MIDTERM ELECTIONS

Overview

Congressional midterms tend to have lower voter turnout than presidential elections, but the current partisan nature of the electorate could have far-reaching repercussions, particularly in light of recent felony convictions of members of President Trump’s campaign and inner circle.

If Democrats take control of one of the lawmaking groups, the legislative branch will be divided, which puts things in a stalemate. Interestingly, this is generally good news for the investment markets. The markets hate uncertainty, and a stalemate helps ensure there will be no major legislation for the foreseeable future.

If Democrats take control of both sides of the legislature, it is likely significant changes could be made — including possible removal of the president and perhaps members of his Cabinet. Impeachment proceedings are likely to unsettle the market, at least temporarily. However, the first order of business is likely to be a restoration of many of the previous administration’s policies and an end to the current trade war. These are all known outcomes that are not likely to shake the investment markets significantly.

If the Republicans retain control of both houses in Congress, this will strengthen GOP resolve and likely lead to more changes in both social and economic policies moving forward. More tax cuts, a stronger stance on immigration and trade, and renewed confidence among the majority of Americans could propel the historically long bull market even further. However, these activities represent a significant departure from past administrations so, again, how the markets react to uncertainty remains uncertain.

“Although a Republican majority in Washington, D.C., historically has been accompanied by strong equity-market performance, a potential split in Congress is unlikely to derail the U.S. equity bull market (in our view).”

- Wells Fargo Bank

Historical Perspective

Historically, the S&P 500 has experienced a correction averaging about 18 percent during mid-term election years. However, the markets tend to rally immediately after the election once clarity of leadership is re-established. As a result, every mid-term election year since the 1940s has yielded a positive return.

1930-2014: Midterm Election Outcomes and Stock Performance

<table>
<thead>
<tr>
<th>S&amp;P 500: Average Price Change</th>
<th>Republican Majority</th>
<th>Democrat Majority</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Day</td>
<td>0.27%</td>
<td>0.83%</td>
</tr>
<tr>
<td>First 3 Months</td>
<td>4.01%</td>
<td>7.02%</td>
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<tr>
<td>First 12 Months</td>
<td>10.95%</td>
<td>14.45%</td>
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Presidential Election Cycle

Investment analysts have accrued data and made observations about patterns that tend to emerge during election years. One of the trends is termed the Presidential Election Cycle, which projects the following trends based on historical patterns:6

- Years 1 and 2 – Returns are lowest in the first half of a president’s term, based on the premise that a president moves quickly to implement new policies to make good on campaign promises and to front-load any negative repercussions so as not to impact his/the party’s chances for re-election.

- Years 3 and 4 – The stock market typically produces its best returns in response to those policies or in anticipation of replacing the president.

Halloween Indicator

This pattern is also known as “Sell in May and Go Away.” It purports that the stock market produces higher returns between Halloween and May — presumably when both companies and investors are more active and productive (whereas people tend to take their vacation time during summer months). This seasonal trend is usually more conspicuous during the winter of a president’s third year. For President Trump, the cycle would begin this November.7

Gridlock

Some market analysts predict gridlock no matter how the midterm elections pan out, mainly because both the Republican and Democratic parties incorporate a significant range of policy stances. No matter which party takes the majority, the idea of heavy infighting actually favors market performance. Otherwise, consensus could trigger significant legislative changes, and Wall Street does not like change.

It is worth noting that the U.S. markets have not experienced a negative third year of a president’s term since 1939. In fact, with the exception of World War II, since the 1920s, stocks have risen 87 percent of the time in each of the three quarters that followed a midterm.8

Risk Factors

While history can be a helpful guide in anticipating how the markets will react after the midterm elections, it is important to view the upcoming midterm elections in context of the current economic environment. Over the past six months, President Trump has embarked on highly unpopular trade tariffs that threaten potential corporate profitability in certain industries. Furthermore, continued low unemployment and the threat of rising inflation increases the likelihood of more Fed interest rate hikes.
Additional risk factors to market performance include:

- The rising dollar poses a potentially negative environment for earnings
- Geopolitical risks
- Rising oil prices and a possible shortfall given U.S. sanctions on Iran
- Consumer confidence could drop in the midst of a political crisis

Sector Strengths and Weaknesses

If Republicans retain their majority, the party is poised to support Trump’s effort to prop up the coal industry, with further gains likely in cyclically oriented sectors including consumer discretionary, financials and industrials.

If Democrats achieve a majority in both Houses, their focus is likely to be in the health care sector in an effort to improve upon the current Affordable Care Act. They also are likely to ramp up policies supporting alternative energy companies, while market underperformers would likely be in the financial, energy and defense sectors.

Final Thoughts

There are a couple of key points worth considering with this year’s midterm elections. First, this hasn’t been a normal, run-of-the-mill presidency, so country and party divisions point to a highly combative period of uncertainty. The second issue has to do with putting too much emphasis on historical applications in general, and cause and effect applications in particular.

In other words, just because two scenarios correlate doesn’t mean they are linked. One financial industry executive pointed out that “the annual number of people who drowned by falling into a swimming pool is highly correlated with the number of films Nicolas Cage appeared in during that year. ... One must remember that there is a dramatic difference between correlation and causality.”

With that said, one trend that does tend to be consistent is that political uncertainty leading up to a midterm election generally generates greater market volatility. If you have concerns, don’t hesitate to contact your financial advisor for specific advice. As for general recommendations, remember that past performance is not indicative of future results; periods of volatility often present good buying opportunities; and broad portfolio diversification can help mitigate temporary declines. In addition, since November signals the approach of year-end, a discussion with your advisor about rebalancing your portfolio to harvest gains and reposition some assets for better stability in the future may be worth considering.
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