October 2020

Vote No on Volatility

Stephanie Hill | Head of Index
Theodore Bair Jr., CFA | Senior Investment Strategist

BNY MELLON | INVESTMENT MANAGEMENT

MELLON

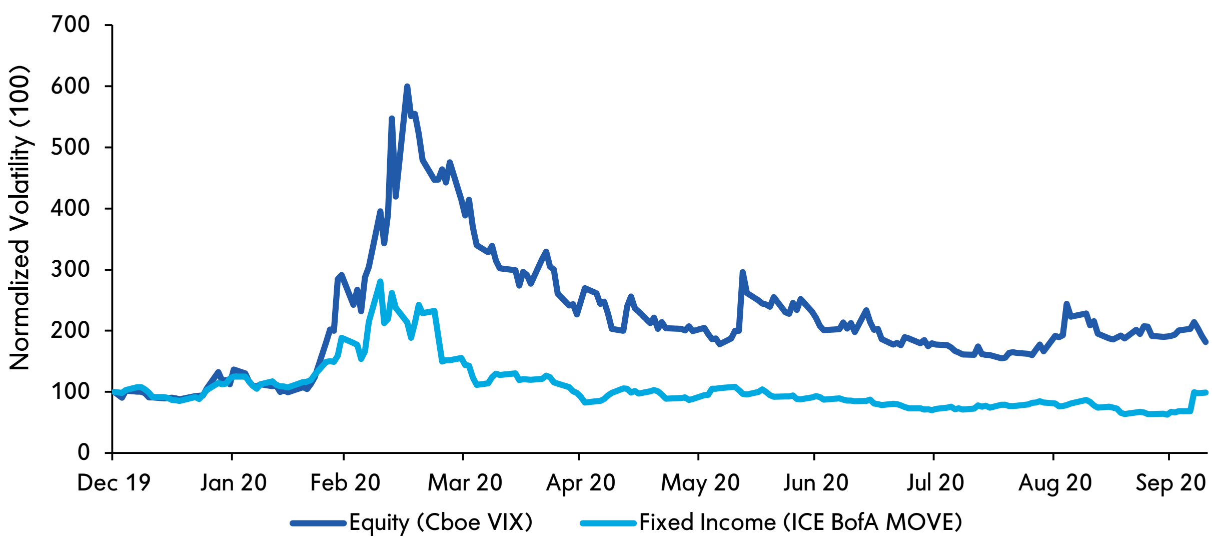
Over the last thirty years, voter polling has taken on increasing importance in the election process in the US and Europe. Polling provides valuable insight into evolving voter sentiment, which is a key component of candidate positioning, campaign strategy and media reporting. However, changing polls can contribute to pre-election market volatility as investors attempt to position themselves in response to the latest perceptions of the winning candidate. While recent polling experiences such as the surprising outcomes of the June 2016 Brexit referendum and the 2016 US presidential election suggest that one should consider polling results with a healthy degree of skepticism, we still need to consider the market impact of changing voter preferences and positioning.

From the perspective of the index manager, whose goal is to deliver benchmark returns with similar risk as that of the index and with minimal tracking error, the impact of election-driven volatility is often of greater importance than the ultimate outcome. Heightened market volatility directly affects price discovery, trade execution and market liquidity; and it can drive periods of brief yet sharp divergences between market sectors, capitalizations (large versus small), and fundamental factors (growth versus value). In light of the looming US presidential election, we review the possibility for a possible uptick in election-related market volatility, as well as the potential market impact of a contested or undecided election.

2020: A Volatility Odyssey

Both equity and fixed income market volatility in the US was muted at the start of 2020, but skyrocketed sharply as the COVID-19 pandemic took hold. At the height of the pandemic lockdown, volatility in fixed income markets was nearly three times its pre-pandemic level, while equity markets reached nearly six times their pre-pandemic level. Since that initial surge, fiscal and monetary responses by the US Government and Federal Reserve (Fed) have served to calm skittish investors. Though volatility has since stabilized during the strong recovery in US equity markets, we believe the risks of a renewed and unexpected election-related surge remain a distinct possibility.

US Market Volatility



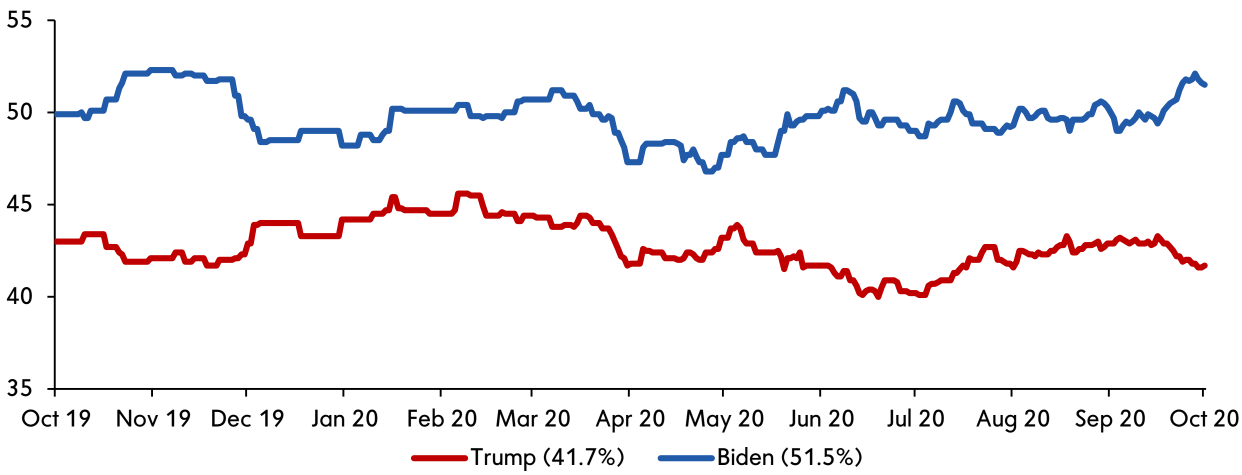
Source: Cboe, ICE BofA, Bloomberg. As of October 9, 2020.

Shape of the Campaign

Throughout the 2020 campaign for the US presidency, Democratic candidate Joe Biden has consistently led in the polls, with his lead widening further in recent weeks. In isolation, this should not be taken as virtual certainty that the US will be inaugurating a new president; merely that there is a reasonably strong probability of this outcome.

Poll Average

General Election: Trump vs. Biden

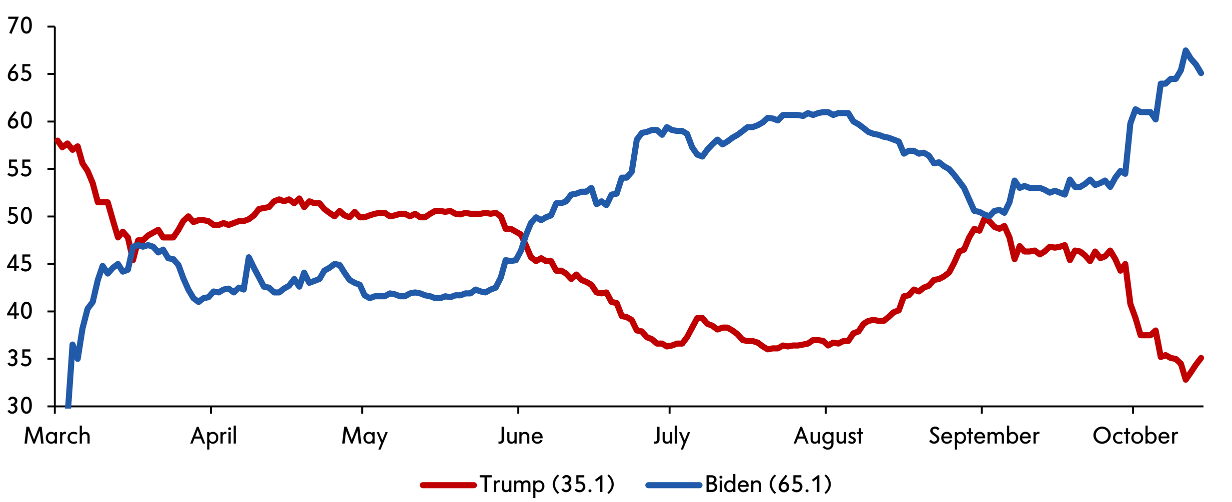


Source: RealClearPolitics, Bloomberg. As of October 14, 2020.

Looking to a different set of prediction markets, we see a similar dynamic at work in the betting markets. Betting markets have gained some credence in recent years as an alternative to polls, perhaps because real money is at stake, as opposed to no-cost opinions. RealClearPolitics' average of eight betting markets showed Biden and Trump at even odds to win the US Presidency in mid-September; those odds have since widened considerably in favor of a Biden victory.

Betting Average

Betting Odds: Trump vs. Biden



Source: RealClearPolitics, Bloomberg. As of October 14, 2020.

Entering the Home Stretch

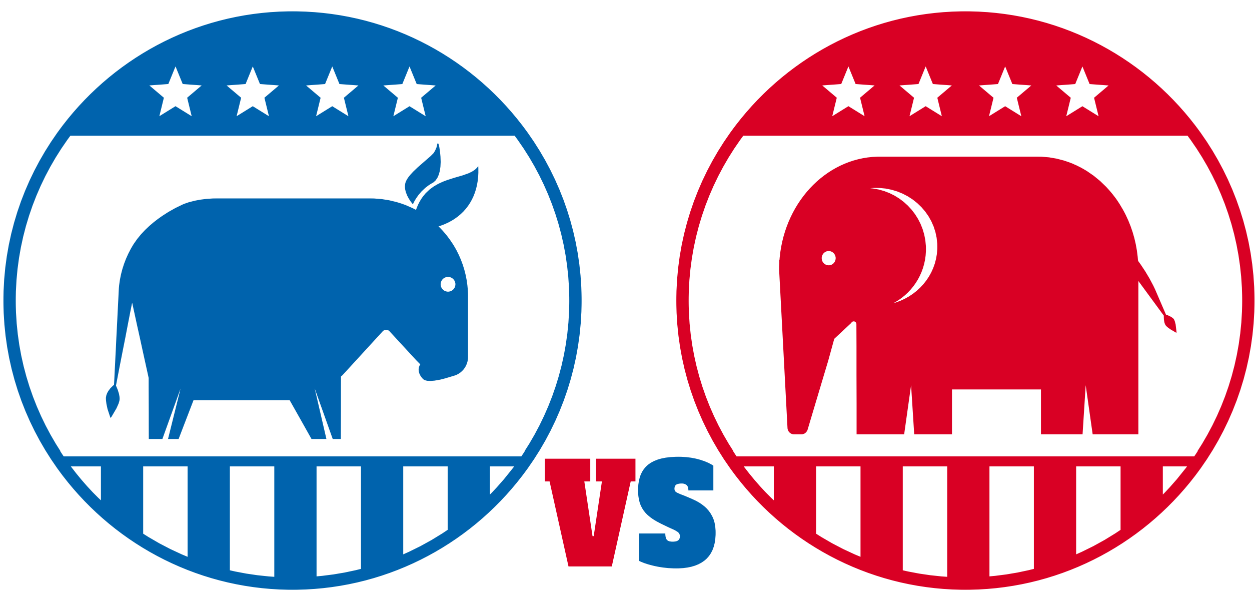
The US presidential campaign, just as 2020, has been anything but ordinary. The COVID-19 pandemic has forced profound changes to campaign dealings; significantly reducing the volume and scale of rallies and forcing the major parties' nominating conventions to be held primarily virtually.

With less than a week remaining before Election Day, there are still several areas with the potential to jolt the markets and ratchet up volatility:

1. Both parties have been unable to reach an agreement on additional stimulus measures ahead of the election. Who will voters punish at the polls?

2. Efforts to nominate Ruth Bader Ginsburg's successor to the Supreme Court ahead of the election have deepened an already bitter partisan divide. Will the nomination process galvanize sidelined voters?

3. The first estimate of third-quarter GDP will be released on October 29. After a precipitous drop of 31.4% (annualized) for the second quarter, voters will most certainly view this release as a twin referendum on the Trump administration's handling of COVID-19 and management of the economic fallout. At the time of publication, Bloomberg estimates a third-quarter rebound of +32.0% (annualized) in US GDP. Will that rebound materialize and will it drive voter behavior?



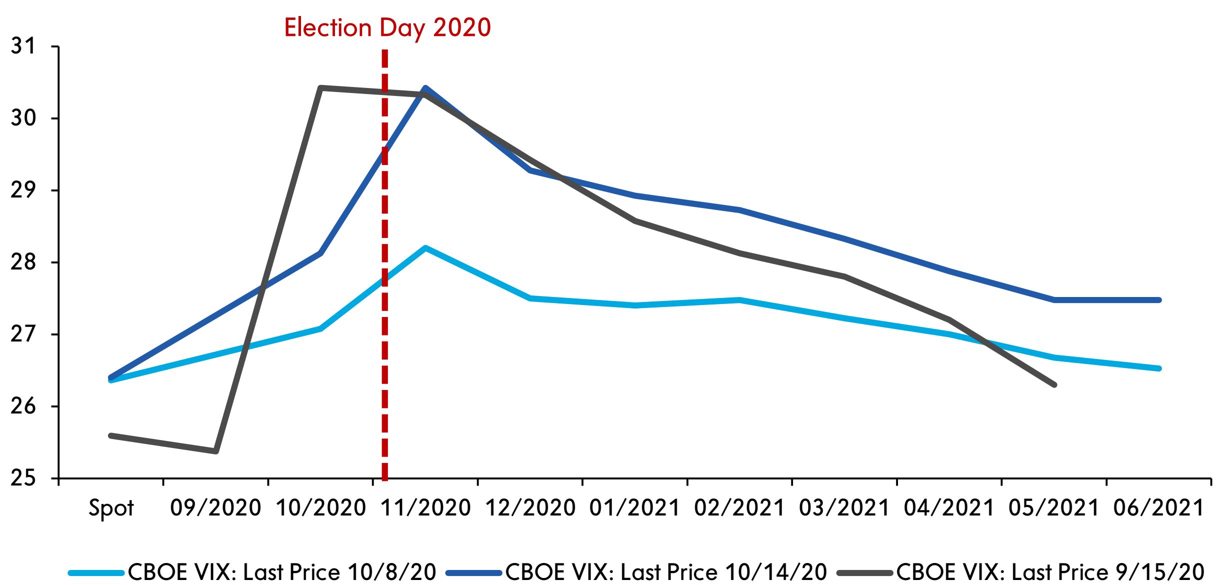
Will We Know Who Won on Election Night?

In more normal times, the answer to this question is usually "yes." However, as is typical of 2020, the COVID-19 pandemic has complicated matters, forcing profound changes on how the electorate will actually vote in 2020. With social distancing restrictions still enforced across most of the US, voters are expected to turn to mail-in and early voting in record numbers, and those that do vote in person can expect to face long lines and wait times before they cast their ballot. Perhaps foreshadowing the possibility of a contested election, Trump has repeatedly linked mail-in voting as an avenue for election tampering throughout his campaign.

Several battleground states such as Pennsylvania and Wisconsin do not allow early or mail-in ballots to be counted until Election Day, and several other key battleground states such as Ohio, Michigan, Texas and Florida place limits on how early these ballots can be tallied. Together these six states account for 131 electoral votes (24% of total electoral votes of 538); therefore, any significant delay in certifying their election results means the country may not know who the next President will be for several days if not weeks.

The prospect of a contested or undecided election is reflected in forward estimates of volatility (using VIX index futures) that is uncharacteristically humped around Election Day:

Forward Volatility Estimates (VIX Index Futures)



Source: Bloomberg. As of October 14, 2020.

Forward volatility normally follows an upward sloping curve, reflecting that volatility "insurance" for longer periods is more costly than for shorter periods. However, as Volatility Index (VIX) futures have rolled forward through time, contracts expiring around and after the election became more costly as investors priced in a higher degree of uncertainty regarding the outcome. Election hedging is expensive and continues to get pricier as reflected in the VIX term structure.

Compared with VIX futures prices one month ago, investors today seem to be more comfortable with poll results indicating a Biden victory. Furthermore, the wider margin of victory in recent polls has diminished, but not entirely reduced the risks of a contested election. However, another poll "surprise" would most certainly move already skittish markets.

Navigating Through Uncertainty

The one key thread unifying any election scenario is the expectation that the Federal Reserve will continue with an extremely accommodative monetary policy. With current Fed Chair Jay Powell's term continuing through February 2022, and both candidates generally supportive of the Fed's extraordinary efforts to support the country's markets through the pandemic, this has been the one government institution that has been a reliable constant throughout this tumultuous year.

While we are not prognosticating any specific outcome for the November elections, as experienced investors we advocate caution. We are preparing for election-related market volatility and have been working closely with our trading desks to prepare for whatever conditions lay ahead.

Stephanie Hill
Managing Director, Head of Index

Stephanie is Head of Index. She is responsible for managing all aspects of the index business including portfolio management, asset retention and growth, business strategy, profitability and the development of index investment staff into roles of increasing responsibility. Stephanie works closely with the heads of equity and fixed income index.

Previously at the firm, she was responsible for co-heading the index division as well as articulating Mellon's index strategies to clients and prospects. Prior to joining the firm, she was a strategic product innovator within the iShares division at BlackRock, focused on designing and developing new ETF products and business solutions. Prior to joining iShares, she was an institutional investment strategist for BlackRock in San Francisco and New York. Previously, she was an investment strategist with Merrill Lynch Investment Managers. Stephanie has been in the investment industry since 1999.

Stephanie earned an MFA from New York University and a BA from the University of California at Berkeley.

Theodore Bair Jr., CFA
Vice President, Senior Investment Strategist

Ted is a senior investment strategist, responsible for articulating the firm's index strategies to clients, prospective clients and consultants to help grow and retain Mellon's index business. He works closely with sales and client service staff worldwide to guide the messaging and positioning of index strategies and to develop product solutions for client portfolios.

Previously, Ted oversaw attribution and risk analytics for Mellon's Active Fixed Income division. Prior to that, Ted held roles of increasing responsibility in fixed income trading and portfolio management for Mellon Bond Associates, followed by roles as a senior portfolio manager and investment strategist for Standish Asset Management and Cash Investment Strategies. Ted has been in the investment industry since 1995.

Ted earned a BA in finance from Westminster College and an MBA in finance from the University of Pittsburgh. He holds the CFA® designation and is a member of the CFA Institute and CFA Society Pittsburgh.

Disclosure

For more market perspectives and insights from our teams, please visit www.mellon.com.

BNY MELLON | INVESTMENT MANAGEMENT

MELLON

www.mellon.com