The Potential Impact of the U.S. Presidential Election on the Markets—and What It Means for Investors

October 2020

The stock market has seen its share of volatility in 2020. Through the first nine months of this year, the S&P 500 moved up or down by at least 2% on 42 days.[1] This already makes it the most volatile year for U.S. stocks since the 2008–2009 Financial Crisis. We've been through a pandemic, disruption to the global economy, turbulence to the capital markets, and, of course, a highly contentious presidential election.

According to BlackRock, stocks tend to perform similarly in the final months of the year regardless of whether it's an election year. From 1926 to 2019, the average monthly performance of U.S. large-cap stocks was 1.4% and 1.6% in November and December, respectively. In election years only, the average returns were 1.3% in November and 1.7% in December.[2]

However, for many people, this does not feel like an ordinary election year.
Amid the backdrop of the pandemic and a political environment that is approaching a boiling point, many investors are asking if we can really treat this election period like any other.

In this paper, we'll investigate some common concerns about the upcoming presidential election and work through various possible scenarios for the coming months.

Is one party better than another for investors?

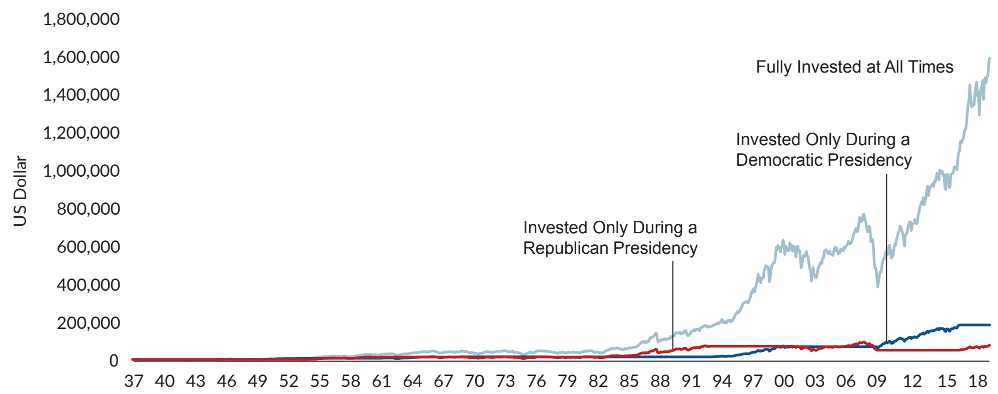
A common question asked by investors around election time is whether the Democratic or Republican party is typically more beneficial to the markets.

Historically, neither party has an edge when it comes to stock market returns. Going back to 1937, the average annual return for the Dow Jones Industrial Average was 9.2% in years of a Democratic president and 9.1% in years of a Republican president.[3]

In fact, investing only when a certain political party is in power may have a devastating impact on long-term portfolio growth.[4]

A $10,000 investment in the Dow Jones in 1937 would be worth approximately $1.6 million as of December 2019. The same investment made only during a Democratic or Republican Presidency would be worth around $200,000 or less. In other words, trying to time the market based on political party does not have a benefit—and can drastically reduce a portfolio's value.

Growth of US$10,000: Dow Jones Industrial Average



Past performance does not guarantee future results.
As of December 31, 2019
Monthly performance of the Dow Jones Industrial Average, dating back to 1937. Source: Bloomberg and AB

Taking things a step further, the markets have performed well under both divided and unified governments. The average annual return for the Dow is 10% during periods of divided governments and 8.2% when a single party controlled both the executive and legislative branches.[5]

Does election year performance matter?

While markets tend to rise regardless of who is in office, volatility is common in the months leading up to an election.[6] In our view, volatility rises during election seasons due to the expectation that there will be market fluctuations, aided by the media circus that tends to surround elections. This can drive people to think more myopically about their investments.

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People also just tend to get scared. For example, since 1993, money market funds have seen higher inflows in election years compared to non-election years.[7] By one calculation, investors send two times as much money to cash in election years as they do in every other year. It's an indication that people tend to get nervous around election time—pretty much every time.

But that's unfortunate because markets tend to perform just fine in election years.

In fact, stock market performance has generally been above average in presidential election years. Dating back to 1926, U.S. stocks were up an average of 11.3% during presidential election years compared to 10.1% in all years.[8] Investors who moved to cash during election years missed out on some growth.

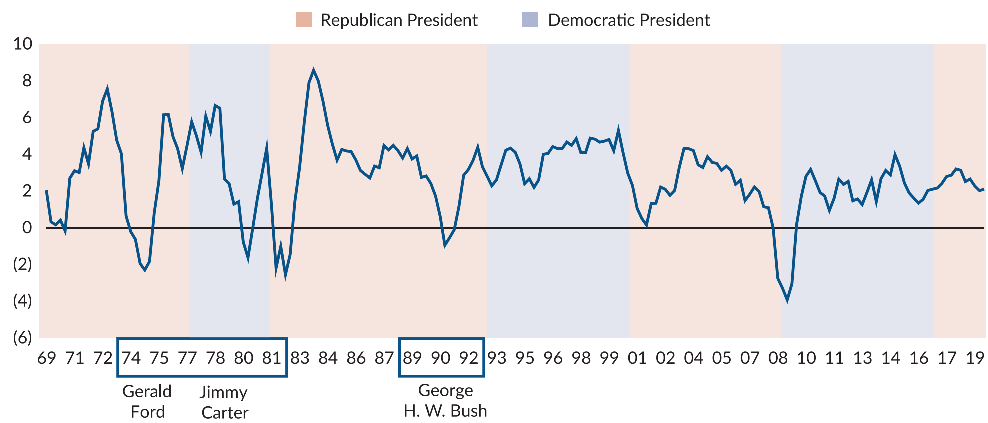
But what about *this* election?

Many people might feel that this year is different—and indeed, there are several unique factors at play in the 2020 election.

The pandemic, and its broad economic costs, is a big one. The health and economic blows have been felt acutely here in the U.S., and the economy is still in tricky territory. Generally speaking, in a situation where the economy is in a recession, re-election of the sitting president would be extremely unlikely.

As a recent Alliance Bernstein study put it, "Presidents don't cause recessions, recessions end Presidents."[9] In other words, the number one way for an incumbent president to lose re-election is to have a recession in an election year.

US GDP: YoY Percentile Change



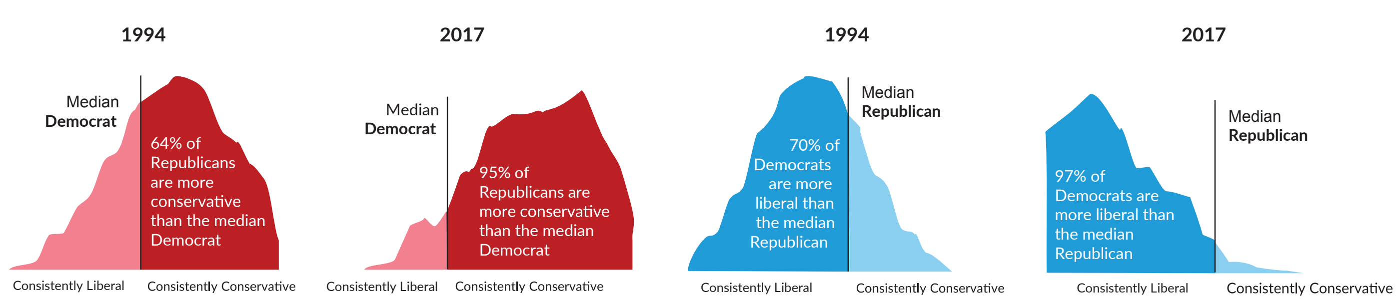
Past performance does not guarantee future results. An investor cannot invest in an index.
As of December 31, 2019 Source: Thomson Reuters and AB

That said, in 2020, the generally strong relationship between re-election and the economy may not hold.

A July 2020 Gallup poll found that only 9% of voters considered the economy to be the most important problem facing the country. Thirty percent of respondents cited the coronavirus as the most pressing concern, followed by government/poor leadership.[10]

Less Overlap in the Political Values of Republicans and Democrats

Distribution of Republicans and Democrats on a 10-Item Scale of Political Values



Past performance does not guarantee future results.
As of December 31, 2017. Surveys conducted on June 8-18, 2017
Ideological consistency based on a scale of 10 political value questions. Republicans include Republican-leaning independents, and Democrats include Democratic-leaning independents. Source: Pew Research Center and AB

The list of key issues for each political party expands from there, and the disparity in beliefs around these issues has widened significantly in the past few decades.

For many voters, the economy is just one issue among many, and there are a host of issues that have varying degrees of importance for voters of both parties. The strong (and apparently growing) political divide between the Democratic and Republican parties means that there is less and less overlap in beliefs around those issues.

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Voter turnout is a critical factor this year

High voter turnout will be a critical issue for this election, especially in the closely watched swing states. In 2016, President Trump won by less than 1% each in three key swing states. The extent to which voters hit the polls will likely once again significantly impact the final result in 2020.

Voter turnout in Florida, Pennsylvania, Michigan, and Wisconsin will be critical for both the Trump and Biden campaigns. Florida and its coveted 29 electoral votes will be a particularly important state. It was 1992 that a presidential candidate last won the election without winning the demographically diverse state of Florida.

To that end, voter turnout has been extremely strong so far. As of October 21, more than 42 million people have voted early. Democratic voters accounted for 52 percent of mail ballots in the 19 states that report on this metric.[11]

Obviously, this is a limited amount of information to work from, but the overall trend is that voter turnout is very strong. This could bring a more decisive victory to one candidate or another, which could help to reduce post-election volatility.

What if the election is contested?

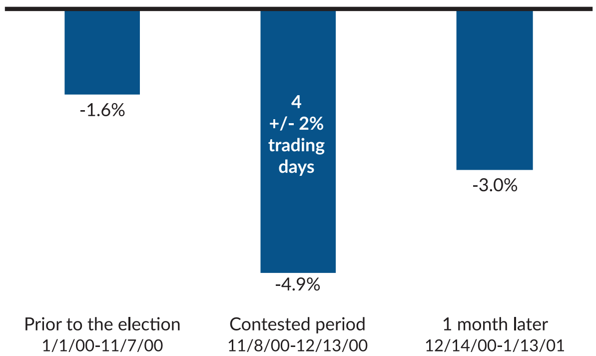
Unprecedented voting procedures due to the pandemic and pre-voting discontent from both parties mean that a contested result is a real possibility.

As you've probably heard many pundits and our team say, markets don't like uncertainty. An election result that could potentially drag on for days—if not weeks—after Election Day could weigh on near-term market performance.

That said, this wouldn't be the first time the markets have dealt with a contested election. The 2000 Bush versus Gore election did not have an outcome for over a month. During that time, increased volatility and a more rapid market decline were certainly more present than in the eleven months preceding the election. One month after the outcome, markets were still down but stabilizing.[12]

Stocks have seen contested elections before

Case Study: 2000 U.S. presidential election
S&P 500 performance, 1/1/00 through 1/13/01



Source: Morning star as of 9/30/20. Stocks represented by the S&P 500 Index. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You cannot invest directly in the index.

2000 U.S. contested election timeline:

- Nov 7: Election day
- Nov 8: Gore retracts concession
- Nov 16: The Florida Supreme court permits manual recounts
- Nov 27: Gore sues to contest election in Florida
- Dec 12: U.S. Supreme courts stops Florida recounts
- Dec 13: Gore concedes

It seems clear that the more contentious the result, the more volatility we can expect. An early, decisive victory one way or another could help pacify markets—while a drawn-out, hotly contested result could bring more short-term swings.

That said, we again caution against acting preemptively. It's very hard to predict short-term market movements and to gauge the right time to exit and enter the markets. As the saying goes, the problem with market timing is that you have to be right two times, not just once. Looking at the long-term data, selling out of the market just before an election is a good way to simply be wrong.

The January transition and the economy

Assuming we have clarity as to the next administration by year-end, which seems reasonable, the next logical question for investors is: what happens come January?
A key area that we are looking at with respect to our clients is fiscal policy.

The economy is in something of a fragile state currently, and we could still see significant shifts depending on how the pandemic progresses and what impact this has on the economy. Additionally, the lead-up to the election has brought several false starts toward another round of fiscal stimulus. Further stimulus could help mitigate the effect of job losses and fragile revenues on Americans and small- to medium-sized businesses.

More specifically, fiscal policy has an impact on two areas of importance to investors:

1. Economic growth, which can be encouraged or compromised
2. "Risk assets" like stocks and bonds, which can rise or fall in value depending on the perceived amount of support for the issuers of those securities

The possibility of an agreement being reached before November 3 has faded, meaning that any follow-on legislation is more likely to fall to the next administration and any new members of Congress. This, in turn, could be strongly influenced by the relative position of each political party.

A recent analysis by Alliance Bernstein concluded that fiscal stimulus is less likely to be rapidly enacted with a split White House and Senate.[13]

Of course, we could be surprised. For example, a scenario in which Republicans win the White House and Democrats control the Senate could mean a continuation of heated debate about further stimulus. At the same time, given the recent willingness of Treasury Secretary Steven Mnuchin and House Speaker Nancy Pelosi to find common ground, we could foresee a situation in which a Democratic Congress and Republican White House are aligned.

On the other hand, if Democrats were to win the White House and Republicans were to remain in control of the Senate, we believe that stricter fiscal policy is likely. Senate Majority Leader Mitch McConnell has been firm in his desire to limit further fiscal support. In this scenario, we believe there is little chance for additional (or significant) government stimulus.

With Interest Rates at the Zero Bound, Fiscal Policy Will Continue to Play a More Prominent Role…But Election Will Determine Policy

Republican White House Republican Senate **Risk Asset Impact:** Short-Term Positive Medium-Term Positive Fiscal: Expansionary Fed: Potential Shift in Fed Chair	**Democratic White House Republican Senate** **Risk Asset Impact:** Short-Term Negative Medium-Term Negative Fiscal: Rediscovered Austerity Fed: Easy Policy
Republican White House Democratic Senate **Risk Asset Impact:** Short-Term Negative Medium-Term Negative Fiscal: Status Quo Fed: Easy Policy	**Democratic White House Democratic Senate** **Risk Asset Impact:** Short-Term Negative Medium-Term Positive Fiscal: Tax and Spend Fed: Easy Policy

Current analysis does not guarantee future results.
Assumes Democrats retain control of the House of Representatives
As of June 30, 2020. Source: AB

What does this mean for investors?

Expansionary fiscal policy could support economic growth in short-run by promoting spending by consumers (which makes up 2/3 of U.S. GDP) and investment by businesses.[14] In our view this type of legislation reduces uncertainty for businesses, meaning that it's also supportive of risk assets. We could see a market upswing that results from the passage of further legislation.

Of course, over the longer run, any fiscal stimulus must be paid off, and we may need to see a combination of reduced government spending, tax policy changes, and monetary policy support by the Federal Reserve to keep debt payments in check. These longer-term issues are beyond the scope of this paper, but they are important considerations as we look to design appropriate tax strategies for our clients.

Regardless of the election outcome, we expect the Federal Reserve to remain accommodative in terms of policies around interest rates. Persistently low interest rates have the potential to support the U.S. economy and the growth of corporate America for a significant period of time. That said, as Fed Chairman Jerome Powell has noted, the short-term effectiveness of supportive monetary policy by the Fed would be bolstered by continued fiscal policy support.[15]

Key Takeaways

We believe it's important to look at this election in terms of the historical and global context.

We expect fourth-quarter volatility, particularly if election results are contested. We also have an example of a previously contested result to work from: while the global context of that election was different, it does give us some indication of the effect of short-term uncertainty.

Over the broader course of history, there isn't a significant difference between parties in terms of economic performance and market growth. In fact, investing by party is, historically, an excellent way to significantly suppress long-term returns.

Going forward, we think it's very useful to look past political agendas and focus instead on the state of the world that underlies them. From an investment perspective, the health of the global economy, consumer spending, and business activity are the key themes to monitor.

No one should ever be faulted for exercising caution with regards to their portfolio. However, history has shown that emotional, short-term decisions based on immediate uncertainty can be detrimental to long-term performance.

Times of uncertainty are always challenging, but we believe that it's important to look to history to see just how incredibly our nation has thrived.

For the most part, we strongly advise taking a long-term view and weathering this election season volatility and media hoopla. Of course, every individual situation may call for differing levels of risk tolerance, which is why your individual investment and overall allocation policy is so important.

Times of uncertainty are always challenging, but we believe that it's important to look to history to see just how incredibly our nation has thrived. Through wars, pandemics, terror, and economic collapse, the resilience and resourcefulness of the American people is simply incredible. We have the ability to honor this by voting for our chosen representatives and the issues that matter most to us.

Whether you agree on politics with your family, neighbors, or anyone else, we are all part of this great American experiment—together. Our ability to strive and thrive in the face of historical events and challenges is what sets us apart. Especially during heated election seasons, we like to step back and take a moment to appreciate this amazing nation. As the song goes, "God bless America – our home sweet home."

Thank you for investigating this important topic with us. We always close by urging you to reach out to us with any questions, concerns, or thoughts and this is no different. We're here to help you navigate through whatever comes next—whether it's over the coming months or the coming decades.

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Asset Allocation and Diversification do not guarantee a profit or protect against a loss.

The Bloomberg Barclays U.S. Aggregate Bond Index measures the investment-grade U.S. dollar-denominated, fixed-rate taxable bond market and includes Treasury securities, government-related and corporate securities, mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities.

The S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market.
Gross domestic product (GDP) is a monetary measure of the market value of all the final goods and services produced in a specific time period. GDP is the most commonly used measure of economic activity.

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