Market Perspectives: A 20/20 Look at 2020's US Election

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September 2020

Please note: *Fisher Investments favors no party nor any candidate. We assess political developments exclusively for their market impact (or lack thereof) and we don't believe any candidate or party is inherently superior for stocks or the economy.*

By most measures, 2020 has been an unprecedented year. One sign that we're slowly returning to some sense of normalcy is the presidential campaign has largely regained the national spotlight and renewed anxiety across the ideological spectrum. Virtually everyone has a deeply ingrained political ideology, which bleeds into their view of how political developments impact markets. Very few ever shift from party to party. If they do, they don't change back. Such deeply held views create biases and blind spots, which increase the risk of investment error. They also create opportunities to capitalize on what others don't see. This is what our investment analysis seeks to identify.

People on the left believe President Trump is bad for everything. People on the right see former Vice President Joe Biden the same way. We can't and won't attempt to shake you of any of those beliefs. As it pertains to social matters, you may be 100% correct. But markets don't think this way. Thinking any president—including Trump or Biden—will be either great or awful for stocks is wrong. Moreover, this mentality raises the risk of acting out of biases and greatly harming your finances in the long run. Don't fall into this trap.

Stocks Don't Practice Party Politics

When analyzing politics' market impact, many focus on whether a politician or political party is "market-friendly." We disagree. We believe policy, not personality, matters more to markets, and no person or group has a monopoly on legislation markets like (or hate). Stocks care primarily about whether new rules will affect critical matters like property rights and the ease of doing business. Campaign trail promises set investors' expectations on this front. Stocks then move on the gap between these expectations and what materializes.

With few exceptions, investors' expectations—particularly during election years—stem from generalizations. Because of how each party typically appeals to its base, investors traditionally see Democrats as favoring increased regulation, higher taxes and other "anti-business" policy. In contrast, Republicans usually run on cutting taxes and reducing regulations, making them appear business-friendly. But in reality, neither party is inherently good nor bad for stocks. Stocks average 9.5% yearly returns under Republican presidents and 14.8% under Democrats.[1] Both parties have passed laws or regulated in ways that were pro- and anti-market.

Gridlock: Why Less Action Is More Bullish for Stocks

In the US, major changes generally require legislation. Hence, stocks care primarily about how active Congress is and whether sweeping laws can pass easily. The more Congress can do, the greater the uncertainty. This can discourage risk-taking, as it incentivizes businesses to enter

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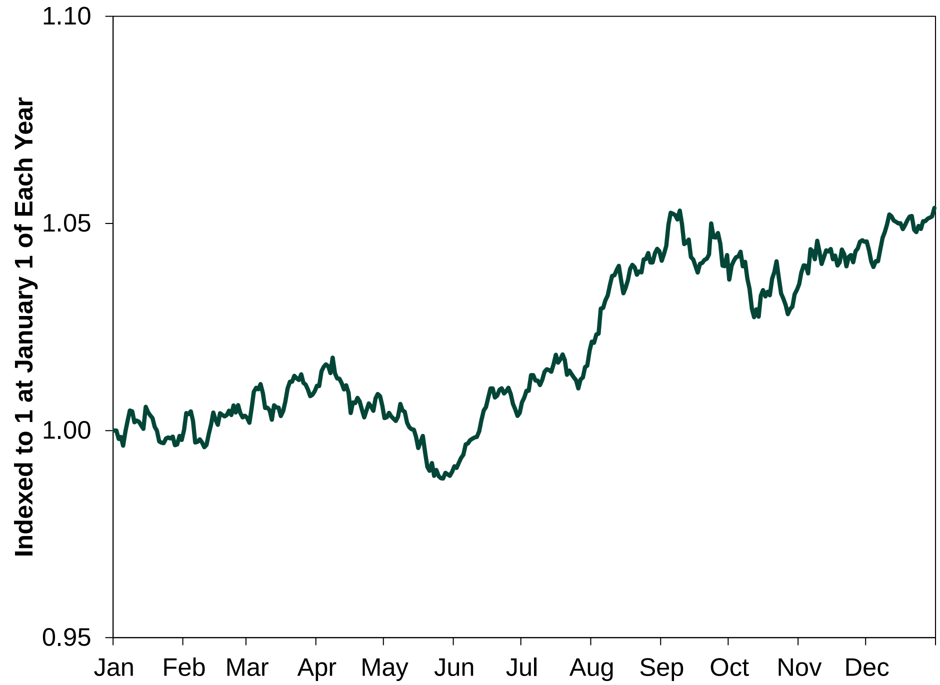
wait-and-see mode. If you are concerned future taxes or regulations could impact the return on an investment, you may wait for clarity before launching a project.

Therefore, in our view, the key political positive isn't the party in power, but simple gridlock. When legislatures are too divided to enact radical changes, uncertainty eases, and legislative risk aversion is mostly a nonfactor. We think investors must weigh not only the presidential contest, but also Congress—and the likelihood of more or less gridlock. This year, as we will show, should bring more gridlock no matter who wins. Neither party looks set to take a huge Congressional majority.

Election Years and the Perverse Inverse

Investors' partisan biases can affect sentiment—and returns—surrounding presidential elections. History shows election years are typically positive, with returns back-end loaded as uncertainty gradually fades. (Exhibit 1) Radical campaign rhetoric can dominate early in the year, hitting sentiment, while the sheer number of primary candidates makes it impossible to assess the likelihood of any proposal becoming law. As Election Day nears, the range of potential outcomes narrows, reducing uncertainty. The winner's policy stance—and ability to enact big legislation—typically gets clearer, too, helping markets see forward. While it is possible other factors may weigh more heavily in 2020, we think this should provide a tailwind for stocks over the remainder of this year.

Exhibit 1: S&P 500 Average Price-Only Returns in Election Years, 1932 - 2016



Source: Global Financial Data, as of 1/21/2020. S&P 500 price returns, 12/31/1928 – 12/31/2019.

Following the election, markets usually follow a trend we call the "Perverse Inverse." When a Republican wins, stocks typically do wonderfully during the election year, cheered by the GOP's pro-business reputation. A Democratic victory means muted market returns as folks fear a tough

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business environment. These are just perceptions—we aren't saying these reputations always match reality. But markets move, always, on changes in relative expectations.

This phenomenon reverses the following year. When a Republican administration is inaugurated, elevated sentiment tees up high expectations—which often leaves investors disappointed when the president inevitably begins to moderate or gridlock blocks big changes. A Democratic president also moderates upon entering the White House, but that reality usually *exceeds* investors' dour expectations. Since FDR, only one Democratic president had negative inaugural year returns: Jimmy Carter in 1977. Even then, it was only modestly down, just -7.4%.[2] The rest were double-digit positive. Therefore, if Biden wins, this points to a muted—but not necessarily bad—2020 followed by a strong 2021.

Zoom out, and returns over this two-year stretch show no party favoritism. It is merely a matter of when the returns come.

Exhibit 2: Perverse Inverse

	Election Year	First Year
Republican Elected	15.2%	2.6%
Democrat Elected	7.4%	16.2%

Source: Global Financial Data, Inc., as of 10/22/2018. S&P 500 total return in election and inaugural years, 1928 – 2017.

Not Your Typical Candidates

Some commentators argue Trump stands no chance in November. Not with an approximately seven-point polling deficit versus Biden and constant criticism over his handling of COVID-19, the recession and social unrest. Perhaps, but it is much too early to predict the winner. There is so much we—and everyone—don't know at this juncture.

Contrary to popular belief, Biden's path isn't easy. For one, he isn't the kind of candidate Democrats typically win with. Since the Civil War, unless the Democratic candidate was already president, no one who was perceived as a likely candidate four years earlier has won. Grover Cleveland (the poster child for this phenomenon), Woodrow Wilson, FDR, JFK, Jimmy Carter, Bill Clinton, Barack Obama—all were completely unexpected nominees four years before winning—real shockers. Some would quibble with FDR's inclusion in this list because he was better known, not young and had been the vice presidential nominee in 1920. But after the Democratic ticket lost that election, many presumed his political career was over. That is, until 1928 Democratic presidential nominee Al Smith tapped FDR to succeed him as New York governor. Four years later he was elected president—completely unexpected in 1927. A fresh face isn't an automatic ticket to victory, or course. Some have lost by running poor campaigns—like Michael Dukakis or George McGovern.

Some fresh faces are literally fresh, youthful blank canvases. Others are older but newcomers to the national scene and therefore carry no baggage. This allowed the party to brand and paint the campaign in ways that inspired voters' hopes and dreams. Whatever your personal opinion of Biden, that doesn't describe him. Not with several prior presidential runs, a lengthy Senate tenure, eight years as Obama's vice president and a number of well-known scandals. This works

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against him, as old war horse Democratic candidates usually lose—sometimes by a lot, sometimes by a little. The list of failed Democratic war horses has some of the party's most familiar names: Hillary Clinton, John Kerry, former Vice President Al Gore, former Vice President Walter Mondale, former Vice President Hubert Humphrey, Adlai Stevenson (fresh-faced in his first unsuccessful bid, trounced as a war horse in his second). Going much further back, William Jennings Bryan was the Democratic nominee more times than anyone else. His best performance was his first run, in 1896. His support fell successively in his second two attempts, as his war-horse qualities grew. If Biden wins, it would be unprecedented. Not impossible! But a first.

Then again, everything about Trump is unprecedented. Before 2016, the old Bill Clinton maxim held that Republicans fall in line behind the party's preferred candidate, while Democrats fall in love. That flip-flopped four years ago. Democrats tried falling in line behind Hillary Clinton, and the GOP tried falling in love with Trump. Neither side pulled off the role reversal well. This time, Trump is a classic fall-in-line Republican candidate. But Biden, the war horse, doesn't fit the fall-in-love mold. Right now, he is playing up that he isn't Trump. That may be enough. We just don't know.

Too Early to Know the Winner

Anyone claiming now to know how the race will go is demonstrating they don't know much about political forecasting. They focus on polls and known factors, utterly disregarding the potential for surprises. So many are possible today. Fact is, we don't know a lot about how this race will shape up.

Pundits now point to campaign chaos and intraparty opposition as reasons Trump can't win. Trouble is, they said the same thing in 2016 and completely miss the obvious parallels between then and now. They cite Trump's demotion of campaign manager Brad Parscale in mid-July as a huge red flag, ignoring that Trump reshuffled campaign leadership twice in 2016—ousting Corey Lewandowski in June and Paul Manafort in August. They hype former GOP Ohio Governor (and 2016 candidate) John Kasich's decision to endorse Biden, but Kasich didn't endorse Trump in 2016 either. As for polls, the Trump/Biden poll differential at the end of July basically matched the Trump/Clinton gap at the same point in 2016. Similarly, according to Rasmussen, Trump's approval rating was one percentage point behind Barack Obama's at the same point in 2012 and six points ahead of the day Trump was elected.[3] Biden is out-fundraising Trump, but so did Clinton.

There are differences, too, which speaks to the unknowns. Though Trump trails the fundraising race, his campaign has hugely more money now than at any point in 2016. How will he use it? COVID means rallies are out—a key difference and potentially the linchpin to his success or failure. Trump also has dramatically more GOP insider support than he did four years ago. In 2016 virtually no Republicans in Congress endorsed him. Now almost all of them do. Perhaps most importantly, Trump is a known quantity this time. How will this affect turnout? Last time, he made many strong promises that appealed to some voters who hadn't turned out in years. This time, he has said very little and made few promises. So far, his campaign theme is primarily that he was good in his first term. Voters generally dislike this, and it usually doesn't work. A lack of

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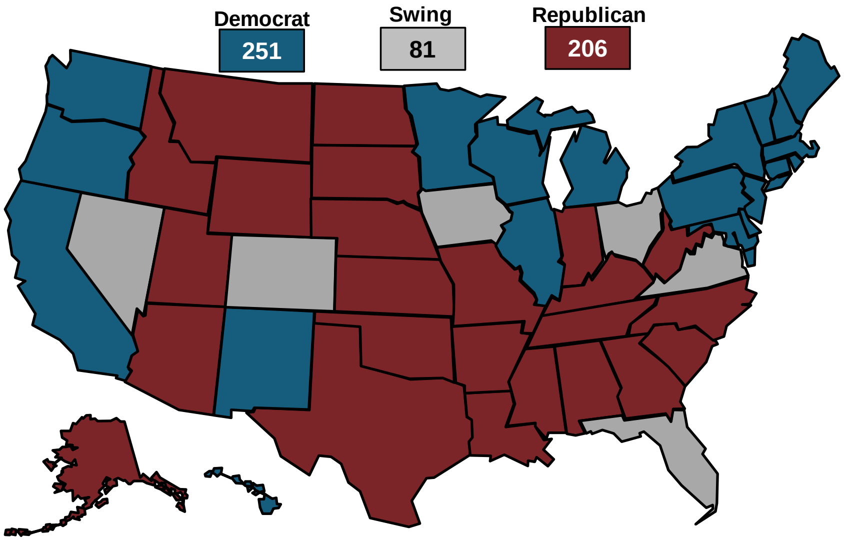
promises means a lack of motivation for voters. Of course, he could make oodles of promises from here. That he hasn't yet doesn't mean he won't. But to this point, it seems he has been asking voters to rubber-stamp a first term—historically, a failing strategy.

Bottom-Up or Top-Down?

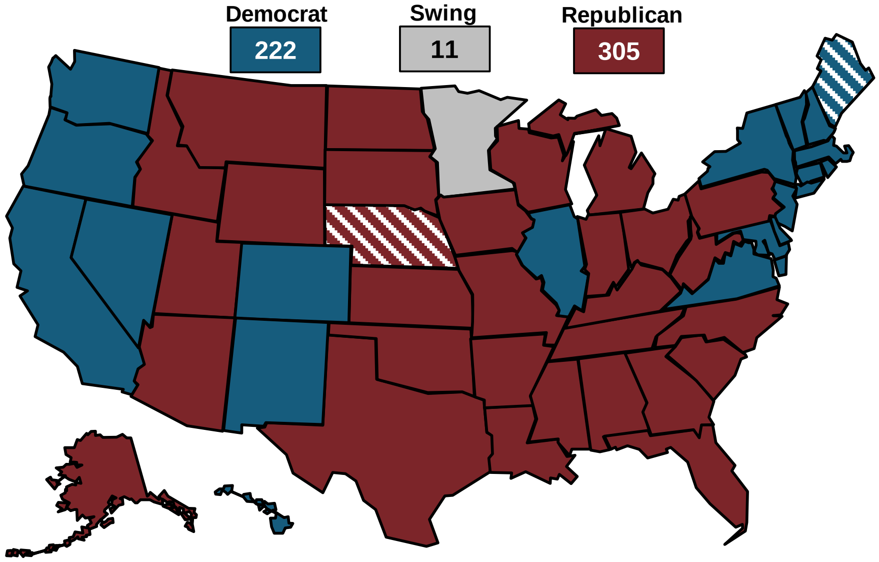
Another parallel with 2016: Trump has more of a chance in the Electoral College than national polls suggest. One way to see this: Reviewing "top-down" versus "bottom-up" analysis. Exhibit 3 uses a "top-down" methodology, which labels states Red, Blue or Swing (gray) based on how they voted in the past five elections. In this depiction, a Swing state must have elected a member of each party twice. But a "bottom-up" map, which breaks the electoral college down by party control of state legislatures to reflect how voters lean at the grassroots or district level, favors Trump. Not as much as in 2016, but an edge is an edge. (Exhibit 4)

Exhibit 3: Top-Down Map



Source: *The Wall Street Journal*, US National Archives and Fisher Investments Research, as of 7/28/2020.

Exhibit 4: Bottom-Up Map



Source: National Council of State Legislatures, US National Archives and Fisher Investments Research, as of 7/28/2020. Nebraska has a non-partisan, unicameral state legislature but leans Republican. DC is counted as Democratic based on the city council's breakdown. Swing state defined as a state without uniform party control of the legislature.

One technical note: Unlike the other 48 states, Nebraska and Maine split their Electoral College vote by district. On a bottom-up basis, all five of Nebraska's votes would go to Trump. On this basis, we categorized one Maine vote as "Swing," with the rest going to Biden.

Which map will prove correct? Bottom-up analysis, a creation of Fisher Investments, has predicted 6 of the past 10 elections and proved uncannily accurate in 2016. Top-down predicted three. We just don't know enough now to know how it will go this time.

Those leaning on national polls make a critical error beyond forgetting the Electoral College's primacy: They overestimate the percentage of voters who are up for grabs. Yes, people may tell pollsters they are undecided. But there is so much confirmation bias, and so many set-in views, that it is difficult to get people to sway one way or the other. That goes double in 2020, with no fresh Democratic face and a widely hated incumbent. People may self-identify as independents more often now than in the past, but they don't necessarily vote that way. In 2016, Clinton won 48.2% of the popular vote while Trump won 46.1%.[4] Those figures include independents. In all likelihood, only a very small percentage of these people will change their allegiances this time. The only question is: Do they actually turn out to vote?

Popularity won't shift materially and affect turnout nationally unless there is an October surprise. But it is marginally more likely to shift in the eight states that swing the election—which hinges on get-out-the-vote efforts. Success requires building staff in swing states—hiring more and better boots on the ground. Whose staff will execute this ground game better? That is unknowable now.

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Turnout is critical. Biden's widely heralded national lead is among *likely* but not *actual* voters. Pretend national turnout ends up being 60% of registered voters, which would be the highest since Humphrey/Nixon in 1968. In this scenario, one side being more effective at mobilizing voters by even a small amount could cover a three-to-five point polling gap. Sometimes campaign execution is everything. It could even create an Electoral College landslide for Trump. How so? Biden will unquestionably take California, giving him a large edge in the popular vote. If Trump takes Texas—perhaps by a narrow margin—he gets the state's many electoral votes yet would be behind sizably in the popular vote. If Georgia is close but goes Trump too, we could easily get a scenario where the popular vote mirrors Biden's present 9% margin while Trump cleans up in the Electoral College. Again, it is impossible to know whether this will happen. There is too much we don't know. But we think notions that the race is over now are laughable.

What About Congress?

Congressional races are also up in the air. A Biden landslide could turn the Senate Blue and preserve the Democrats' House majority. A second Trump term could flip the House to the GOP while maintaining Republicans' tiny Senate edge. Or one or both chambers could split with the White House, regardless of who wins. With races still only just taking shape, any projection is a wild guess.

COVID-related delays extended uncertainty as well. Indiana, West Virginia, Kentucky and Virginia moved primaries to June. New Jersey and Maine delayed theirs to July. Alabama, Texas and Georgia rescheduled critical primary runoffs. Former governor and ex-presidential candidate John Hickenlooper—who will challenge incumbent Republican Senator Cory Gardner—won Colorado's Democratic Senate primary on June 30. In Alabama, Tommy Tuberville became the GOP candidate on July 14—initially, his runoff with Jeff Sessions was scheduled for March 31. Tuberville will now challenge incumbent Democrat Doug Jones, widely considered vulnerable. With more primaries scheduled in Q3, final Senate races will remain uncertain far longer than in a normal election year.

However, there are a few general principles to bear in mind. Few voters split their ballots. It is possible some anti-Trump Republicans will do so, but again, unknowable. That very small cohort aside, voters' tendency to stay in-party up and down the ballot speaks to the importance of turnout—and each party's ground game. How this shapes up is as unknowable as the presidential campaigns. Hence, pundits' insistence that the Democrats will take the Senate is meaningless.

Importantly, neither party looks set to win a huge Senate majority. Looking at Senate races and sorting candidates by how their states swung in the past two presidential contests, the Democrats must defend just one seat in Republican territory (Doug Jones in Alabama), while Republicans have only two seats in Democratic states (Cory Gardner in Colorado and Susan Collins in Maine).[5] Here, too, this is just a baseline. Parties play offense as well as defense. Again, it all hinges on each party's ground game.

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The Primary Pre-Election Takeaway

Overall, we think cumulative returns in 2020 and 2021 will probably be largely the same whether Trump or Biden wins. We expect markets to greet the victor as they would a traditional Republican or Democratic winner. If Biden wins, 2020's returns will probably be less buoyant than if Trump is re-elected—consistent with the perverse inverse. Yet that trend would flip in Biden's inaugural year as a more moderate reality relieves investors. If Trump wins, vice-versa. Exhibit 5 shows returns in the election and inaugural years with a re-elected Republican or a newly elected Democrat—as well as the very similar returns over the two-year stretch.

Exhibit 5: Different Paths to Similar Two-Year Returns

	Election Year	Inaugural Year	First Two Years
Re-Elected Republican	10.6%	2.7%	13.1%
Newly Elected Democrat	-2.8%	21.8%	15.9%

Source: Global Financial Data, Inc., as of 7/15/2020. Based on S&P 500 total returns, 12/31/1925 – 12/31/2019.

Gridlock is a key support for this. Neither party looks set to have a big enough edge to pass sweeping new laws, even if we end up with single-party control. Just look at Trump's first two years—even with a Republican majority in both houses, he passed just one signature bill, 2017's tax reform. It was also heavily watered down, thanks to intraparty disagreements. Intraparty gridlock also limited legislation in Obama's first two years, when he had a Democratic majority. He got just two big laws—the Affordable Care Act and Dodd-Frank—both of which were scaled down heavily from initial proposals. None of these laws were make or break for markets, which rose in each of these presidents' first two years.

We will leave it to political pundits to decipher whether Biden is an anti-market Democrat. But even if he is, there is zero evidence this is bad for stocks. People initially thought Bill Clinton would be disastrous thanks to his campaign support for single-payer healthcare. But the S&P 500 rose 10.1% in his first year—and every year in his first term.[6] Returns were positive in three of Carter's four years. Lyndon Johnson? Positive returns in every year except 1966.

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[1] Source: Global Financial Data, Inc., as of 7/16/2020. S&P 500 average annual total return in years Democratic and Republican presidents are in office, 1926 – 2019.
[2] Source: Global Financial Data, Inc., as of 1/9/2020. S&P 500 total return, 12/31/1976 – 12/31/1977.
[3] Source: Rasmussen Reports, as of 7/27/2020. Daily Presidential Tracking Poll comparing Obama and Trump on 7/27/2020 and 7/27/2012.
[4] Source: Federal Election Commission, as of 7/28/2020.
[5] Source: Fisher Investments Research, US Senate and Ballotpedia, as of 7/13/2020.
[6] Source: Global Financial Data, Inc., as of 1/9/2020. S&P 500 total return, 12/31/1992 – 12/31/1993.

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