The election effect

Tylar Lunke:

Hello, everyone, and welcome to a discussion focused on the midterm elections and their impact on markets from RBC Wealth Management. We're recording this on Thursday, October 6th, 2022. My name is Tylar Lunke, and I lead the Managed Portfolio Strategies Team, and I'm joined today by Kelly Bogdanova, Co-chair of RBC's Global Portfolio Advisory Committee. We just want to say thank you to everybody for joining us today.

So on top of everything going on within the financial markets, inflation, and interest rates, we have the midterm elections a little bit over a month away, and we know this will only add more noise to the news cycle. So our goal over the next 10 minutes or so is to provide some perspective on the midterm elections and their impact on markets. Really looking to history, we'll attempt to see what we can learn from the past, we'll touch a bit on political parties and how they drive returns, and then close with what to watch from here.

So Kelly, with things set up, welcome. Thanks for your time and let's get started. So as I mentioned, using history as our guide, what can we learn from the past, and more specifically, what type of equity market returns have we seen in past midterm years?

Kelly Bogdanova:

It's interesting, Tylar. The stock market has a rhythm when it comes to elections, and strangely enough, especially when it comes to midterm elections. Over the course of many decades, so say going back to the 1930s at least, the stock market has traded in four-year cycles that correspond with election years. Market returns in midterm election years tend to be the most subdued of the four-year cycle, with the S&P 500 rising 5.8% on average in those years since 1932. However, gains in the year following the midterm elections tend to be the most robust, and this is by far, with the index rising 16.3% on average.

But even more important than those numbers, there's a nuance that really isn't captured within the annual data that I just quoted, and there's a very persistent pattern that has occurred historically. The market typically corrected meaningfully in the 12-month period before the midterm election, on average, by about 21%. But then it rallied notably at some point in the year after the midterm elections by almost 47% on average. This pattern persisted regardless of what was going on in Washington, regardless of which party was in power, or which party was gaining or losing momentum, meaning that the pattern actually had little to do with politics or political parties. It's just how the market has reacted in the past.

Now, we have to keep in mind that the pullback we've seen so far this year roughly corresponds to the historical trend. So on average, the market pulled back 21%. This year, we've corrected 25% from the

January 2022 peak to the recent trough that occurred at the end of September. Now, of course, the fact that the market rallied sharply on average following previous midterm elections doesn't guarantee we get such a strong rally this go around, and not all of the rallies were around the 47% average. That's a big number. Some were not nearly as strong, but others were even more robust. So the rallies that followed midterm elections since 1934 had a wide range. They ranged from about 15% on the low end of the spectrum, all the way up to 87% on the high end of the spectrum. But what's interesting is that in each and every case, the market traded higher.

Overall, if you consider all of these historical patterns and we step back, maybe we shouldn't be too surprised that this year is a tough one for the U.S. equity market so far. It's actually kind of normal. And if history is a guide, perhaps the period following the midterm election and into next year will be better.

Tylar Lunke:

Well, we can certainly hope so, but that historical context is definitely helpful, especially interesting observations around the midterm. Well, another frequent question we receive is party impact. So based on the work that we've done, do stocks tend to perform better when a particular party is in control?

Kelly Bogdanova:

Political party control hasn't been a key factor historically for the U.S. stock market, and that might be surprising to some people, but the S&P 500 has performed best actually when gridlock prevailed. Specifically, performance was highest when the Democratic Party controlled the presidency and when congressional control was either split between the two parties or when Congress was fully controlled by Republicans. But the market also has historically done well when Republicans controlled both the presidency and Congress.

Tylar Lunke:

Okay. Well, maybe we'll broaden things out a little bit more here. And so we know election results are only one factor that impact equity market returns. What are some of the other factors we should be considering?

Kelly Bogdanova:

Yeah, we've poured over historical return data and the factors that influence the market, the sort of big picture, what we call macro factors. And we think market performance actually has greater linkages to the Fed's monetary policy and interest rate decisions, and also just to the natural ebb and flow of the economy, and importantly, to related corporate earnings trends. Those factors have more impact than the decisions that emanate from the White House or Capitol Hill. And these factors related to the Fed, the economy, and corporate earnings are currently in flux. There's a lot of uncertainty, and this is why we think the market has been so volatile recently.

So it makes sense for investors to focus on domestic economic fundamentals and specifically the path of forward-looking recession indicators, especially given the current economic vulnerabilities that is facing the country and many large economies around the world. We believe recessions, U.S. recessions in particular, and the related movements of corporate profits matter more to investment returns than political party control in Washington, and that's because recessions and the related decline in earnings are usually responsible for ushering in equity bear markets. And then during periods of economic duress, often when headlines are at their absolute worst and investment sentiment is very negative, any early hints of economic green shoots typically spark new bull market cycles, and that typically occurs even before recessions end.

Tylar Lunke:

Certainly good to know. And I guess from here, practically speaking, we know this is an evolving story over the next month before the elections, but what are we watching and what resources are available for investors to digest these headlines?

Kelly Bogdanova:

As the election gets closer and also after the results are known, we'll be considering potential sector and industry implications. So for example, whether various election scenarios would impact, say, the Energy sector, the defense industry, Health Care, Financials sector, and so on. But we're mindful that most of the time, midterm elections have fewer sector and industry implications than presidential elections.

The results of midterm elections are often used by Congress to set the table for the next presidential race. So whichever party or parties control both branches of Congress typically try to identify and push key issues that could help their party during the forthcoming presidential election, and we don't doubt that will be the case again this cycle. But regarding potential sector and industry implications in this midterm election, we'll provide clients with additional resources about this in the coming weeks.

Tylar Lunke:

Well, thank you, Kelly. That's really good perspective, comparing the midterms to the presidential election cycle, so thank you again for your time and perspective today. We'll continue to provide updates and special reports as the midterms near. Do want to make special note of the focus article, which highlights much of what was discussed here today. That piece is linked from the audio player for this recording. And as Kelly mentioned, keep an eye out for additional resources from RBC in the coming weeks. Of course, as a reminder, if you have questions about your investments, we would encourage you to stay in touch with your RBC financial advisor. Thank you all for the time today. Take care, and have a great day.

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