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The 2020 US Elections and the Markets: What Can History Tell Us?

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What are some historical predictors of presidential elections?

Do elections matter to financial markets?

Do elections lead to greater market volatility?

Does it matter which party wins the election?

How would Biden's economic policies differ from Trump's?

What are some unique aspects that may cause the drivers of this election to differ considerably from historical precedent?

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Every four years, the world's attention turns to the political spectacle that is the US presidential election. Key issues affected by this election include healthcare, immigration, trade policies, taxes, climate change, the Supreme Court composition, and foreign relations. Voters are inundated with exclamations about how the results of the upcoming election carry high consequences. With the widening gap in views between political parties, perhaps the election truly will drive generational change.

In this paper we look to history to provide some context to the election's impact on financial markets and the economy. We recognize that the data set for presidential elections is relatively small, given that elections are held every four years. That being said, there are some historical relationships among elections, markets, and the economy that we can observe.

Historical predictors of presidential election

Two of the most reliable predictors of election outcomes are the state of the economy and the performance of the stock market. In 1992, presidential adviser to Bill Clinton, James Carville, famously said, "It's the economy, stupid" when referring to what drives elections. Whether the economy is in a recession or expansion leading up to a presidential election has had a strong historical correlation with the outcome of the election. In research conducted by Dan Clifton of Strategas Research Partners, he points out that over the last 100 years, every incumbent president who avoided a recession during the two years leading up to an election was re-elected.[1] Further, only one candidate, Calvin Coolidge, was re-elected when there was a recession in the two years leading up to the election.

The behavior of the stock market in the months leading to the election has likewise been a good predictor. When returns for the S&P 500 index were positive in the three-month period ahead of the election, the incumbent party won. If the index suffered losses in that window, the incumbent lost. According to Clifton, this has accurately predicted 87% of elections since 1928 and 100% since 1984.

[1] https://www.cnbc.com/2020/07/06/head-of-policy-research-at-strategas-says-the-stock-market-will-determine-the-election-in-november.html

Do elections matter to financial markets?

One area that often gets conflated with the outcome of elections is the subsequent performance of the stock market. The stock market is often seen as a discounting mechanism for future expectations for the economy and corporate earnings. Because the presidency is one of the most, if not the most, powerful and influential positions in the world, it makes sense that markets would be influenced by the election. As such, people often point to the performance of the stock market leading to a presidential election as a proxy for investors' aggregate expectations for the economic impact of the election's outcome and the policies of the winner.

Before proceeding, it is important to reiterate that the data set is limited (i.e., there have only been 23 presidential elections since 1926[2]). Additionally, elections may be influenced by external events such as depressions, pandemics, world wars, and financial crises, which may not have been under the control of the President. Reviewing the S&P 500 index return during election years versus non-election years is informative. In an analysis by T. Rowe Price, the market returned 10.7% during election years and 11.6% in non-election years. This modest 0.9% differential may indicate that who holds the presidency is not as important (for the markets) as many voters, and investors, assume.

[2] The year 1926 is used as the start date as it marks Standard & Poor's (S&P) development of their first stock index which was comprised of 90 stocks and later expanded to 500 in 1957.

	Election Years	Other Years	All Years
Count	23	69	92
Mean	10.7%	11.6%	11.4%
Median	12.0%	14.3%	14.0%
Standard Deviation	16.9%	20.7%	19.7%

TABLE 1

Calendar Year Returns for the S&P 500 Index: December 31, 1927 through December 31, 2019

Source: T. Rowe Price; Data from Bloomberg Finance L.P.; S&P 500 Index Returns (gross of dividends). Prior to formal S&P 500 Index inception in 1957, data is sourced from Robert J. Shiller. (http://www.econ.yale.edu/~shiller/data/chapt26.html)

That said, history appears clear on one point: elections have a greater market impact when there is a change of political parties. Looking at calendar years from 1926 through 2019, during years with presidential elections where the presidency stayed in the same party (either the president was re-elected or the new president was from the same party), the S&P 500 averaged an annual return of 16.0%, but when the presidency switched parties, the annual average return was 5.1%. So history seems to suggest that there is a substantive impact due to a switch in political parties. However, it is important to remember that if a weak economy is a primary factor in a change in the party of the president, it would follow that the new president inherits an economy often in recession. This could contribute to weak equity market returns depending on where the economy is in the course of the recession.

Overall, except for a change in parties, it does not appear that presidential election years have an outsized impact on markets. Rather, as we discussed, the chain of cause and effect appears to move in the opposite direction: the markets and economy have a greater impact on who will be elected.

Do elections lead to greater market volatility?

Another commonly held, but historically erroneous assumption, is that elections cause greater market volatility. This assumption seems intuitive given all the uncertainties of an election and its impact on the direction of the economy and market. However, looking at the S&P 500 index's annualized volatility, Vanguard's research finds that this assumption is contradicted by the data. Starting in 1964, the annualized volatility of the S&P 500 index was 13.8% in the 100 days preceding and following a presidential election versus a full sample period annualized volatility of 15.7%.[3] As the volatility around elections is below the historical average, it points to markets potentially pricing in the anticipated winner of the election or perhaps that market participants are unwilling to risk capital until after the election; waiting until there is more clarity on the elected President's agenda as well as the make-up of Congress.

[3] Source: Vanguard calculations of S&P 500 Index daily return volatility from January 1, 1964, through December 31, 2019, based on data from Thomson Reuters.

FIGURE 1
Volatility and the Vote: Markets Tend to Ignore Elections
Source: Vanguard calculations of S&P 500 Index daily return volatility from January 1, 1964, through December 31, 2019, based on data from Thomson Reuters.

Does it matter which party wins the election?

In the face of today's partisan rhetoric, what does history have to say about the impact of the parties on stock market performance? It is often assumed that the traditional policies of lower taxes and less regulation of the Republican Party would benefit the economy and ultimately the markets. This conclusion is also not borne out in the data.

From 1926 to 2019, there have been 48 years with a Democratic president in office, while a Republican president has led for 46 years. The return differential between parties was dramatic, with nearly a 6% per year premium in the S&P 500 index for periods when a Democratic president held office (15% versus 9% per annum).

Obviously, viewing only which party controls the presidency overlooks the importance of Congress. Since Congress can aid or check presidential power, it is critical to look at which party, if either, controls Congress when evaluating the ability of the president to enact legislation and to spend more freely on initiatives. From 1926 to 2019, there were an equal number of years of unified government during which the same party controlled the presidency and both houses of Congress, and divided government during which at least one house of Congress was held by the opposition party. During periods of divided government, the S&P 500 returned 9.7% per year, but during periods of a unified government, the annual average return was 14.5%.

However a deeper look provides an even more nuanced perspective. There are four potential states of play: unified Republican, unified Democrat, and divided with each presidential party. What we find is the political composition that has experienced the best stock market performance is a divided Congress with a Democratic President. The opposite - a divided Congress and a Republican President - has historically produced the worst returns.

Political Composition	Number of Years	S&P 500 Average Annual Return (%)
Unified Republican	13	14.5
Unified Democrat	34	14.5
Divided w/ Republican President	33	7.0
Divided w/ Democrat President	14	15.9

TABLE 2

S&P 500 Returns by Political Composition

Source: Retirement Researcher. Data from 1926 through 2019. 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.

We caution against drawing dogmatic conclusions from these data. We note that while we are looking at close to a century, it covers only 16 presidents (two of whom started as vice presidents and assumed power). Given such a limited data set it can be heavily influenced by factors outside of the president's or Congress' control. We also note that the measurement period has an outsize effect on the outcome. Using a narrower measurement period of the past 70 years shows a unified Republican government producing the best results with a nearly 3% advantage over a unified Democratic government, and a 5% advantage over a divided government. We raise this to highlight how sensitive outcomes can be to changes in sample size when we are already using an extremely limited data set.

How do Biden's economic policy proposals differ from Trump's?

One of the key reasons many argue for the similarities in economic and stock market performance under Republican and Democratic control is the fact that, despite the rhetoric, the policy differences between the two parties have been historically limited. Additionally, with the exception of changes in taxes, most of the impacts of various policies are long-term in nature.

However, today some argue we are in a new paradigm where the ideological divide is widening, which may portend a greater differentiation in the performance of the economy and the stock market.

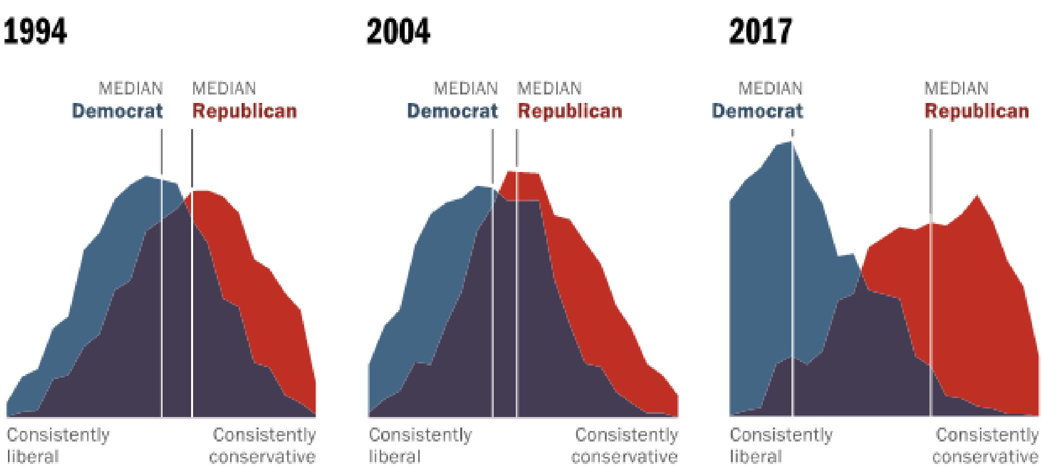

FIGURE 2

Democrats and Republicans More Ideologically Divided Than in the Past: Distribution of Democrats and Republicans on a 10-Item Scale of Political Values

Source: PEW RESEARCH CENTER Survey conducted June 8-18, 2017.

Notes: Ideological consistency based on a scale of 10 political values questions asked on Pew Research Center surveys going back to 1994 to gauge the degree to which people hold liberal or conservative attitudes across many political values. The blue area in this chart represents the ideological distribution of Democrats and Democratic-leaning independents; the red area of Republicans and Republican-leaning independents. The overlap of these two distributions is shaded purple.

In 1994 and 2004, the median Democrat and median Republican had a large percentage of overlapping political values, as shown in the graph above from the Pew Research Center. The political views of the two parties have since diverged significantly, with Republicans skewing further right and Democrats skewing further left, leaving fewer areas of common ground. This may indicate that the policy views of the parties have a greater impact than in previous elections.

To help better understand the differences between the candidates' platforms, we summarized policy views on several key issues in the following table. It is important to note that President Trump has not formally released many of his proposed policies, so the table was derived primarily from his 2021 Budget Proposal. We will also discuss the impacts these policies might have on the economy and markets.

TABLE 3
Key Policy Stances

Policy Area	Trump	Biden
Tax Policy & Wages	Favors lower taxes and lower capital gains rates; "Made in America" tax credits; expanded tax breaks for investing in lower-income communities; Has indicated support for an increased minimum wage but prefers to leave it to States.	Increase corporate tax rates from 21% to 28% (still lower than under President Obama) and implement a minimum 15% tax on global income over \$100 million; increase the tax rate for individuals earning over \$400,000 to 39.6%; Supports a \$15 an hour national minimum wage.
Infrastructure	Allocate over \$1 trillion over ten years to highways and transit, rural broadband, and 5G cell service.	Allocate over \$2 trillion to "sustainable infrastructure" and clean energy, 5G cell service, rural broadband, and modernize schools.
Government Reach and Regulation	Favors smaller government and de-regulation; continue to ease regulation for businesses.	Favors increased government involvement; strengthen regulation and oversight.
Trade Policy	"America First", protectionist in nature, use of tariffs; hard line stance with China.	"Why America Must Lead Again"; coalition forming to confront China.
Immigration	Favors restrictive immigration policies including building the southern wall and more restrictive visa requirements.	Vowed to reverse President Trump's immigration policies including border detention and public charge rule.
Climate Change	Pulled the US out of the Paris Climate Accord.	Proposed a \$2 trillion climate plan with the goal of achieving an emissions-free power sector by 2035 and upgrading four million buildings over four years to meet the highest standards for energy efficiency.

Despite the sizable difference in proposed policies, it is likely the course of the economy would be similar for at least the first few years, as both candidates have pledged robust fiscal support to help the economy respond to the pandemic. Coupled with an exceedingly accommodative monetary policy, it is likely that the economy will make substantial strides in 2021, especially if an effective vaccine is developed and dispersed in the first half of the year. Years 3 and 4 of the next President's term are likely where the policy differences will become most evident.

President Trump's economic initiatives are largely a continuation of those implemented pre-pandemic, focused around low taxes, deregulation, and protectionist trade policies, with a particularly aggressive stance against China. By contrast, Mr. Biden's plans include an increase in taxes for individuals and high earners, a more collaborative approach with our allies on foreign policy, broader regulation, and "green" initiatives. The degree to which either candidate can implement their economic agenda depends largely on the composition of Congress. Given current projections, a re-elected President Trump would probably face a divided government, making it difficult to move his proposals through Congress.

Under a Biden victory, the likely scenario is a Democratic House with uncertainty about who will control the Senate. If Democrats capture enough seats in the Senate, and Biden wins, there is the chance for a unified government if Democrats can continue to hold the House. Even with a unified government, it is still uncertain whether the more ambitious portions of Biden's agenda would pass, as the seat advantage in the Senate would be small and the gap in views within the Democratic party has widened.

Why might the drivers of this election differ from historical precedent?

People often choose to ignore the lessons history provides by claiming that "this time is different". History, however, tends to show that "this time" is often truly not that different. That said, there are several unique aspects to this election that may influence the outcome. The economy is currently in recession which history would indicate portends a change in the presidency. However, this recession was driven by the need to shut down the economy to slow the spread of COVID-19. Prior to the shutdown, the economy was performing particularly well, with unemployment hitting 50-year lows. Perhaps some voters will overlook the recession given the unprecedented circumstances and look to the projected recovery.

As we previously discussed, market performance in the three months leading up to the election has been a relatively reliable guide. While we do not know the S&P 500 return for the full month of October, we do know that the August and September period produced a 3.4% return. Therefore, if October's return is greater than -3.4%, the markets will have been positive for the three months heading into the election. However, many analysts attribute much of this equity market rally to central bank intervention and historically low interest rates. Given the current level of wealth inequality, and the benefits of stock ownership not accruing evenly across the population, it may not matter if the market is strong. Given the widening of views held by each party across a variety of areas this election may not be solely about the economy and as such market performance may not be as predictive as it has been in prior elections.

Conclusion

Presidential elections are undoubtedly important events, as they shape the direction of the country. That said, historically, the election itself has not been the major disruptive force that many assume it is with many policies not having immediate impacts. Additionally, the performance of the stock market as a proxy for the economy and national sentiment has been relatively consistent across different political party compositions. While some mixes appear more favorable than others, these apparent differences may be due largely to a limited data set and one-off exogenous factors more than a specific preference by the market for one party over another.

Turning to the 2020 Presidential Election, when looking at Mr. Biden's proposed economic policies we see an obvious shift away from some of President Trump's core policies. We believe President Trump's policies would remain largely the same as his first term if he is re-elected. This would lead to an environment of lower taxes, decreased regulation, a protectionist trade stance, and spending focused on infrastructure and defense over areas like healthcare. In contrast, Mr. Biden's proposed policies focus on healthcare, climate change, re-regulation, increased taxation, and immigration. Other areas, like infrastructure spending and a COVID-19 fiscal response, do not appear to differ significantly; that is, the dollar amount spent will be roughly the same, but what comprises the programs will be different (e.g., more dollars spent on "green" infrastructure). Additionally, no matter who is elected, they will inherit an environment of extremely supportive monetary policy and an economy that needs significant support in emerging from the pandemic induced recession. As such, the 2020 election may not be as disruptive as many have assumed and historical precedents may not prove predictive of the results.

The important thing to remember in this charged political climate is that the economy and the stock market go up and down under all presidents. There have been periods of tremendous prosperity as well as dire hardship under both parties, yet over time, the entrepreneurial spirit and dynamism of the American people has driven long-term economic growth and the trajectory for the stock market has been positive as shown in the following graph.

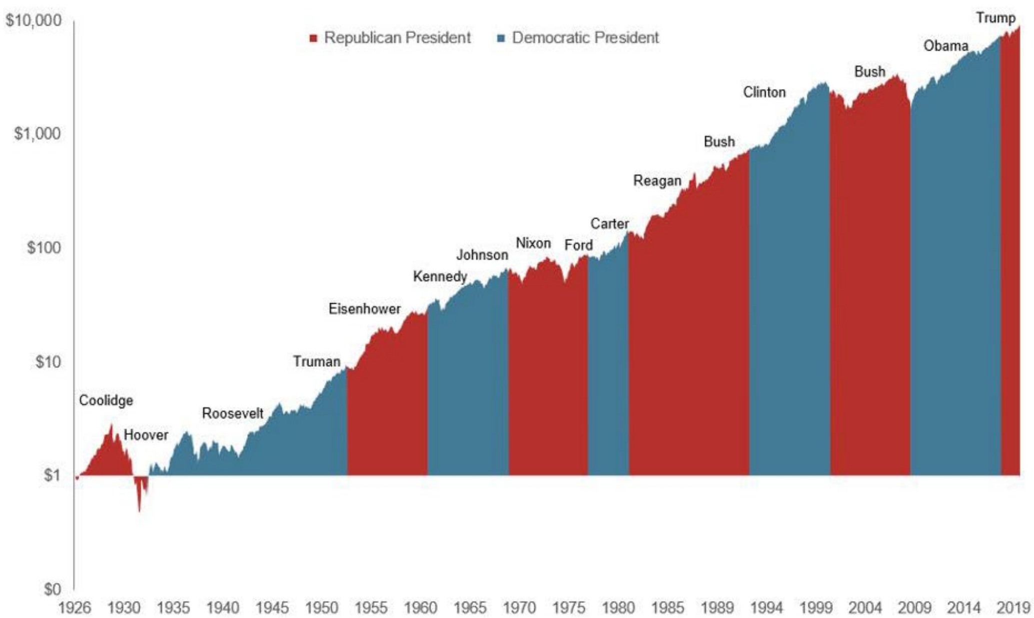

FIGURE 3

Growth of a Dollar Invested in the S&P 500: January 1926-December 2019

Source: https://www.forbes.com/sites/kristinmckenna/2020/08/18/heres-how-the-stock-market-has-performed-before-during-and-after-presidential-elections/#345307c84f86

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