The Conservative Strategist

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Markets and the Election: 4 things to know (that most people don't)

With markets gyrating and election season heating up, it's timely to look at the relationship between the two. There's a lot of conventional wisdom out there, and much of it is wrong. A cool-headed look at the statistics can tell us a lot.

1 The last 90 days are critical.

James Carville had it mostly right back in 1992. Voters do care more about their economic well-being than any other issue. But it's not so much the economy that affects voters as the *stock market* — and only the movement of the stock market in the last 90 days before the election. This may seem odd, since only about half of Americans own stocks. But apparently, Americans look at the stock market as an easier-to-understand barometer of how they're doing. And our recency bias being what it is, only the stock market movement during election season matters.

Result: In the contest for the Presidency specifically, there's an 86.4% correlation between the direction of the S&P 500 stock index in the 90 days before an election, and the re-election success of the incumbent (or incumbent party). In 22 elections since 1928, 14 were preceded by stock market gains in the three months prior. In 12 of those 14 instances, the incumbent won the White House. Meanwhile, in seven of eight elections that were preceded by stock market weakness, the incumbent lost.

So keep your eye on the 3295 level of the S&P 500. That's where the S&P closed on August 3 — 90 days before Election Day (November 3). For a while we had soared well above that level, but as of this writing (September 21), we are back below that mark.

Another myth punctured: Divided government is better

S&P performance under various government regimes, 1926–2019

Situation	Number of Years	S&P 500 Index Annual Average Return
Unified Republican	**13** years	**14.52**%
Unified Democrat	**34** years	**14.52**%
Divided with Republican President	**33** years	**6.99**%
Divided with Democratic President	**14** years	**15.94**%

Unified government means that the Presidency, the House of Representatives and the Senate are all controlled by a single party. Divided government means that at least one house of Congress or the Presidency is controlled by the other party.

When the White House and Congress are controlled by the same party, returns are identical regardless of party. When the President is a Democrat and Congress is Republican or divided, returns are even a bit better than under unified government. But the one category where markets substantially underperform is when a Republican president has served during a divided or Democrat Congress. ***This seems to counter the myth that divided government helps markets because the government has less power over the private sector.***

2 Democratic Presidents are better, but it may not matter.

Conventional wisdom has it that Republican Presidents are better for the economy and markets than Democratic Presidents. But the evidence says

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The Markets	September 30, 2020	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)		3363.00	8.89%	5.47%
International Stocks (Vanguard Index)		16.76	6.46%	-4.88%
Emerging Markets Stocks (Vanguard Index)		27.33	8.98%	-1.51%
Real Estate Stocks (Vanguard REIT Index)		26.25	1.28%	-12.83%
Bonds (30 year US Treasury/Vanguard Index)		1.46%	0.04%	21.51%
Dollar (US Dollar Index)		93.89	-3.59%	-2.59%
Gold (London Afternoon Fix)		$1886.90	6.72%	24.57%
Money Market Funds (Vanguard Prime – SEC yield)		0.01%	-0.19%	-1.70%

*change in yield

Portfolio Planning

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otherwise. Since 1926, we have had a Republican in the White House for 48 years, and a Democrat for 46 years. That's quite a sufficient sample space.

Result: Under Democratic Presidents, the S&P 500 has gained 14.94% per year through 2019. Under Republican Presidents? 9.12%. That's a 5.8% per year edge under Democrats.

As huge as this edge seems, it may be overwhelmed at any time by non-political factors. The President with the best record? Calvin Coolidge, a Republican, who presided over the stock market boom of the 1920s. The President with the worst record? His successor, and also a Republican, Herbert Hoover, who was unfortunate enough to be in office during the 1929 Crash and the Depression that ensued.

3 Wall Street votes before the Election.

When candidates disagree broadly about economic policy as do Trump and Biden, it's possible to discern what the investment community thinks about their relative prospects of election. How? By constructing baskets of stocks that will do well if each becomes President, and tracking their performance pre-election.

A Biden presidency, for instance, will favor renewable energy, healthcare, pro-globalization companies, and cannabis producers and distributors. You can call that the Blue Portfolio.

In the Red Portfolio are fossil fuel exploration and production companies, defense contractors, and money center banks, as well as companies that derive most of their revenue from domestic sources and are thus relatively immune from trade wars, among others. That's the Red Portfolio.

How are the two portfolios doing this season? The Blue Portfolio is outperforming the Red Portfolio by a substantial margin. For instance, while traditional energy stocks are lagging, renewable energy stocks are seeing strong bids. Wall Street is not decisive, but it is influential. And currently it is wagering on a Biden presidency.

4 Presidents usually receive a rough start.

Conventional wisdom has it that Presidents enjoy a 'honeymoon' early in their term. But the pattern of stock returns in the four-year Presidential election cycle indicates that the honeymoon with investors is a delayed one.

The year after the election has been the weakest of the four years — and that's if you consider the performance of the S&P since 1950 (see graphic), or even if you go all the way back to the inception of the US stock market in 1789, as Fidelity's research arm did in one study.

Since 1950, the first half of a President's term has been sub-par, while strength has come mainly in the third year. Not only has it been strong, but it's been consistent as well, rising in 88% of all cases since 1950. Meanwhile, the first, second, and fourth years have all underperformed the long-term average return of the S&P 500.

(Note that Donald Trump's first term defied this pattern *in its first half.* He front-loaded much economic stimulus, and his first year saw a 19.4% gain in the S&P, while his second year saw the index backtrack 6.2%. However, his third year, true to the pattern of most third years, was indeed his best based on stock performance, with the S&P up 28.9%.)

None of these patterns and effects is determinative, and over time other factors can swamp their influence. (Today, the path of the virus is calling much of the tune for investors. It doesn't respect the Election cycle, or any other human-made cycles.) But in managing portfolios, it's essential to move past the conventional wisdom and employ evidence-based and data-driven investing. ■

Markets and the Presidency: Third year is the charm

S&P average return by year of Presidential term, 1950–2016

+6.5%	+7.0%	+16.4%	+6.6%
Year after the election	Second year of term	Third year of term	Fourth year of term

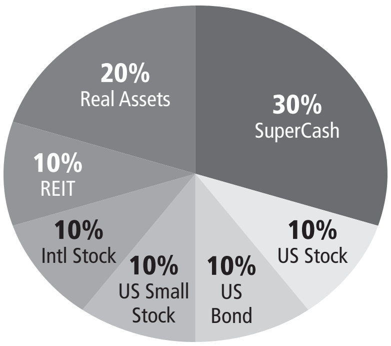
Stock market returns since 1950 have been remarkably consistent by presidential year — except for the third year, which has shown exceptional strength. It may be that it takes that long for the new President to find his sea legs, and for his policies and leadership to take hold in the form of investor confidence. Then in year four, he becomes pre-occupied with campaign matters, and confidence flags.

Source: Charles Schwab

SuperDiversified Portfolios (SDPs)

SDPs recovering but remain negative YTD

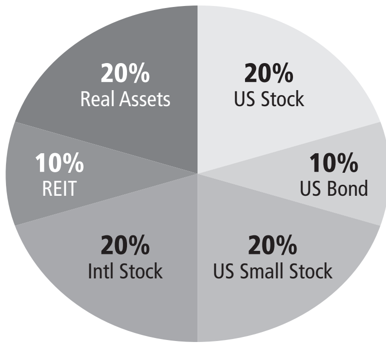
SDP1 ***Conservative***



3rd Quarter	*Year-to-Date*
4.98%	***0.33%***

The SDPs suffered their worst quarter in 12 years in Q1, followed immediately by their best quarter in 11 years in Q2. Despite all the market cross-currents and volatility of Q3, the on-balance return looks more like a typical solid quarter. And year-to-date, both portfolios are nearly back to flat.

SDP2 ***Moderate***



3rd Quarter	*Year-to-Date*
6.65%	***-1.40%***

For 2020, the Conservative portfolio continues slightly ahead of the Moderate portfolio, due in part to the resilience of the SuperCash allocation in a turbulent year, and in part to the underperformance of small-cap US stocks and foreign stocks, which are twice as heavy in the Moderate portfolio.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Govt bonds offer return-free risk

Asset Class	Mutual Fund	Performance 3rd Quarter '20	Performance Year-to-Date	
SuperCash	PIMCO Instl Low Duration	0.58%	2.88%	Best
	Merger	1.75%	1.63%	Worst
	Calamos Market Neutral	2.14%	3.15%	
US Stock	Vanguard Index Trust 500	8.89%	5.47%	
US Bond	Vanguard Long-Treasury	0.04%	21.51%	
US Small Stock	Vanguard Small-Cap Index	5.76%	-6.37%	
Intl Stock	Vanguard Intl Index	6.46%	-4.88%	
REIT	Vanguard REIT Index	1.28%	-12.83%	
Real Assets	PIMCO Commodity Real Return	11.47%	-10.80%	

Risk-free return is an investor's dream. Conversely, what we call *return-free risk* is an investor's nightmare. Substantial volatility with no long-term prospect of gain. That's what appears to be on offer in the government bond market, thanks to the Federal Reserve's shock-and-awe monetary stimulus.

At this writing, the five-year Treasury yields 0.28%, the ten-year yields 0.67%, and the 30-year yields 1.41% — *all of these rates below the current rate of inflation.* Meanwhile a 2% rise in interest rates across the board would hit the price of the five-year by 9%, the ten-year by 17.5%, and the 30-year by 37.5%!

Invenomic (BIVIX)

You can divide the US stock market into nine style boxes, 3x3, depending on whether a company is large, medium, or small, and whether it is a growth company (prized for its earnings growth), a value company (prized for its cheapness to its asset value and its cash flow), or a blend of the two.

Historically, small-company value stocks have been the best-performing of the nine style boxes. They have done especially well coming out of bear markets.

But so far, the COVID-driven market of 2020 has been an exception. Not only did small-cap value stocks do worse than their large-cap growth opposites in the selloff leading to the March 23 bottom, but they have lagged in the recovery since that bottom, up 42.70% vs. 59.09% as of September 23, precisely six months since the nadir. As of 9/23, small-cap value remains down 20% year-to-date, while large-cap growth, led by the mega-cap tech stocks we discussed last issue, is actually *up* 20%. That 40% spread is the greatest recorded over such a short time since the Great Depression.

COVID hitting small-caps hard

Is such a spread warranted? Clearly, COVID has walloped small companies, while investors are running for cover into the few giant tech stocks they view as resilient during these times. Still, the comparative valuations are just absurd. That's why we like *Invenomic* (BIVIX), a long/short fund which buys selected small-cap value stocks, and sells short the stocks of large-cap growth stocks that it considers absurdly priced and vulnerable. We're impressed by its managers' stock selection, because even with the spread moving 40 percentage points against it, the fund was flat on the year as recently as September 17. When the worm turns and small-cap value outperforms, BIVIX should shine, though it may be a volatile path until then.

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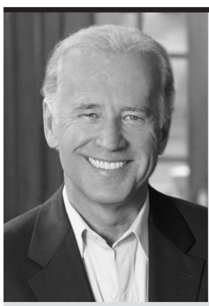
"If Biden is President, will my taxes go up?"

We have seldom seen two presidential candidates with such widely divergent plans for the country. Tax policy is no exception.

Donald Trump and the Republican Party are committed to keeping the tax burden on Americans light. It's reasonable to assume that if Trump is President and a Republican majority is maintained at least in the Senate, an effort will be made to render permanent most or all of the tax cuts passed in the 2017 Tax Cuts and Jobs Act (TCJA), some provisions of which are scheduled to sunset in 2025.

Joe Biden and the Democrats, on the other hand, are committed to raising taxes on corporations and wealthy individuals to address income inequality and the widening budget deficit, and to pay for a number of social programs.



Biden tax breaks

Joe Biden would also add tax breaks for low- and middle-income families

- Enhancing the child tax credit, and the child care credit
- Forgiving student loan debt
- Creating tax credits for small businesses that offer retirement plans

We're not sure how tax policy will change if Trump wins, because most promises and projections have been somewhat vague. However if Biden wins and the Democrats achieve critical mass in Congress, here are some of the changes we can expect, based on Biden's tax platform:

Higher taxes on high income

Biden pledges to work to restore the top marginal rate on incomes over $400,000 per year from 37% to 39.6%. This will happen in 2026 when parts of the TCJA expire.

For those with incomes over $1 million per year, Biden wants to eliminate capital gains rates over that $1 million income, instead taxing gains at ordinary income rates. That will raise that rate from 23.8% to an effective rate of 43.4%.

Biden also wants higher earners to pay more in Social Security taxes, to help shore up the program. Currently, payroll taxes are owed on any earned income up to $137,000 (at a 6.2% rate). Biden wants to pass an additional payroll tax on earned income over $400,000 (at the same 6.2% rate). (Earned income between 137k and 400k will remain exempt from payroll taxes.)

Higher taxes on inheritances

Biden wants to eliminate the cost-basis step-up at death on highly appreciated assets. Instead, capital gains will be taxed at death. This would have a major impact on estate planning.

Biden also proposes that the exemption amount for estates be lowered to $5 million per person from the current $11.6 million per person. Again, this will happen automatically in 2026 when the TCJA expires.

Higher taxes on corporations

Other proposals include raising the corporate tax rate from 21% to 28% — effectively halfway back to the 35% it stood at pre-TCJA.

Biden's also talking about changing the tax *deduction* on 401k contributions to a tax *credit,* in order to make saving more attractive to lower-income workers. It's not an official proposal yet.

Action to take?

If Trump wins, there's little or no action to take on taxes. If Biden wins, there's plenty of time to adjust your finances. The only provisions above to affect those taxpayers who are not in the ultra-high-income range are the basis step-up cancellation, and the 401k contribution treatment. The latter should have a minor effect on most contributors in the middle-to-moderately-high-income range. As for the former, those of advanced age, couples especially, with substantial home price appreciation may want to consider their options, such as selling and realizing the $250,000 per person capital gains exemption (assuming that provision survives). ■