North America Strategy

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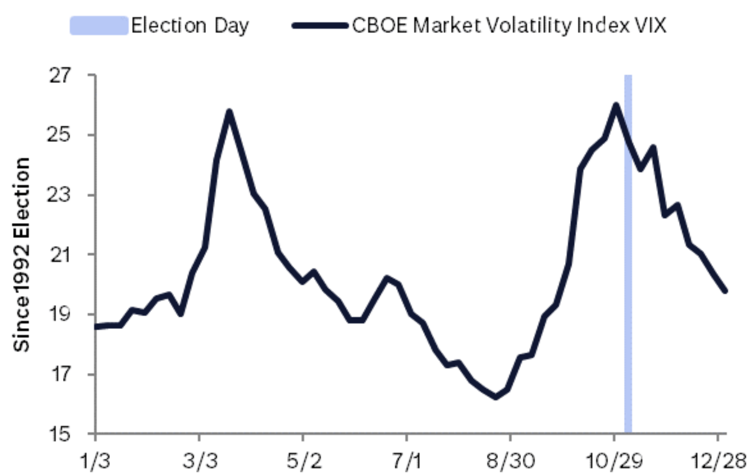
Road to the White House: Part 7

- After formally accepting the Democratic Party nomination for President, Vice President Harris is in a tight race with former President Trump. According to the average of the Real Clear Politics polls, she is ahead nationally by 1.5%, 48.4% to 46.9%. Trump has a 0.1% edge in the battleground states with small leads in Arizona, Georgia, Nevada, North Carolina, and Pennsylvania while Harris has a slight advantage in Michigan and Wisconsin. If we don't allow for toss-ups, RCP has Trump ahead 287-251 in the Electoral College tally. The polls should mean more after the September 10 debate.
- Stock market volatility in election years has tended to decline into the summer months and then pick up as the election draws near (**FIGURE 1**). Leadership has often been defensive in the six months before elections and cyclical in the six months after them (**FIGURE 2**).
- There are two main ways the election may impact municipal bonds. The first involves taxes and the second involves federal funding for states and localities.
- Historian, Professor Allan Lichtman, has correctly called every election since 1984 but one. His read using his "Keys to the White House" framework is expected before the debate.

FIGURE 1: Average CBOE VIX Index During Election Years, Since 1992



Source: Haver Analytics of August 26, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

Close Race but Polls Matter More After the Debate

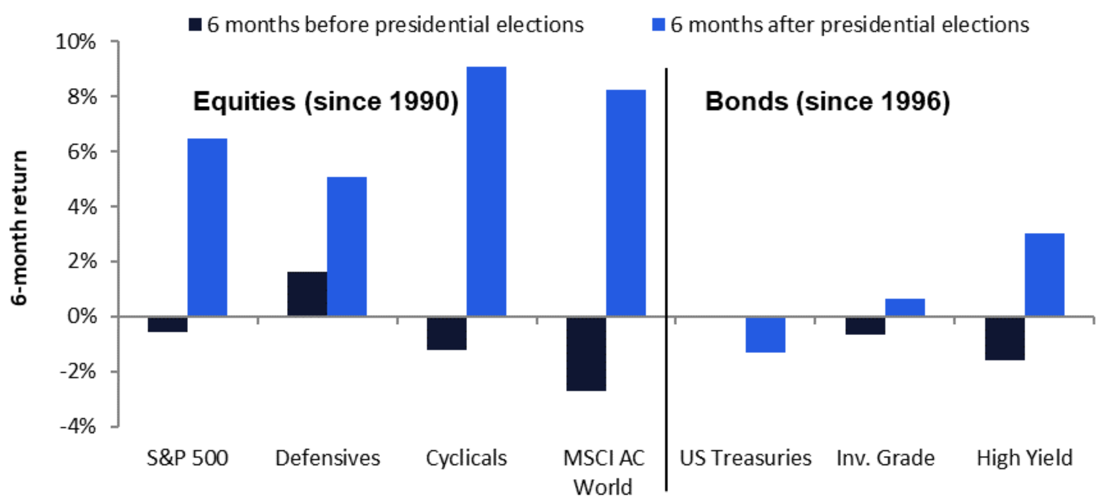
The 2024 US Presidential election has tightened since President Biden dropped out on July 21 and tossed his weight behind Vice President Kamala Harris to head the Democratic ticket. At that time former President Trump had a 3.0% national lead in the Real Clear Politics polls. It's still too early to rely too much on the polls. They'll likely be more telling following the Presidential debate on September 10. Still, according to the average of the Real Clear Politics polls, Harris is now ahead of Trump nationally by 1.5%, 48.4% to 46.9%. Trump has a 0.1% edge in the battleground states with small leads in Arizona, Georgia, Nevada, North Carolina, and Pennsylvania. Harris has a slight advantage in Michigan and Wisconsin. If we don't allow for toss-ups, RCP has Trump ahead 287-251 in the Electoral College.

Turning to the prediction markets, they give Harris the slight edge. For example, PredictIt now assigns a 56% chance of Harris winning in November versus a 48% chance for Trump. As a matter of perspective, the GOP nominee's chances peaked at 69% on July 15 shortly after a July 13 assassination attempt was made on his life. The highest probability Harris has reached to date was 59% on August 11. The RCP average is closer at 50.5% for Harris and 48.0% for Trump.

Election Year Volatility and Market Leadership

Stock market volatility in election years has tended to decline into the summer months and then pick up as the election draws near (**FIGURE 1**). Stock and bond market leadership has often been defensive in the six months before elections and cyclical in the six months after them (**FIGURE 2**). In 2024, defensive stock market sectors have outperformed cyclical ones since mid-July, and Baa credit spreads in the bond market are up slightly since late May.

FIGURE 2: Cyclical versus Defensive Positioning in Stocks and Bonds Around Elections



Source: Haver Analytics, FactSet, and Bloomberg as of August 26, 2024. Note within the S&P 500, Defensive sectors include Consumer Staples, Health Care, Communication Services and Utilities; Cyclical sectors include Consumer Discretionary, Energy, Financials, Real Estate, Industrials, Information Technology and Materials. US Treasuries are measured by Bloomberg US Aggregate Government – Treasury Index, Investment Grade by Bloomberg US Corporate Investment Grade Index, and High Yield by Bloomberg US High Yield – Corporate Index. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

How the Election May Impact Municipal Bonds

There are two main ways the 2024 elections may impact municipal bonds. The first involves tax policy and the second includes federal funding to states and localities that supports the credit quality of municipal issues.

We think municipal bonds have strong support on both sides of the aisle, although Democrats have been friendlier in recent years. For example, the 2021 Infrastructure and Jobs Act expanded the use of private activity bonds. But neither party has been vocal on municipals during the 2024 campaign. Unless Congress acts, trillions in tax cuts will expire after 2025. The Tax Cuts and Jobs Act of 2017, or TCJA, lowered the federal tax brackets with the top rate falling to 37% from 39.6%. The $10,000 cap on the federal tax break for state and local taxes, known as the SALT deduction, is also slated to sunset after next year. Former President Trump wants to extend these provisions while Vice President Harris wants to do so for those earning less than $400,000 a year.

As a Senator, Harris joined the entire Democratic caucus in voting against the *Tax Cuts and Jobs Act (TCJA) of 2017*. As the Governor of a major municipal bond issuer, Minnesota, Democratic Vice-Presidential nominee, Tim Walz, probably has the most experience with municipal bonds of anyone on the two major tickets in this election, according to the National Association of Bond Lawyers. In his time as a Governor, Minnesota has issued five general obligation bonds. As a member of Congress, Walz also voted against the TCJA.

Given the size of recent deficits, some type of tax reform cannot be ruled out in the future. But arguments for responsible fiscal stewardship are more likely to come in the next Congress not the Presidential election.

What the next President will be able to tackle ultimately depends on the balance of power mix it shares with Congress. If some of the TCJA's lower income tax rates are allowed to expire with a Democratic sweep, for example, it would make the municipal bond tax exemption feature more valuable versus other bonds, especially if the corporate tax rate is also raised, as it would make tax-exempt bonds more valuable to corporations. However, if the tax exemption on interest income is capped for individuals, at say a 28% tax rate as was proposed under the Obama administration, it would reduce the value of the exemption for those investors in higher tax brackets versus where it stands today.

The Journal of Accountancy notes there could be a greater incentive to diversify portfolios out of state if the TCJA sunsets. That's because the $10,000 cap on state and local taxes (SALT) would also sunset. This may occur where a taxpayer's resident state excludes municipal bond interest on in-state bonds, but taxes interest generated from those that are out of state. The sunset of the SALT cap would make it easier for investors to deduct state and local tax payments on bond interest and thus make it easier from a tax perspective to diversify their holdings out of state. In practice, investors will have to weigh these incentives against any mitigating affects emanating from the alternative minimum tax (AMT) or limitations to itemized deductions allowed for high income earners.

In the case of a Republican sweep, the GOP will need to raise money to make the TCJA permanent. In passing the TCJA in 2017, the municipal tax exemption remained in place, but there was a provision that eliminated the tax-exempt status for advance refunding bonds which allowed municipalities to refinance once before their bonds' redemption. In 2025, lawmakers could find themselves once again on the hunt for new ways to finance lower tax rate extensions.

Turning to spending, the federal government provides significant funding each year for states and localities. Over the last four decades, federal grants to state and local governments have made up about 17 percent of their total revenues, according to the Peter G. Peterson Foundation. However, during the pandemic, this share rose to 20%. As the relief aid came in, state rainy day funds, in the aggregate, swelled to record levels (**FIGURE 3**).

In 2023, federal grants totaled $1.1 trillion with $616 billion going to Medicaid, $167 billion to income security, $48 billion to education, another $48 billion to highways and $24 billion to disaster relief, according to the Peter G. Peterson Foundation. Looking ahead, the general appetite for federal spending may be lower than it has been in recent years, as the nation's fiscal position is more stretched. Municipal bond yields, at the index level and before being converted into a tax-equivalent yield, have only been higher 17.4% of the time since 2011 (**FIGURE 4**).

FIGURE 3: Total States Rainy Day Fund Balances in Dollars and as a % of General Fund Expenditures

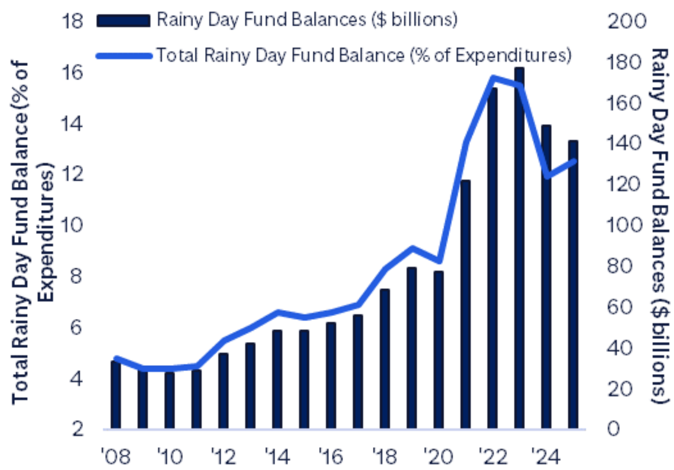
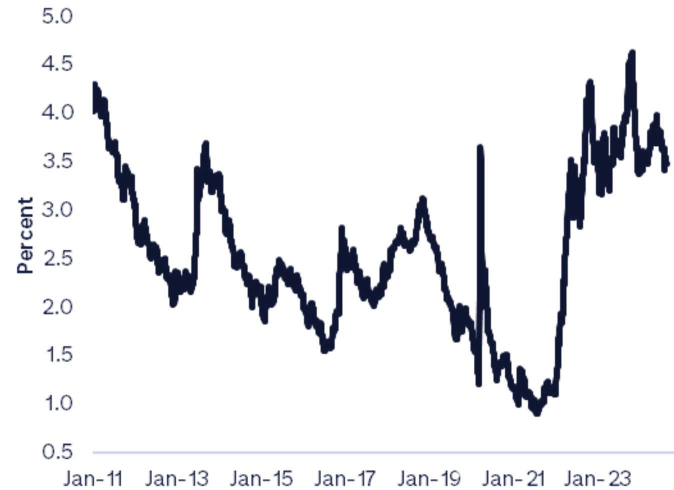


FIGURE 4: ICE BofA US Municipal Securities Yield Since 2011



Source: Haver Analytics, FactSet, and National Association of State Budget Officers, as of August 26, 2024. They are shown for illustrative purposes only and do not represent the performance of any specific investment. **Past performance is no guarantee of future results. Real results may vary.**

13 Keys to the White House Framework

Historian, Professor Allan Lichtman, has correctly called every election since 1984 but one using his "Keys to the White House" framework[1]. He is expected to make is verdict known after Labor Day but before the September 10 debate. He doesn't rely on polls or debate performances. His methodology is based on the hypothesis that all elections are really a referendum on the incumbent party and they either earn another four years or they do not. The 13 Keys are listed below. If six or more of these 13 true/false statements are false, the ruling party is predicted to lose the election. Should five or less be false, the ruling party is expected to win.

As we await Professor Lichtman's conclusion, he has recently said that keys 1, 3, and 12 are false while 10 and 11 are leaning false. Keys 5 and 8 are still shaky although recent protests have been below 1968 Vietnam era levels. While many pundits say RFK Jr. dropping out and supporting Trump hurts Harris, Professor Lichtman's Keys take a different angle. Third party candidates emerge when there is widespread dissatisfaction which, of course, is a problem for the incumbent in the race. By this logic, RFK Jr. dropping out signals there isn't ample space for a third-party challenge to capture the widespread imagination of voters in 2024 from the two main parties. Stay tuned!

1. **Party mandate:** After the midterm elections, the incumbent party holds more seats in the U.S. House of Representatives than after the previous midterm elections.
2. **No primary contest:** There is no serious contest for the incumbent party nomination.
3. **Incumbent seeking reelection:** The incumbent party candidate is the sitting president.
4. **No third party:** There is no significant third party or independent campaign.
5. **Strong short-term economy:** The economy is not in recession during the election campaign.
6. **Strong long-term economy:** Real per capita economic growth during the term equals or exceeds mean growth during the previous two terms.

[1] Lichtman, Allan J. (2016). *Predicting the Next President: The Keys to the White House.* Lanham, Maryland: Rowman & Littlefield

7. **Major policy change:** The incumbent administration effects major changes in national policy.
8. **No social unrest:** There is no sustained social unrest during the term.
9. **No scandal:** The incumbent administration is untainted by major scandal.
10. **No foreign or military failure:** The incumbent administration suffers no major failure in foreign or military affairs.
11. **Major foreign or military success:** The incumbent administration achieves a major success in foreign or military affairs.
12. **Charismatic incumbent:** The incumbent party candidate is charismatic or a national hero.
13. **Uncharismatic challenger:** The challenging party candidate is not charismatic or a national hero.

Parting Thoughts

The S&P 500 has risen in 13 of the past 15 election years. It has also posted positive returns during both the Trump and Biden-Harris administrations. But elections are just part of our analysis. We expect inflation to fall, the Fed to cut rates, and stock market leadership to broaden out on rising profits that are also broadening out by sector. Following our latest Global Investment Committee (GIC) meeting, for a moderate risk balanced portfolio, we are recommending **a** Global Equities overweight of 4.5%, a Fixed Income underweight of 3.5% and a Cash underweight of 1%. For now, our tactical weightings remain generally higher for US assets versus the rest of the world.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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