White Paper Report

What Does History Tell us About Midterm Elections?

In roughly a month, Americans will be able to cast a vote to voice their opinion about the direction of the country and the economy. On midterm election day the entire House of Representatives and about a third of the Senate will come up for re-election and/or need to be voted in. It is also the first midterm election cycle since 2006 that both sitting majorities in Congress are at risk of losing control.[1] In addition, nearly 70% of U.S. state Governors are on the ballot. With 85% of the American population believing the country is on the wrong track (including eight in 10 Democrats)[2], the U.S. economy facing the worst inflationary environment in over 40 years and arguably one of the most divisive political climates since the Civil War, this midterm election is shaping up to be about as important as a Presidential election.

Political officials have taken note and according to the nonpartisan firm AdImpact, candidates are spending ~$10 billion on political ads for the upcoming elections. This is a record amount for any midterm election and surpasses the record high ad spending during the 2020 Trump-Biden Presidential election. We also expect another record-breaking year for voter participation across Congressional and Gubernatorial races not only because of so many pressing issues and discontent across both political affiliations but there are an additional ~8 million young voters who turned voting age since 2020.[3]

Megan Horneman | Chief Investment Officer
mhorneman@verdence.com
Past performance is not indicative of future returns

In this white paper we will not voice a political opinion about the election or what combination of political party is better suited to change the trajectory of an economy that is facing so many headwinds. Instead, we will focus on the key economic (we will avoid societal issued such as immigration, crime, and abortion) issues that Americans are considering when they head to the polls next month. In addition, we will look at history and what past midterm elections and Presidential cycles have meant for the economy and financial markets. The analysis we offer in this white paper on the economy and the performance of financial markets surrounding midterm elections is simply using history as a guide. In these highly volatile times, it would be foolish to use only history as the deciding factor when making investment decisions. However, it is interesting to acknowledge some patterns (some consistent) seen in the aftermath of past midterm elections.

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Key Economic Topics that may Influence the Election Outcome

The midterm elections are considered a report card for the President and his party on the health of the economy midway through the President's four-year term. Historically there has been a high correlation between the President's approval rating at the time of the midterm election and the number of seats the President's party wins or loses in Congress. **(Chart 1)**. With the U.S. economy in the technical definition of a recession this year with two consecutive quarters of negative economic growth (1Q22 and 2Q22) and President Biden's approval rating sitting below the historical average seen at midterm elections for all Presidents going back to President Truman in 1946, the Democratic party is facing a challenging election.[4] Below we focused on the key economic topics that are at the forefront of voter's minds and what may influence the upcoming election.

- **Inflation Eating at Voter's Minds and Wallets:** Inflation has been an adverse result of the pandemic related actions taken in 2020-2021 which caused the money supply to grow to nearly 100% of nominal GDP, a record high, and the supply chain to collapse. As a result, prices across nearly every sector of the economy are growing at an uncomfortable pace and inflation as measured by the Consumer Price Index is rising at the fastest annual pace seen since the early 1980's. **(Chart 2 – next page)**. Food prices are rising more than 10% a year and at the fastest pace since the late 1970s and energy costs (including housing related energy costs) are up more than 20% over the past year. In addition, the savings rate has dwindled to a 14-year low and credit card debt has grown by more than 14% over the past year, the fastest since the late 1990s. This is affecting consumer sentiment and will likely be a key consideration at the voting booths.

Chart 1

President Approval Rating Correlates with Mid-Term Election Outcome

Data is from 1946-2018 midterm election years. Source: statista.com, Verdence Capital Advisors.

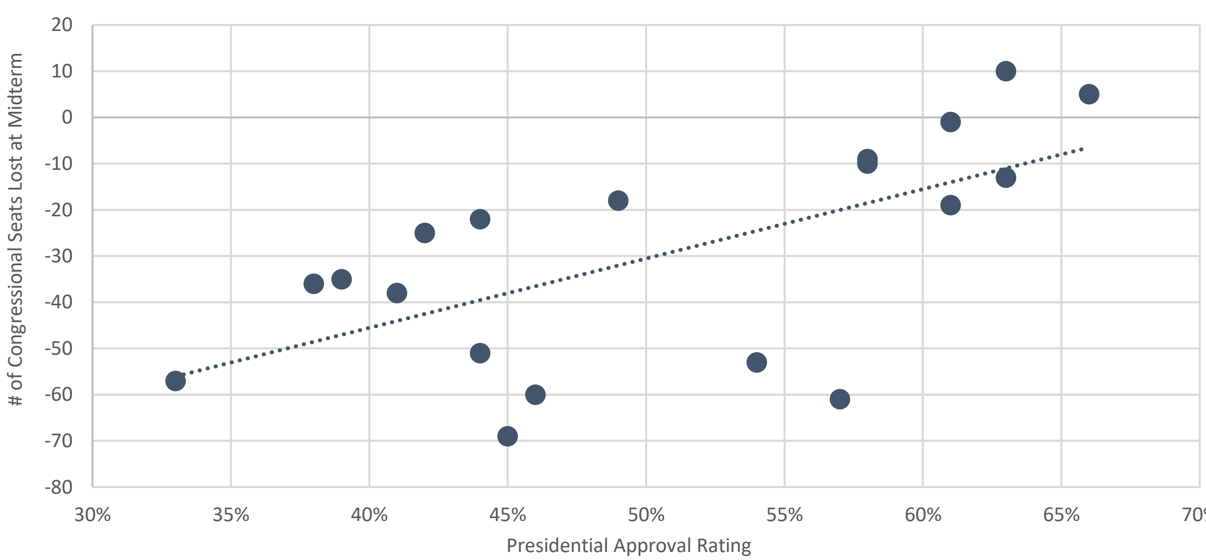
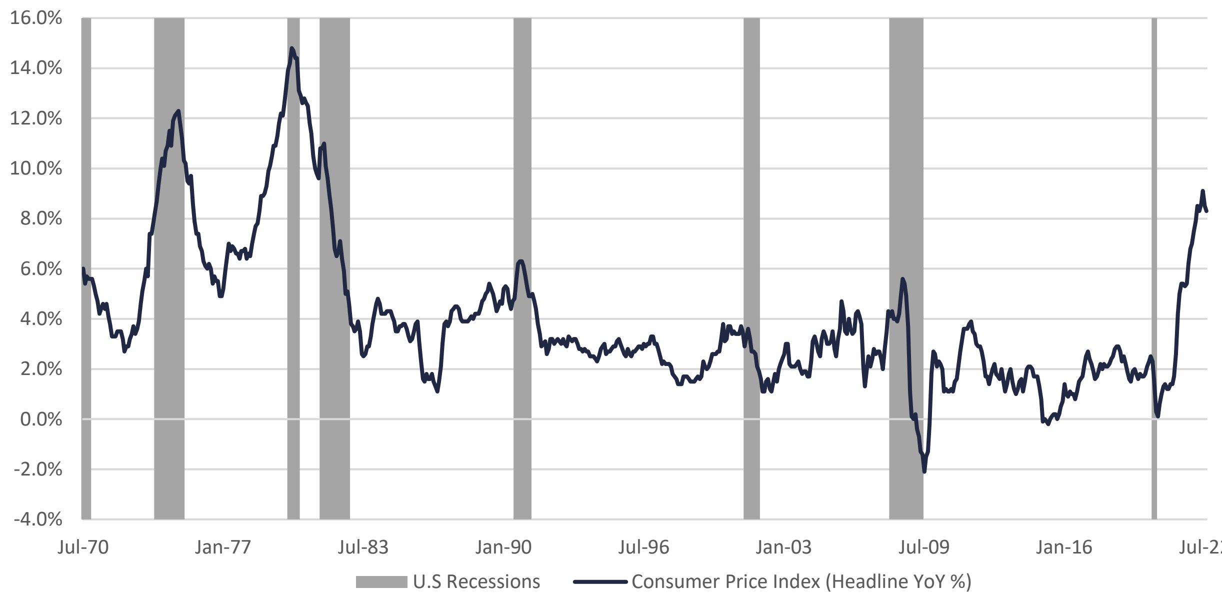


Chart 2

Inflation a Key Concern on Voter's Minds

Data is as of August 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **The Impact of Higher Interest Rates on Americans**: To combat inflation, the Federal Reserve has started its most aggressive Fed tightening cycle in decades. This is good news for savers who have not seen a 4% two-year Treasury yield since 2007. However, higher rates hamper the younger generation that is trying to accumulate wealth through buying a home. Homebuyer affordability (which takes into consideration home prices and mortgage rates) for first time homebuyers has fallen to a level that matches the record low posted in 2006. **(Chart 3 - next page)**. In addition, those Americans that are forced to rely on credit card debt to afford everyday necessities in this high inflation environment are facing growing monthly expenses. The national average APR for credit card debt is ~18% up from ~16% in 1Q22.[5]

- **High Energy Costs an Immediate Concern:** While gasoline prices have fallen ~$1.25 per gallon from their peak this year (to $3.08/gallon), this is still significantly higher than Americans have been accustomed to over the past decade. The average price of a gallon of gasoline over the past 10 years has been $2.82. **(Chart 4 - next page)**. While the global shift to green energy has its advantages for the long term, the lack of infrastructure and shunning of fossil fuel investments in the present leave us little opportunity to increase supply and no realistic immediate relief at the pump. However, the options to fix our energy predicament are very partisan. As a result, we expect the future of energy and energy independence to be a main theme this midterm election.

Chart 3

Young Losing Out on Chance for Wealth Accumulation

Data is as of June 2022. Index and a level of 100 means the first-time buyer can qualify for a loan with 10% down given typical income and rent of those 25-44 years old. Source: Bloomberg Finance LP, Verdence Capital Advisors.

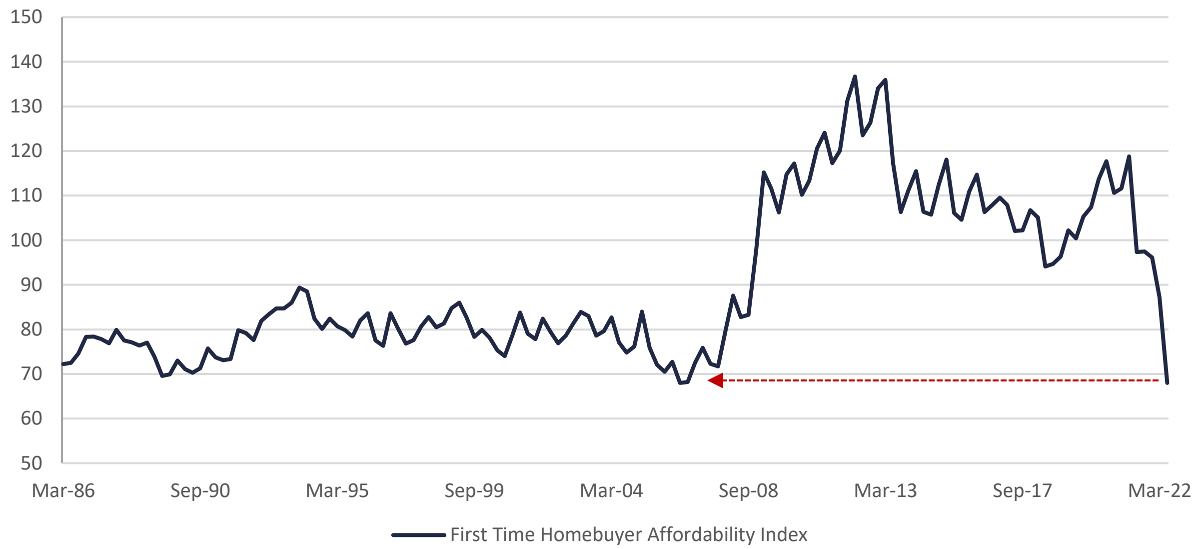


Chart 4

Gasoline Prices Moderating but Still Above Historical Average

Data is trailing 10 years as of September 28, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

Megan Horneman | Chief Investment Officer
mhorneman@verdence.com

The Economy and Midterm Elections

The U.S. economy has already crossed into the technical definition of a recession. We agree with Economists and the Federal Reserve that a substantial and sustainable economic rebound in the near term is unlikely, and risks are more to the downside than the upside. However, if you were to use history as a guide, it paints a more optimistic picture about midterms and economic growth at this point in a Presidential term. Going back to 1929, the third and fourth year of a Presidential term are the best years for economic growth (will be 2023 and 2024 for Biden). **(Chart 5).** In addition, most recessions in history have started in the first year of a Presidential term. Of the 15 recessions that have occurred between 1929-2020, nine of them started in year one of a President's term and only one recession started in the second and one in the third year. **(Chart 6 – next page).** This may be because a President does not mind making tough decisions in the first part of his tenure but wants economically friendly policies as they move towards reelection.

When only using history as a guide it tells us that the combination of government that has delivered the best economic climate has been a full Democratic sweep. As can be seen in **(Chart 7 – next page).**, the average annual GDP growth when Democrats control all facets of the Government has been ~5%. However, this is a good example of how using history as an overriding factor in decision making may be misleading. This average statistic is also skewed by Democratic majorities in the aftermath of the Great Depression and World War II. In addition, when looking at a variety of different early polls this combination is unlikely. However, early polls lean towards the Republicans taking control of the House and the Senate is a very thin margin for the Republicans to gain full control.[6] However, if that were to occur, as can be seen in **(Chart 7 – next page)**, history suggests this is the next best scenario for economic growth.

Chart 5

Good Time for Economy Given Presidential Term

Time period reflects 1930-2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.

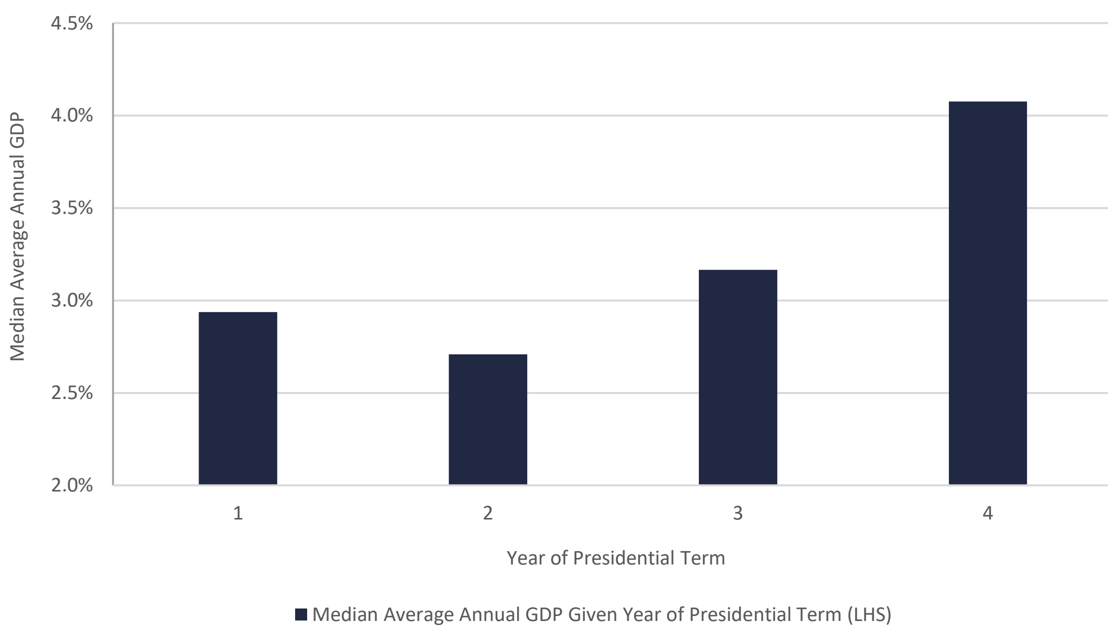


Chart 6

Recessions are Rare in the Middle of a Presidential Term

Time period is all recessions from 1929-2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.

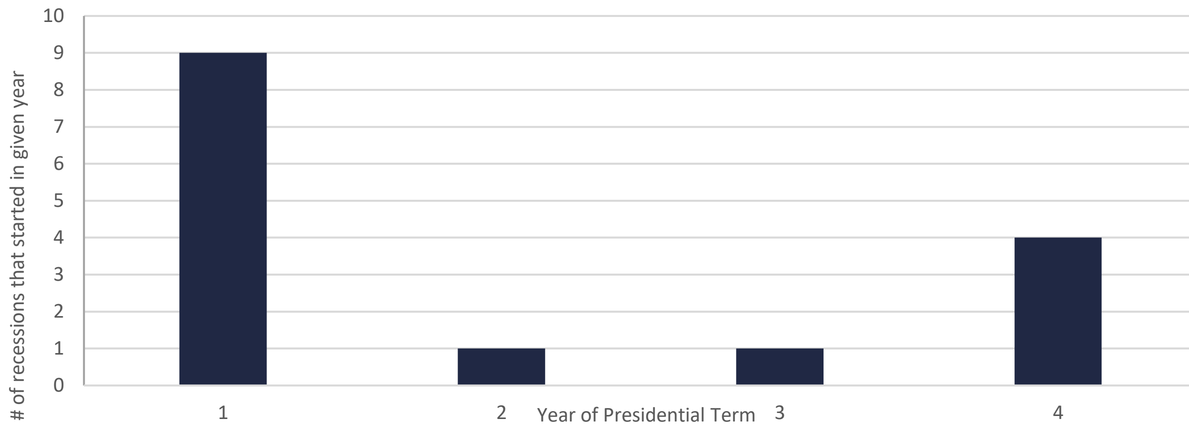
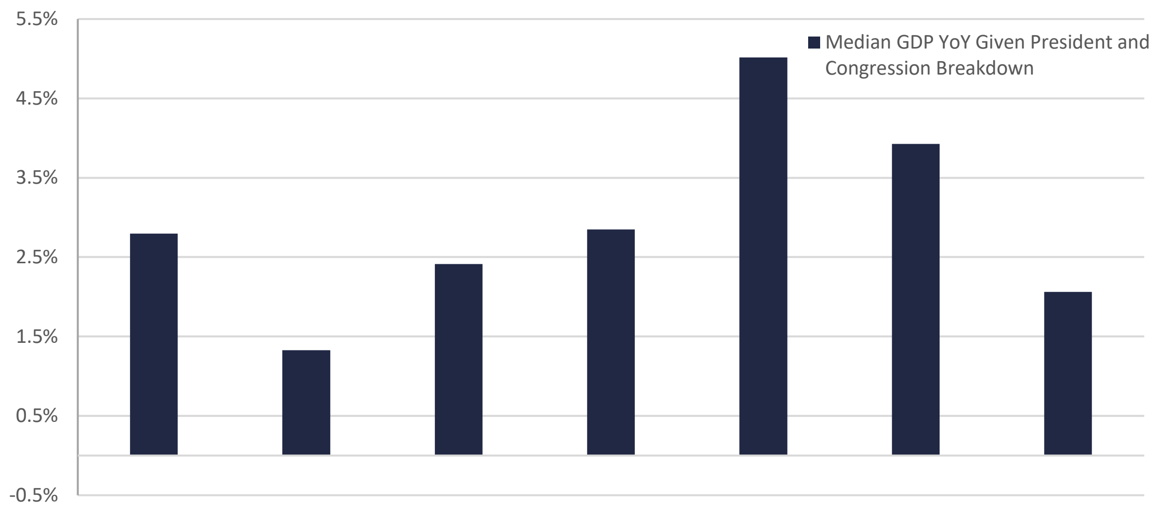


Chart 7

A Look at Historical Government Combinations

Data is median average DGP year over year from 1929-2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.



President	**R**	**R**	**R**	**R**	D	D	D
Senate	**R**	D	**R**	D	D	**R**	D
House	**R**	**R**	D	D	D	**R**	**R**

Megan Horneman | Chief Investment Officer
mhorneman@verdence.com

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The Equity Market and Midterm Elections

When we deliver our findings about midterm elections and the historical relationship with equity performance, we must remind investors about the common refrain that *past performance is not indicative of future results*. This economic environment is highly complex and there are a plethora of other factors influencing the equity markets than just politics. This includes company earnings and the expectation for further downgrades, how high the Federal Reserve will need to raise interest rates, how much damage it will inflict on the economy and will the Fed be successful in tackling inflation. What we can draw from history is that midterm election years tend to be volatile. The average drawdown in a midterm election year has been 19% since 1934 and, as illustrated, the ~25% drawdown thus far this year is more than the historical average. **(Chart 8).** However, history has also suggested this should be used as a buying opportunity as the year after midterm elections is a favorable time for equity markets regardless of the economic environment. As can be seen in **(Chart 9 – next page)**, there has only been one time in history that the S&P 500 was negative in the year after a midterm election (i.e., 1938) and the index is positive, on average, ~15%. Even the midterm elections in the 1970s and 1980s (which many are drawing a parallel comparison to the current inflation and economic environment) delivered attractive returns in the aftermath of the midterm election. The story becomes even more favorable in years that the S&P 500 is negative year to date (like 2022) leading up to the midterm election (which has occurred in 45% of the midterm election years since 1934). In these instances, the S&P 500 is positive 100% of the time a year later and up by, on average, 19%. This compares to the index being up by 11% in the years that the S&P 500 is positive leading up to midterm election day.

Chart 8

S&P 500 Tends to See Dramatic Drawdowns in Midterm Election Years

Data is all midterm elections from 1934-2018. 2022 is as of September 28, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

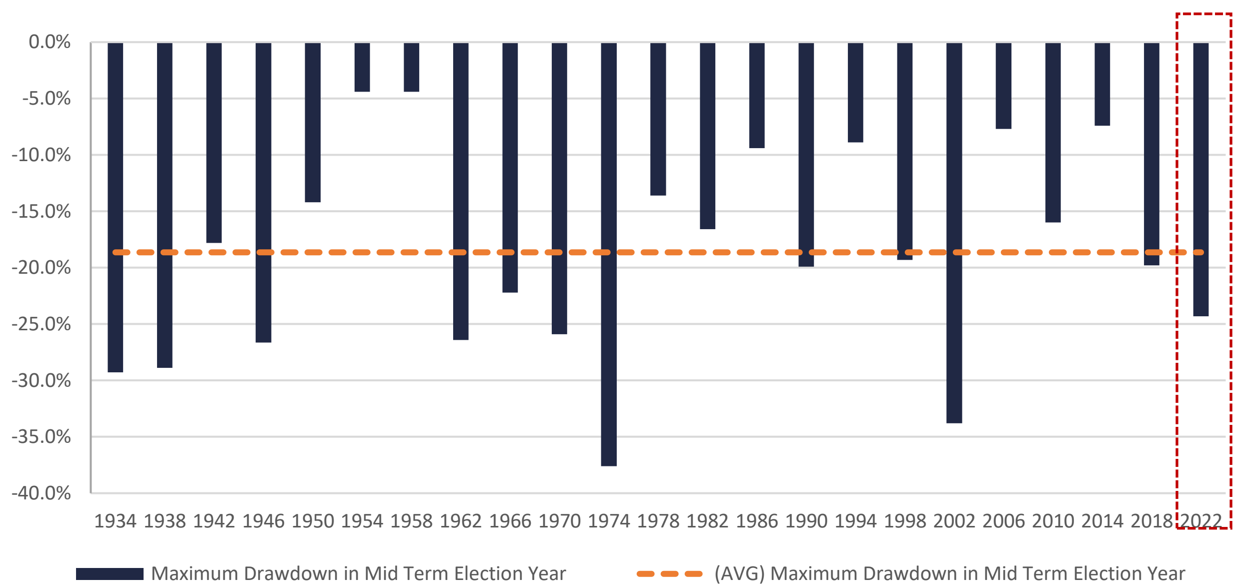
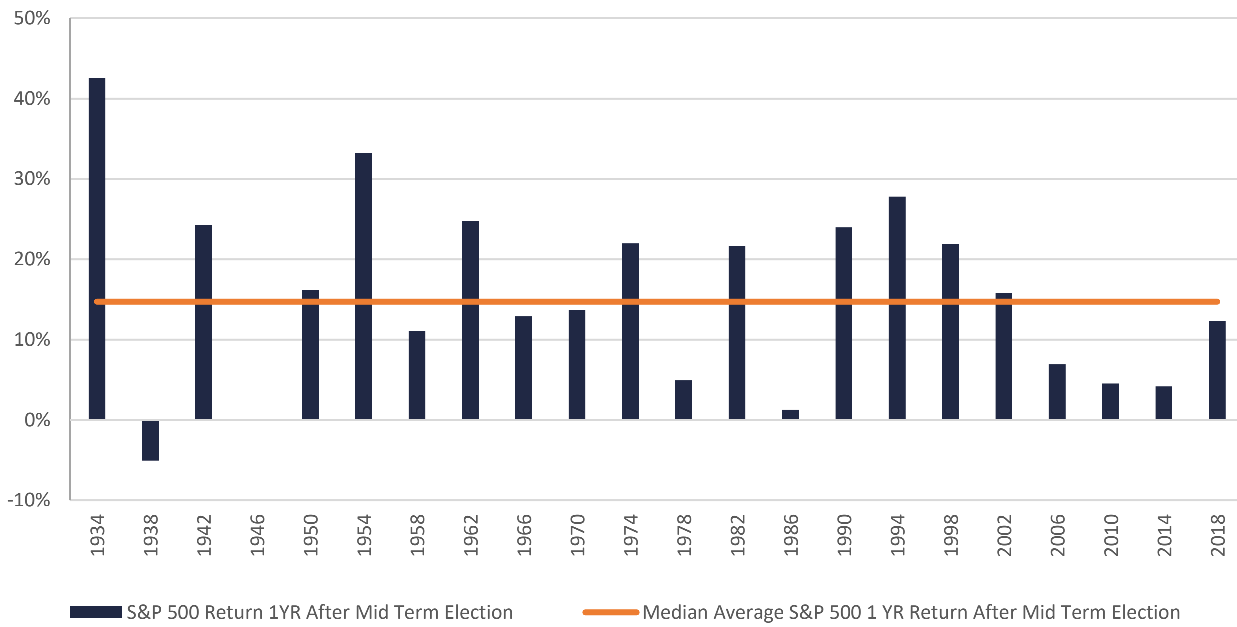


Chart 9

S&P 500 Returns One Year After Midterm Elections

Data is all midterm elections from 1934-2018. Source: Bloomberg Finance LP, Verdence Capital Advisors.



Our View

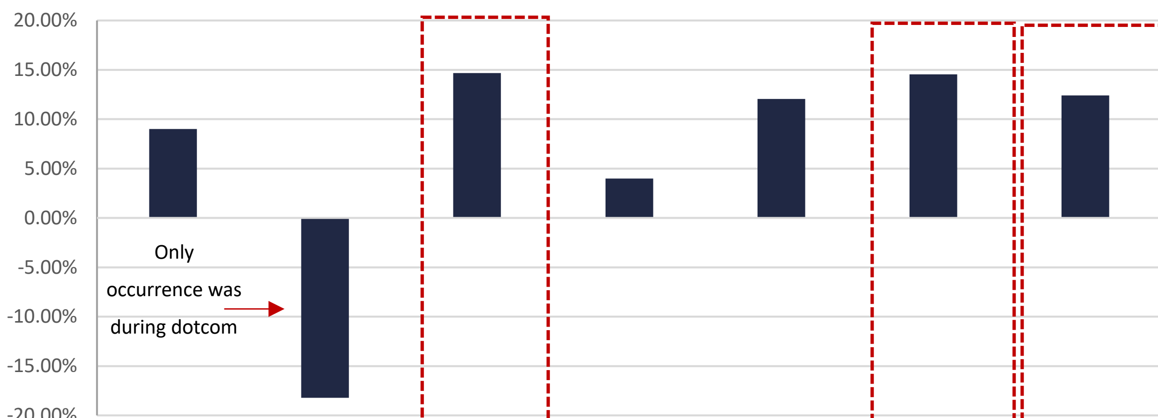
We realize that this year has been extraordinarily difficult for not just Americans but citizens around the world and sentiment towards how governments' have handled major issues is mediocre at best (e.g., COVID, inflation, civil unrest, geopolitical tensions). It is not just Americans' who have low confidence in their government. Canada's Prime Minister Justin Trudeau has only a 40% approval rating.[7] German Chancellor Olaf Scholz has a record low approval rating [8] and Italy has elected the "most right-wing" government since World War II.[9] This overwhelming political dissatisfaction may bring change in the U.S. and around the world this year and next. While we are cognizant that using history to draw future comparisons (especially for the economy and asset classes) may be an interesting exercise, it may also mislead investors. It is important to note that every midterm election year was accompanied by a different economic, interest rate and political climate. At this time, the Congressional race in the U.S. is still tight and we are not going to speculate on what political issue either party will tackle first. Instead, we will focus on what we know and continue to focus on economic fundamentals and asset class valuations when considering asset allocation. There are a few parallels we can draw from history and the current environment which include:

- **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. **(Chart 10).** This may be because markets do not expect major changes to law with a split Congress.

Chart 10

A Historical Look at Equity Performance and Government Combinations

Data is annual S&P 500 performance for 1929-2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.



President	R	R	R	R	D	D	D
Senate	R	D	R	D	D	R	D
House	R	R	D	D	D	R	R

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- **Selectivity and active management:** Even with the current bear market, select sectors are still in price discovery mode. They are trying to find a suitable valuation that will be appropriate given the changing interest rate and inflation environment. Therefore, we remain focused on an active management strategy and focus on long term investment objectives.

- **Next stop is Presidential race:** We are not certain if Biden will run again and if not who the Democratic front runner may end up being. However, we do know the day after midterm elections, the race for 2024 for both parties begins.

If you have any questions or concerns, please feel free to reach out to your financial advisor.

Megan Horneman | Chief Investment Officer
mhorneman@verdence.com

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[1] https://www.cnn.com/2022/08/11/politics/political-ad-spending-midterms/index.html

[2] According to a survey by Associate Press-NORC Center for Public Affairs Research, June 2022.

[3] https://circle.tufts.edu/latest-research/more-8-million-youth-are-newly-eligible-voters-2022

[4] https://projects.fivethirtyeight.com/biden-approval-rating/ as of October 4, 2022, President Biden's approval rating is 43% compared to a median average of 49% since 1946.

[5] https://www.bankrate.com/finance/credit-cards/current-interest-rates/

[6] According to 270towin.com as of September 29, 2022.

[7] https://angusreid.org/trudeau-tracker/ as of September 2022.

[8] https://newsghana.com.gh/scholzs-approval-rating-drops-to-record-low-25-percent/

[9] https://www.cbsnews.com/news/giorgia-meloni-italy-election-results-brothers-of-italy-far-right-wing-government/