FEG Insight

THE MARKET IS A VOTING MACHINE

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The Market Is a Voting Machine

The 2024 U.S. Presidential Election

Benjamin Graham, Warren Buffet's mentor and author of the seminal work Security Analysis, is often paraphrased by Buffet with the quote, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." This analogy aptly captures the essence of elections and market behavior.

Elections reflect the immediate mood and opinions of the electorate, much like short-term market movements reflect sentiment. However, the true measure of politicians' effectiveness is the assessment of their policies over time, akin to the market better reflecting fundamentals and valuations over time.

Political polarization has been increasing for more than a decade. Some investors may look at the politically divisive environment and feel anxious about the election and policies that may follow. Similarly, some may have a desire to alter their investments based on the potential outcomes of the election. However, FEG believes making short-term asset allocation decisions based on potential policy changes that may follow an election is generally imprudent.

Instead, long-term investors should consider that although election winners set the fundamental tone of policy that dictates the environment in which commerce and investment occur, American ingenuity has historically found ways to overcome adverse policies.

The 2024 election has been marked by numerous surprises, including Donald Trump's trial, the attempts to assassinate him, and the announcement that Kamala Harris would be the new Democratic candidate just 100 days before the election. Despite these surprises, the policies of the two leading candidates remain quite predictable. Investors can safely assume that Trump will probably reestablish his prior administration's policies, while Harris is likely to continue the policies of the Biden administration.

In most circumstances, avoiding political discussions is wise. However, the upcoming presidential election has prompted many questions from clients around issues of elections and investing, thus the topic of this insight. The goal of this piece is not to advance any candidate's campaign or support a specific political party but to provide balanced information that addresses clients' questions and to offer a macro view of how elections and investments do—and do not—affect each other.

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If the Market Was Voting

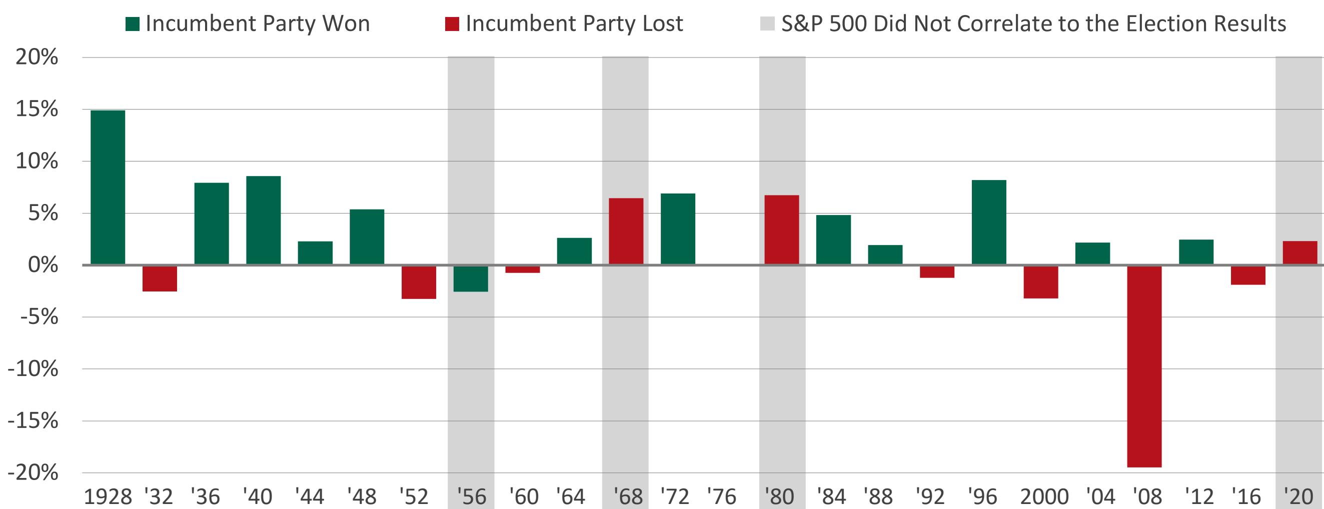
Investors are not alone in searching for insights into who might win the election, as indicated by the widespread popularity of polls. Yet polls are inaccurate for a multitude of reasons, which is why investors often look to the familiar realm of markets for insights into election outcomes beyond what the polls have to offer. Interestingly enough, markets have often been remarkably effective prognosticators.

THE EQUITY MARKET AS A POLITICAL PUNDIT

Indeed, the return of the S&P 500 Index has historically been a better predictor of presidential election results than most pundits. Since 1984, a positive return in the three months before the election has often preceded the incumbent party's reelection, while a negative return has heralded a loss. The S&P 500's predictive accuracy has been 83% since 1928, with the most recent election being one of the few exceptions.

THE U.S. STOCK MARKET HAS BEEN AN EFFECTIVE ELECTION PREDICTOR

S&P 500 Index Performance 90 Days Prior to Election Date, 1928-2020



Data source: FactSet

Polling for this year's presidential election indicates that this will be another tight race, with results within the margin of error. But what do current market conditions indicate?

Simply stated, the strength of the U.S. equity market year-to-date suggests an incumbent party win for Harris. Solid earnings growth, subsiding inflation, a resilient job market, and the Federal Reserve's (Fed's) policy shift to easing have all supported the equity market. Relatedly, the VIX—which measures implied equity market volatility—also supports an incumbent party win if the VIX peaks well before election day and subsides as election day approaches, indicating a lack of market stress in the weeks preceding the election.

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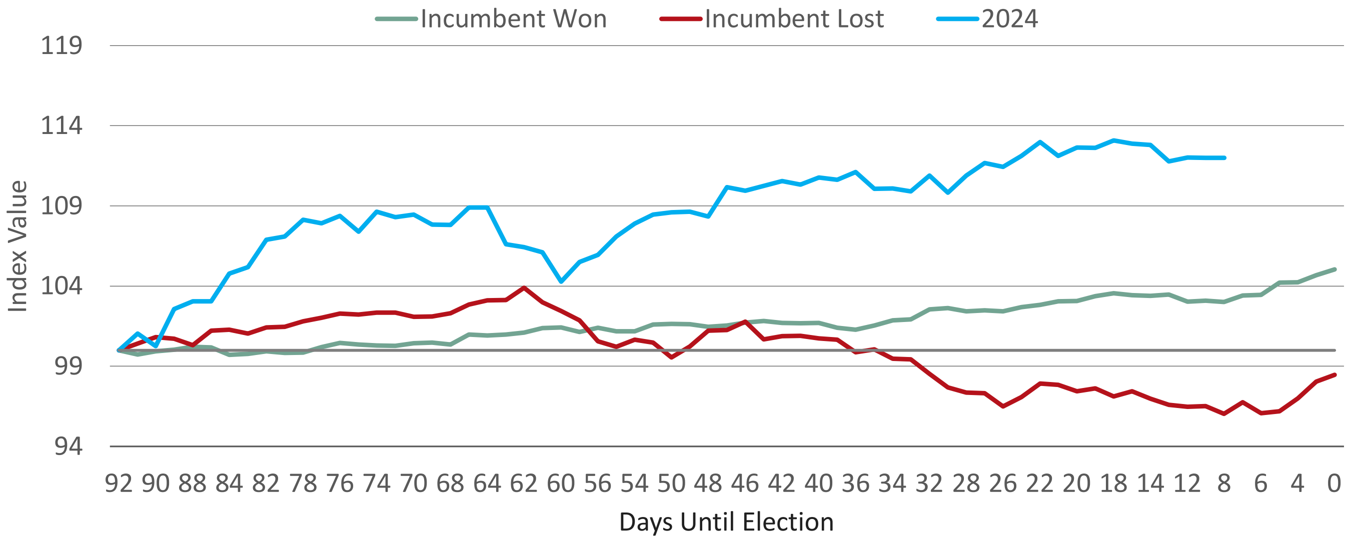
THE U.S. STOCK MARKET IS TRENDING TOWARD A DEMOCRATIC WIN

S&P 500 Index Average Performance Three Months Prior to Election Day, Past 24 Elections



Data source: Strategas; Data as of September 23, 2024

Similar to the strength of the U.S. equity market, a weaker dollar has been an effective indicator for eight of the past nine elections, with a declining dollar in the months before election day supporting an incumbent party win. To date, the dollar had been trending weaker, but that trend has reversed in the final weeks before election day. A weaker dollar makes U.S. exports more globally competitive, aiding manufacturing, employment, and higher corporate earnings for multinational companies. A weak dollar is also aligned with lower interest rates, which makes credit more accessible.

These measures reflect elements of the market's health and well-being and its assessment of economic conditions, and the economy is always a central issue in national elections.

IT'S THE ECONOMY, STUPID

James Carville coined the phrase, "It's the economy, stupid," when directing Bill Clinton's campaign in the run against President George H.W. Bush, whose reelection campaign was plagued by the early 1990's recession.

RECESSIONS KILL U.S. PRESIDENCIES

U.S. Recessions vs. Re-Election Results

NO RECESSION TWO YEARS BEFORE RE-ELECTION

PRESIDENT	RECESSION	RE-ELECTED
Obama	No	✓
W. Bush	No	✓
Clinton	No	✓
Reagan	No	✓
Nixon	No	✓
LBJ	No	✓
Eisenhower	No	✓
Truman	No	✓
FDR	No	✓
FDR	No	✓
FDR	No	✓
Wilson	No	✓

RECESSION TWO YEARS BEFORE RE-ELECTION

PRESIDENT	RECESSION	RE-ELECTED
H.W. Bush	Yes	✗
Carter	Yes	✗
Ford	Yes	✗
Hoover	Yes	✗
Coolidge	Yes	✓
Taft	Yes	✗
Trump	Yes	✗

Data sources: Bruce Mehlman, Strategas

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Historically, an economic recession in the final two years of a presidency has often resulted in the incumbent party's defeat, with President Coolidge in the 1920s being a notable exception. The past four years have been characterized by inflation, which helped trigger recession expectations. The Fed has countered the inflationary surge with tight monetary policy. While a recession may still occur, current indications support an economic soft-landing scenario.

Given the market's strength and other economic measures through the third quarter, market history would indicate an incumbent party win for Harris. But whether or not voters view their financial health as good in the face of elevated price levels despite subsiding inflation remains to be seen.

Does the Market Care?

A CLOSE PRESIDENTIAL ELECTION

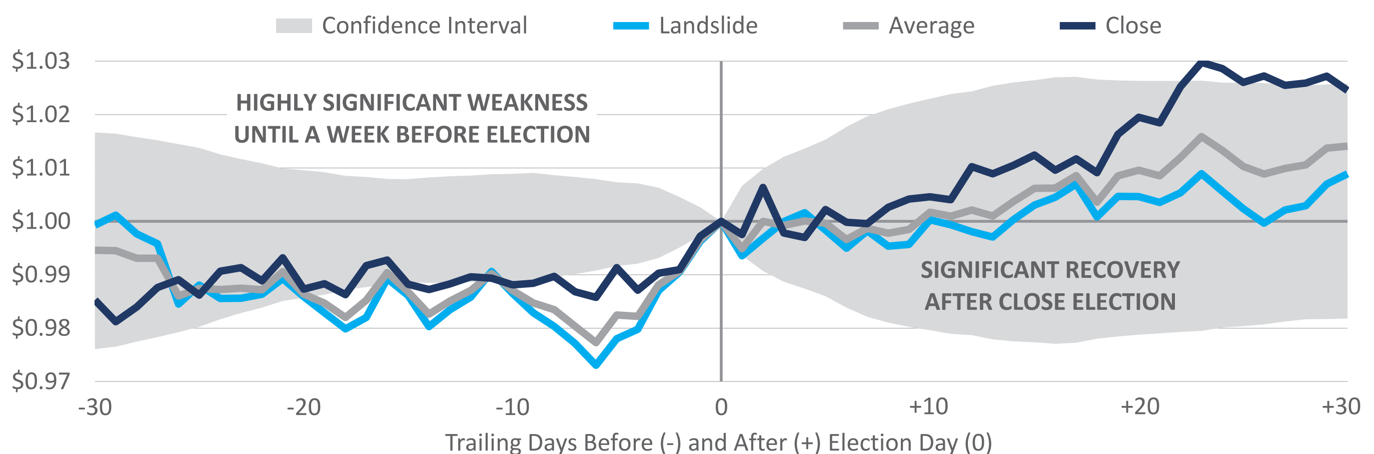
Much like the 2016 and 2020 elections, the 2024 presidential election is expected to be very close, with just seven swing states likely determining the outcome. This close election scenario introduces more uncertainty in the markets leading up to election day.

ELECTION FEARS AND RALLIES

Research Affiliates found that historically, closely contested elections have led to stronger equity market rallies in the 30 days following the election. One explanation is that politically motivated investors who were "risk-off" before the election gain comfort if their side wins. Another reason may be that the market responds positively to the clarity provided by the election results.

CLOSE ELECTIONS HAVE PROVIDED STRONGER POST-ELECTION SURGES

U.S. Presidential Elections – Average Market Returns in Close vs. Landslide Elections



Data source: Research Affiliates

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The same work from Research Affiliates indicates the equity market does not provide meaningful evidence that a Republican or Democratic victory on election day enhances market returns. As the forward-looking markets consider the election results in the subsequent 30 days, returns for Republican victories are right on top of those for Democratic victories.

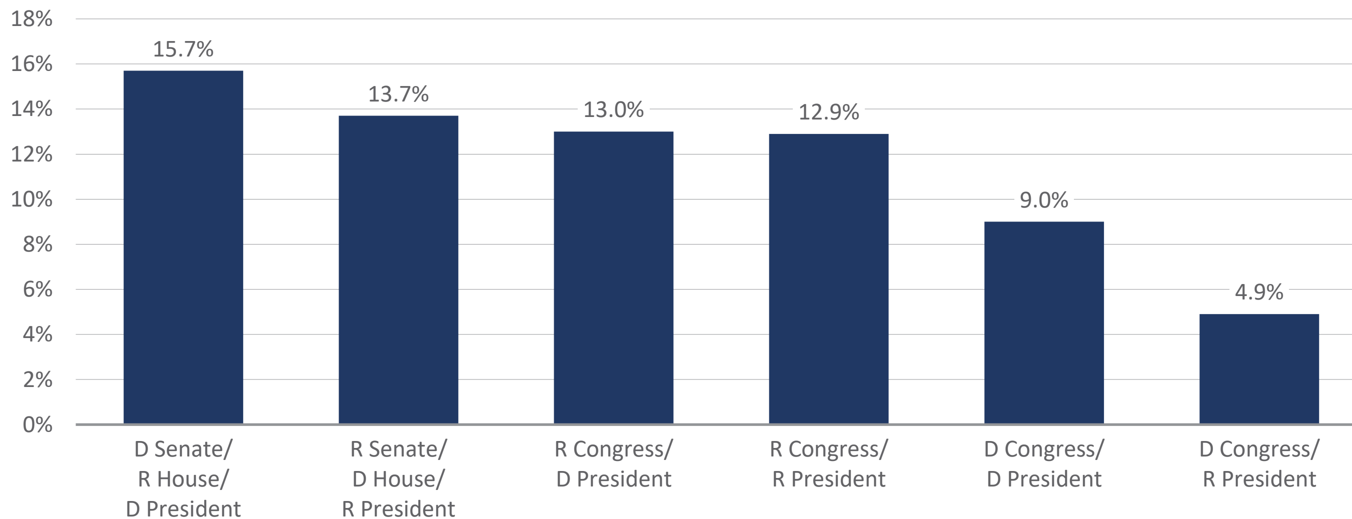
SHOULD INVESTORS CHANGE ALLOCATIONS DUE TO THE ELECTION?

Investors should take solace in knowing that, in most cases, market performance over time has been strong regardless of who controls the White House, so making allocation changes based on election expectations or results is a fool's errand.

Having some level of partisan divide has historically been good for market returns, as gridlock may reduce uncertainty—which markets abhor—and negotiation is required to enact public policy.

MANY TIMES, GRIDLOCK IS GOOD

Partisan Control – Average Annual S&P 500 Index Performance, 1933-2023



Note: Excludes 2001 – 2002 due to Rep. Jeffords change in party affiliation.
Data source: Strategas

DO POLICIES INFLUENCE SECTOR PERFORMANCE?

Investors may believe that a given party influences the performance of sectors more positively or negatively than the other; however, as with overall market performance, there is no evidence to suggest that political parties determine sector performance.

The correlation between sector performance and the S&P 500 Index under different political parties is near zero when comparing the years following an election. Market conditions are far more influential. For historical examples, consider the weakness of information technology after the Tech Bubble or the weak performance of defensive consumer staples versus the strength of consumer discretionary during the early stages of recovery from the Great Financial Crisis in 2009. Those periods of performance were driven by market conditions rather than political policies.

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Lastly, policy implications can be counterintuitive. For instance, the Biden administration's policies, which some might consider harmful to the energy sector, actually supported energy prices and improved earnings for energy companies in 2021 due to restrictions on exploration and drilling, making energy the top-performing sector that year.

In truth, while a presidential election is a historic event, the combination of checks and balances, three branches of government, and limited terms help temper the influences of a political victory on markets.

The Impacts of Expiring Tax Cuts

THERE IS NO ESCAPING TAXES

The Tax Cuts and Jobs Act (TCJA) lowered personal and corporate tax rates and was central to Trump's first-term economic policies. Major portions of the TCJA are set to expire in 2025, with potential increases in personal income tax brackets and corporate tax provisions expected to be a point of negotiation. The election's resulting congressional control will likely significantly influence the range of potential outcomes. If Harris wins the presidency, she is expected to favor breaks for low-income tax brackets and potentially higher corporate rates. In contrast, Trump is likely to push for a broader extension of the legislation.

TAX CUTS BOOSTED EARNINGS IN 2017

Before the enactment of the TCJA, U.S. corporate tax rates were broadly viewed as uncompetitive relative to other developed market nations. The TCJA cut the U.S. corporate tax rate to an average of 21%, a level comparable with the OECD average, from a top level of 35%.

In the years before the TCJA, foreign tax inversions were commonly undertaken to reduce taxes. These occur when a U.S.-based multinational corporation restructures so that the U.S. parent is replaced by a foreign parent and the original U.S. company becomes a subsidiary of the foreign parent. These inversions essentially stopped under the TCJA as the U.S. corporate tax rate became globally competitive.

Following the TCJA in 2017, U.S. equity markets experienced earnings growth, which supported market performance before the pandemic and limited the tax burden during the pandemic.

If the corporate tax rate were to increase under a Harris presidency to fund lower-income tax breaks and social spending, an approximately five percentage point tax rate increase to S&P 500 index companies would not be unexpected. Tax inversions may also increase if the U.S. corporate tax rate were no longer globally competitive.

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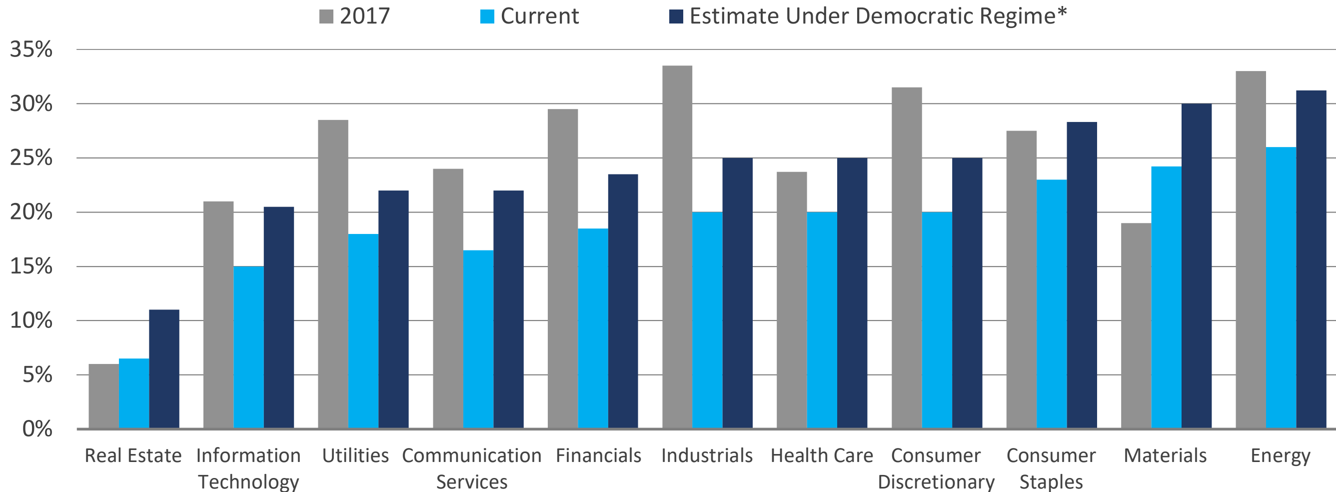
AVERAGE SECTOR TAX INCREASE COULD BE FIVE PERCENTAGE POINTS

S&P 500 Index Sectors Effective Tax Rate



*Based on cap-weighted effective tax rates and domestic/international revenue exposure for each sector.
Data sources: Alpine Macro, FactSet

Today, with equity markets trading at elevated valuations, expected earnings growth is central to supporting current price levels. We believe investors should anticipate that declines in expected earnings would likely weigh on market performance.

Regulation, Trade, and Paying for It All

In addition to tax policy, a litany of other policy-related items often garner attention from investors, including regulation, the post-pandemic reshoring of manufacturing, and fiscal policy.

RULES, RULES, RULES

Regulations are meaningful to the way businesses operate regardless of industry. The number of pages in the Federal Register is often referenced as an indicator of the regulatory stance of a presidential administration. However, the costs associated with those regulations are also meaningful. Early in Trump's presidency, his administration pushed for a reduction in regulatory rules, significantly decreasing the estimated finalized cost of regulation. Conversely, the Biden administration's stance on regulation re-elevated those costs. Interestingly, the estimated costs of regulation during the Obama administration had peaks that were on par with Biden's administration and valleys comparable to costs during the Trump administration.

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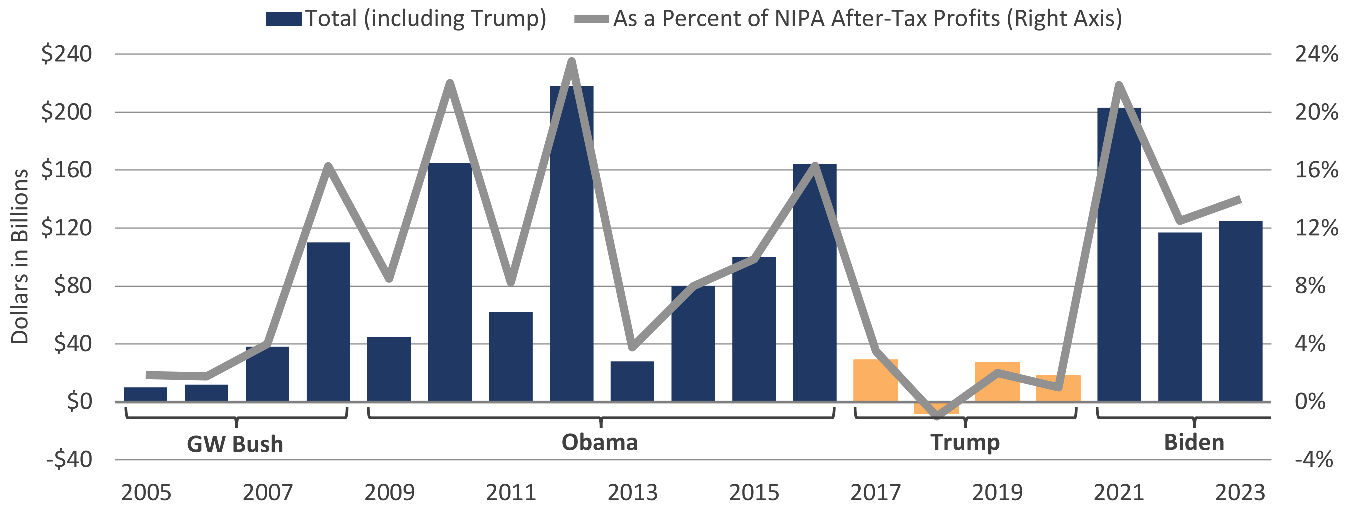
REGULATORY COSTS DROPPED DURING TRUMP'S ADMINISTRATION AND RESURGED UNDER BIDEN
Finalized Cost of Regulation



Data sources: Alpine Macro, Bureau of Economic Analysis, American Action Forum; Data as of December 31, 2023

Considering the regulatory implications of the election, it is reasonable to assume Trump would take the same deregulatory stance as before, while Harris would likely continue Biden's approach. Regardless of the election winner, the regulatory environment has experienced meaningful changes in recent years. To illustrate, the Supreme Court nullified Chevron Deference in a landmark case, meaning that in cases where federal legislation is ambiguous or leaves an administrative gap, the courts no longer have to defer to the regulatory agency's interpretation. This is one of several majority opinions that may weigh on future rulemaking, as rules will be more easily challenged by both ends of the political spectrum in court.

TRADE WITH CHINA

Despite the wide-ranging political differences in Washington, D.C., both sides of the aisle hold an unfavorable view of China. Although trade with China declined after Trump's tariffs and Biden's continuation of tariffs, the nation remains a material U.S. trading partner. For example, companies in the S&P 500 Index derive over 7% of their revenue from mainland China, according to data from FactSet.

Trump's proposals include pressuring China and other nations on trade practices, with threats of substantially higher tariffs on Chinese goods. A Harris administration is likely to be less aggressive on trade but can be expected to keep the Biden administration's effort to protect sensitive industries in place.

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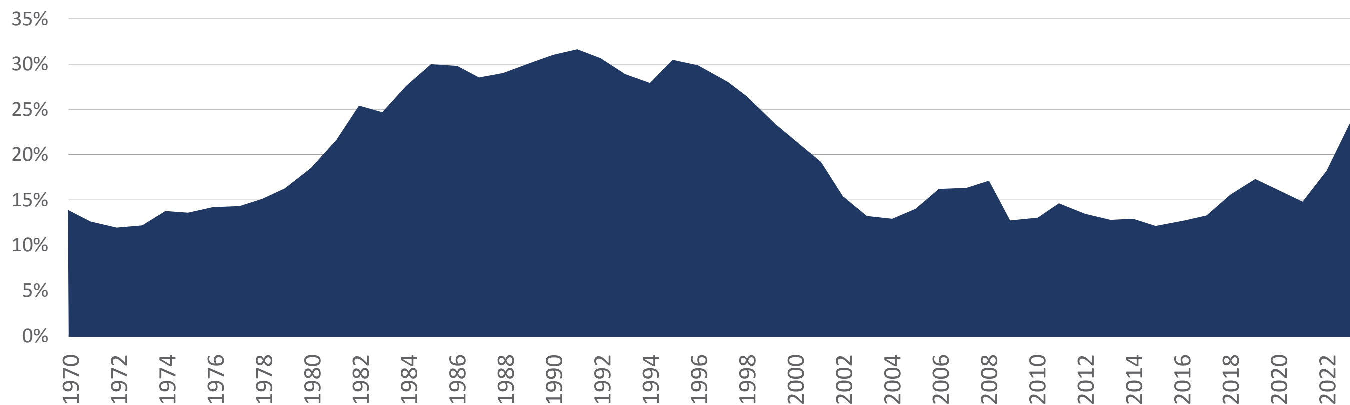
SPENDING COMES AT A COST

Fiscal restraint is rarely the foundation of a candidate's platform, and this election is no exception. Neither candidate has shown concern over spending levels, with Trump generally favoring the continuation of tax cuts and Harris predominantly favoring social spending and tax credits.

Due to the elevated interest rate environment relative to the past decade, the U.S. Treasury faces a higher cost of servicing debt. According to the Congressional Budget Office, the interest payments on the federal debt are approaching 14% of total government spending and are expected to continue rising. As a percentage of GDP, this measure is also increasing substantially. As the cost of servicing debt increases, the stimulative impact of accommodative fiscal policy is lessened.

HIGHER INTEREST RATES MAKE FISCAL POLICY LESS ACCOMMODATIVE

Federal Outlays – Interest as a Percent of Gross Domestic Product



Data sources: U.S. Office of Management and Budget, Federal Reserve Bank of St. Louis; Data as of December 31, 2023

Conclusion

With Trump being the first former president in over 100 years to become a candidate in a presidential election, his policies from his prior administration are already known. He is expected to push for a continuation of the TCJA, pressure international trading partners—most notably China—and limit regulation.

Similarly, with Harris serving as vice president, her policies are expected to be similar to those of the Biden administration over the past four years. She is likely to push for limiting the extension of tax cuts to lower income brackets and raising corporate taxes, be more friendly to international trading partners, and continue Biden's regulatory trends.

Neither candidate appears concerned with the budget deficit, as both support additional spending without commensurate revenue-raising policies. Their proposals are unlikely to equal what is ultimately realized. Nevertheless, enacting such proposals might exacerbate the U.S. dollar's weakening trend as well as push the cost of servicing debt higher.

In and of themselves, none of these potential outcomes are reasonable grounds for altering asset allocations. Investors should instead expect the change in Fed policy, the pace of subsiding inflation, labor market strength, economic growth, and earnings to be far more influential on market returns than the results of the upcoming election.

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All data as of September 2024, unless otherwise specified.

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