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The 2016 U.S. Election: All bark, no bite for markets

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Executive summary

- Recent U.S. presidential elections have had minimal market impacts.
- The 2016 race, though unusual in many respects, has so far produced few major market swings.
- While it's possible the race will generate financial market volatility ahead of Election Day, we don't expect it to be a driving factor in investment performance over the balance of the year.
- Markets view this election as very likely to result in a Democrat as president and Republican control of at least one chamber of Congress, very similar to the political status quo.
- In our view, investors should not make dramatic shifts in their investment mix or delay decisions about investing purely due to concerns about the U.S. election.

Introduction

If the U.S. election was a hot topic of conversation at your end-of-summer BBQ, you weren't alone. Presidential elections have become all-consuming quadrennial affairs for print, television, and social media. And with this cycle being the longest (and arguably the most unusual) in history, many investors are concerned that the 2016 U.S. election will affect financial markets and, in turn, their invested wealth.

So far, we haven't found many instances in which the 2016 campaign has swung markets one way or another. Pharmaceutical stocks dropped by nearly 25% last September after former Secretary of State Hillary Clinton proposed, among other things, giving the government more power to negotiate prescription drug costs. But that was the exception that proves the rule. With two months to go until Election Day, it's still possible for the race to change in a way that invites financial market volatility. Ultimately, however, we don't expect the 2016 U.S. election to be a driving factor in investment performance over the balance of the year.

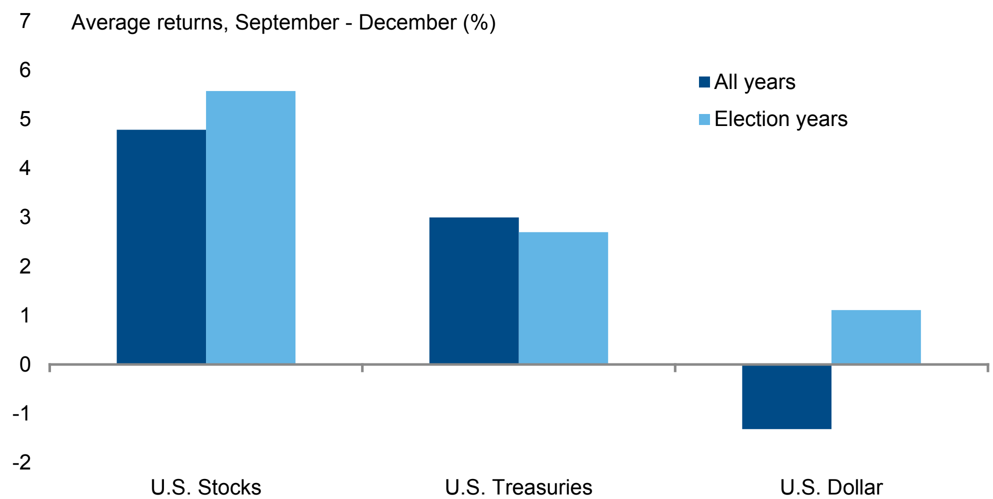
A brief history of presidential elections and markets

Investors worried about the election's immediate effect should find Figure 1 comforting. Excluding the financial crisis in 2008 (for which we do not hold the 2008 election responsible), equity, fixed-income, and currency markets have behaved no differently in the final four months of election years than they have in other years.

The one recent exception was in 2000, during the unprecedented recount in Florida following the near-tie between Al Gore and George W. Bush. That process left the result uncertain for more than a month following the vote, and equities sold off over 7% during that period. But the uncertainty generated by the recount probably only exacerbated pre-existing market worries, given that the U.S. economy was (we now know) already sliding into recession. It's unlikely that the election alone caused the markets to struggle.

Excluding 2008, U.S. presidential election seasons have not been unusually bad (or good) times to invest.

Figure 1. Presidential election seasons have been fine for markets*



Source: Bloomberg (*data from 1968 – 2012, excluding 2008)

An election's market impact hinges on uncertainty

To have a measurable effect on markets, an election needs to be both:

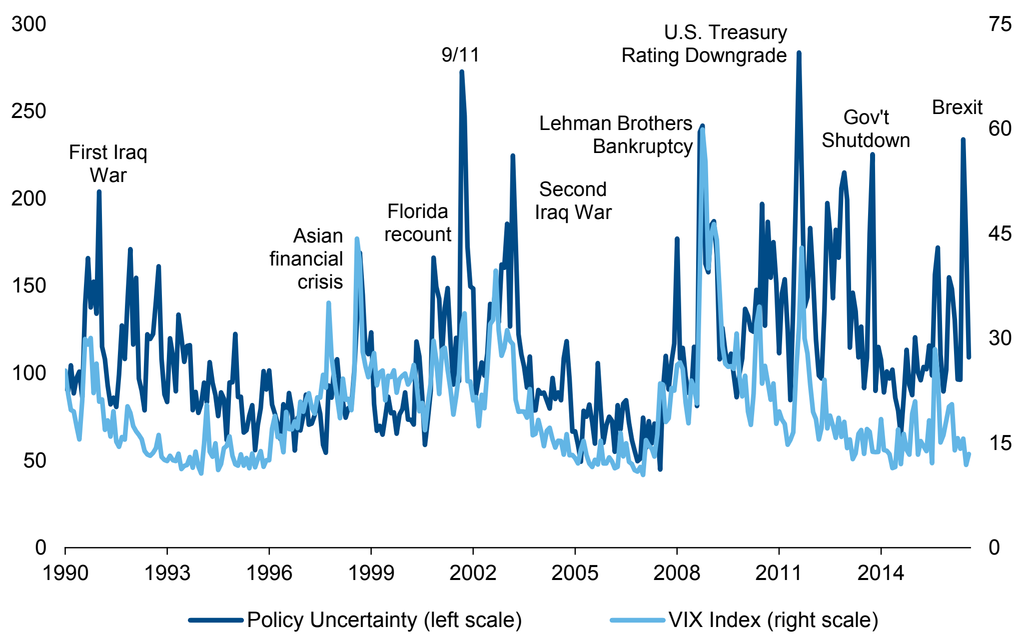
- Close (i.e., the outcome is uncertain leading up to the vote); and
- Consequential (i.e., fought over wide gaps in policy proposals)

The recent U.K. referendum on EU membership, known more commonly as Brexit, is a good example of this. The large price swings across U.K. assets just before and just after the vote came not only because it was close (it was…and a surprise), but also because it was enormously consequential. It's actually rare for U.S. elections to be fought over a razor-thin vote margin with huge policy implications for the economy and corporate profitability. That said, the uncertainty generated by a 50-50 race could contribute to lower equity multiples, higher market volatility, and lower interest rates than would otherwise be the case.

Social scientists and statisticians have developed ways to quantify this uncertainty and study its impact over time. Figure 2, for example, shows a multi-faceted measure of economic policy uncertainty developed by social scientists at the University of Chicago, Northwestern University, and Stanford University. Over the years, this policy uncertainty index has closely tracked equity market volatility as represented by the VIX index. The events with labeled spikes should be familiar given the fervor with which they were covered at the time, but most of the resulting market responses were short-lived. Since Brexit, both policy uncertainty and equity market volatility have declined even as the U.S. election has crept closer.

Policy uncertainty and U.S. equity market volatility have fallen since Brexit, despite the looming U.S. election.

Figure 2. Policy uncertainty correlated with equity market volatility



Source: policyuncertainty.com, Bloomberg

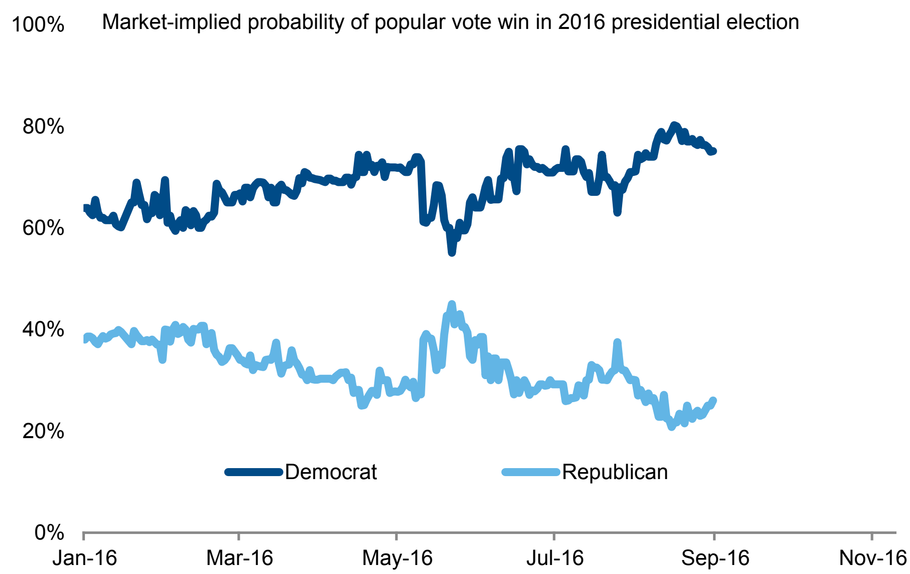
Political prediction markets offer another way to measure uncertainty by allowing users to wager on specific outcomes and receive payouts if they're correct. Right now, Democrat Hillary Clinton is priced at close to 75% to win in several leading prediction markets, including the Iowa Electronic Market (IEM) shown in Figure 3. An analysis by Goldman Sachs showed that as far back as 1992, no nominee has ever been priced below the 25% currently ascribed to the Republican nominee Donald Trump and gone on to win. While certainly still possible, a Trump victory would be an unprecedented miss by political prediction markets, one that could spark market volatility if it came as a complete surprise.

Hillary Clinton also has a large lead in national and state opinion polls compared to the last six presidential election winners. Organizations like FiveThirtyEight combine opinion polls with historical data to model likely election outcomes. Its "polls only" model gives the former First Lady a 74% chance of winning the White House. RealClearPolitics, a poll aggregator, currently puts Clinton ahead by 4.6% in a 1-on-1 match up with Trump. Together with prediction markets, these data-driven sources help us evaluate likely political outcomes to avoid being surprised by an election-related market shock come November.

The size of the comeback necessary for a Trump victory is without modern precedent but not impossible. A geopolitical calamity, a new scandal, or a string of debate victories could all help Trump gain ground in the race. There is also still some chance that economic conditions could turn sharply negative to the benefit of non-incumbents. But the change would have to be dramatic to have an impact over the next 9 weeks. While a few economic data points have softened this quarter, we have not seen nor do we expect to see the kind of broad-based weakness that could decisively swing an election result.

Clinton's perceived likelihood of winning has increased since the conventions.

Figure 3. Prediction markets currently indicate a Clinton victory



Source: Iowa Electronic Markets

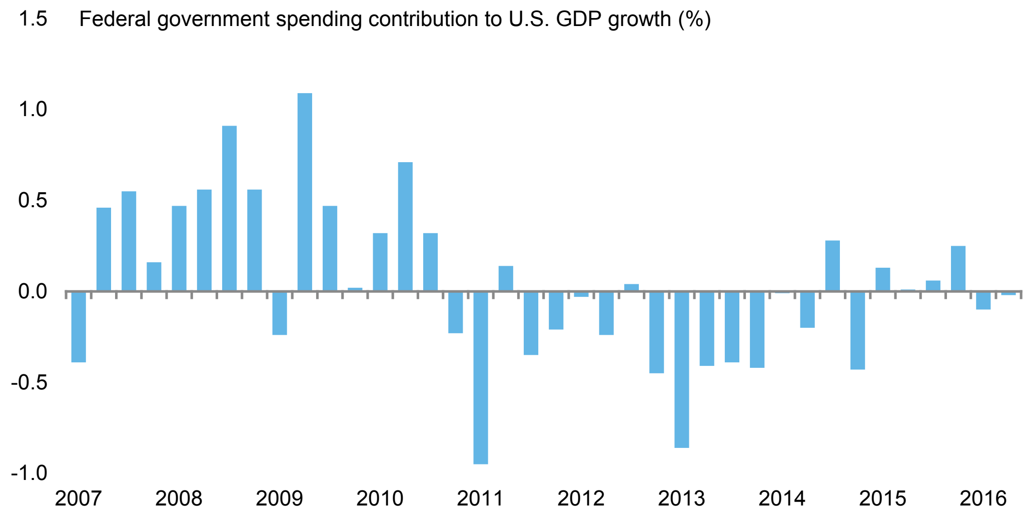
Clinton and Trump share similar policies in areas like trade, but they have starkly different approaches to tax reform, foreign affairs, and the stewardship of the Federal Reserve. All of these issues have the ability to move markets. A Clinton victory coupled with Republican retention of at least one house of Congress invites minimal market volatility given its resemblance to the current balance of power. A sudden tightening in the polls could rattle financial markets, particularly equity markets, because of the uncertainty it could create. If the race stays on its current course, however, it's likely that non-election factors (e.g., economic data, monetary policy) will continue to drive investment returns.

What to expect after the election

Should the executive and legislative branches remain divided next year, the new president will have difficulty securing sweeping policy changes. We see some potential for common ground on modest tax reform accompanied by fiscal stimulus through new spending. Federal spending often contributes to economic growth early in presidential terms as new administrations enact their agendas. A combination of higher taxes and restrained spending in recent years has created a small fiscal drag on growth since the effects of the 2009 stimulus package faded (Figure 4.)

Federal government spending boosted U.S. GDP growth during the financial crisis and in the aftermath.

Figure 4. U.S. fiscal policy has been a drag on growth since 2010



Source: Bureau of Economic Analysis

Bottom line: Don’t overweight the election in your investment decisions

Markets like certainty. A more certain election outcome gives investors the ability to make more informed and confident decisions. And because the most likely result this November would represent only a small deviation from the political status quo, the prospect of major disruptive policy changes is limited. This has helped keep a lid on politically-driven market volatility.

Thus, despite the unusual nature of the 2016 campaign, our analysis suggests that investors should not dramatically change their asset allocations or delay making new investments based solely on election-related concerns.