Heading into the presidential debate, two key points to remember

Bob Pisani

September 23, 2016

"I don't have any idea what he's going to do, and I don't think the markets have any idea either."

That was George Selgin, director of the Center for Monetary and Financial Alternatives at the Cato Institute, speaking CNBC this morning about what Trump about the economy if elected president.

Now that the Fed is out of the way, at least until December, traders are pondering exactly what the election of either major candidate will mean for the markets.

One thing's for sure: Up to this point, the presidential election has not moved markets much. Goldman acknowledged this in a recent note, saying, "While it is already a common topic of conversation with clients, it does not yet seem to be affecting investment decisions."

But that will change soon — particularly after the first presidential debate on Monday.

Here is the conventional narrative:

1. The base case is divided government. Markets are positioned for a Clinton win, with the House staying Republican.
2. Markets are not positioned for a Trump victory. Therefore, as we get closer to the election and if it appears Trump has a reasonable chance of winning, market volatility will notably increase.

Smart traders are bringing up two points about the election and markets. No matter who wins, austerity will likely be de-emphasized, and the conventional narrative that a Trump victory will be bad for the markets should be questioned.

1) No matter who wins, it's likely that austerity is over, and several sectors will be likely beneficiaries. Congress may seem gridlocked, but there is a growing consensus that the new Congress — whoever controls it — may be in a mood to spend.

"One of our key themes for both the US and global economy is that fiscal policy is shifting from austerity to modest stimulus," Ethan Harris, global economist for Bank of America Merrill Lynch, wrote in a recent report.

Some are even more aggressive. "Government austerity is over, and monetary policy will pass the baton to aggressive fiscal policy," Michael Arone, chief investment strategist for State Street Global Advisors' U.S. intermediary business, said in a recent note.

But what kind of stimulus? Both candidates have expressed a desire for more infrastructure spending and both are strong on defense. That would mean that certain industrials and materials firms with exposure to higher infrastructure spending, as well as aerospace & defense stocks, would be logical choices. Goldman specifically cites Honeywell,Northrop Grumman, and L-3 Communications in the aerospace & defense space. It also highlights Vulcan Materials, Martin Marietta Materials, Summit Materials (all building materials) and Gerdau (steel) in the materials space.

OK, that makes sense. But past these sectors, it gets murky. Clinton and Trump differ significantly on many sectors that could affect markets, including:

- Energy: Clinton, for example, favors more regulation of the fracking industry and more investment in alternative energy. Trump favors less regulation.
- Health care: Clinton supports keeping the Affordable Care Act, which will continue to benefit hospitals. Drug companies will face pressure on drug costs. Trump would repeal the ACA.

Congress is also a significant wild card. Beyond infrastructure spending, it's not clear where Congress may come down on many critical issues. Corporate tax reform, for example, is frequently cited as an area of cooperation between Clinton and GOP House Speaker Paul Ryan, but that would depend on whether they could find common ground on a lower rate and closing loopholes.

That also applies to trade. Current deals will stay in place but the Trans-Pacific Partnership is likely in trouble.

On financial regulations, a Republican-dominated House would not support big tax increases on the wealthy or a significant expansion of Dodd-Frank or other financial regulations, as Clinton supports.

2) The conventional narrative on a Trump victory, that the markets will be more volatile and stocks will decline should be questioned.

Didn't we learn this lesson from the British referendum on leaving the European Union? It was the same scenario: Markets were positioned for a "no" vote. Polls indicated a "no" vote was the winner. When the UK voted "yes," the S&P 500 dropped a little more than 100 points in the following two days, but then gained it all back in the next few days! Even more, it was the start of a significant breakout, with the major indices powering to historic highs in the next six weeks.

OK, a Trump victory has different characteristics, but you get the point.

Another point rarely discussed is that a Paul Ryan-led House will not necessarily be Trump's lapdog. Ryan, by all accounts, is no fan of Trump's and will almost certainly serve as a break on any of his more controversial proposals.

We could thus ultimately see a Trump victory — a victory that seems like a radical departure from everything that came before it — turn into something that is much more status quo Republican than anyone is really thinking.

Finally, the ultimate rule may be that presidents are not as important as other issues. It's likely that the most important issue for the markets will be the Fed and tightening by central banks, lack of earnings growth, high valuations, consumer balance sheets and the threat of a recession after eight years of expansion.

That's a good point to end on. The next president will very likely face a recession sometime in the next four years, if history is any guide.