December 23, 2019

Saddle Up for a Highly Contentious Election Year

What do Presidential elections mean for the economy and investment portfolios?

In 2020 a more than 200 million Americans can exercise their right to vote for the 46th U.S. President. While President Donald Trump is running for re-election, he is also attempting to make history by being the only U.S. President impeached by the House but still seek a second term. Currently the Democratic field is still crowded with 15 candidates trying to gain momentum before the February Iowa caucus but only one has more than a 25% chance of winning the nomination according to a December 10th poll by Politico (Biden at 30%). Given the drama surrounding the 2016 election, the concern over election safety (e.g. interference) and the growing divisiveness in this country, next year's election is predicted to break records.[1] Americans should get ready for political overload every time we turn on our TVs, pick up the paper or log into our preferred social media outlet. It is estimated that we will see ~$6 billion of political spending for the 2019-2020 election cycle. The biggest increase will be seen in the highly controversial, digital space (e.g. Facebook, Google) which is expected to increase by over 100% since the 2018 midterm elections.[2]

In this white paper, regardless of what our findings may show we are not taking a political bias, instead we are using history as a guide to get a playbook about what we may expect from the economy in the fourth year of a Presidential term as well as what the economic environment has historically told us about election outcomes. In addition, we will outline some historical facts regarding election years and what they have meant for stocks and bonds.

It's the Economy, Stupid!

The phrase, "It's the Economy, Stupid!" was coined by James Carville in the early 1990's as part of Bill Clinton's campaign. In all the elections except one since 2000, the economy has been the number one topic on voter's minds when heading to the polls **(table 1).** However, a President seeking re-election is unlikely to allow an economic downturn in the year they are trying to be re-elected. In fact, the fourth year of a Presidential term has historically seen the best annual economic growth of their tenure **(chart 1).** Even if the President is serving a second term, they want to preserve economic growth so that their party can stay in office (Ronald Reagan's economic success helped George H.W. Bush get elected). Below we discuss some economic factors that have historically been key deciding factors in a Presidential election.

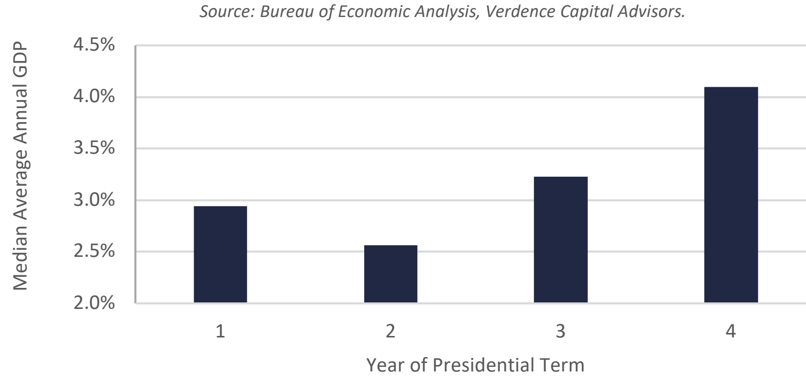
Table 1: Most Important Topics for Voters

Footnotes: Data source varies in past elections. 2020 election is as of July 2019.
Source: Bankrate.com, Pew Research, Gallup, Verdence Capital Advisors.

	2020	2016	2012	2008	2004	2000
#1	Economy	Economy	Economy	Economy	Economy	Education
#2	Immigration	Terrorism	Jobs	Energy	Terrorism	Social Security/Medicare - Future Generations
#3	Health Care	Foreign Policy	Budget Deficit	Health Care	Jobs	Health Care
#4	National Security	Health Care	Healthcare	Education	Iraq	Economy
#5	Personal Financial Situation	Gun Policy	Education	Iraq	Education	Social Security/Medicare - Current policy

Chart 1: Fourth Year of Presidential Term is Strongest

Footnotes: Time period reflects 1930-2018.
Source: Bureau of Economic Analysis, Verdence Capital Advisors.



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- **It's all about the labor market:** Historically, if the employment market is strong, the incumbent party wins re-election. In contrast, the last four times that the unemployment rate was rising in the one year before an election, that President or their party lost control of the White House **(chart 2).** The two most pronounced election years were in 1980 (Reagan beat Carter) and 2008 (Barack Obama won) and in both those instances, either the incumbent or the incumbent's party lost control of the White House. However, the direction of the unemployment rate is only one component of the entire employment environment. For example, while Harry Truman saw a modest rise in the unemployment rate in 1948, at 3.8% the rate was historically low, and he was re-elected. At this point, President Trump has the lowest average unemployment rate of any President for as long back as we have records (since 1948). **(chart 3).** Even if the unemployment rate rises and averages 5% in 2020 (from 3.5% currently), he would still have the lowest average unemployment rate during his tenure thus far.

Chart 2: Unemployment Environment Crucial in Election

Footnotes: All elections since 1948. 2016 and Trump tenure is as of November 2019. Source: Bloomberg Finance LP, Verdence Capital Advisors.

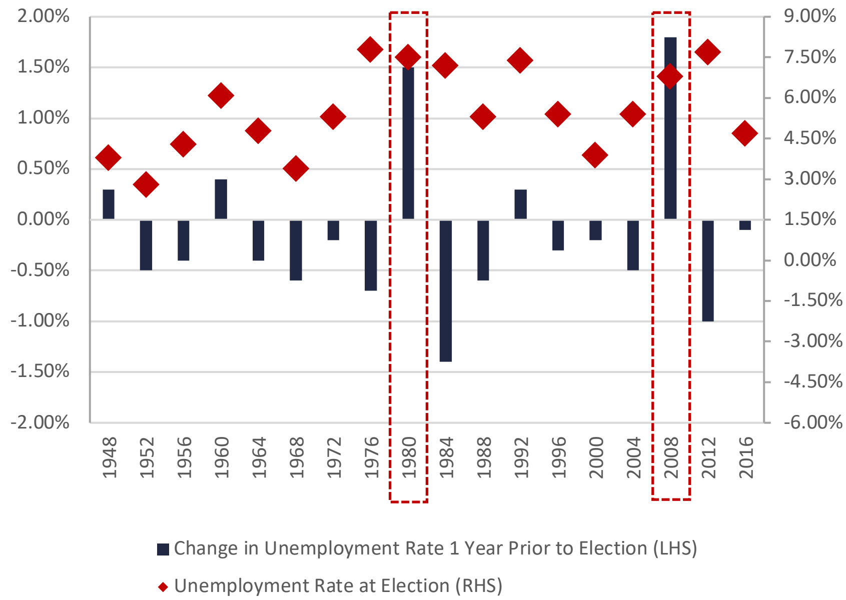
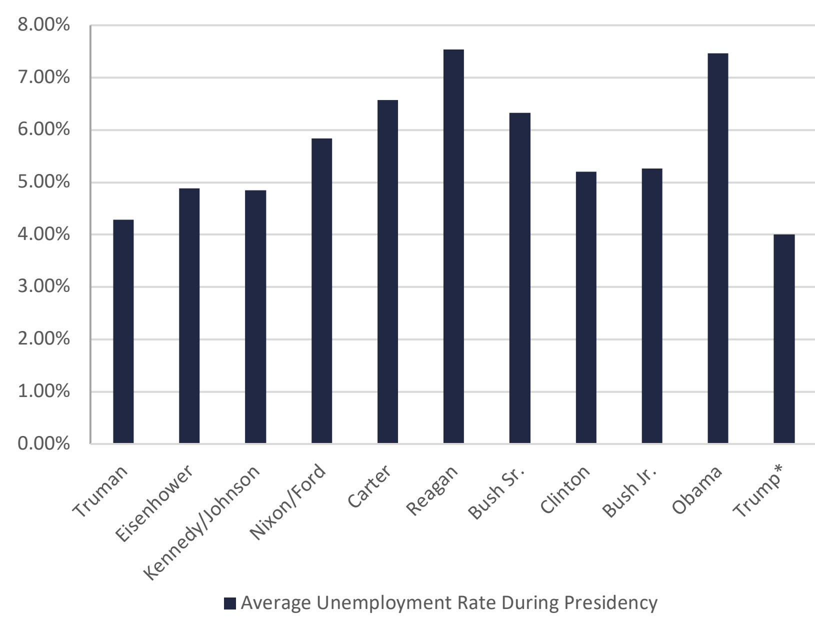


Chart 3: Trump Has Strongest Labor Market

*Footnotes: Time period reflects all Presidents since 1948. *Trump's average rating is through November 2019. Source: Bloomberg Finance LP, Verdence Capital Advisors.*



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Past performance is not indicative of future returns

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- **Consumer health important:** Since the economy is the number one factor voters consider when casting a vote there is a good indicator that measures how the average American feels about the overall economic environment. The Misery Index was developed by an Economist at the Brookings Institute during the high inflation period of the 1970s. It is an Index that simply adds the unemployment rate to the inflation rate **(chart 4).** High unemployment and high inflation are a recipe for economic pain for a consumer. In contrast, low inflation and a low unemployment rate typically coincide with periods when the consumer is flourishing. This indicator can also add some insight into Presidential outcomes. As seen in **table 2**, a rise or decline in this Misery Index has coincided with the success of the incumbent party. For example, President Carter had the highest Misery Index and biggest jump in the Index during his tenure, he only served one term. Ronald Reagan had great success in reducing the Misery Index during his Presidency and his Republican party was re-elected to office even after he served two terms. However, George H.W. Bush (Sr.) saw high and a rising Misery Index during his Presidency, he only served one term and the Democrats took over. At this time, because the labor market is strong and inflation is low, President Trump's tenure has seen the lowest average Misery Index since Dwight Eisenhower.

- **Recessions are rare in fourth year of Presidency:** While many have been trying to predict the ultimate demise of the current record economic expansion, it is important to note that it is rare the U.S. economy enters a recession in the fourth year of a Presidential term. Since 1929, a recession started in the fourth year of a Presidential term in only three separate occasions. The recession of 1948-1949 started in the fourth year of Harry Truman's Presidency. His was the only instance where the President and his party were still re-elected despite entering a recession in the election year. Dwight Eisenhower saw a recession start in his fourth year (1960) of his second term. His party fell victim to the economic woes and the White House swung from the Republican party to the Democratic party with John F. Kennedy's victory in 1960. Lastly, the Democrats and Jimmy Carter lost the bid for a second term as a recession started in the 1980 election year and President Ronald Reagan and the Republicans took over.

Chart 4: Consumer Health Important

Footnotes: Data as of December 11, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Table 2: Misery Index and Past Presidents

Footnotes: Calculation uses year over year change in consumer price index and the unemployment rate.
** Trump is using most recent data as of November 2019.*
Source: Bloomberg Finance LP, Verdence Capital Advisors.

	Median Average During Term	Start (Year of election)	End (Last year of President term)	Change During Term
Truman	8.75%	11.50%	5.30%	-6.20%
Eisenhower	5.75%	5.30%	7.00%	1.70%
Kennedy/Johnson	6.80%	7.00%	7.90%	0.90%
Nixon/Ford	10.50%	7.90%	13.50%	5.60%
Carter	13.65%	13.50%	20.80%	7.30%
Reagan	12.30%	20.80%	9.60%	-11.20%
Bush Sr.	10.55%	9.60%	10.50%	0.90%
Clinton	8.35%	10.50%	7.40%	-3.10%
Bush Jr.	7.65%	7.40%	9.60%	2.20%
Obama	9.30%	9.60%	6.20%	-3.40%
Trump*	6.25%	6.20%	5.40%	-0.80%

Fixed income and politics

Interest rates and the performance of fixed income is highly dependent on the economic and inflation outlook and can experience short-term volatility depending upon a candidate's economic policies. However, given the 30+ year bond bull market in bonds it is difficult to find any clear patterns with fixed income performance and election years. What we can gather is that Republicans generally favor less regulation, lower taxes and, contrary to perception, have been known to run a higher deficit to support growth. This should be negative for bonds as higher growth and a higher deficit should drive interest rates higher. In contrast, Democrats favor more Government intervention and higher taxes. This should be positive for bonds as it can stifle economic growth and drive interest rates lower.

The most recent and most pronounced example of what an election can do to interest rates was the surprising victory of Trump in the 2016 election. Many saw Hilary Clinton's policies as a continuation of Barack Obama which may have resulted in stable but below trend growth and support lower rates. However, if you stayed up through the wee hours of the night during the 2016 election, you would have seen the 10-year Treasury yield sink (price up) initially when President Trump was closing in on a victory (because it was a surprise and investors tend to flock to quality in times of uncertainty) but then move significantly higher in the aftermath of his win (price down). Of all the Presidential elections since 1964, the victory of President Trump saw the largest increase in bond yields from election day to year end**. (table 3).** In fact, as seen in the table, a fixed income investor may favor a Democrat winning as they have seen interest rates (10 Treasury Yield) decline, by on average, ~30 bps from election day to year end (inverse relationship between bond yields and prices).

Table 3: Initial Reaction for Bond Investors to Election Outcome

Footnotes: All elections since 1964.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Election Year	Change in 10 YR Yield (in %) from Election Day to Year End	Presidential Winner	Winning Party
1964	0.06%	Johnson	Democrat
1968	0.53%	Nixon	Republican
1972	0.14%	Nixon	Republican
1976	-0.57%	Carter	Democrat
1980	-0.03%	Reagan	Republican
1984	-0.04%	Reagan	Republican
1988	0.27%	Bush Sr	Republican
1992	-0.17%	Clinton	Democrat
1996	0.15%	Clinton	Democrat
2000	-0.75%	Bush Jr.	Republican
2004	0.17%	Bush Jr.	Republican
2008	-1.51%	Obama	Democrat
2012	0.01%	Obama	Democrat
2016	0.59%	Trump	Republican
Average All	**-0.08%**		
Average Republican	**0.11%**		
Average Democrat	**-0.34%**		

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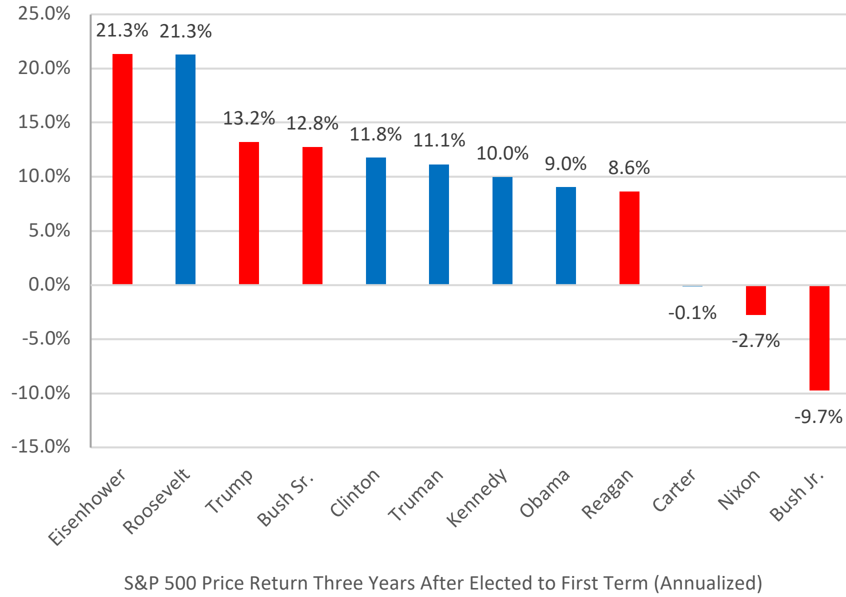
Equity markets and politics

Since election day, President Trump has seen the third best return for the S&P 500 in the first three years of the first term of any President, just behind Eisenhower and Roosevelt. **(chart 5).** History would also tell us that the equity market can continue to rally into 2020. Going back to 1932, the median average S&P 500 return in an election year is ~9% and it has been positive ~70% of the time. This positive relationship gets even stronger when you analyze the S&P 500 return in the year when an incumbent President is running. Historically, when an incumbent President is running (even regardless of whether they win) the S&P 500 is up, on average ~13% and it is positive 100% of the time. Where investors may see the biggest impact is at the individual sector level which can be impacted depending on differing views on areas such as healthcare, banks and energy. For example, healthcare is a top political topic no matter what election, and candidates tend to outline their own specific programs in order to lure the populist vote. Therefore, the healthcare sector is one that can experience high volatility in an election year. The one thing we know for certain is that active management is crucial in periods where political changes or the threat of political changes can sway the outlook for earnings and growth.

Chart 5: S&P 500 Price Return in Past First Three Years of Tenure

Footnotes: Data is first three years from election day. Trump returns are through 11/8/2019. Red bars are for Republicans while blue bars are for Democrats. Price returns are annualized. Source: Bloomberg Finance LP, Verdence Capital Advisors.



Verdence View

Politics swing; Do not let emotion overtake long term objectives

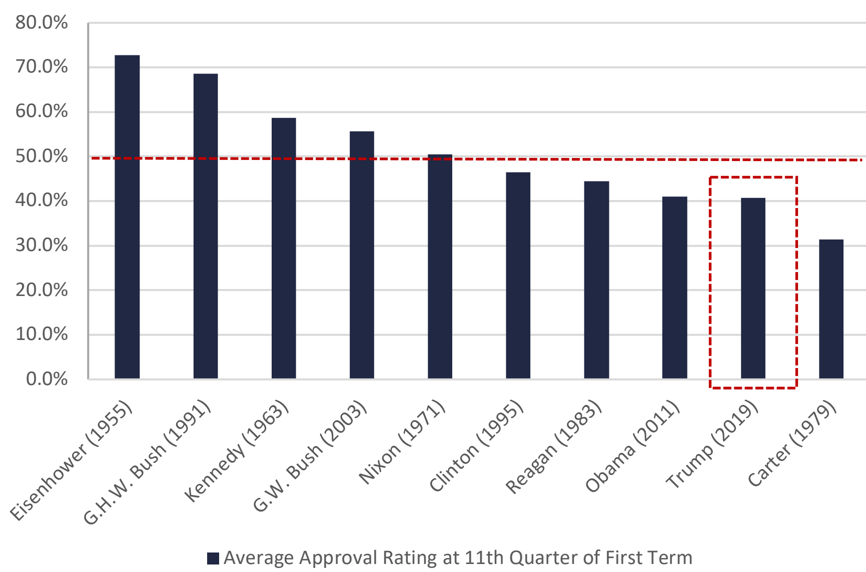
At this early point (about a year before the election) there is little to no historical significance in the polls regarding predicting the correct outcome of the election. In fact, studies show that voting polls do not get close to predicting the correct outcome until ~21 days before the election.[3]

We can analyze all the different election years possible and look at what traditionally should happen during an election year regarding the economy and what long term impact, if any, the election may have on portfolios. However, we would be complacent to not acknowledge the very nontraditional nature of this administration and the unique state of American politics. Social media has an ever-growing presence in how news is disseminated and has a way of amplifying and validating one's own opinions. In addition, our current President has the second worst average approval rating of any President since 1955 at the 11th quarter of their first term (behind Carter).[4] **(chart 6).**

While Jimmy Carter was not re-elected, Barack Obama, Bill Clinton and Ronald Reagan were all re-elected with below 50% approval ratings. In the end, we believe the most deciding factor on both your investment portfolio and the outcome of the election will be the state of the economy. At this point there is little evidence to suggest we are heading towards an economic downturn within the next 12 months. It is important to note that politics are only one factor when we analyze the appropriate asset allocation and we are familiar with that fact that politics swing like a pendulum over time. The most important success factor for investing is focusing on long term investment objectives and not acting on headlines or short-term events. Therefore, instead of getting overly concerned/excited about these early polls, we will enjoy the Saturday Night Live entertainment and wait until we at least get past the Iowa caucus before looking at portfolios to see if any changes are necessary given the political environment.

Chart 6: Is Trump's Approval Rating a Problem?

Footnotes: Data is as of October 2019.
Source: Gallup, Verdence Capital Advisors.



[1] According to University of Florida, United States Election Project by Professor Michael McDonald.

[2] According to Advertising Analytics as of July 2019.

[3] "The Polls are all Right." FiveThirtyEight as of May 30, 2018.

[4] According to Gallup Polls, as of October 18, 2019.

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