Politics and Investing? Holiday Dinner Rules Apply.

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If you're trying to avoid thinking about the Presidential election later this year, you're in good company - According to a recent poll, 59% of registered voters do not want a rematch between Mr. Biden and Mr. Trump. Yet, barring an unforeseen turn of events, that's what we'll get.

Since this year's election process has the potential to be somewhat unusual, we think it's worth a few minutes to look at the historical intersection of elections and investing, and some of the dynamics we will all face over the next six to eight months. First, let's look at the calendar:

June 27	Presidential Debate #1 (CNN)
July 15-18	Republican National Convention
August 19-22	Democratic National Convention
September 10	Presidential Debate #2 (ABC News)
November 5	Election Day
December 17	State Electors formally vote.
January 6	Electoral Votes formally counted.
January 20	Inauguration Day

So, with things likely to **start heating up in a few weeks**, are there any historical patterns that we should be aware of when it comes to election years and markets? Well, while not related to the political calendar, the U.S. stock market has in fact exhibited seasonal and annual trends throughout its history. You have likely heard of the seasonal "*Sell in May and go Away*" rule, coined in response to the market's tendency to be strong between October and May and weaker from June through September. Or the "*Santa Claus Rally*" – a period at the end of the year when stocks have often risen strongly. Both phenomena can be attributed to investor psychology as well as work and vacation patterns.

Regarding elections, much work has been done on market performance over the four-year Presidential cycle. Politics and elections affect markets in a few ways that seem intuitive when you think about it. Presidents often enjoy a "honeymoon" period in the first year after winning, during which they often implement economically stimulative policies. Once the honeymoon is over, Presidents then often face more challenges from Congress in the 2nd year of their terms. As they approach reelection, incumbents often try to implement popular, stimulative policies in the year before their reelection contest, which again often bolsters stocks. The evidence of this effect is actually pretty strong - Over the past 100 years, on average, for stocks the best year of the Presidential cycle has been the third year while election years have been the second best. The second year of a Presidency has been the unequivocal worst on average.

If we look with a closer eye *within* Presidential election years, we see how the uncertainty of an election may affect investor psychology. Markets don't like uncertainty, and most elections present plenty of it. Until they don't. According to Ned Davis Research, historically, Presidential election years are **weak in the first half and strong in the second half**. But averages can hide outliers and the timing of election year rallies has varied considerably. One theory that makes sense to us is that markets are choppy until it becomes clear who the winner will be. Once that uncertainty is removed, markets breathe a sigh of relief and can rally.

But so far, this year has been quite different from previous election years. In fact, the year-to-date performance of the S&P 500 index has been the best of any election year going back to 1952. Are these gains telling us something about the upcoming election? **Both sides can look to this year's strong start and argue in their favor**.

When challenged by a reporter about strong stock market gains the last six months, Mr. Trump responded that the market is rallying because it expects him to win. Of course he did. His quick, confident response was perhaps a little humorous in light of the variables and significant uncertainty. But considering his relatively strong polling and the market's 15-month bullish run after he won the 2016 election; he may have a point. On the other hand, historically, markets have done much better leading up to an election when the incumbent eventually won and markets have even averaged a small decline leading up to elections when an incumbent party is on its way to a defeat. So, Mr. Biden could similarly argue that recent gains indicate expectations that he'll remain in office.

Looking at the remainder of this race, we certainly will not try to handicap the outcome, but amongst the research that we've read so far this year, we think the following points are worth highlighting:

a. Mr. Biden's approval rating (41%) is the lowest on record of any President seeking reelection and is consistent with incumbents who have lost reelection.

b. BUT…since 1952, incumbents are undefeated if there was no recession or 20% stock market decline in the year prior to the election.

c. From just a simple life expectancy perspective, and not considering their specific personal health circumstances, each candidate has **only about a 50% chance** of surviving the full four years of their next term, making this year's Vice President selection critical. Will many Americans consider this in their voting decision? Probably not, but this issue may be highlighted in the months ahead.

d. Outside of the Presidential race, based on the number of seats up for reelection in various locales, Republicans have a tailwind to retake the Senate while Democrats have an advantage to retake the House. The odds of a clean sweep for either party are low, but slightly favor Republicans.

As if normal election year dynamics are not enough, there are several real "Wild Cards" that could be played between now and January.

a. Following his recent conviction in New York, Mr. Trump is scheduled to be sentenced July 11th. There's no precedent for this, so who knows what will happen.

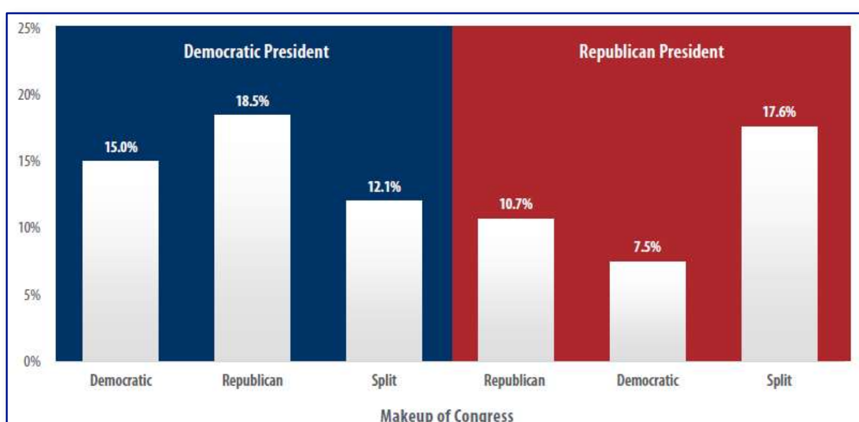
b. Considering again just their ages (and not their specific health circumstances), according to life expectancy tables, there is a **10% chance** that one of either Mr. Biden or Mr. Trump does not even survive until the November election. Ten percent is not trivially insignificant.

c. If it's a close contest, there's a non-trivial chance that we will not know the winner immediately after Election Day. In 23 states, including three important swing states, recounts are mandatory if the margin between the top two candidates is very narrow – typically 0.5%.

d. If it is a close race between the two main candidates, independent candidate Robert Kennedy may impact the election. In a close race, it's not out of the realm of possibility that he garners enough electoral votes to block either Mr. Biden or Mr. Trump from winning the electoral college. This would trigger a Contingent Election in the House. That would be complicated and likely chaotic.

e. If the Democratic party controls both houses of Congress after the election, based on how the electoral process works, Congress theoretically "could" rule Mr. Trump as ineligible, citing insurrection as the reason. We can all have our opinions on how far-fetched or not this would be. It may be a close to zero chance, but once again, there is a theoretical possibility.

Looking past the election, some investors may be tempted to overthink how the results will affect the economy and the stock market. We think it's important to avoid this trap. This chart shows the average S&P 500 index total return during different political scenarios from 1950 to 2023. **Once again, both sides could use this data to argue their case**. The bottom line is that markets have been strong under a variety of political scenarios - the only scenario that's resulted in sub-10% returns was with a Republican President and fully Democratic Congress.



Even if these patterns were compelling for one side, we don't think they would be useful because the historical sample size is so small. Statisticians would tell you that you need a meaningful number of outcomes to have confidence in a statistical pattern. How many Presidential elections have we had that might be relevant to today? Ten? Fifteen?

Additionally, we think investors who let Presidential politics cloud their judgement ignore the reality that every President inherits something from their predecessor. While policies certainly do matter, sometimes a newly elected President is just **lucky or unlucky**. In recent memory, the beginning of Ronald Reagan's presidency was marked by very cheap valuations for both stocks and bonds. Bill Clinton was lucky to follow the early 90's recession and be President during the Tech boom. George W. Bush was unlucky to start his presidency when the Tech bubble was bursting, and just prior to the September 11th attacks. Barack Obama was fortunate to start his presidency toward the tail end of the Great Financial Crisis and 50% bear market in stocks.

But what about policies? Of course they matter and elections do have consequences. A President's biggest policy levers are taxes, spending, and their regulatory approach. On taxes, whoever is our next President will have work to do since many of the income tax changes implemented by Mr. Trump will expire ("sunset") at the end of 2025. Mr. Biden has said that he will draw a line at $400,000 of income and seek to raise taxes only on those earning more than that. He'd also like to raise corporate taxes. Mr. Trump would like to make his original tax policies (more) permanent, and perhaps even cut taxes further.

Importantly, both candidates seem uninterested in addressing the U.S. deficit. Neither have made Social Security or Medicare spending reform a priority either. And with trade, Mr. Biden has recently looked to enact tariffs on Chinese goods just like Mr. Trump did. And keep in mind that we're likely to have a divided Congress which will restrain the policy objectives of whomever wins in November. So as far as their policies might affect markets, it seems likely that current economic factors and the two candidates' policy similarities may overwhelm their differences. Thus, many analysts have concluded that both candidates are likely to be **more inflationary** than not.

So, this year is off to a good start and if history is any guide, it should end well as well. But valuations are rich, normal seasonality suggests a summer pause, and the election process will soon start adding to stress levels. Thus, it may be difficult for stocks to continue advancing strongly over the next five months, and some choppiness would be unsurprising.

While the election will garner a lot of media and investor attention the rest of the year, <u>from an investment perspective</u>, we think it's **not worth worrying about**. To us, the markets' ultimate direction the next 6-12 months will continue to be determined more so by the fundamentals we've been discussing the last few years - namely inflation, interest rates, unemployment, and whether the economy slides into the recession that so many analysts were predicting the past 18 months. If the election process affects anything, it might be the Fed, who has cut interest rates between May and an election only once - in 2008 when the economy and markets were collapsing. (This is another reason to be cautious since an absence of rate cuts would be a headwind to core assets like Stocks and Bonds.)

We suggest treating the intersection of politics and investing like many families treat politics and holiday dinners – don't mix the two. Try your best to block out the noise and the tensions, remember that we're all long-term investors here, and stick to your investment plan regardless of the ups and downs between now and January.