Weighing the Impact of a Historic U.S. Presidential Election

OCTOBER 2020

The 2020 U.S. presidential election is fast approaching. No matter what your political orientation, this election cycle probably feels highly consequential and filled with uncertainties. And as if the election wasn't enough, there is still a pandemic looming in the backdrop with an economy fighting to regain footing.

As the old saying goes, never a dull moment.

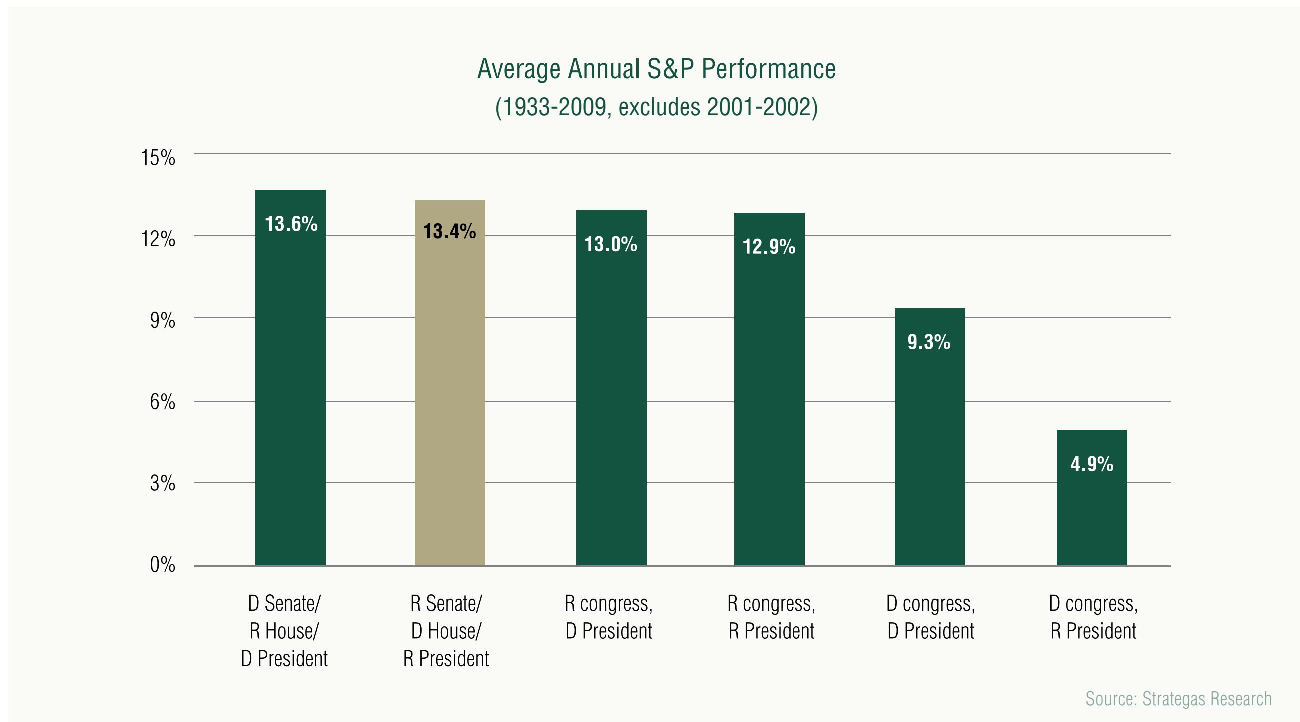
The last three months of the year present several "what-if" scenarios, and many investors and readers may be worried about how events will unfold. We empathize with your concerns and our goal is to address them here.

Before we offer our thoughts on elections, politics, and the potential impact both have on markets and the economy, we want to remind readers we are politically agnostic. As investment managers, it is absolutely critical to separate political views from the investment decision-making process, and we take this mindset very seriously. We do not favor one candidate or political party over another. What matters to us is how policy-setting may or may not affect corporate earnings and long-term economic growth.

In the realm of politics, it is tempting for investors to assume their political party is better for the stock market, or that some specific division of power between Congress and the executive branch is best—or worst—for asset prices.

In reality: the stock market has pushed higher no matter what the division of power in Washington, though returns have lagged when Democrats control Congress and a Republican is in the White House (which, interestingly, is a distinct possibility in this cycle).[1]

THE MARKET TRENDS HIGHER, EVEN AS POWER CHANGES HANDS OFTEN[1]



Data frequently cites that Democratic presidents are better for equity market returns. Since 1933, for example, Democratic presidents have experienced higher stock market returns than Republican presidents. But if we strip-out the outsized gains during the 90's tech boom (Clinton) and losses of the dot-com bust and 2007-2008 Financial Crisis (Bush), then the difference in returns between Democrats and Republicans is essentially zero. In our view, market and business cycles matter more than political parties do.

[1] Performance during 2001 and 2002 are excluded because control of the Senate changed hands three times in that period.

SHIFTING FOCUS TO POLICY PROPOSALS

A popular narrative today is that a Biden presidency would be bad for the economy and stock market, due to the potential for higher taxes and more regulation. The prevailing sentiment is that a Biden win would mean higher corporate and top-end tax rates, which is a perceived negative for earnings and equity markets.

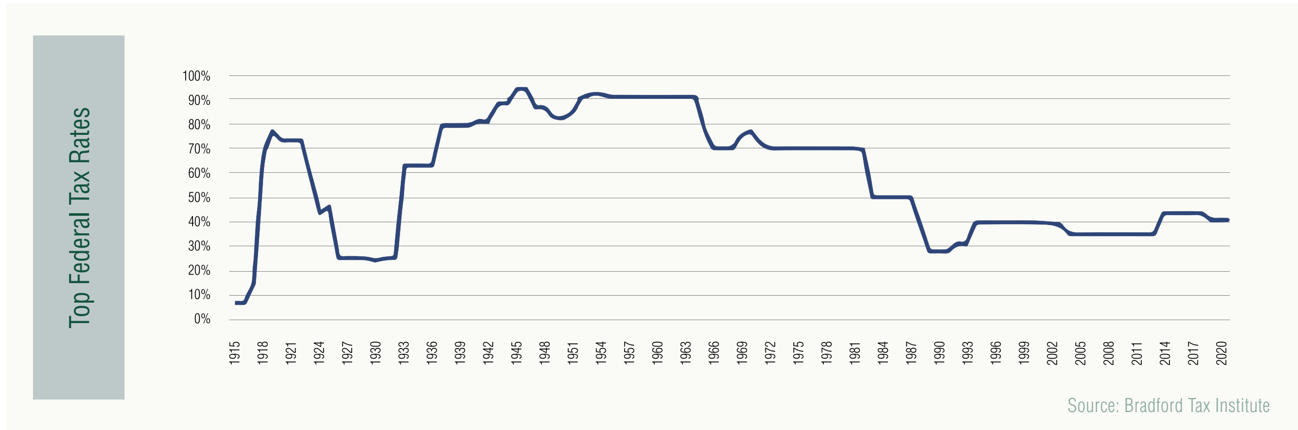
On the individual tax front, Biden's campaign has proposed raising tax rates for those earning over $400,000 to 39.6% from 37%, and moving the corporate tax rate from 21% up to 28%. Biden has also proposed raising Social Security payroll taxes, which are currently not collected on income greater than $137,700. Biden's plan would keep the cap at $137,000 but re-impose the tax on incomes exceeding $400,000. For those earning more than $1 million, it is possible that long-term capital gains and qualified dividend tax rates could bump up to ordinary income tax rates, and we could see an end to the step-up provision upon death for estate plans.

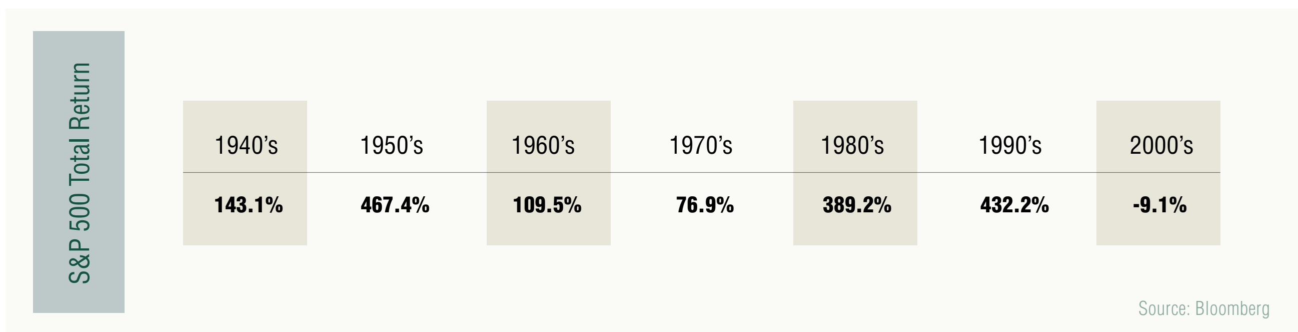
Taken together, these changes would almost certainly warrant adjustments to tax and estate planning strategies on an individual level, and we stand ready to work with clients on potential adjustments. From a macroeconomic standpoint, however, marginal changes to the tax code seem far less likely to severely impact corporate earnings and/or reverse economic growth trends.

For example, the biggest sustained increase to corporate taxes occurred in the 1940s and 1950s (see chart on next page), with the tax rate topping 50% during that period. Even as corporate tax rates soared, the stock market kept rising. During the 1940s, the S&P 500's total return was +143.10%, and during the 1950s the index jumped +467.40%.

A similar pattern can be observed with regards to the top individual tax rate and the capital gains rate. Taxes have fluctuated over the years—and been mostly higher than they are today—but the stock market has delivered solid long-term performance.

TAXES GO UP, TAXES GO DOWN, BUT THE MARKET ALMOST ALWAYS GOES UP OVER TIME





YEAR	CHANGE TO CAPITAL GAINS TAX	S&P 500 PERFORMANCE THAT YEAR
1981	Cut from 28% to 20%	-4.7%
1987	Raised back up to 28%	+5.81%
1997	Cut back to 20%	+33.10%
2003	Cut to 15%	+28.36%

The impact of marginally higher tax rates could be offset by additional spending. Biden's plan calls for $400 billion to buy American goods, $300 billion for research and development, $50 billion in worker training, and a $2 trillion, four-year infrastructure plan designed to promote energy efficiency and make the U.S. carbon neutral by 2035.

While higher taxes on the wealthy and big spending programs frame the vision for a Biden White House, it is important to remember that campaign proposals are designed to generate voter enthusiasm—very few are enacted as advertised. We saw this outcome in 2010 with the Affordable Care Act and in 2017 with the Tax Cuts and Jobs Act. The pieces of legislation signed by Presidents Obama and Trump, respectively, were far more moderate than the original proposals.

If President Trump emerges victorious in November, he will almost certainly encounter a divided Congress, as Republicans in the House face a significant uphill battle to gain a majority. With a divided Congress, the probability of meaningful, business-impacting legislation remains low, and governing by executive order has many limitations. As far as policy is concerned, we might expect more deregulation, perhaps another effort to cut taxes, and likely more tension in foreign policy and trade — a mixed policy bag that arguably has pros and cons, much like a potential Biden presidency.

ANTICIPATING HIGHER VOLATILITY

These are not normal times, and this will not be a normal election. For investors, it is impossible to know how the next three months will shake out, though it appears increasingly likely that the election result will be contested or accompanied by some level of controversy. Short-term volatility seems assured.

Long-term investment strategies should not attempt to factor-in the possibility of short-term volatility, and in our view, the fear of election mayhem may ultimately be far more dramatic and worse than the actual outcome. The disconnect between expectations and reality has already been a feature of 2020, with 'worse than the Great Depression' pandemic

forecasts not coming to fruition. Corporate earnings and revenues, for example, took big hits in Q2 2020, but 79.7% of S&P 500 companies beat consensus earnings-per-share estimates and 62.9% beat revenue estimates. On a blended basis, 55.7% of companies exceeded expectations, which represents a very strong showing relative to recent history. The pandemic's impact on earnings was not as bad as most feared.

Over time, the stock market responds more to long-term earnings and economic growth trends—not to changes in political leadership. The emotional gravity of an election—and in particular this one—may make it appear as though the outcome will make or break the nation. But we think this mindset places far too much emphasis on political figures and policies and far too little emphasis on business leaders, innovators, entrepreneurs, and American citizens and families. Politicians and politics get all the attention, but they are not the drivers of the U.S. economy.