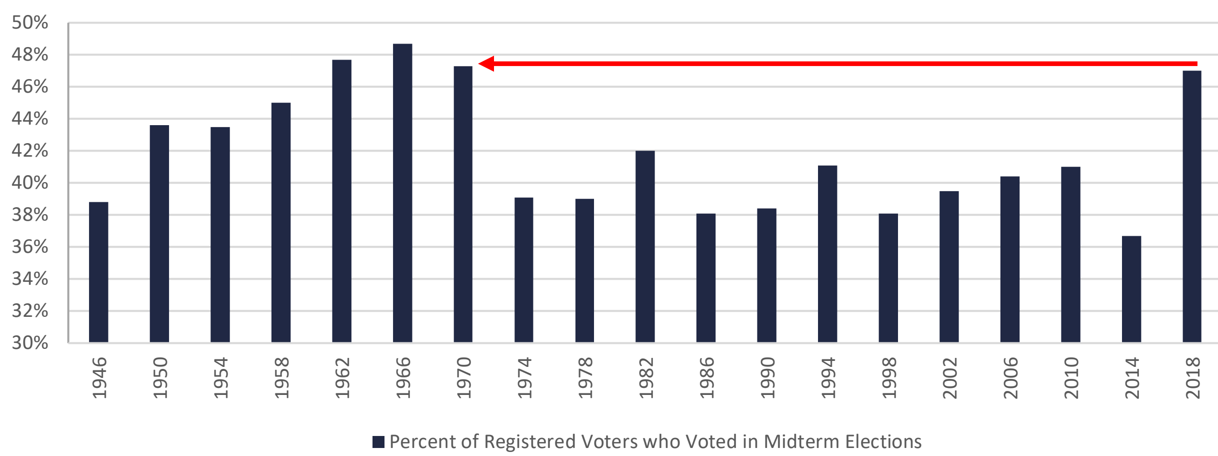
2018 Midterm Elections and What Investors Should Know

Focus on Facts and Fundamentals do not Surmise and Speculate

This year's midterm elections shattered records! Candidates spent a record amount of money to lure voters to an election that typically gets a mediocre turnout compared to a Presidential election. According to the Center for Responsive Politics, candidates spent over $5 billion on their election campaigns, ~40% more than what was spent in the 2014 midterm election ($3.8 billion) and a record high for a midterm election. The spending paid off when you look at voter turnout. It was the first time in history that more than 100 million people voted in a midterm, and the percentage of eligible voters that cast their vote reached the highest level since 1970.[1] ***(Chart 1).*** *Diversity was a major theme in the election results (e.g. sex, age, religion and race). Over 100 women were elected to serve in Congress marking a record high.[2] This included the two youngest women ever to be elected to Congress as well as the first Muslim and Native American women to head to Capitol Hill.*

Chart 1: Highest Voter Turnout Since 1970

Source: Statista as of November 12, 2018, Verdence Capital Advisors.



Midterm elections are typically a vote on the approval of the sitting President. Therefore, with such a divisive political climate and President Trump heading into the midterm with only a 47% approval rating, it is not surprising this election broke records. At the time of writing this white paper, there are still a few key elections being decided including a manual vote recount (Florida) and a contentious fight for the Governor seat in Georgia. It is important to note that this white paper is not meant to voice a political opinion about the midterm elections or the current political climate. Instead we will focus on facts, history, and present what past midterm elections have meant for the economy and financial markets.

Will the Lame-Duck Pour Cold Water on the Expansion?

The term "Lame-duck session" is the period when Congress must come back into session after the midterm election and before the new Congress convenes. As a result, some of the defeated head back to Capitol Hill (and can cast a vote) once more before their successor is sworn in the following January. Every political cycle is different, in some instances there is little if anything on the agenda during this time. In other instances, the lame-duck session has been highly combative and/or required action on current laws/proposals with the sitting President. For example, in 2010, President Obama signed major legislation in regard to taxes and the military (i.e. Don't ask, Don't tell Repeal Act and Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act). In 1998, Republicans in the House convened in the lame-duck session to impeach Bill Clinton (even after losing seats in the midterm).

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

This year's lame-duck session will not be without fireworks. The key items on the agenda include major judicial nominations, farm bills, criminal justice reform and new leader appointments to each party. Congress must also avoid a partial government shut down by passing several appropriations bills before year end while the President is trying to push for border wall spending. History tells us "lame-duck sessions," translate into slower economic growth in that quarter. Since 1950, the fourth quarter of a midterm election year is typically the slowest quarter of economic growth of the entire year. On average, the economy grows ~2% in the 4Q of a midterm election year after its strongest quarterly growth of the year leading into the election (3Q). **(chart 2).** This is important as the current consensus (2.6%) for economic growth in 4Q18 is a bit more optimistic than history would suggest.

Looking Past 2018 for Growth

If you look past the fourth quarter of 2018, we see that in the prior 21 midterm elections before 2018, there have only been two occurrences where the U.S. economy entered a recession in either the fourth quarter of the midterm election year or in the following first quarter (1970 and 1982). The slowdown in 4Q has historically been short lived as the first quarter following a midterm election year tends to see a solid rebound in GDP (average GDP 3.4% QoQ). Investors can be happy to know that history shows the economy grows at a faster pace in the year following a midterm election year than the year of a midterm election year. **(Chart 3).**

We can take this historical analysis one step deeper and look at the makeup of Congress and what that may mean for the economy in the coming years. **Chart 4** shows the composition of Congress that won in this midterm (i.e. President=**Republican**, Senate=**Republican**, House=**Democrat**) has historically seen the worst average annual GDP. However, historical data can be misleading as the weakness was primarily due to significant contractions in growth during the Great Depression. If you exclude the Great Depression, the average annual growth rate has been the second to the highest of all combinations in Washington.

Chart 2: History Suggests Moderation in 4Q GDP

Footnotes: Time period reflects 1950-2014 midterm elections.
Current estimate for 3Q + 4Q18 GDP is as of November 12, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

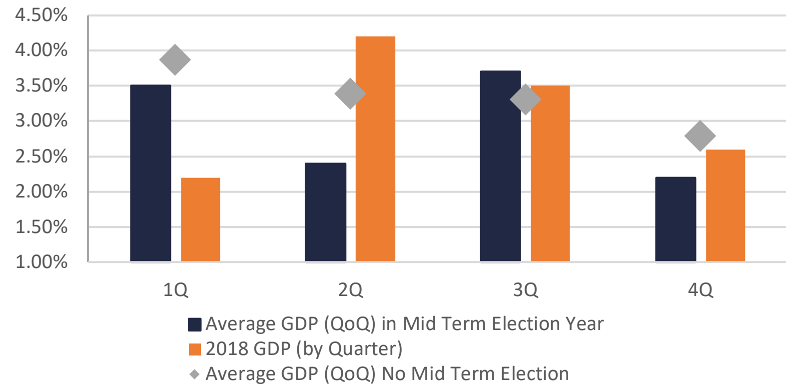


Chart 3: GDP Typically Rebounds Year After Midterm Election

Footnotes: Time period reflects 1950-2014 for midterm years, all remaining years as of 2017.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

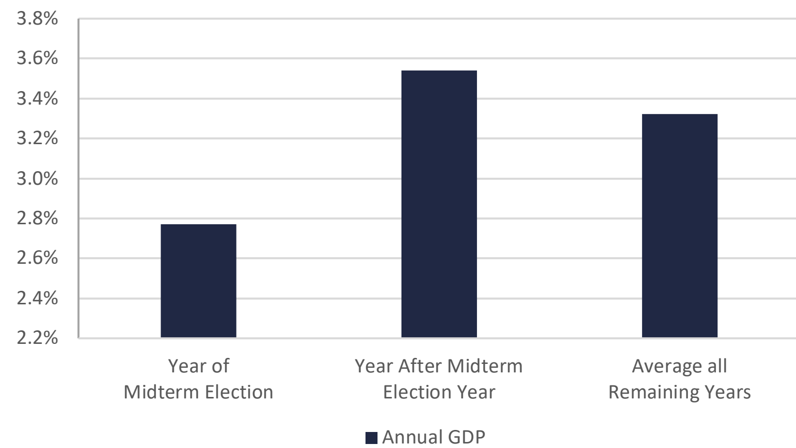
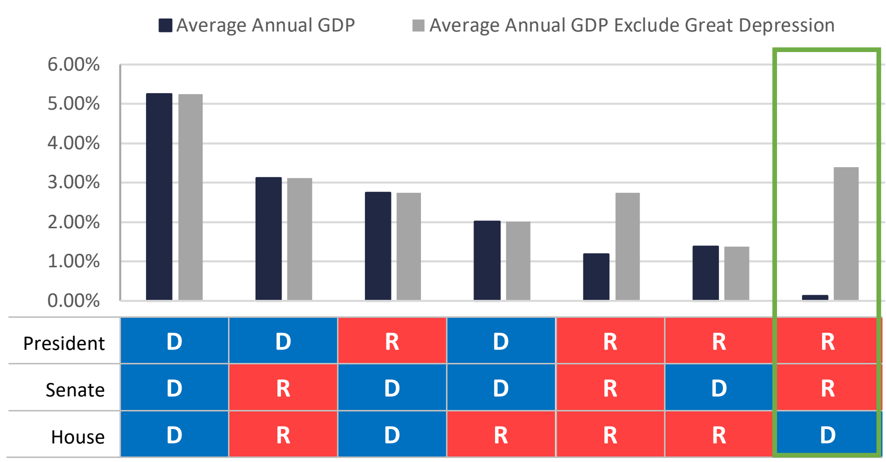


Chart 4: Congress Composition Good for GDP

Footnotes: Time period reflects 1929 - 2017. Excluding Great Depression starts 1933-2017.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com
Past performance is not indicative of future returns

Midterms and the Impact on Equity Markets

When we deliver our findings about midterm elections and the impact on the equity markets, it is hard not to remind investors about the common financial term that *past performance is not indicative of future results.* In fact, there has already been a break from history with the current administration when looking at the returns the S&P 500 historically delivers in each year of a President's term. For example, as shown in **chart 5,** the first year of a President's term the S&P 500 has historically rallied 7%. In the first year of President Trump's term, the S&P 500 rallied 19%. Therefore, one could argue that his returns have been pulled forward and some give back is past due. Some may say it is contributing to the lower-than-average performance in year two (this year) of his Presidential term. In addition, typically investors absorb more volatility in a midterm election year than what was experienced in 3Q of this year. As can be seen in **chart 6,** the S&P 500 has historically seen 18 days of a daily move of 1% or more (up or down) in the third quarter of an election year. However, in 3Q18 investors did not experience one day where the S&P 500 moved 1% or more (up or down). Instead, investors have seen 13 days of a 1% move already in 4Q with more than 30 trading days left in the quarter.

Putting what we have seen in the current environment aside, equity investors should be happy that we are moving beyond the midterm election. Historically, the equity market has been positive in the one year following all midterm election years since 1950 — on average by 15% **(chart 7)** — and the 4Q returns in a midterm election year are also favorable. Since 1950, there has only

Chart 5: Annual S&P 500 by Year in Presidential (Year 2)

Footnotes: Time period reflects 1929 - 2018. Price return only. 2018 is as of November 12, 2018. Source: Bloomberg Finance LP, Verdence Capital Advisors.

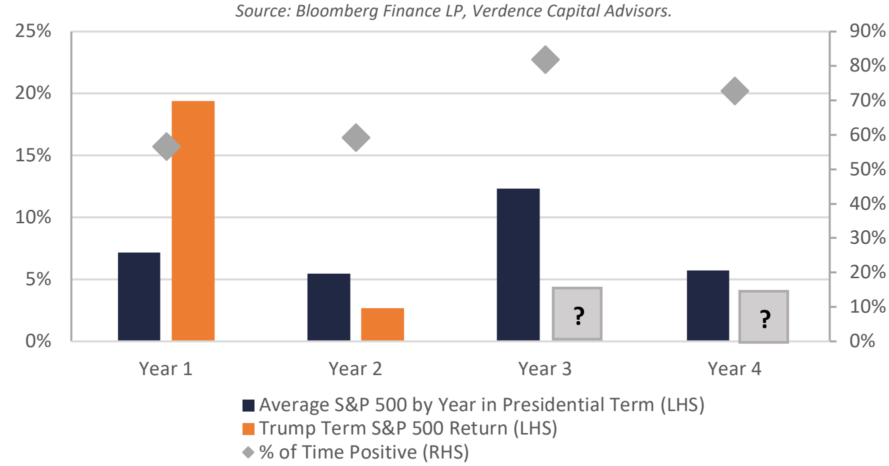


Chart 6: Volatility is Historically High in Midterm Years

Footnotes: Time period reflects 1934-2018. Price return only. 2018 is as of November 12, 2018. Source: Bloomberg Finance LP, Verdence Capital Advisors.

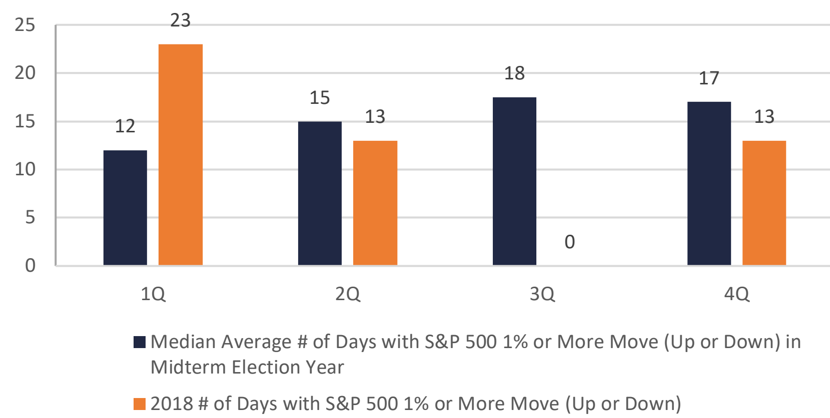
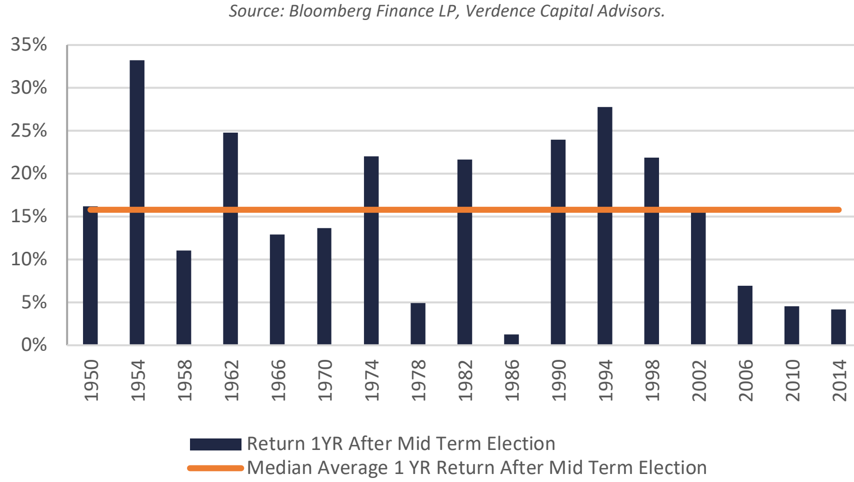


Chart 7: One Year After Midterm Equities Rally

Footnotes: Time period reflects 1950-2014. Price return only and taken one day prior to midterm election date to one year later. Source: Bloomberg Finance LP, Verdence Capital Advisors.



been two fourth quarters in a midterm election year that the S&P 500 has declined (1978 and 1994). The average S&P 500 4Q return in a midterm election year has been 7.9% compared to 2.9% in the fourth quarter of all other years. **(chart 8).**

Volatility Historically Presents Buying Opportunities

Just using history and not looking at underlying fundamentals, it would suggest that investors should evaluate pullbacks over the next year as a potential buying opportunity. Using our base case scenario that the next recession would likely occur in late 2019/early 2020 at the earliest and analyzing the history of recessions and Presidential cycles, this would prove reasonable. As can be seen in **chart 9**, most recessions begin in the first year of a Presidential term. This makes sense as new Presidents are more inclined to make the tough decisions early in their term so that they can gain momentum into the midterm election and hopefully for their re-election. However, recession odds pick up in the fourth year of a Presidential term (would be 2020 for Trump). Therefore, investors should get used to volatility, but history says buying on weakness pays off. For example, since 1950 in the one year following a midterm election the S&P 500 has experienced a pull back by of at least 5% or more in every year except 1994. In fact, the average maximum drawdown in the S&P 500 is 10% with the smallest being in 1994 at 4.4%. History also tells investors that if that pullback is used as a buying opportunity, the average upside one year after that maximum drawdown has been 19%. **(Chart 10).**

Chart 8: Solid Equity Returns in 4Q of Midterm Election Year

Footnotes: Time period reflects 1950-2014. Price return only.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

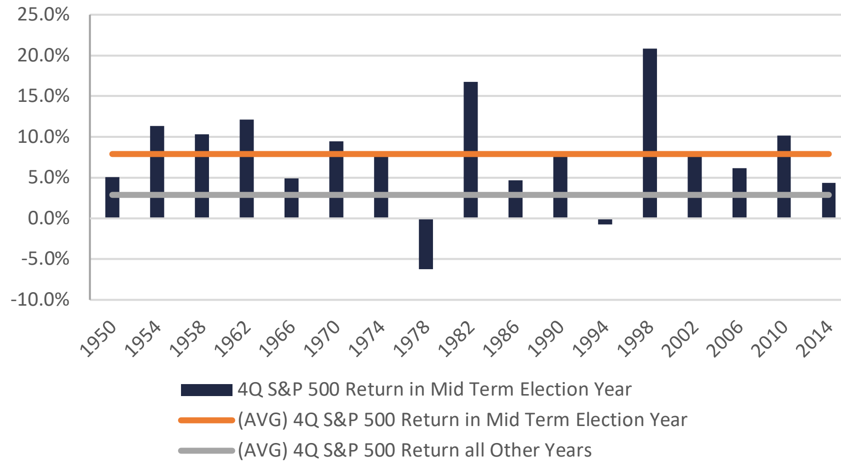


Chart 9: Number of Recessions That Start by Year in Presidential Term

Footnotes: Time period reflects 1929-2017.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

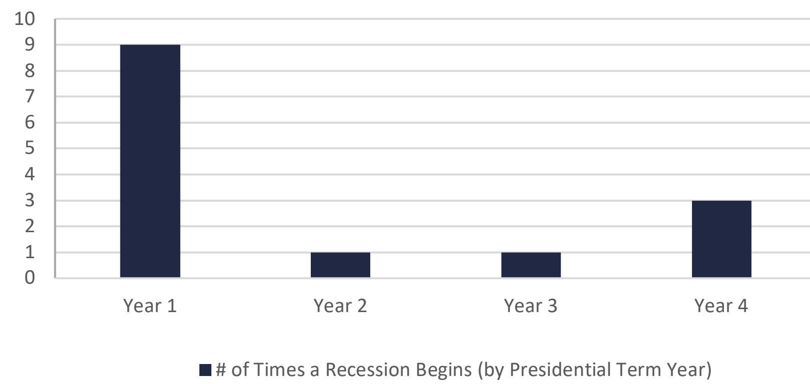
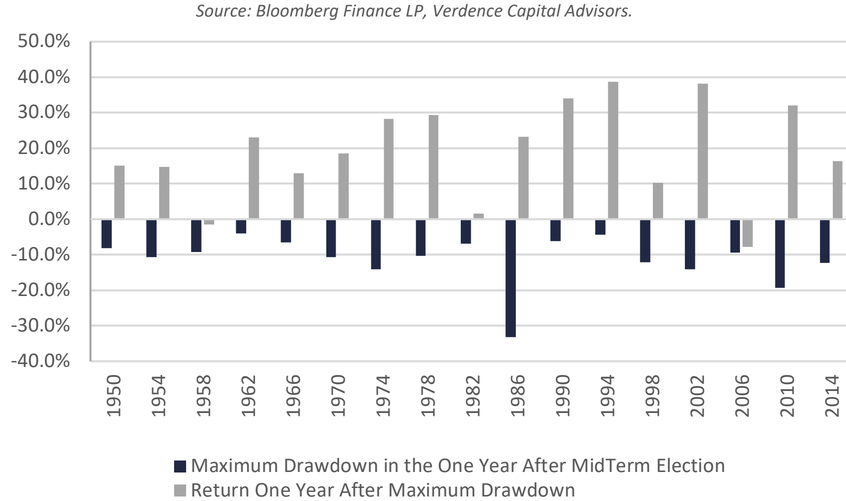


Chart 10: Maximum Drawdowns After Midterm Elections

Footnotes: Price return only.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



The Bottom Line:

What investors have experienced over the past two years is that this administration is unique and often unpredictable. Headlines have been known to move markets only for investors to see a reversal of the initial price reaction (sometimes in the same day!). Therefore, instead of speculating about what the political environment may look like, we would advise investors to focus on the facts that we do know at this time:

- **Déjà vu.** The change up in the current administration is historically common. On average, the sitting President loses ~30 seats in his first midterm election. At the time of writing this white paper, President Trump lost 31 seats (in the House, gained seats in the Senate).
- **Equities like gridlock.** Equities have historically preferred a split Congress and/or White House. Going back to 1929 and excluding the Great Depression, some of the best annual returns for the S&P 500 have been seen when the sitting President does not have full control over both sides of Congress. This may be because markets do not expect major changes to law with a split Congress.
- **Fundamentals are solid.** The economic fundamentals in the U.S. remain strong and we do not see a disruption to the economic expansion because of the election results. In fact, with a split Congress it is highly unlikely Democrats will be able to reverse the tax reform plan, but it is equally unlikely that Republicans will be able to make some, if any, of the plan permanent. So, status quo on tax reform!
- **Volatility is here to stay.** Regardless of the election outcome, we are in the late cycle of both the bull market and the economic cycle. It is normal for investors to experience the type of volatility that we have been accustomed to this year at this stage of the cycle. In addition, with trade still uncertain, inflation rising, the Fed tightening monetary policy and the outlook for future earnings clouded, investors should expect volatility.
- **Selectivity and active management.** Even with the recent pullbacks, select sectors and specific companies are still trading near record high valuations as momentum has taken over fundamentals. Therefore, we remain focused on an active management strategy and would caution investors against chasing momentum-driven investments that are still prone to further downside (e.g. FAANGs, growth).
- **Presidential race just began!** While Democrats do not have a candidate for the 2020 race, President Trump is gearing up for his fight to serve a second term. He may be taking solace in the fact that the "blue wave" did not happen as some expected. In fact, he lost fewer seats than President Obama and Clinton in their first midterm elections. In contrast, Democrats energized their base and headed to the polls at record numbers, especially among women.

While looking at history to try to draw future comparisons may be an interesting exercise, it can also mislead investors. It is important to note that every midterm election year was accompanied by a different economic, interest rate and political climate. We are aware that there have been countless articles and opinions written about midterm elections and what it may mean for your investment portfolio, however we caution investors not to fall into the headlines. At this time, we are not going to assume we know exactly what the Democrats priorities will be and in what order once they come into office. It is fair to say they will try to reign in government spending and may use the debt ceiling to do that (March 2019). It is equally fair to say that Democrats will work on healthcare changes and the likelihood of Republicans overturning the Affordable Care Act is nonexistent.

We will continue to monitor the developments regarding the political environment and what it may mean for your portfolio. However, the political environment is only one of the factors that we consider when making recommendations on asset allocation. While we consider politics, especially any potential changes to laws/regulations and/or trade, we find it dangerous to use speculation to dictate asset allocation. Instead, we find more importance in evaluating economic fundamentals, the outlook for earnings and current equity valuations. At this time, we are positioned to take advantage of the underlying economic fundamentals, the late stage of the business cycle (e.g. value over growth), rising interest rates (e.g. short duration and floating rate bonds) and dislocations in valuations that have presented long-term opportunities (e.g. international equities over the U.S.). If any portfolio changes are needed, we will always take into consideration an investors individual risk tolerance before making any recommendations to asset allocation.

[1] *United States Election Project. Forbes Magazine. As of November 7, 2018. Statista. com*

[2] *Vox, "It's Official: A Record-Breaking Number of Women Have Won Seats in Congress." November 7, 2018.*

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com