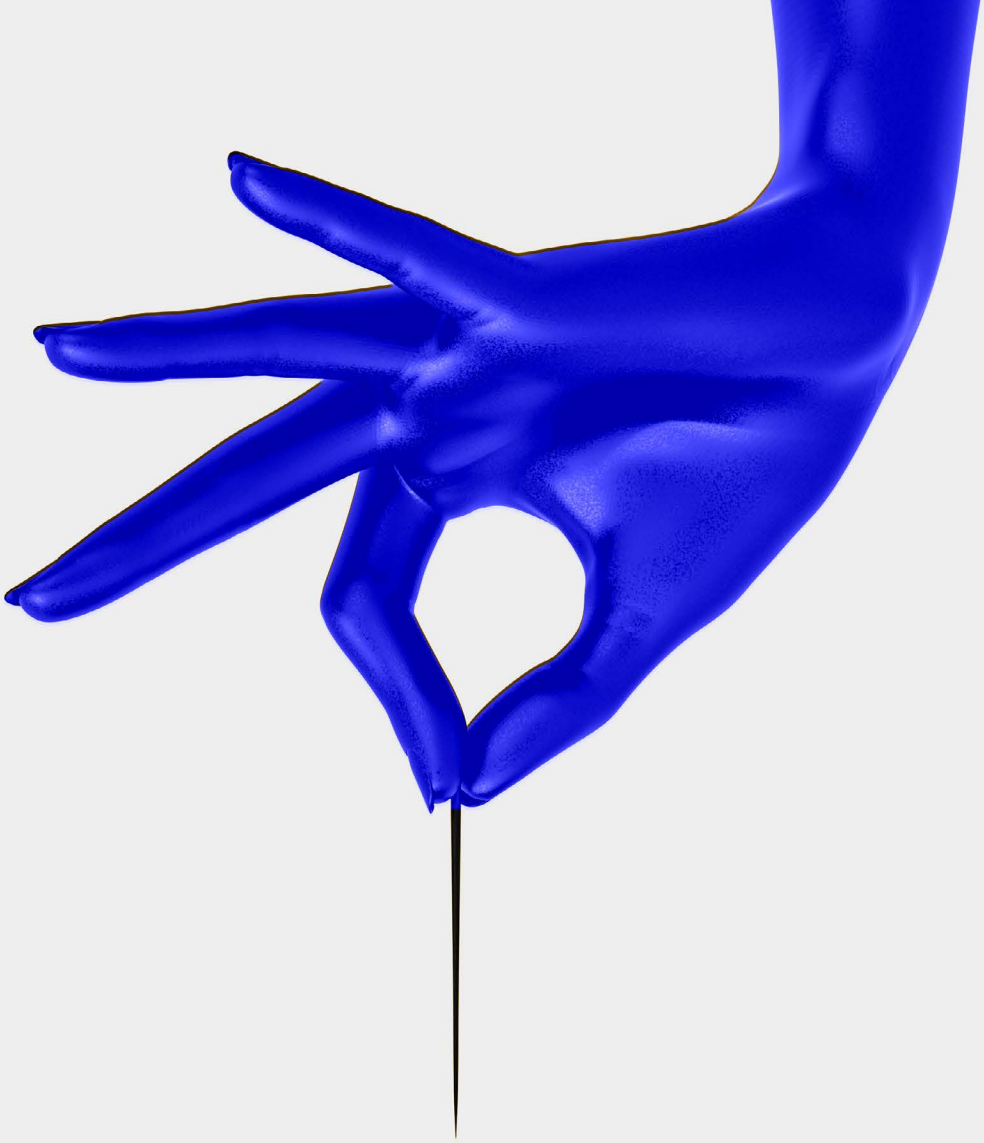
TD Wealth



On the Brink

U.S Election Special Edition

Brad Simpson, Chief Wealth Strategist

Monthly Perspectives // September 2020

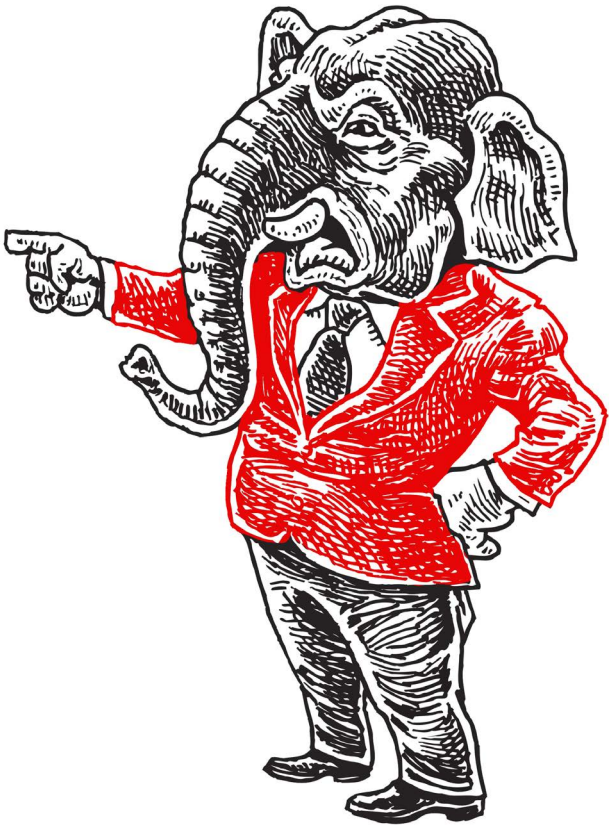
15 minutes

One way or the other

Summary of potential outcomes under each administration

The Trump platform

• Continued fiscal stimulus, deficit spending • Additional corporate tax cuts • Deregulation to limit consumer and environmental protections • Greater potential for trade tension, tariffs, geopolitical uncertainty • Infrastructure spending, but modest compared with Biden's platform	Policy
Neutral • Trump wants lower interest rates and a less independent Federal Reserve • Unconcerned about level of public debt • Credit-spread assets expected to outperform due to looser regulatory regime • Continued trade tensions could increase volatility and risk premium • Lower taxes would reduce revenue, could lead to higher deficits	Fixed Income
Neutral to positive • Deregulation would be a positive for equities • Reform/repeal of Affordable Care Act would require realignment by insurance and service providers • Reduction of environmental protections, benefitting energy • Financials could benefit from looser regulations • Lower tax rates would benefit businesses, boosting equities • Nationalist trade agenda could be a headwind as companies incur higher costs • Protectionist agenda could provoke retaliation against U.S. technology companies	Equities
Neutral to positive • Energy, environmental policies and deregulation positive for infrastructure projects • Pledge to increase spending on infrastructure would provide a boost • Cross-border M&A could be subject to greater government intervention, which could hurt private-equity and merger arbitrage	Real Assets, Alternatives
• Likely weaker USD due to expansionary monetary and fiscal measures, with interest rates not expected to rise over the next few years • Greater geopolitical and trade uncertainty may support safe havens such as USD	Foreign Exchange



The Biden platform

Policy	• Greater fiscal stimulus spending on health care, infrastructure, environmental programs • Support for small businesses, low-income citizens and local governments fighting pandemic • Tax increases on corporations and ultra-wealthy • Tighter environmental, financial and energy regulation • Supports raising the national minimum wage to $15 an hour from $7.25
Fixed Income	**Neutral** • Biden believes in an independent Federal Reserve • Fiscal policies likely to keep rates low • Higher taxes, tighter regulation risks slowing economic growth • Treasury curve expected to steepen due to fiscal stimulus • Lower risk of tariff escalation could reduce volatility and risk premium • Higher taxes would increase revenue, could lead to lower deficits
Equities	**Neutral** • Tighter regulation could hurt pipelines and other energy • Higher taxes would be a negative for stocks • Has vowed to bolster health care under the Affordable Care Act • Some concern over potential financial regulatory reform • Liberal policies may smooth runway for technology sector • Greater fiscal stimulus, support for immigration would be a positive • More predictable trade policy would ease volatility • Minimum wage hikes likely negative for labour-intensive sectors
Real Assets, Alternatives	**Neutral to negative** • Negative for fossil-fuel-based utilities, such as pipelines • Net positive for clean energy infrastructure, with pledge to spend billions • Tax increases would have little impact on utilities with ability to pass on costs to customers • Higher taxes on real estate investments, elimination of real estate tax deductions • Negative for alternative investments because of increases in capital gains taxes
Foreign Exchange	• Likely weaker USD due to expansionary monetary and fiscal measures, with interest rates not expected to rise over the next few years

A Grain of Salt

Brad Simpson, Chief Wealth Strategist and Head of PAIR

"What impact will the U.S. election have on my investments?" This is the question we've been asked repeatedly over the past few weeks — and often with such a sense of impending doom that the answer would appear to be a foregone conclusion. What people really want to know is this: How will my investments do? How much pain should I expect? Will my financial goals be out of reach?

It's not easy to maintain perspective in times like these. The pandemic has left us feeling disconnected and disoriented, and I'm no exception. Right now, for instance, I am writing this in my home in Victoria, and not in my office in Toronto. As I look outside the window, my usually pristine view of San Juan Island is impeded by smoke billowing off wildfires that are currently devastating California, Oregon and Washington State. Later today, as my wife and I run an errand, we will be wearing face masks to protect our lungs (from the smoke in the air) and our fellow citizens (from the virus that could be in any one of us). Last night, I watched a football game with no fans in the stands, where players demonstrated against racial injustice. And if that weren't enough, we've got a trade war that could turn into a real war; threats from the UK to break international law; and an American President who openly questions the validity of science.

Market noise right now has reached a deafening crescendo — amplified by social media, cable news outlets and two very well funded political parties that are trying to convince the American electorate that a calamity will ensue if the wrong president is elected. It would be nice to say that we are all capable of blocking out this noise, but unfortunately, the study of behavioural finance tells us otherwise. At TD Wealth, we are pioneers in this field of research. We've surveyed thousands of clients to understand how personal traits affect financial decision-making, based on five dimensions of personality — openness, conscientiousness, extraversion, agreeableness and reactiveness — and the research here is unequivocal: not all of us are able to keep our cool in a crisis.

This is where professional advice comes in. If, for instance, we were to review the psychological makeup of the investment professionals who produced this special edition on the U.S. election, we would find that they score high in "conscientiousness," and are therefore organized, disciplined and careful. They also have a low susceptibility to noise, the kind of noise that is filling our airwaves and social media feeds. Our professionals also score low on "reactiveness," which means they tend to be calm and secure and have a propensity for resilience. The second piece of good news is that, if you push away all the noise, the cold, hard fact is that U.S. elections tend to have very little impact on investment returns — regardless of who wins (more on this below).

The reality is that nobody knows who will win the election or what will come after. Most of the polls were dead wrong about Clinton vs. Trump in 2016, but that's not the only example of experts getting it wrong. I remember history textbooks with the infamous picture of Harry Truman holding up a "Dewey Defeats Truman" newspaper headline after he was formally declared America's 33rd president-elect. I also remember many experts insisting that we were headed for a Great Depression this year, and that the market was destined to crash a second time. Neither of those predictions, as of mid-September, have come true.

As November 3 approaches, let us remember that the U.S. election is just one of the three forces driving financial markets right now (and, I would argue, the distant third). Irrespective of the election results, we are investing a world that is already in an era of massive monetary and fiscal policy upheaval. The pandemic has accelerated the use of a new form of monetary policy — one where central banks make use of ultra-stimulant frameworks that prioritize tight labour markets over inflationary controls. In this new era, central bankers will have enormous power to influence the economy and financial markets.

In this new era of monetary policy — known as "Modern Monetary Policy" or "Monetary Policy 3" — central banks and governments are intertwined. While central banks increasingly intervene in private affairs such as corporate credit markets, national policies around taxes, tariffs, trade and currencies — and particularly those of the largest economy in the world — will have ramifications for global markets and ultimately our clients' portfolios. As we discuss below, whoever wins the election, the question is no longer whether there will be large infusions of fiscal stimulus, but rather how that stimulus will be doled out.

The second most important of these three market drivers is COVID-19. Improving health outcomes, coupled with the rapid development of a vaccine and therapeutic treatments, have given us the means to confront the virus. No longer are we like deer in the headlights, bracing for the inevitable. How this pandemic plays out is still the great unknown, but we are undoubtedly in a much better place.

There's probably no way to block out all the doomsaying, but as we approach the U.S. election, let us make a commitment to take all the dire predictions we hear with a grain of salt. Some things will go wrong, and many others will go right. Let us go into this period expecting the best and planning for the worst. Let's have a well thought out wealth plan and a portfolio with true diversification, balancing asset and risk-factor diversification with our own financial behaviour. By doing this, we will considerably increase the likelihood that we will make it through this period with our goals intact.

What does history tell us?

The state of the U.S. economy, society and polity are unprecedented in many ways, so history may not be a reliable guide to how the market may behave under a Trump or Biden presidency. Even setting aside these reservations, it's difficult to extract salient observations about financial market performance by simply looking at historical precedents.

Going back to 1900, we can observe that the political party occupying the White House is not a reliable predictor of market outcome, since bull and bear markets have occurred under both Republican and Democratic administrations (Figures 1 and 2). The S&P 500 generated an annualized return of 13.4% during the Trump administration, which is higher than the average of 9.8% since 1900 and 11.2% since 1945. However, this performance is lower than what the S&P 500 returned during the Clinton and Obama administrations. U.S. stocks generated their highest returns since 1945 under the Clinton administration. The only presidency with negative annualized stock-market returns during this time is that of George W. Bush. Besides that, stock-market returns have been in the double-digits since the Carter administration.

Figure 1: S&P 500 Performance since 1900

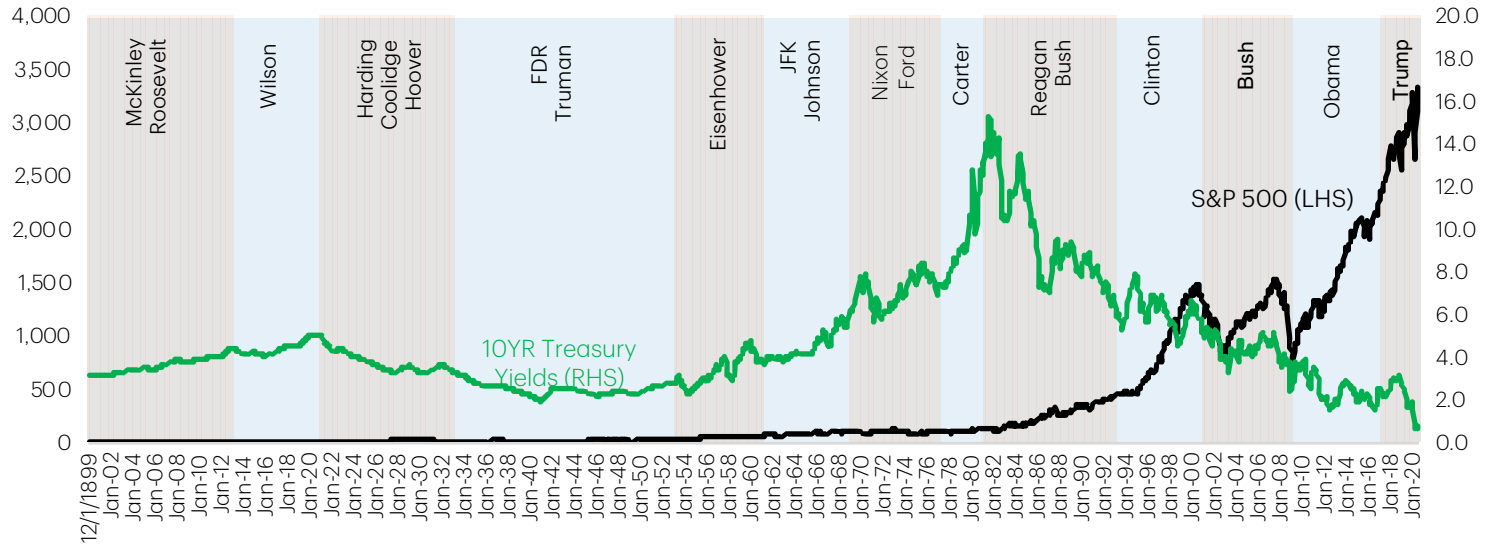


Figure 2: Republicans vs. Democrats

	Nominal			Inflation-Adjusted		
	Annualized Return	Standard Deviation	Sharpe	Annualized Return	Standard Deviation	Sharpe
McKinley	19.7%	14%	1.2	19.0%	16%	1.1
Roosevelt	6.5%	13%	0.3	4.7%	13%	0.2
Taft	5.9%	9%	0.4	4.1%	10%	0.2
Wilson	2.3%	12%	0.0	-6.2%	12%	(0.7)
Harding	14.9%	11%	1.1	19.4%	13%	1.4
Coolidge	28.4%	10%	2.7	28.7%	10%	2.7
Hoover	-21.6%	40%	(0.6)	-16.2%	40%	(0.5)
FDR	11.4%	20%	0.6	8.6%	20%	0.4
Truman	15.3%	12%	1.2	9.6%	13%	0.7
Eisenhower	14.9%	10%	1.3	13.3%	10%	1.1
JFK	12.8%	12%	0.8	11.4%	13%	0.7
Johnson	10.9%	9%	0.7	7.8%	9%	0.4
Nixon	0.9%	12%	(0.4)	-4.3%	12%	(0.8)
Ford	7.7%	17%	0.1	-0.3%	17%	(0.4)
Carter	11.7%	11%	0.3	1.2%	11%	(0.7)
Reagan	14.2%	13%	0.4	9.6%	13%	0.1
Bush Sr	15.7%	11%	0.9	11.1%	11%	0.4
Clinton	17.3%	10%	1.2	14.3%	10%	0.9
Bush Jr	-3.4%	15%	(0.4)	-5.7%	14%	(0.6)
Obama	14.9%	11%	1.3	12.9%	11%	1.1
Trump	13.4%	14%	0.9	11.2%	14%	0.7
All Presidents Since 1900	9.8%	14.8%	0.4	6.6%	14.9%	0.2
All Presidents Since 1945	11.2%	12.1%	0.6	7.4%	12.3%	0.3

Source: Robert Shiller, Bloomberg, and PAIR, as of August 2020

The Trump administration, for its part, has seen strong equity-market performance from a risk-adjusted perspective, although this performance trails the Clinton and Obama administrations. In addition, volatility during Trump's presidency has been higher than average. We can make similar observations when we adjust returns for inflation. Although the past few administrations have coincided with strong equity-market returns, there is no clear pattern when it comes to which political party is more auspicious for financial markets.

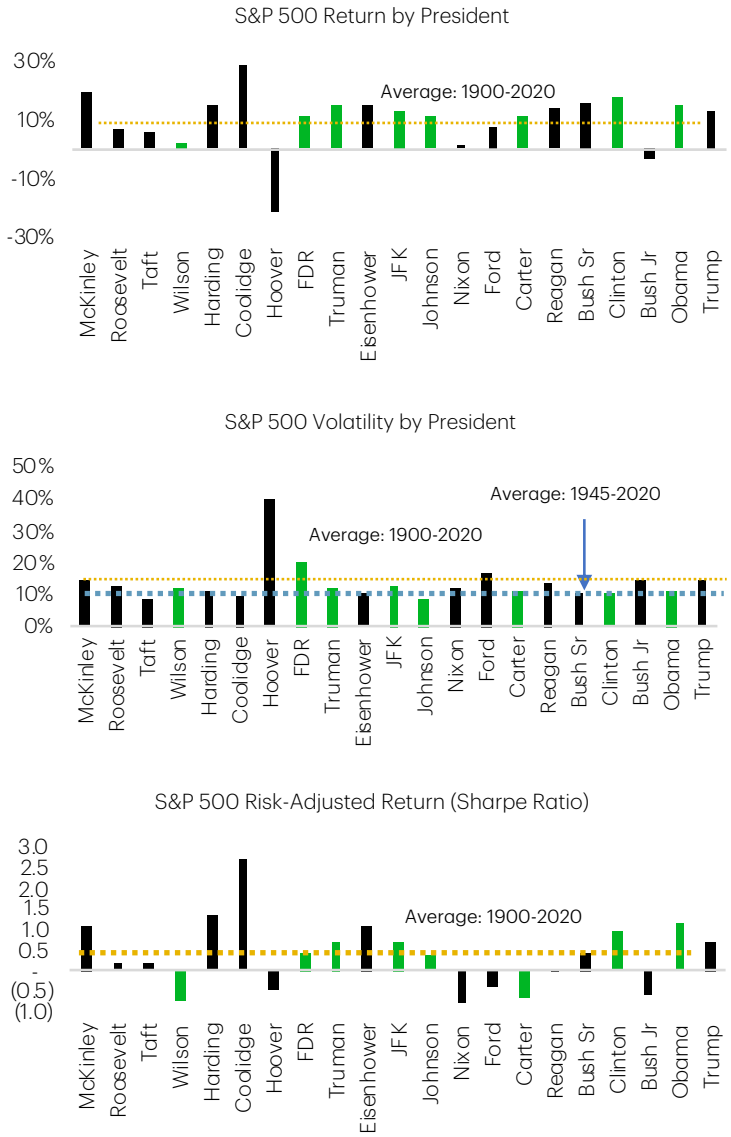
Nonetheless, we can make some broad observations:

The S&P 500 has historically performed better under the Democrats compared with Republicans. The index returned 12.0% under Democratic presidencies compared with 7.9% under Republican presidencies since the start of the 20th century (Figures 3 and 4). This observation applies to the period between 1900 and 2020, as well as more recent periods, such as post-1945 and post-Bretton Woods. In fact, the outperformance of the S&P 500 is even greater during the latter two periods.

The S&P 500 is generally more volatile under Republican administrations. This conclusion applies to the entire performance history as well as the post-war and post-Bretton Woods periods. As a result, the return-to-risk (aka Sharpe) ratio of the S&P 500 is generally superior under Democratic presidencies. Even when we adjust the performance by inflation, the S&P 500 still outperforms under Democratic administrations. Volatility is also lower, and overall Sharpe ratios are superior.

These observations are strictly based on what we can distill from limited data, recognizing that the low number of scenarios is not enough to make statistically significant conclusions. Moreover, the economy and financial markets have changed substantially since the beginning of the 20th century. This makes it difficult to compare Democratic and Republican administrations across more than a century, since we've transitioned through multiple

Figure 4: The S&P 500 by Presidency



Source: Robert Shiller and PAIR. As of September 2020.

Figure 3: Republicans vs. Democrats

	Nominal			Inflation-Adjusted		
S&P 500 Performance	Annualized Return	Standard Deviation	Sharpe	Annualized Return	Standard Deviation	Sharpe
1900-2020						
Republican (54%)	7.9%	15.7%	0.5	6.0%	15.9%	0.4
Democrat (46%)	12.0%	13.6%	0.9	7.4%	13.7%	0.5
Both	9.8%	14.8%	0.7	6.6%	14.9%	0.4
1945-2020: Post World War II						
Republican (52%)	8.4%	13.1%	0.6	4.8%	13.2%	0.4
Democrat (48%)	14.4%	11.0%	1.3	10.3%	11.2%	0.9
Both	11.2%	12.1%	0.9	7.4%	12.3%	0.6
1972-2020: Post-Bretton Woods						
Republican (59%)	7.5%	13.8%	0.5	3.4%	13.9%	0.2
Democrat (41%)	15.2%	10.9%	1.4	11.0%	10.9%	1.0
Both	10.6%	12.7%	0.8	6.5%	12.7%	0.5

Source: Robert Shiller and PAIR. As of September 2020.

political regimes since 1900 — from the dust bowl of the Great Depression era to the New Deal and post-war Welfare State, to the post-Bretton Woods, monetarist era, and the age of globalization and smartphones. On top of this, interest rates (and to some extent inflation) have fallen steadily since the early 1980s, regardless of the presidency, providing a robust tailwind for markets over the past few decades.

There will be winners and losers depending on which candidate gets elected into the White House in November. The overall impact on the economy and financial markets in the near term and longer term, however, is far from clear-cut. What we can say with confidence is that the impact of the 2020 U.S. election on financial markets will not be as black and white as many pundits suggest.

The Taxation Argument

Much has been written about Biden's pledge to increase the corporate tax rate from 21% to 28% and the likely adverse impact on the economy and corporate bottom lines. While it's true that companies will likely pay more taxes under a Biden administration, the increase in headline tax doesn't tell the whole story, since many other factors play into the effective tax rate that corporations pay.

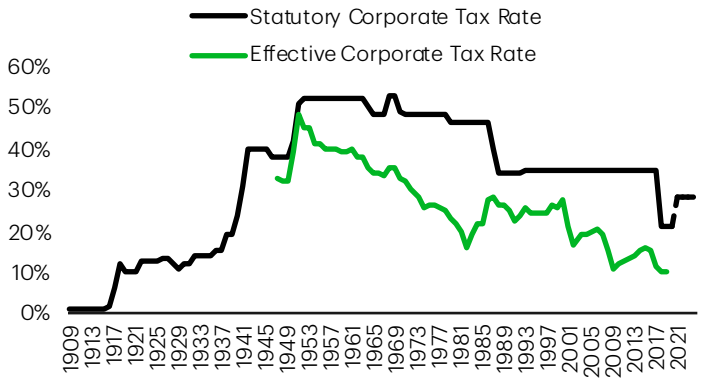
Corporations since the early 1950s have not paid anywhere close to the statutory corporate tax rate. The rate was set at 35% from 1993 to 2017 but the effective tax rate fell from 26% to 15% during this period (Figure 5), even though the statutory rate remained fixed at 35%.

The effective tax rate did fall from about 15% to 10% after the Trump administration cut the statutory tax rate from 35% to 21%, so some of this tax benefit will likely disappear. Biden is expected to raise taxes, but the flip side of that is greater spending on infrastructure, services, and research and development, which are expected to boost aggregate demand.

Fundamentally, financial assets are driven by changes in economic growth and inflation. Growth-oriented assets or risk assets (such as stocks and commodities) tend to perform well under rising-growth environments, while safe-haven assets (such as nominal bonds and gold) tend to outperform during falling-growth environments.

Similarly, inflation-protected assets (such as inflation-linked bonds, gold and oil) tend to outperform when inflation is rising; conversely, assets that don't provide protection against inflation (such as nominal bonds and, to a lesser extent, stocks) tend to underperform during rising-inflation environments but outperform when inflation is falling. This framework is supported by empirical evidence (Figure 6). Each of the four scenarios occur about a quarter of the time, and key assets perform as we would expect given their environmental characteristics.

Figure 5: Statutory vs. Effective Tax Rate



Source: US Bureau of Economic Analysis and Tax Policy Center. As of Sept 2020.

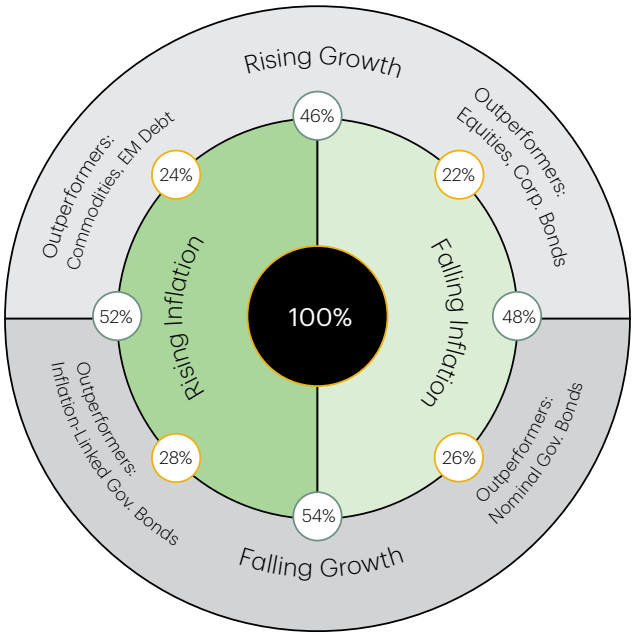
Figure 6: Four Economic Environments

Annualized Return		1973-2020	1997-2020	1973-2020	1983-2020	1948-2020	1948-2020	1968-2020	1983-2020
Scenario	Frequency	US Treasury	US IL Bonds	US Credit	US HY	S&P 500	TSX	Gold	Oil
Rising Growth	46%	7.0%	5.4%	9.1%	10.7%	13.8%	10.9%	3.8%	3.4%
Falling Growth	54%	7.2%	5.7%	6.5%	7.0%	9.6%	4.5%	11.7%	-1.2%
Rising Inflation	51%	5.2%	6.2%	5.3%	8.3%	7.5%	6.3%	13.6%	7.1%
Falling Inflation	49%	9.2%	4.7%	10.5%	9.3%	15.9%	8.6%	2.0%	-5.4%
Rising Interest Rates	44%	4.3%	4.5%	3.5%	6.2%	9.8%	8.2%	7.7%	12.0%
Falling Interest Rates	56%	9.2%	6.3%	11.0%	10.5%	11.6%	6.7%	8.8%	-5.7%
Rising Yield	50%	1.0%	0.0%	-0.3%	3.8%	5.2%	3.4%	7.7%	19.1%
Falling Yield	50%	12.6%	9.8%	15.1%	12.4%	15.4%	10.3%	8.2%	-10.0%
Entire History	100%	7.1%	5.5%	7.7%	8.8%	11.5%	7.4%	8.0%	1.0%
Risk-Free Rate		4.6%	2.0%	4.6%	3.5%	4.0%	4.0%	4.6%	3.5%

Source: Factset and Bloomberg. As of Sept 2020.

Ultimately, we believe basing an investment strategy on the outcome of the upcoming election is a futile exercise, since it's still very much a coin toss. The economic environment can be broken down into four quadrants: rising/falling inflation and rising/falling growth (Figure 7). Because nobody knows how the election will affect the future economic environment, the most prudent action is to build and manage portfolios in a way that is agnostic to any possible shifts.

Figure 7: Asset Class Performance by Environment



Source: Factset, Bloomberg, and PAIR, as of September 18, 2020.

In fact, our underlying philosophy is agnostic to economic environments in general. In accordance with this agnostic philosophy, we avoid making predictions about what risk factor, assets or security will outperform. Instead, we aim to diversify our exposures across the four economic quadrants and key risk factors as much as feasible. This way, we are not overexposed to any single adverse event, including the outcome of the upcoming election. Once the election is decided, we can then make dynamic portfolio changes at the margins.

Scenario 1: Clear Trump Victory

In the event of an undisputed win for the incumbent, we can expect more of the same from an emboldened Trump. On government policy, he is expected to ease the regulatory burden for businesses and capital markets, in part by weakening environmental and consumer protections. On fiscal policy and taxation, he is expected to run large deficits due to the 2016 tax cut and a promise to spend big on infrastructure. Trump has also promised to enact a new payroll tax cut, which may have adverse consequences for social security and Medicare. On global relations and trade, he is likely to incite conflicts with key partners — notably China, but also allies in western Europe and Canada. Trump will likely continue to distance the U.S. from global institutions like the WTO, the United Nations and NATO. This will expedite the decoupling and deglobalization trends we've seen over the past few years. On immigration, he is likely to impose greater limits on the number of people entering the U.S. On health care, he is likely to seek a repeal of Obamacare. Trump advocates for a quick reopening of the economy despite the elevated risk of COVID-19 infections.

Trump on Equities

A Trump victory would signal further deregulation, which makes it easier for companies to expand and get projects off the ground. This would have a positive influence on equities. The White House itself claims to have slashed regulatory costs by $50 billion. A Trump victory would also eliminate worries around Biden's proposed tax hike for corporations and investors, which would undoubtedly be good news for equities.

On the other hand, Trump's nationalist trade agenda will continue to generate a headwind. Companies that are pressured to re-route supply chains from cost-efficient regions will feel significant pain from increased costs. It should be noted, however, that this pain will not be felt equally by all emerging-market issuers. Countries like India and China have huge domestic markets in high-growth economies, so for companies that sell domestically, the impact won't be too bad. Pulling supply chain out of emerging markets will certainly have an impact on EM equities; however, we do not anticipate a strong threat to EM equities in the near future.

Impact on Equities

Proposed Agenda	**Impact**
Trade Policy	Negative
Deregulation	Neutral to Positive
Tax Cuts	Neutral to Positive
Boost to Infrastructure	Positive
Impact on Sectors	
Automobiles	Negative
Energy	Positive
Health Care	Neutral to Negative
Banks & Financials	Neutral to Positive
Industrials	Neutral
Materials	Neutral
Technology	Neutral to Negative
Impact on International Equities	
Emerging Equities	Neutral
EU equities	Neutral

Source: TD Portfolio Advice & Investment Research

A more serious threat may stem from the uncertainty around trade deals that are yet to be finalized, particularly with China and Europe. In the case of the EU, trade tensions will likely persist if Trump is re-elected, as the anxiety over Chinese tariffs extends to EU imports. However, a deepening fragmentation in global trade is going to be bad for both U.S. and EU equities, so investment flows between the two regions should be negligible. Foreign exchange is also an important consideration here. While the euro is expected to appreciate given the Fed's more recent policy changes, a stronger euro might also hurt export-oriented sectors of the economy.

Sectors that are likely to benefit from a Trump victory include energy and financials. A Trump victory would pave the way for a more favourable regulatory environment for energy explorers and producers, and particularly for energy infrastructure, although the slump in oil demand due to the pandemic will be a more important driver in this respect. Banks and financial companies, meanwhile, would benefit from lower relative taxation and the alleviation of fears over regulation.

Sectors that are likely to be hindered by a Trump victory include automobiles and technology. Auto manufacturers in the U.S. are the beneficiaries of long and complex supply chains that stretch across Europe and emerging markets. As a result, conflict over trade policies and tariffs will have a significant impact on the entire automotive value chain. Trump's stance against immigration and visa processing, meanwhile, will continue to be a hindrance for technology companies. However, many of these companies have partially rationalized their organizational structures. Thus, we do not anticipate a negative shock to tech equities if Trump wins. If anything, the push towards a "Made in America" economy could boost efforts in automation and robotics, which would ultimately

Trump on Fixed Income

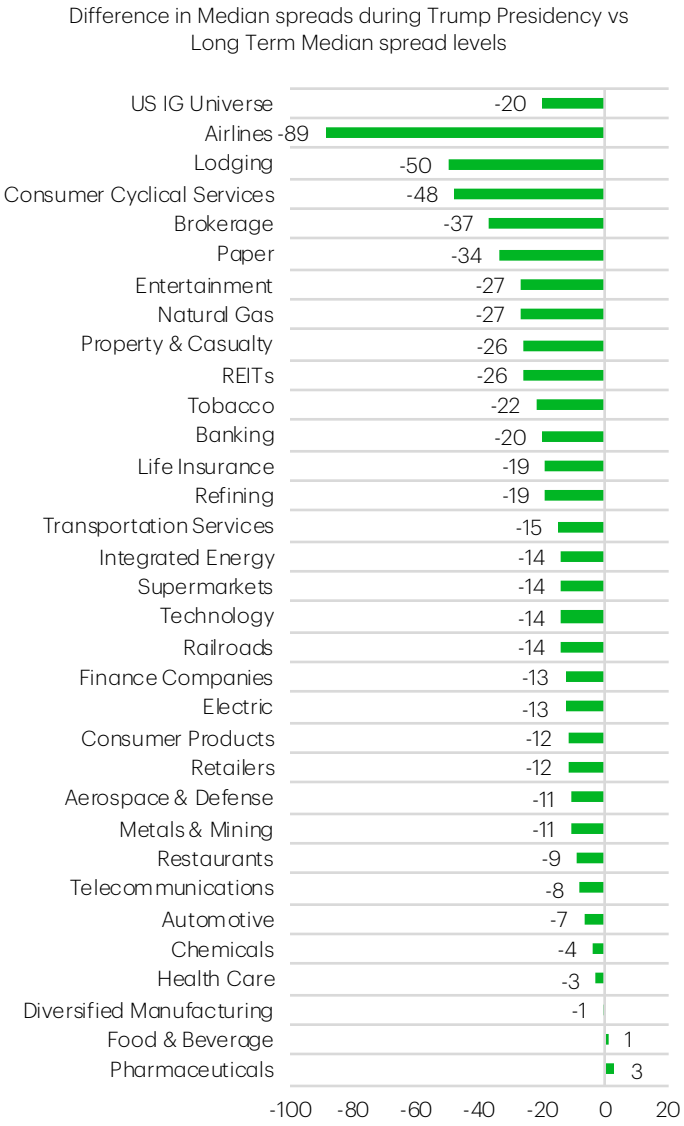
The U.S. president has been very consistent in his desire for lower interest rates and for a less independent Federal Reserve that would take its direction from the White House. In reality, though, it's questionable how much influence any U.S. president can have over interest rates. The president can influence rate policy in three key ways.

The first is through fiscal policy: Raising or lowering the public deficit and debt through spending and tax initiatives can have an impact on the level of interest rates. Trump has so far shown little concern for the level of the public debt, and this seems unlikely to change in a second term. The second is through political power: the president can privately (as was the case most prominently with Nixon) and publicly (as is the case with the current president) badger the Fed into getting his way. It also seems fair to say that the attacks on the Powell Fed will have given it at least some pause for thought. The third is through Fed appointments: The president appoints the Fed chair of course, but he also has the power to appoint members to the Fed's Board of Governors.

Today, the Fed is of the view that "lower for longer" is the correct policy path as it transitions to an average inflation-targeting program, and perhaps in the future yield-curve control. Hence, to this effect, the current president and the Fed are somewhat united in their views, even though the Fed would prefer for it to be acknowledged that it arrived at its conclusion independently and for different reasons. In general, while the U.S. president may have some moderate influence on rates, it is likely to be fairly small within the greater scheme of things, unless radical policies are implemented to heavily erode central-bank independence.

Overall, the Trump presidency has been beneficial for corporate credit sectors (Figure 8). Median spreads have been lower generally, and particularly for sub-sectors that have seen a large reduction in their effective corporate tax rate. These sub-sectors are also in the cross-winds of massive rating downgrades due to weaker balance sheets during the pandemic, but that's a different story. Overall, it wouldn't be a surprise if the status quo in credit sectors is maintained during Trump's second term.

Figure 8: Spread compression during Trump presidency



Source: Factset and Bloomberg. As of September 2020.

A second Trump term would also likely see some prospect of continued, and perhaps increased, fear of ongoing tariff increases against China, particularly given the deterioration in U.S.-China relations over the course of the past year. This can be seen as another negative for market risk appetite and can lead to heightened price volatility.

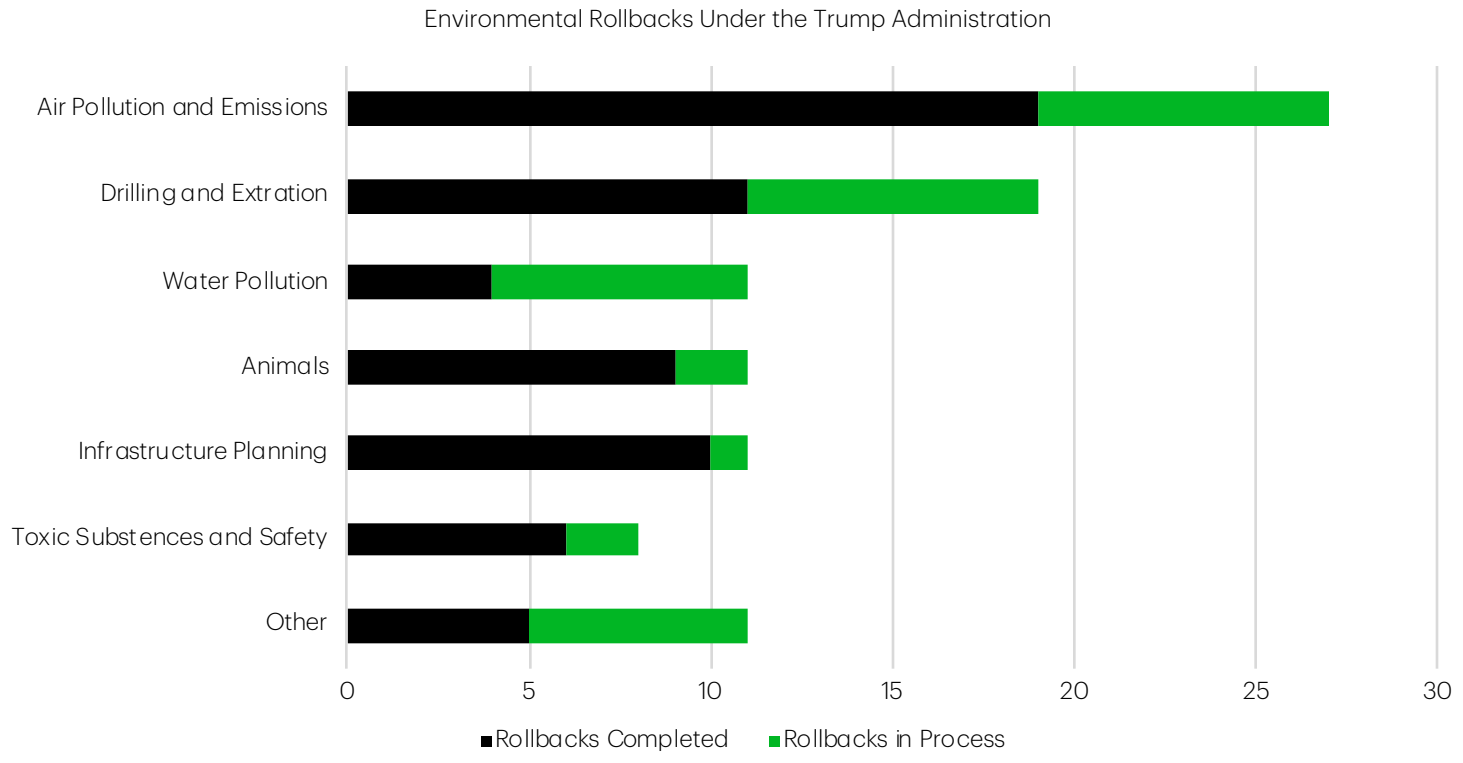
Trump on Real Assets and Alternatives

President Trump's first term was a net positive for risk assets, including real estate and infrastructure, by virtue of his administration's push for deregulation, and his insistence (see "badgering the Fed" above) on lower interest rates, which in turn lowers financing costs for real asset investments. Trump has reversed or is in the process of weakening 87 environmental regulations (Figure 9). This includes the weakening of the country's landmark environmental law, the National Environmental Policy Act (NEPA), by narrowing the scope of review for federal infrastructure projects such as pipelines, highways and power plants. Typically, a full NEPA review takes approximately 4.5 years, and has often contributed to delays to infrastructure projects, such as the Keystone XL and Dakota Access pipelines.

We expect pipelines and midstream operators to do better in a Trump administration given the continual regulatory rollbacks that started in his first term. For real estate, we expect the status quo; however, transportation, retail and hospitality may continue to experience negative growth under a prolonged pandemic scenario if the Trump administration is unable to slow the infection rate.

As for alternative investments, we continue to see heightened political risk for mergers and acquisitions (M&A), which will have an impact on private-equity and merger arbitrage strategies. This is largely due to legislation under the Trump administration that expands the scope of review for foreign investments. M&A transactions today are executed under an increasingly heavy cloud of politicization, led by President Trump's "America First" approach. In March 2020, for example, the review board blocked the acquisition of StayNTouch, a U.S. hotel property-management software company, by China-based Beijing Shiji Information Technology on the basis of national security. For a more recent example, look no further than ByteDance's forced divesture of TikTok to Oracle. This deal has yet to be signed off by China, which may opt to scuttle TikTok than hand a political victory to Trump. With increased political risk, we expect a slight uptick for potential deal breaks in M&A, increasing risk and reducing the expected return for strategies such as private-equity and merger arbitrage.

Figure 9: Environmental Rollbacks under Trump



Source: New York Times, as of May 2020

Scenario 2: Clear Biden Victory

Biden's policy platform is starkly different from Trump's, but not much different from what we've seen under recent Democratic administrations. On the role of government, he is expected to run a more interventionist policy agenda. This means the return of many regulations that were in place prior to Trump — everything from greater restrictions on capital markets and industry (notably energy) to environmental and consumer protections. On fiscal policies and taxes, Biden has proposed spending trillions of dollars in stimulus measures, redistributive social services, domestic manufacturing, and green technology and infrastructure projects. To fund the increased spending, he is expected to raise taxes on corporations and high-income individuals, cancelling out some of the tax cuts that Trump enacted. On global relations and trade, he is expected to return the U.S. to its post-war leadership role on the neoliberal world stage, and strengthen old alliances, such as NATO, although geopolitical tension with China is expected to continue as the latter challenges the U.S. in global influence. On health care, Biden has promised to expand on Obamacare; however, he has come out against a single-payer health-care system. And on the COVID-19 front, he has promised to take a cautious approach to reopening the economy, making it conditional on widespread testing and scientific advice.

Biden on Equities

A Biden win would give the markets a break from controversy, since Democrats are expected to deal with trade policy in a more conciliatory way. Both the Democrats and Republicans want to encourage manufacturing within America, but heightened concerns around tariffs are likely to subside. Though trade negotiations with China will continue, especially around intellectual property rights, Biden is expected to behave in a more diplomatic manner.

Increased taxation, on the other hand, may generate a headwind. Biden plans to increase corporate taxes to 28% from the current rate of 21%. According to estimates from a number of buy- and sell-side analysts, Biden's tax increases could lead earnings on the S&P 500 to fall between 6% and 9%. Biden is also proposing an increase in capital gains tax to 39.6% for individuals with annual incomes over $1 million, so we could see some investors trying to book profits in the near term. This could lead to short-term volatility and even a correction, but once clarity around the tax rate prevails, markets will price in this risk and move on.

Sectors that stand to benefit from a Biden presidency include utilities, technology and health-care services. Utilities, for example, are well positioned to pass the burden of higher taxes on to consumers. Moreover, Democratic initiatives around green energy will lead to stronger government support and higher capex investment in this space. For tech companies, a Biden win would make it easier to recruit talent abroad and would provide a less adversarial business environment in China. Biden's promised expansion of public health care, meanwhile, would benefit companies engaged in services, like hospitals and diagnostic centres, although the pharmaceutical sector would likely be weighed down by increased scrutiny on pricing power.

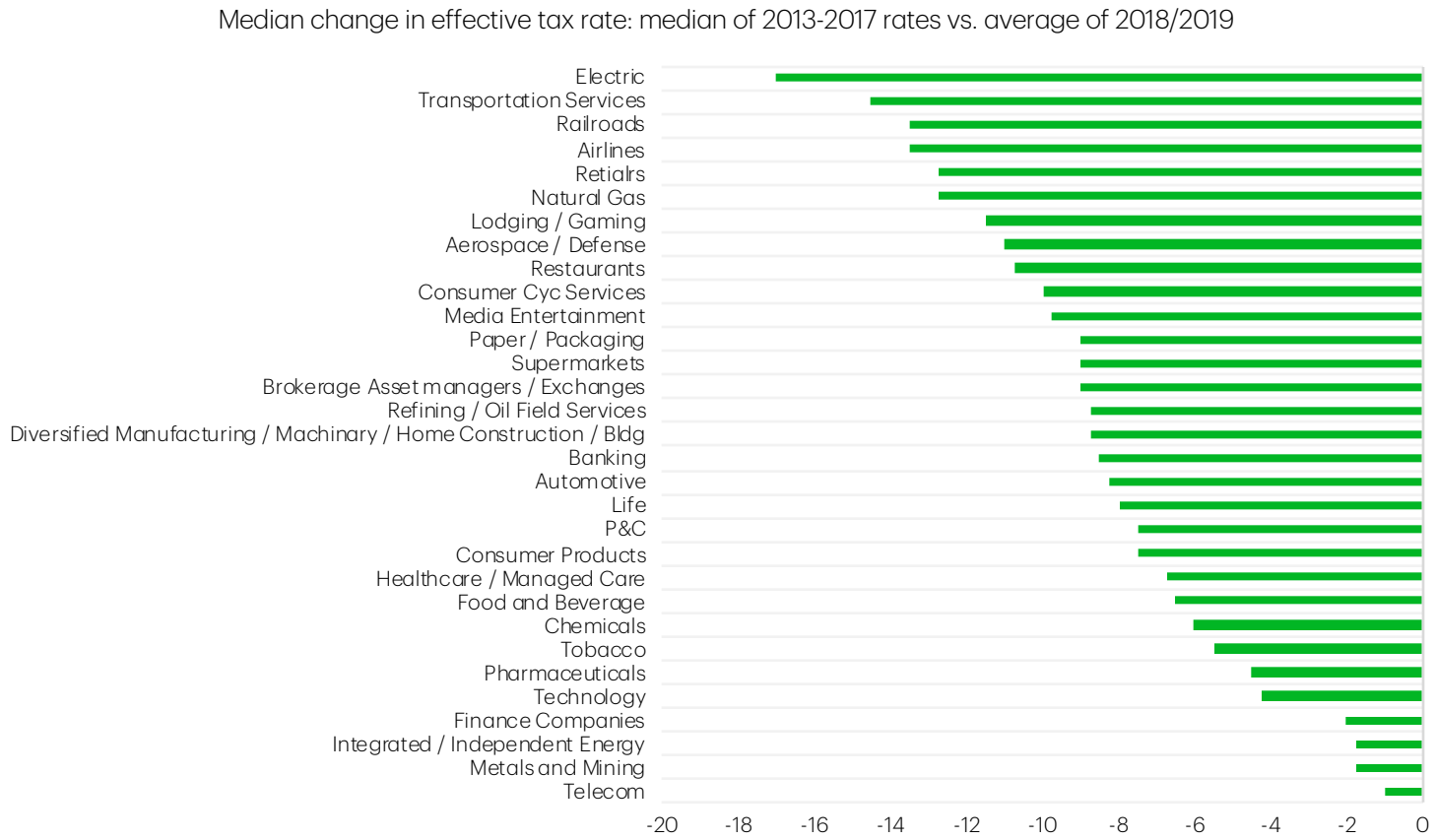
Sectors that are likely to be hindered by a Biden presidency include energy, financials, consumer discretionary and communications. Energy explorers, producers and infrastructure companies will be impaired by stringent environmental regulations. For the banking sector, higher tax rates will hit their bottom lines, particularly at a time when low interest rates are putting the squeeze on net interest margins. Regulations are expected to tighten with more focus towards consumer protection. Within the consumer discretionary sector, companies engaged in luxury goods and retail may come under pressure as higher taxes for the wealthy put a damper on spending. The tax hike, however, is not expected to have a lasting effect on growth opportunities for these companies. Finally, a Biden victory could lead to significantly more regulation within the communications sector, including the restoration of net neutrality, expansion of broadband availability across low-income groups, and potentially efforts to limit broadband price increases. This could have a dampening effect on cable companies, while entertainment platforms like Netflix may also come under more intense scrutiny.

Impact on Equities

Proposed agenda	**Impact**
Trade Policy	Neutral to Positive
Green Initiatives	Neutral
Rise in taxes	Neutral to Negative
Health Reform	Neutral to Negative
Impact on Sectors	
Utilities	Positive
Technology	Neutral to Positive
Industrials	Neutral
Materials	Neutral to Positive
Health Care	Neutral to Positive
Energy	Negative
Banks & Insurance	Neutral to Negative
Consumer Discretionary	Neutral to Negative
Communications	Neutral to Negative
Impact on International Equities	
Emerging Equities	Neutral
EU equities	Neutral

Source: TD Portfolio Advice & Investment Research

Figure 10: Most vulnerable to a tax hike?



Source: TD PAIR, Bloomberg, as of August 2020.

Biden on Fixed Income

The former vice president very much believes in an independent Federal Reserve Board and would undoubtedly let it guide monetary policy the way the Obama administration allowed the Fed to do so under Ben Bernanke and Janet Yellen. Biden's ambitious fiscal policies, however, risk slowing economic growth further, thereby keeping rates low.

The Biden campaign has endorsed a "comeback package for Main Street businesses," which we expect would involve, at a minimum, allowing businesses to take additional loans under the Paycheck Protection Program (PPP) and some additional funding for that program. All in all, this will be supportive of smaller market segments but cascade into broader support to the credit space. Following fiscal stimulus early in 2021, we expect that a Democrat-controlled Congress and White House would enact an infrastructure package and potentially other fiscal measures. Revenue from tax increases may be limited by the pandemic shock initially, however, so we do not expect such measures to pass before mid-2021, with the bulk of the spending set to begin in 2022.

Biden's proposed corporate tax hikes — from 21% to 28% — will effectively reverse half of the benefit from the Trump administration's late-2017 tax reform (which lowered the rate from 35% to 21%). The plan would also: double the global intangible low-taxed income (GILTI) tax rate on certain foreign income; impose a minimum tax rate of 15%; and add an additional payroll tax on high earners. In the U.S. investment-grade market, some of the most vulnerable sectors to social distancing and indoor business restrictions (e.g., lodging, gaming, retailers, airlines, restaurants) also ranked among those sectors whose average effective tax rate declined the most in the two years following the passage of tax reform (Figure 10). Therefore, the higher corporate tax rate, when implemented, could have a major impact.

Biden on Real Assets and Alternatives

We expect a Biden victory to be a net positive for infrastructure and a net negative for real estate. The former vice president has outlined a $2-trillion spending package for infrastructure, with particular focus on green initiatives such as wind and solar energy. The long-term goal would be to establish 100% fossil-free power generation by 2035. We expect utilities to benefit because they would receive government support as they shift away from coal to renewables. More stringent environmental assessments, however, are likely to hurt pipelines and other energy infrastructure companies, potentially delaying or killing off projects such as the Dakota Access pipeline or Keystone XL. Biden has also pledged to fund investments in mass transit and energy-efficiency retrofits for four million buildings and up to two million homes.

Figure 11: Higher taxes ...

Tax Regime	Sale Price	Cost Basis	Taxable Gain	Federal Tax Rate	Capital Gains Tax	After Tax Proceeds
Current Tax Regime	100	0	100	20.00%	20	80
Biden Planned Tax Regime	100	0	100	39.60%	39.6	60.4

Figure 12: ... demand higher exit multiples

Tax Regime	Sale Price	Cost Basis	Taxable Gain	Federal Tax Rate	Capital Gains Tax	After Tax Proceeds	EBITDA Multiple
Current Tax Regime	100	0	100	20.00%	20	80	10.0
Biden Planned Tax Regime	132.5	0	100	39.60%	52.47	80	13.3

Source: TD PAIR, Bloomberg, as of August 2020.

On the other hand, we expect negative implications for real estate. Biden has touted a $775-billion "sharing economy" proposal that would offer universal preschool for three- and four-year-olds and eliminate the waiting list for home and community services under Medicaid. Biden expects this initiative to be funded by real estate taxes, by removing the exemption that allows a real estate investor to defer capital gains by reinvesting the proceeds of one property into another similar property. Biden also vows to eliminate tax deductions from real estate losses and to raise the dividend tax rate from 15% to 39.6% for the top income bracket of investors, which would represent a negative demand shock for REITs, which are taxed at the investor level and are negatively correlated to dividend tax rates.

A Biden victory may also have serious tax implications for alternative investments, such as private equity and other M&A-based strategies. He proposes to effectively double the tax rate, from 20% to 39.6%, on material long-term capital gains for those with adjusted gross income exceeding $1 million. This would impact private-equity portfolios or any M&A transaction, affecting the net proceeds or exit multiples required to achieve target returns.

For example, take a company with an EBITDA of $10 million, sold at a 10.0x multiple:

As Figure 11 illustrates, Biden's proposed tax regime would increase the tax paid and lower after-tax proceeds by 24% (from 80 cents on the dollar to 60.4 cents on the dollar).

From a different perspective, a private-equity sponsor would require a higher exit multiple to obtain the same amount of cash proceeds. As shown in Figure 12, in order to obtain the same cash proceeds, the private-equity sponsor would, under the Biden plan, have to sell at 13.3x EBITDA versus 10x under the current tax regime. Therefore, if Biden is elected and the tax reforms are passed, we expect negative repercussions for the private equity and M&A.

The Outlier Caveat

Until now, we've been talking about the possibility of a "clear" election victory for either nominee, and the usually negligible impact that U.S. elections have on investments over the long term. But as we all know, this is a far from usual election year. In 2020, we are confronted by a once-in-a-lifetime pandemic that is likely to delay the results of the election, and a president who, in any event, has suggested he may question those results. It's a recipe for extreme uncertainty, and uncertainty tends to generate volatility and dampen enthusiasm for risk-taking.

The threat of a disputed election — not to mention pandemics, protests and riots — would be an example of what are known as "outlier events" — the monkey wrenches that are occasionally thrown into our sophisticated predictive models — and they are part in parcel with our philosophy.

Here at TD Wealth, we believe markets are complex and adaptive, which is to say, they are driven by unpredictable human behaviour, and not by logical motives or mechanical processes. It's the reason we put so much stock in the fields of behavioural economics and behavioural finance. It's also the reason we need to prepare for all scenarios, including worst-case scenarios. Because if the aggregate behaviour of market participants is unpredictable, just imagine how unpredictable an erratic president looking to upend the social order can be. Whether you like him or not, Donald Trump represents revolutionary change. His presidency itself is an outlier event.

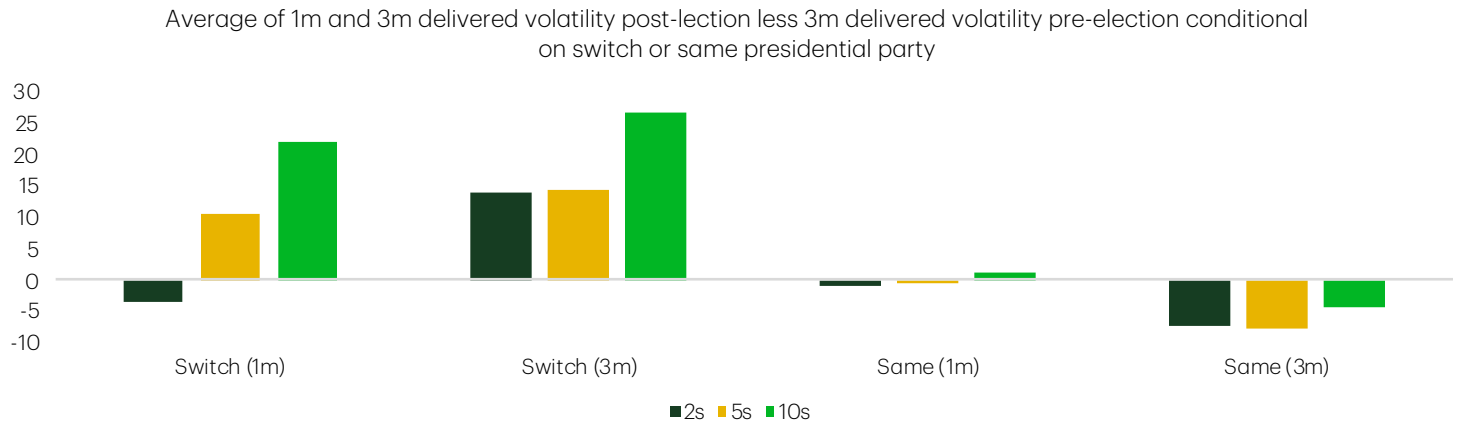
Volatility, as a result, is highly likely as we approach election day, as we can see by looking at the interest-rate volatility market (Figure 13). The market is currently pricing in a period of volatility for the day after and the week following the election, with levels high enough, by historical standards, to suggest that the market is anticipating a "switching year," where a significant policy regime shifts. In other words, the market seems to be anticipating a Biden victory (as do the polls). It's notable, however, that most of that premium comes from the election itself and the immediate aftermath, with a quick reversion to current volatility levels thereafter. Again, with probably higher use of voting by mail, delayed election results could lead to a period of volatility that's very different from the past experiences.

Markets and polls aside, we believe basing an investment strategy on the outcome of the upcoming election is a futile exercise, since it's still very much a coin toss. The present state of the U.S. is unprecedented in many historic ways, so history may not be a reliable guide to how the market may behave under a Trump or Biden presidency. Even then, it's difficult to extract salient observations about how we can expect financial markets to perform looking at historical precedents.

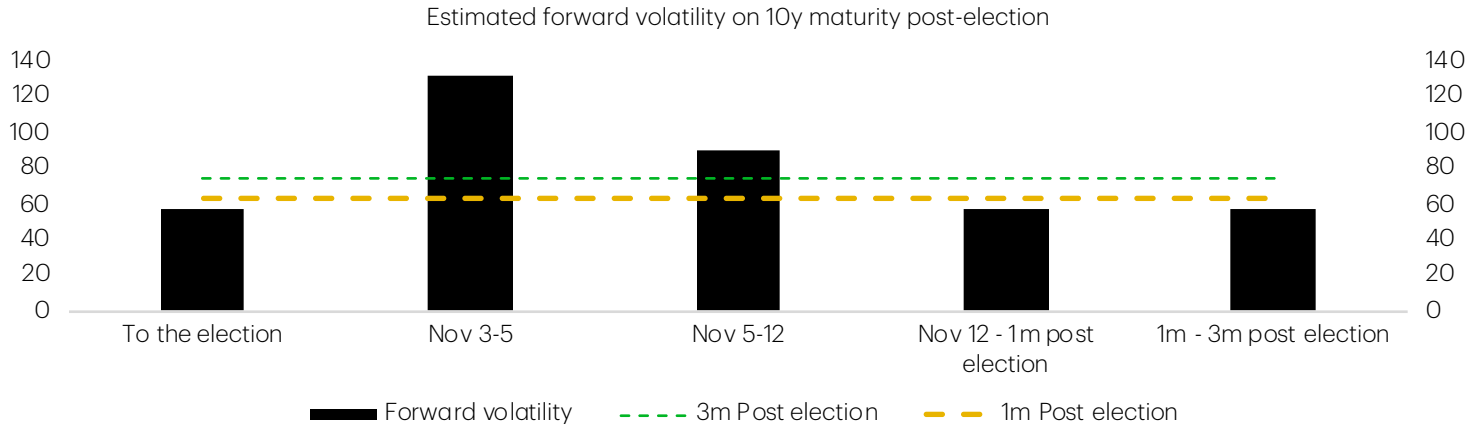
At TD Wealth, we don't make bets on things we can't know; instead we take proper account of what we do know and prepare for change as it comes. The economic environment can be broken down into four quadrants: rising/falling inflation and rising/falling growth. Nobody knows who's going to win the election, or what economic environment we're moving into, so the most prudent action is to build and manage portfolios in a way that is agnostic to the election or changes in the economic environment. Once the election is decided, we can make dynamic portfolio changes at the margins.

In fact, our investment philosophy is agnostic to economic environments in general. In accordance with this philosophy, we avoid making predictions about what risk factor, assets or security will outperform. Instead, we aim to diversify our exposures across the four economic environments and key risk factors as much as feasible. This way, we are not overly exposed to any single adverse event, including the outcome of the upcoming election.

Figure 13: Higher volatility since 1968 when presidency changes



Volatility concentrated around election and week after



Source: TD PAIR, Bloomberg, as of August 31, 2020

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	59,824	2.35	9.57	-1.05	3.80	6.04	6.81	6.45	4.63
S&P/TSX Composite (PR)	16,514	2.14	8.70	-3.22	0.44	2.78	3.57	3.32	1.94
S&P/TSX 60 (TR)	2,911	2.48	8.92	-0.10	4.35	6.94	7.31	6.81	4.52
S&P/TSX SmallCap (TR)	940	4.08	18.03	-4.22	-1.10	-1.00	4.00	1.87	0.03
U.S. Indices ($US) Return									
S&P 500 (TR)	7,192	7.19	15.48	9.74	21.94	14.52	14.46	15.16	6.34
S&P 500 (PR)	3,500	7.01	14.98	8.34	19.61	12.30	12.16	12.80	4.27
Dow Jones Industrial (PR)	28,430	7.57	12.00	-0.38	7.68	9.01	11.46	11.00	4.76
NASDAQ Composite (PR)	11,775	9.59	24.08	31.24	47.88	22.35	19.78	18.74	5.28
Russell 2000 (TR)	7,971	5.63	12.40	-5.53	6.02	5.03	7.65	11.53	6.91
U.S. Indices ($CA) Return									
S&P 500 (TR)	9,379	4.28	9.23	10.19	19.62	16.03	14.15	17.53	5.70
S&P 500 (PR)	4,565	4.10	8.76	8.78	17.33	13.79	11.85	15.12	3.64
Dow Jones Industrial (PR)	37,076	4.66	5.94	0.02	5.63	10.45	11.15	13.28	4.13
NASDAQ Composite (PR)	15,357	6.61	17.37	31.77	45.06	23.98	19.45	21.18	4.65
Russell 2000 (TR)	10,396	2.77	6.31	-5.15	4.00	6.42	7.35	13.82	6.26
MSCI Indices ($US) Total Return									
World	10,551	6.72	14.87	5.73	17.41	10.42	11.04	11.36	5.44
EAFE (Europe, Australasia, Far East)	8,275	5.15	11.33	-4.28	6.60	2.84	5.23	6.37	3.92
EM (Emerging Markets)	2,589	2.24	19.71	0.68	14.88	3.21	9.05	4.12	7.77
MSCI Indices ($CA) Total Return									
World	13,760	3.83	8.65	6.16	15.17	11.88	10.74	13.65	4.81
EAFE (Europe, Australasia, Far East)	10,791	2.30	5.31	-3.89	4.57	4.20	4.94	8.56	3.29
EM (Emerging Markets)	3,376	-0.54	13.23	1.09	12.69	4.58	8.75	6.26	7.12
Currency									
Canadian Dollar ($US/$CA)	76.68	2.79	5.72	-0.40	1.94	-1.31	0.28	-2.01	0.61
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	5,964	1.12	-1.86	-20.93	-17.26	-7.07	-0.93	1.33	-0.56
Hang Seng (Hong Kong)	25,177	2.37	9.65	-10.69	-2.13	-3.45	3.04	2.06	1.95
Nikkei 225 (Japan)	23,140	6.59	5.77	-2.18	11.76	5.61	4.14	10.12	1.60

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	0.15	0.39	0.62	1.16
U.S. Treasury Yields	0.11	0.27	0.71	1.48

Canadian Bond Indices ($CA) Total Return	Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)
FTSE TMX Canada Universe Bond Index	1,210	-1.13	1.82	7.66	5.85	5.51	4.14	4.39
FTSE TMX Canadian Short Term Bond Index (1-5 Years)	766	0.09	1.10	4.63	4.38	3.15	2.19	2.45
FTSE TMX Canadian Mid Term Bond Index (5-10)	1,314	-0.42	1.64	8.92	6.61	5.42	3.95	4.69
FTSE TMX Long Term Bond Index (10+ Years)	2,129	-3.01	2.78	10.54	7.04	8.60	6.76	6.97
HFRI Indices ($US) Total Return (as of April 30, 2020)								
HFRI Fund Weighted Composite Index	15,053	2.37	7.51	1.76	5.17	3.39	4.01	4.11
HFRI Fund of Funds Composite Index	6,561	2.08	6.55	2.81	5.50	3.12	2.76	3.15
HFRI Event-Driven (Total) Index	16,522	2.45	7.02	-2.67	0.28	1.67	3.45	4.22
HFRI Equity Hedge Index	23,329	3.46	10.26	3.91	9.85	4.76	5.52	5.20
HFRI Equity Market Neutral Index	5,576	0.15	0.90	-1.03	-0.91	0.91	1.91	2.50
HFRI Macro (Total) Index	15,641	0.14	2.90	2.31	0.24	1.99	1.50	1.44
HFRI Relative Value (Total) Index	12,466	1.36	4.81	-1.69	0.55	2.19	3.26	4.37
HFRI Indices ($CA) Total Return (as of March 31, 2020)								
HFRI Fund Weighted Composite Index	19,633	-0.48	1.55	2.26	3.13	4.79	3.74	6.23
HFRI Fund of Funds Composite Index	8,556	-0.76	0.65	3.31	3.45	4.51	2.49	5.24
HFRI Event-Driven (Total) Index	21,548	-0.40	1.09	-2.19	-1.67	3.05	3.18	6.34
HFRI Equity Hedge Index	30,425	0.58	4.16	4.42	7.71	6.18	5.24	7.34
HFRI Equity Market Neutral Index	7,272	-2.63	-4.69	-0.55	-2.84	2.28	1.65	4.58
HFRI Macro (Total) Index	20,399	-2.65	-2.80	2.82	-1.71	3.38	1.24	3.50
HFRI Relative Value (Total) Index	16,258	-1.46	-1.00	-1.21	-1.41	3.58	3.00	6.49

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return,. As of August 31, 2020.

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