USD – Election response begins to appear

- **The USD has begun to move roughly in line with Trump online market re-election odds**
- **Trump re-election odds have risen sharply over the last week**
- **Bloomberg remains more electable than Sanders, but Sanders leads in nomination probability**
- **We see USD-JPY downside as the best election hedge**

US financial markets may be responding to election risk

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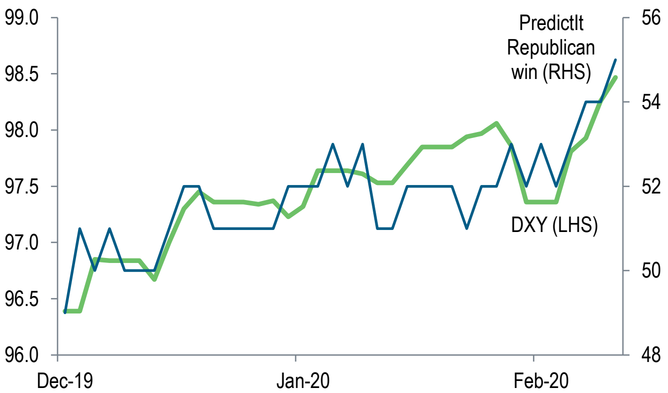
We find a stronger correlation between Trump re-election odds in online markets and the USD than we expected (Figure 1). The 6-percentage point increase in Republican re-election probability has mirrored the roughly 2% move seen in DXY since the beginning of the year. There is a similar correspondence between re-election odds and the S&P (Figure 2). These data are suggestive but are based on about six weeks of data, so are not definitive. However, they may partly explain why US asset markets have done so well over the last week when coronavirus worries have hit asset prices abroad.

We still suggest that investors seriously consider hedging election risk because neither polls nor online markets suggest a shoo-in for Trump. We like USD-JPY downside as a hedge when it moves into the 109.50-110.50 range. We like USD-JPY downside for other reasons as well, see *USD-JPY – Fading flow support*. JPY has not been able to stay above 110 for any sustained period since early May 2019 (Figure 3). However, it has also been responsive to downside economic shocks. We suspect that Japanese policy makers want to avoid an overly weak JPY that could become a political issue in an US election year. To us, the limited upside on JPY, its low implied volatility, and the responsiveness to negative political and economic shocks make it an attractive hedge to long risk positions.

We also think that perceptions of political risk may be understated. In most markets 6-4 probability of profit is not considered a sure thing and investors would often look to find a hedge for 40% risk of loss. In our survey *Informal survey responses*, less than a quarter of respondents assessed President Trump's re-election probability as more than 60%, and more than 30% saw the re-election risk in a 53-60% range.

Figure 1: Republican presidential probabilities and DXY edge up together

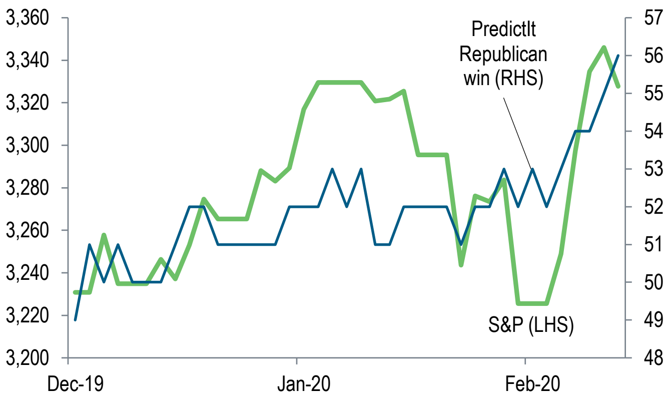
Index DXY (LHS); Republican win, % (RHS)



Source: Macrobond, Standard Chartered Research

Figure 2: Republican presidential probabilities and S&P edge up together

S&P (LHS); Republican win, % (RHS)



Source: Macrobond, Standard Chartered Research

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Some question whether the Democrats can win a Senate majority, given that the Republicans now have a 53-47 majority, and whether a Democratic president could accomplish much facing a Republican Senate majority. Of the 35 seats up for election, 23 are held by Republicans largely in safe states, and online markets give the Republicans about a 70% chance of keeping control. This confidence misses important issues, in our view. If a strongly left-leaning candidate wins the presidency, it probably means that there has been a broad shift in positions held by the electorate that will show up in other races. In other words, Sanders does not have a high chance of winning the presidency, but a Sanders (or Warren) win and a Democratic Senate are correlated events. Even if the Republicans keep the Senate, there are again almost twice as many 2022 Republican candidates as Democrats, and the weaker ones could cooperate with the Democrats as a re-election ploy.

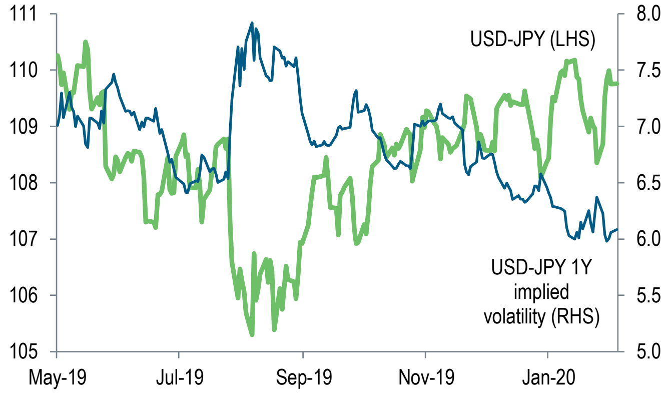
Even if the Senate is unfriendly, the president can do a lot through decree. Limits on fracking, carbon-based energy production, other environmental, health and labour regulation, discretionary enforcement of existing laws and re-orienting trade negotiations do not need legislation. These would have a significant impact on expected cash flow in affected industries.

We calculate electability in online markets by dividing the probability of winning the presidency by the probability of winning the nomination. If a candidate has a one-third chance of winning the nomination and a 10% chance of winning the presidency, their implied electability is 30%. As of 9 February Bernie Sanders is the big leader in the Democratic field, with 35-40% probability of winning the nomination based on online market prices. However, the probability of his winning the election, conditional on winning the nomination, is a low 40% (Figure 4) and his odds of winning the presidency are much lower than his odds of winning the nomination. By contrast, Bloomberg has been moving up in both his nomination and presidential election probabilities in online markets, and is now the number 2 Democrat in both. However, his electability is around 50%, the only major Democratic candidate near 50% at present.

Despite his strong performance in Iowa, Buttigieg has not become a top-ranked candidate in online markets. The probability of his winning the nomination has surged to around 15%, but online markets are sceptical of his ability to win the presidential election. We suspect the improved Republican probabilities reflect both the higher Trump re-election odds and scepticism that Sanders can win the presidency. In turn, these developments may be contributing to the bid on US asset prices.

Figure 3: USD-JPY high, USD-JPY 1Y ATM volatility low

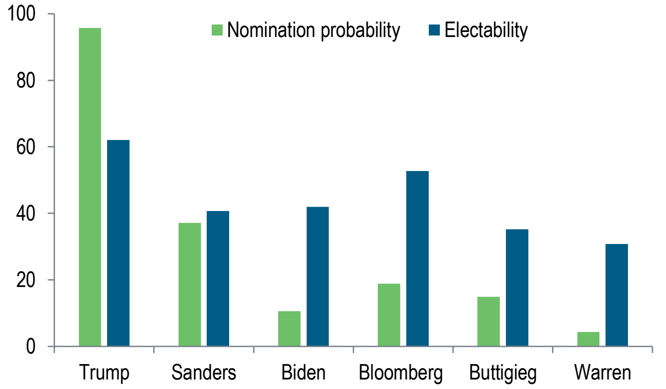
USD-JPY (LHS); USD-JPY 1Y implied ATM volatility (RHS)



Source: Macrobond, Standard Chartered Research

Figure 4: Nomination probabilities and electability

%



Source: Macrobond, Standard Chartered Research

As an aside, the moves of the last week or so illustrate some of the strengths and weaknesses of online markets. The dive in Biden nomination probabilities and the rise in Buttigieg and Sanders have very much followed the headlines and the available Iowa caucus results. The changes in election probabilities in online markets look reasonable, but occurred after the news on polling and the Iowa caucus, not before. We think it is fair to treat the online market prices as a good summary of election views held by the public, but we do not see the prices as having a major predictive edge. For a deep dive into the US election, see *US elections – Trump redux?*; for an earlier discussion of online markets and electability see *US asset markets and electability*.

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