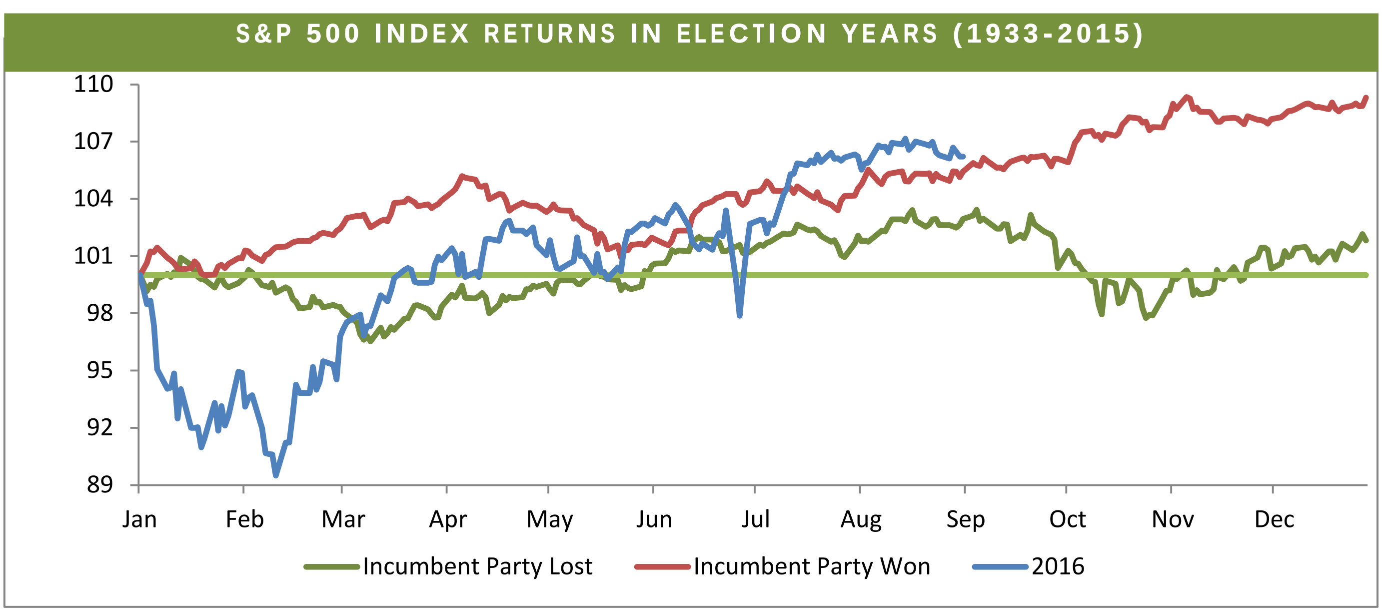
Elections and Financial Markets

THIRD QUARTER 2016

Presidential elections occur every four years, and while the choices change over time, one thing is consistent: financial markets prefer certainty versus the unknown and therefore market volatility tends to increase at this time of year. Open elections, where the sitting President is not on the ballot, can create even more uncertainty and market volatility. In addition, as the length of the "campaign season" has expanded and with the rise of a 24/7 news media and multiple social media outlets, the level of rhetoric and contention has increased. There is plenty of evidence of bitter fights across party lines going as far back as the 1876 election fight between Rutherford B. Hayes and Samuel J. Tilden. Our job is to look past the rhetoric and focus on the impact the election might have on the fundamental drivers of the economy and prospects for future growth, rather than to predict the outcome of the event. In this sense, the election is no different than any number of events we have faced since the end of the last recession, including Brexit, the EU debt crisis and the previous debt ceiling and government shutdown debates. Our focus is thus on how what we already know can impact the long-term outlook.

That being said, there are some interesting relationships between financial markets and Presidential election years. Historically, equity markets have done a relatively good job of forecasting the outcome of Presidential elections. Since 1928, the S&P 500 Index has correctly predicted 19 of 22 presidential elections and every election since 1984. Here is how it has worked: if stocks rise in the 3 months prior to the election, then the incumbent party will most likely win, while if stocks fall in the 3 months prior to the election the incumbent party will likely lose. In years where the incumbent party has lost, the S&P 500 Index has peaked in mid-August, been flat over the next month and then declined as the debate season begins. When the incumbent party wins, the equity market has moved steadily higher throughout the remainder of the election cycle. This relationship is probably a reflection of concerns about the unknown because the re-election of an incumbent party would generally suggest no major policy changes. The graph below shows the performance of the equity market in Presidential election years, along with the returns this year. August 8th marked the beginning of the 3-month period for this election and time will tell if this historical precedent holds.



The good news is that regardless of the outcome, the market generally rallies following an election, as what was once uncertain becomes a reality. In addition, that rally tends to continue over the 12-months following the Presidential election. Historically, equity markets have performed best with a Republican President and a Republican Congress, although a divided government led by a Democratic President has also performed well. Equity markets have posted its worst performance with a Republican President and a Democratic Congress.

In an open election, it can be more difficult to know what priorities the new President will emphasize. We can look at the party platforms and political speeches for clues, but ultimately we don't know how a new President will govern until they are in office. While we can point to certain sectors of the economy that may benefit or be harmed depending on who wins the Presidency, the key to understanding the legislative impact will likely be determined not only by the resident of the White House, but by the makeup of Congress. A divided Congress would likely limit the ability of either candidate to push his or her legislative agenda. But that does not mean there are not areas of common ground or opportunities for compromise. As an example, both candidates have expressed the need for infrastructure investment. It is likely that following the election, we will see some type of program implemented, but the size, funding source and priorities of any program could differ depending on the Presidential and Congressional make-up. It also appears likely that at least some of the sequestration cuts to defense will be relaxed under either administration. The need for some type of corporate tax reform provides another opportunity for compromise. However the design of the program could differ vastly depending on the make-up of Congress.

So, with less than 70 days until Election Day there are any number of unknowns and only a few things that we know with certainty. With the conventions behind us, we know who the candidates are that will represent the major political parties as well as those of the 3rd parties. We know that beginning on January 20th, 2017 we will have a new President and we know that nearly half of the country will not be happy with the result. Other than that, we and the financial markets are left to speculate. However, aside from the election, what we do know is that the U.S. economy continues to grow at a moderate, but somewhat uneven pace. We know that the consumer is in a healthy position supported by a solid labor market and lower energy costs. We know that the housing sector appears stable and is contributing positively to economic growth. We believe that these conditions will continue no matter the outcome of this election. Our focus remains on planning for the long term, so that we do not react unthinkingly to short-term volatility. We will make changes to portfolio positioning when we see tangible signs that the fundamentals of the economy are changing. We should all remember that it is normal for election cycles, particularly one as polarizing as we are seeing now, to create uncertainty and angst for investors. No doubt we are all looking forward to the prospect of greater clarity after the election so that the markets can once again focus on the fundamentals.