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Elections & Markets: Conventional Wisdom Often Wrong

Keith Lerner, CFA, CMT
Managing Director, Chief Market Strategist
SunTrust Advisory Services, Inc.

Dylan Kase, CFA
IAG Associate, Portfolio & Market Strategy
SunTrust Advisory Services, Inc.

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Elections Matter, but Other Factors Matter More

It is an election year, and emotions are running high. Investor angst regarding how the election outcome will impact financial markets is palpable. Elections play a role and often add to market volatility; however, an objective review of the historical data indicates that Washington's perceived influence on market returns may be overstated.

From an investment perspective, we are not suggesting a change in government control does not matter. We are, however, positing that the election is just one of the many factors that influence investments. Elections should not be viewed in a vacuum. The business cycle matters, as do valuations, geopolitics, monetary policy, and other factors, such as the path of the coronavirus.

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Taxes and Market Impact

Still, one of the common concerns voiced by some investors recently is the potential of higher taxes' impact on the stock market should a shift in government control occur in Washington. On an individual level, tax policy can have significant and varied consequences. However, from a market perspective, the data in aggregate suggests other factors have often overwhelmed tax policy.

Indeed, markets have, counterintuitively, produced better returns, on average, and been more consistently positive in years in which taxes have risen. Again, this does not mean that raising taxes is a positive for the stock market; however, history suggests other factors play a larger role in stock returns.

For instance, despite the top marginal personal tax rate averaging above 90% as well as an elevated corporate tax rate in the 1950s, the US stock market had its best performing decade of the past 70 years, aided by a post-WWII economic boom and very low stock market valuations entering the decade. Conversely, despite having among the lowest average tax rates of the past 50 years, the 2000s generated the worst stock market returns and economic growth in the modern era. The first decade of the 21st century was beset by the aftermath of the bursting of the technology bubble, record high valuation levels and the 2008 global financial crisis.

In a more recent example, despite a tax increase in 2013, the S&P 500 rose more than 30% that year. The market was supported by below-average valuations and a significant rise in monetary stimulus as the Federal Reserve's (Fed) balance sheet ramped up.

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Conversely, in 2018, despite tax cuts, stocks declined by more than 4%. Starting market valuations coming into 2018 were elevated at the same time monetary policy was becoming restrictive as the Fed started to unwind its balance sheet and raise short-term interest rates on fears the economy was overheating. This weighed on the market.

Sectors and Elections

Another area where a lot of ink is often spilled ahead of elections is which segments of the market will do best under one candidate or another. However, despite a consensus view often contrasting the large difference the impact of a Democratic or Republican president would have on various segments of the market, the top two sectors (technology and consumer discretionary) and bottom two sectors (energy and financials) have been the same under the last two presidents. Small caps also underperformed large caps under each. This speaks to secular forces and fundamental factors influencing market returns beyond Washington.

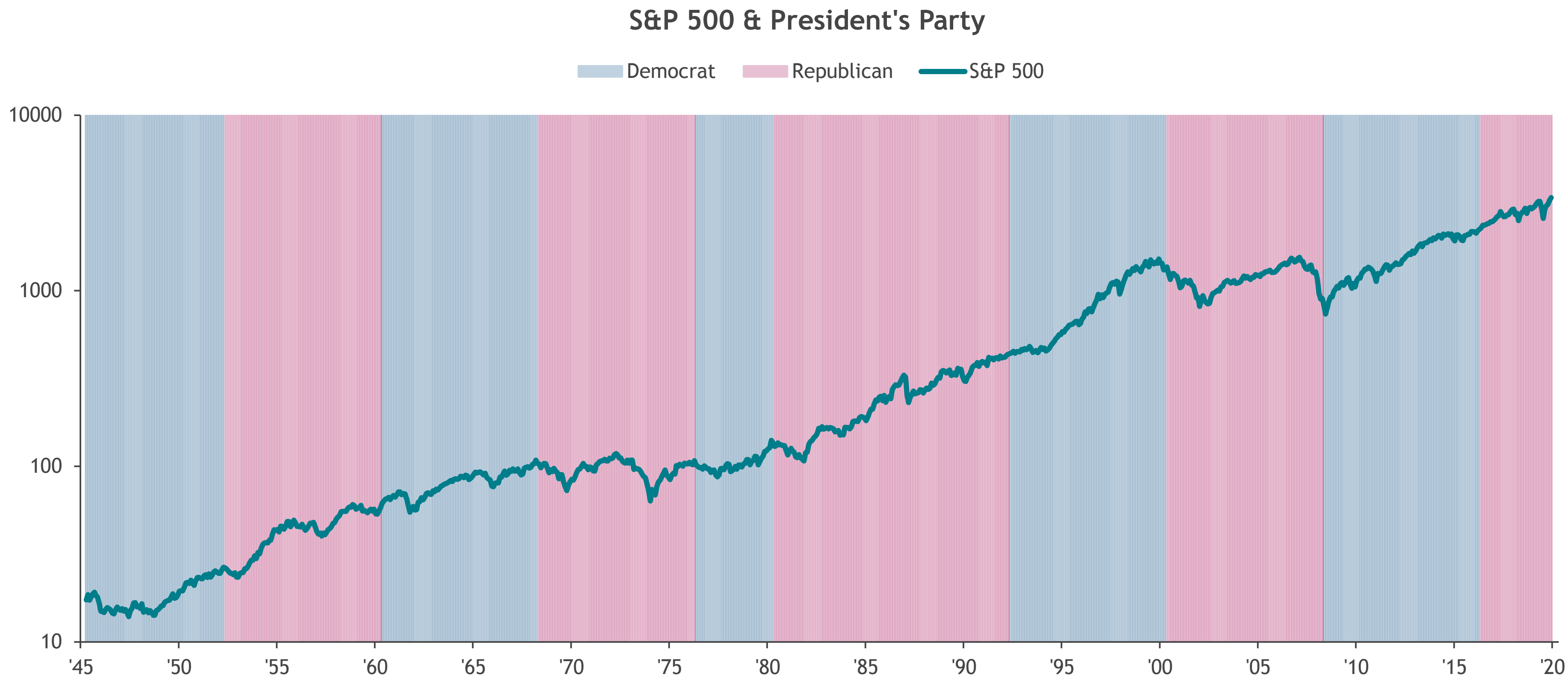
Bottom Line

We strongly caution against mixing portfolios and politics. We are not suggesting whoever is in the White House does not matter. Nor are we implying that there is a lack of potential for market downside; that is always the case. We are, however, suggesting the election is just one of the many factors that influence market returns. Importantly, while policy can certainly hinder or help the economy, businesses are dynamic and will adjust once they understand the rules. Historically, there have been opportunities and risks while each party was in power. <u>Moreover, in the coming year(s), the path of the coronavirus and progress toward vaccines and treatments will likely have a more significant impact on the performance of the economy, markets and sectors than the election outcome.</u>

Accordingly, until the weight of the evidence in our work shifts, our overall positioning stance remains intact. We maintain an equity tilt relative to fixed income, especially with government bond yields hovering close to all-time lows. Within equities, we hold a US bias, where earnings trends remain stronger compared to much of the globe. Yields are set to stay low, but high quality fixed income should continue to serve its role as a portfolio stabilizer. Although credit spreads have tightened substantially, investment grade and high yield bonds should remain supported by the Fed and investors' search for yield.

Markets Have Presented Opportunities & Risks Under Both Political Parties

Elections matter, but it is important not to look at them in a vacuum. The business cycle matters, as do starting valuations, geopolitics, monetary policy, and other factors, including the path of the coronavirus and progress toward a vaccine.



Data Source: SunTrust IAG, Bloomberg
Past performance does not guarantee future results.

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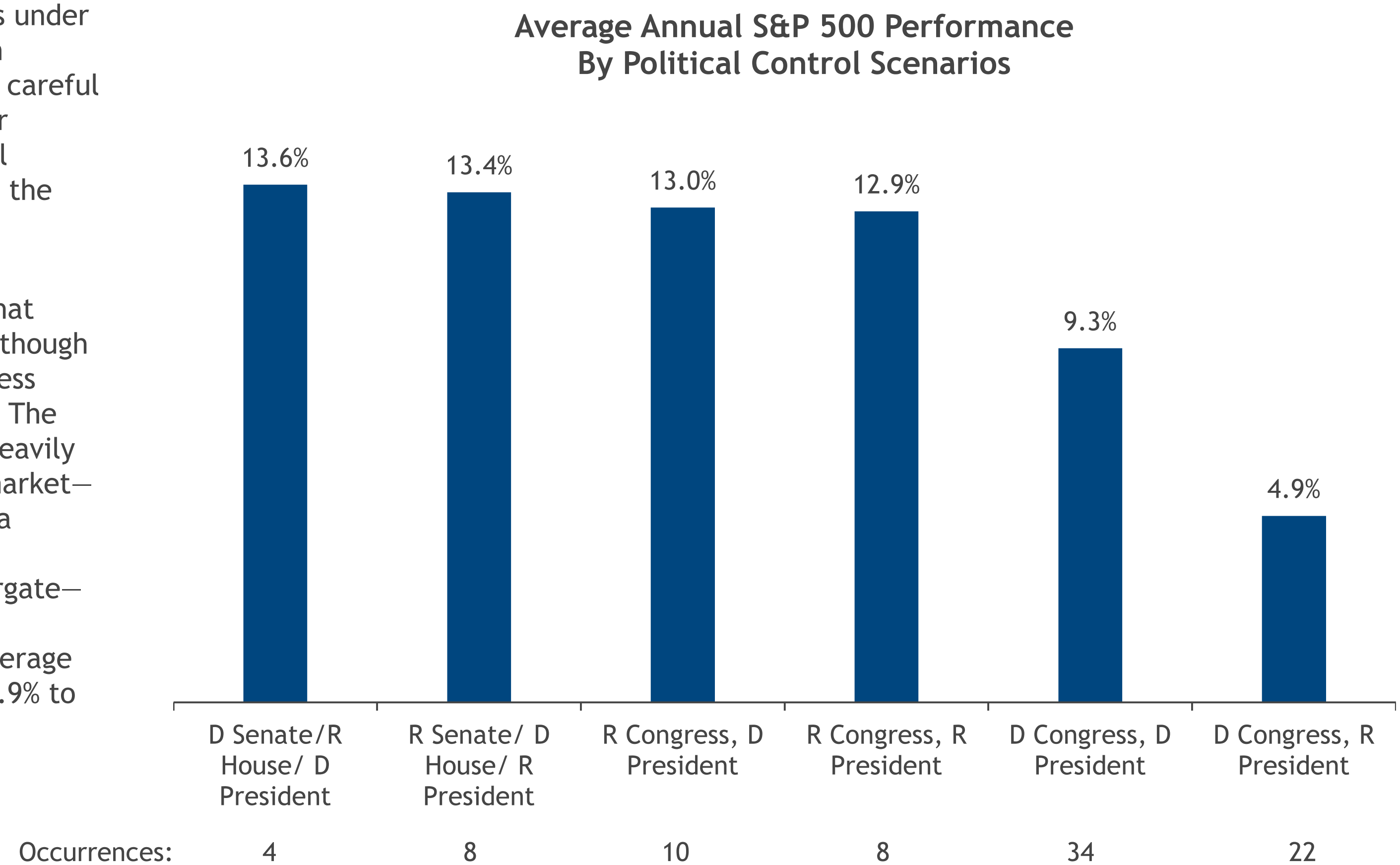
Markets Have Done Well Under a Wide Range of Political Control Scenarios

Markets have shown positive returns under various political control scenarios in Washington. However, we would be careful not to over extrapolate this as other factors beyond Washington's control impact markets, such as valuations, the business cycle and monetary policy.

The one political control scenario that stands out as an extreme outlier, although still positive, is a Democratic Congress paired with a Republican President. The average return for this scenario is heavily influenced by the 1973-1974 bear market—which was due to a combination of a recession, war in the Middle East, quadrupling of oil prices, and Watergate—as well as the 2008 financial crisis. Excluding just those periods, the average return for this scenario rises from 4.9% to 10.2%.



Source: Strategas, SunTrust IAG

Period includes (1933-2019, excl. 2001-2002)

Past performance does not guarantee future results.

Typical Market Path: All Election Years, Incumbent Party Wins/Loses

The stock market has tended to do best when the incumbent party wins an election, presumably because the status quo is maintained and this signals the economy is holding up well enough that the incumbent is not voted out of office.

Conversely, the market has tended to do worse when the incumbent loses. That said, we advise caution on selling based on an election outcome alone:

- Excluding the 2008 financial crisis outlier, the average path of the S&P 500 during years the incumbent party loses is roughly in line with the average for all election years.
- Investors selling just prior to President Obama taking office would have missed out on a 26% total return year in 2009 and the kickoff to the second strongest bull market in history.
- Investors selling just prior to President Trump taking office would have missed out on a 22% return in 2017.

S&P 500: Average Election Path: Incumbent Party Wins vs. Loses (Composite: 1928-2016)

Data Source: SunTrust IAG, FactSet
Past performance does not guarantee future results.

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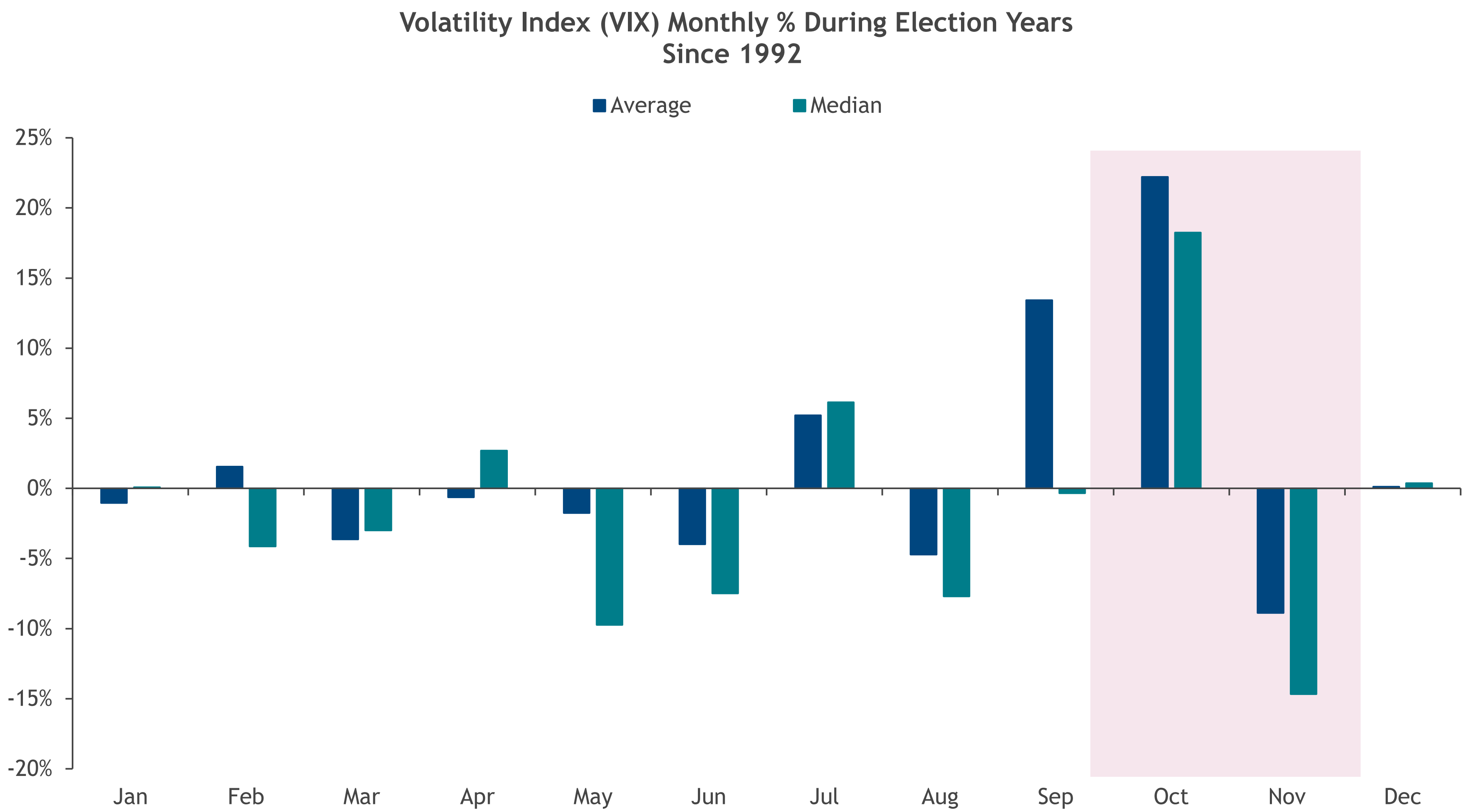
Volatility Tends to Heat Up Closer to an Election & Then Recede Thereafter



Data Source: SunTrust IAG, FactSet
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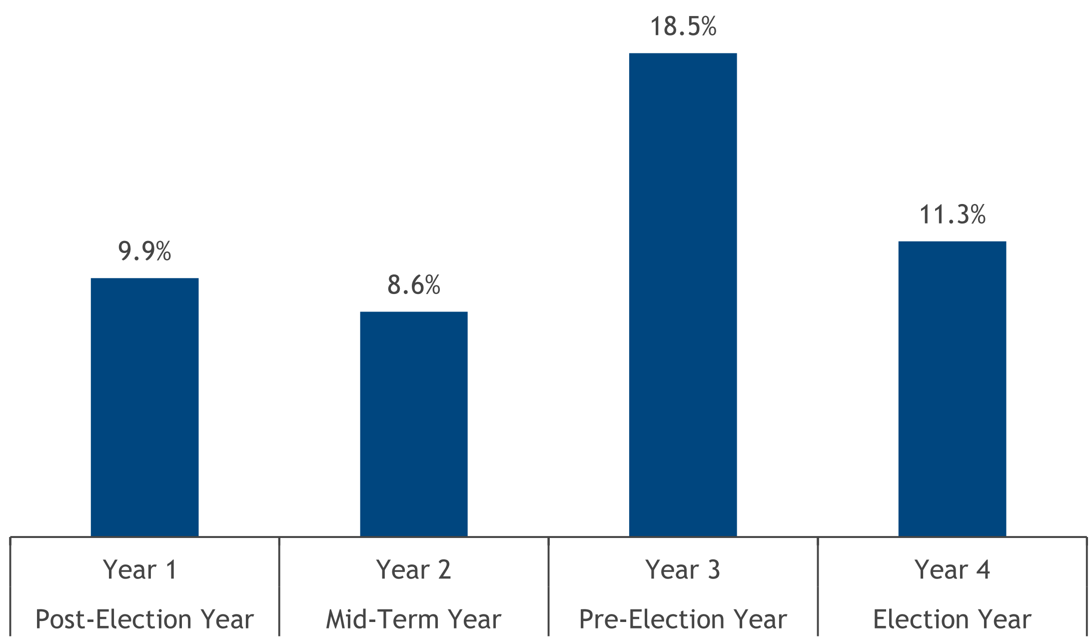
Historical Stock Market Returns During Four-Year Election Cycle Since 1926

Historically, **the first two years** of a president's term tend to be weaker than the final two years. Tough decisions and changes are often made early in an administration's term, presumably while the president has more political capital.

The third year of the election cycle, or the pre-election year, has tended to be the strongest and most consistently positive for stock market returns. The rationale often given for the robust performance is that policy makers tend to push stimulus through in Year 3 in order to boost the economy before the election year.

The fourth year of the election cycle also tends to be a good year, as it typically benefits from the lagged effect of stimulus in the prior year.

S&P 500 Average Total Return by Presidential Election Cycle (1926-2019)



% Positive = 57%	% Positive = 63%	% Positive = 92%	% Positive = 83%

Data Source: SunTrust IAG, Morningstar
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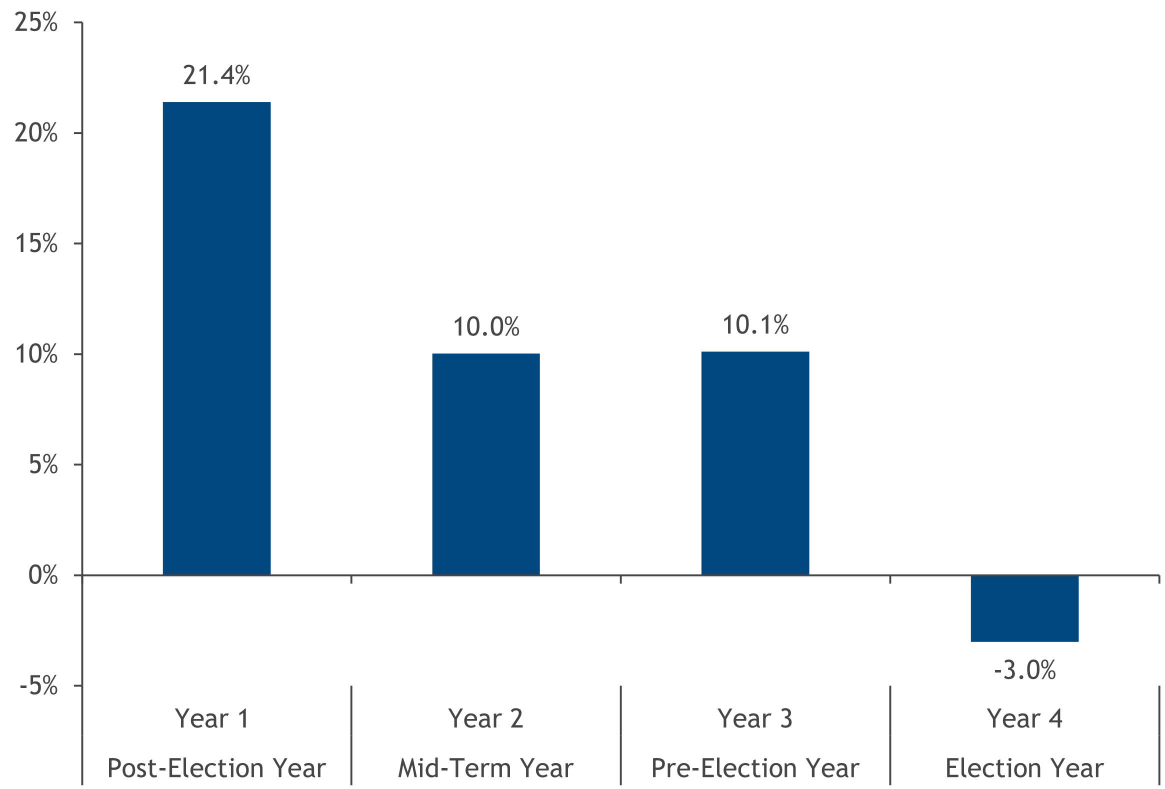
However, Since 2005, the First Year of the Election Cycle Has Been the Strongest

The returns during Year 1 of an election cycle have been stronger over recent years relative to history. This included 20%-plus returns in the first year of both President Obama's (2009) and President Trump's (2017) term in office, even while a large number of investors suggested that the market would go down if either person was elected.

Conversely, Year 3 returns have been solid but weaker relative to history. The average return was dragged down by weak returns in 2011, given the US debt downgrade and European financial crisis; 2015 also saw weak returns driven by geopolitical uncertainties and the Fed's policy transition to raising rates.

S&P 500 Average Total Return by Presidential Election Cycle (2005-2019)



Data Source: SunTrust IAG, Morningstar
Past performance does not guarantee future results

Other Factors Beyond Taxes Influence Market Returns & Economic Growth

Despite extremely high taxes, the 1950s had the best stock market returns of the past 70 years as well as a robust economic environment, aided by the post-WWII boom and stock valuations that were very low coming into the decade.

Conversely, despite very low taxes, the 2000s were beset by the aftermath of the bursting of the technology bubble, record high valuation levels and the 2008 global financial crisis.

Decades	Average Corporate Tax Rate*	Average Top Individual Tax Rate	Average Annual Real GDP Growth	S&P 500 10-Year Annualized Total Return
1950s	50.9%	90.5%	4.2%	19.3%
1960s	50.8%	80.3%	4.5%	7.8%
1970s	47.9%	70.2%	3.2%	5.9%
1980s	43.0%	48.4%	3.1%	17.6%
1990s	34.7%	36.7%	3.2%	18.2%
2000s	35.0%	36.2%	1.9%	-1.0%
2010s	32.2%	37.7%	2.3%	13.6%
Average	**42.1%**	**57.1%**	**3.2%**	**11.6%**

Strong market returns, despite high tax rates

Weak market returns, despite low tax rates

Data Source: SunTrust IAG, Morningstar

*The corporate tax rate is represented by the marginal tax rate on corporations with income greater than $18.33 million

Past performance does not guarantee future results

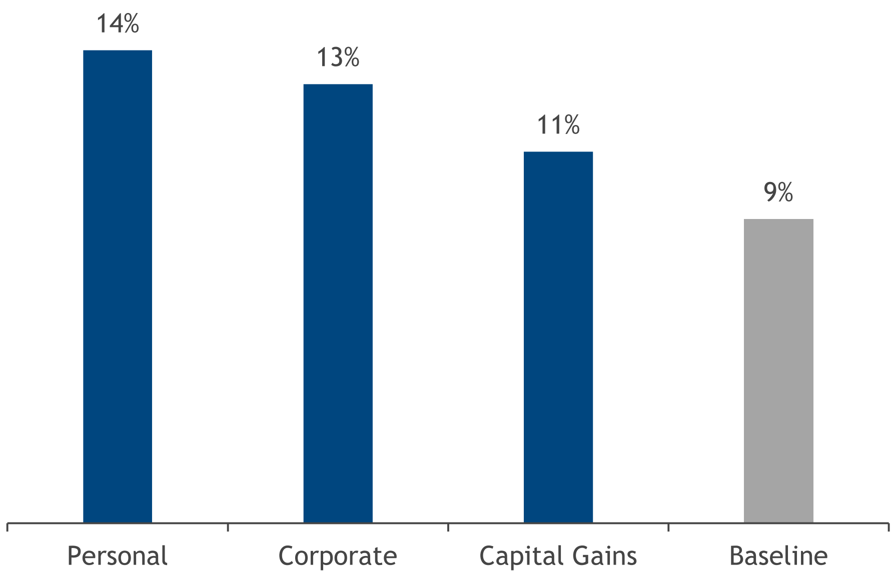
Stocks Have Been Stronger During Years of Tax Increases as Other Factors Influence Returns

Counterintuitively, market returns during years with tax increases have been higher on average and more consistently positive than the typical year. This does not mean that raising taxes is good for the stock market; however, this study suggests that other factors historically have overwhelmed the influence of tax increases.

Years in Which Taxes Were Increased

Year	Personal	Corporate	Capital Gains
1950	X	X	
1951	X	X	
1952	X	X	
1968	X	X	X
1969	X		X
1970			X
1971			X
1972			X
1976			X
1987			X
1991	X		X
1993	X	X	X
2013	X		X
Total	**8**	**5**	**10**

S&P 500 Average Returns During Years With Tax Increases 1950 - Current



% Positive: Returns	88%	100%	80%	72%

Source: Fidelity, Cornerstone Macro, SunTrust IAG
Past performance does not guarantee future results

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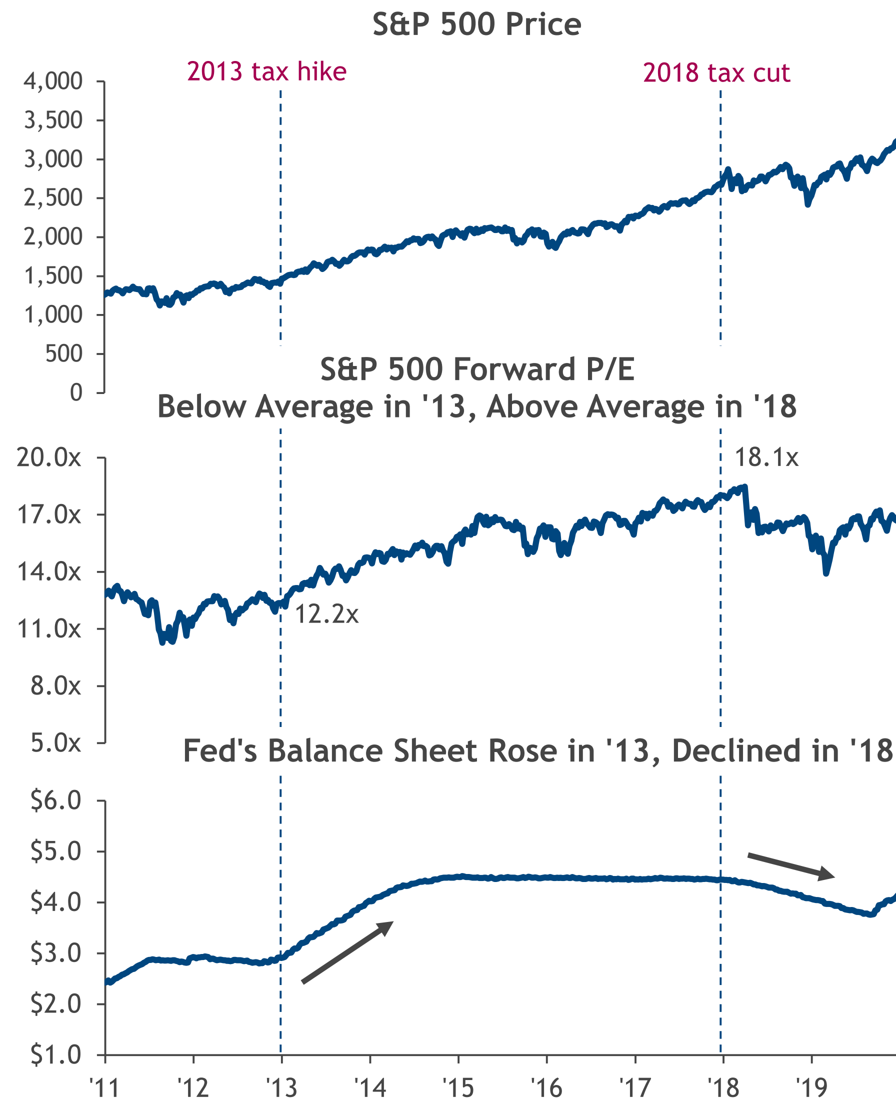
Stocks Rose in ’13 Despite Tax Hike and Fell in ’18 Despite Tax Cuts as Other Factors Came Into Play

Despite a tax increase in 2013, stocks rose more than 30%. The market was supported by below average valuations and a significant rise in monetary stimulus as the Fed’s balance sheet ramped up.

Conversely, in 2018, despite tax cuts, stocks faltered by about 4%. Starting valuations coming into the year were well above average and at a cycle high; at the same time, monetary policy was becoming more restrictive as the Fed started to unwind its balance sheet and raise short-term rates on fears the economy was overheating.



Data Source: SunTrust IAG, FactSet, Bloomberg

Chart y-axes (from top): S&P 500 index level; S&P 500 Forward Price-to-Earnings Ratio; Federal Reserve Balance Sheet in trillions

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Top & Bottom Sectors Were the Same Under the Last Two Presidents

There are some sectors that, in theory, could benefit based on the election outcome. For example, under a Biden presidency, renewable energy, infrastructure and stocks impacted by trade policy could benefit; alternatively, under Trump, defense & aerospace, traditional energy and financials presumably could do better.

That said, other factors well beyond Washington influence sector returns. For example, the top two and bottom two sectors have been the same under both President Obama and President Trump. Moreover, following the last Presidential election outcome, the consensus was that financials, energy and small caps would be beneficiaries, but each underperformed the S&P 500.

This speaks to secular forces and fundamental factors influencing sector returns.

Market & Sector Returns Under Obama & Trump

	Annualized Total Return	
S&P 500 Sector	**Obama**	**Trump**
Consumer Discretionary	18.5%	20.7%
Technology	16.4%	30.4%
Health Care	14.2%	14.7%
Consumer Staples	12.8%	8.4%
Industrials	12.7%	9.0%
Utilities	10.9%	8.8%
Materials	10.1%	9.8%
Communications Services	9.4%	10.1%
Financials	7.2%	7.4%
Energy	5.0%	-12.4%
Large Caps (S&P 500)	12.3%	15.2%
Small Caps (Russell 2000)	11.8%	8.6%

Top 2 sectors are the same under each President

Bottom 2 sectors are the same under each President

Large Caps outperformed under each President

Data Source: SunTrust IAG, Bloomberg
Obama = Performance from Election Day 2008 to Election Day 2016;
Trump = Performance from Election Day 2016 to August 21, 2020.

COVID-19 Progress Likely to Have Greater Impact Than Election on Economy, Markets and Sectors

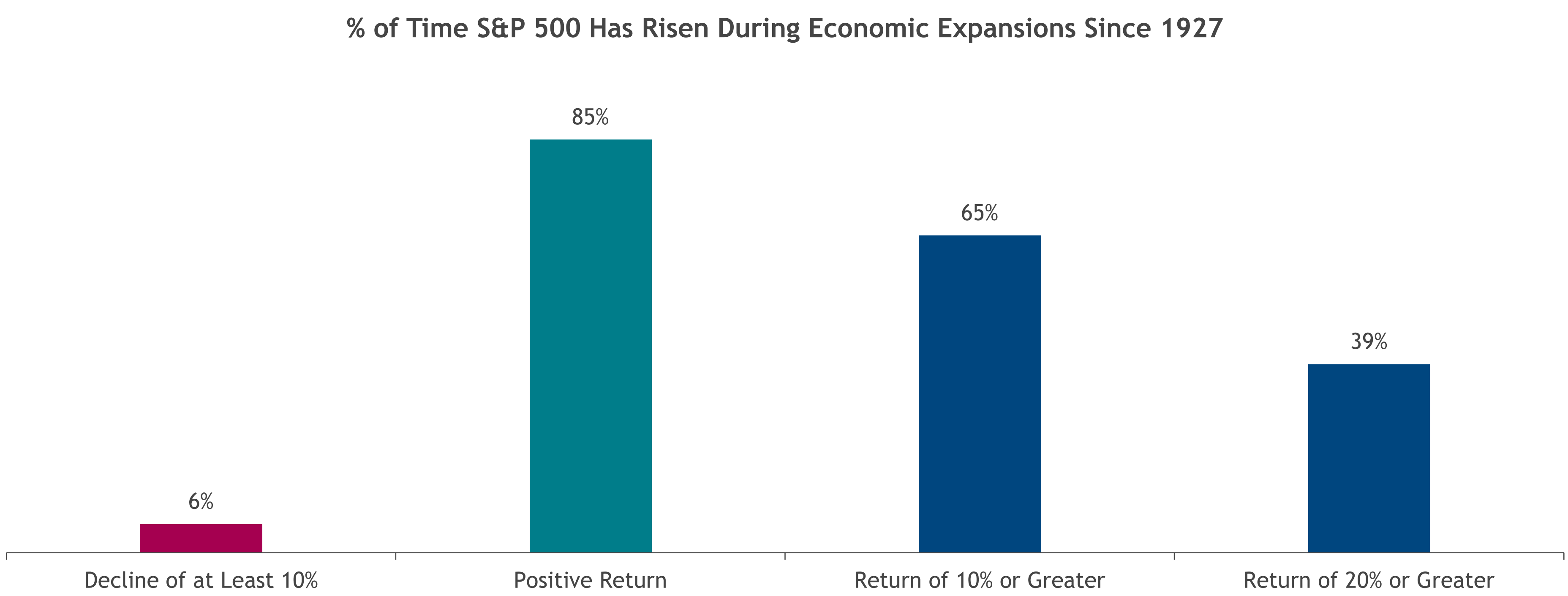
Unprecedented Number of Vaccine & Treatment Candidates Simultaneously Being Developed

	Pre-Clinical Phase	Phase I	Phase II	Phase III
Vaccine Candidates 176	135	20 Limited Testing (<100)	13 Expanded Testing (100-300)	8 Extensive Testing (300-3,000)
Treatment Candidates 186	97	9 Limited Testing (<100)	54 Expanded Testing (100-300)	26 Extensive Testing (300-3,000)

Data Source: SunTrust IAG, NY Times, Milken Institute. US Food & Drug Administration (FDA) Approval Phases: Pre-Clinical = Collect data to support feasibility and safety, iterative non-human testing, evaluates toxic and pharmacological effects; Phase I = limited human testing of healthy people (typically under 100) to evaluate safety and immune response at different doses; Phase II = Studies hundreds of people (usually 100-300), further evaluates safety, assesses efficacy, and informs optimal dose and vaccine schedule; Phase III = Studies at least hundreds but usually thousands of people, further evaluates safety and efficacy. A vaccine or drug can fail at any point during the FDA approval phases.

Business Cycle Has Significant Influence on Market

The economy appears to be in the recovery phase, albeit one that is uneven and expected to see fits and starts. Nevertheless, stocks have tended to rise during expansionary periods.



Data Source: SunTrust IAG, Haver, Morningstar
Study covers period since 1927 and is based on rolling one-year total returns
Past performance does not guarantee future results.

Important Disclosures

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S&P 500 Index is comprised of 500 widely-held securities considered to be representative of the stock market in general.

S&P sectors are represented by a subset of the S&P 500.

The Russell 2000 Index is a measure of the performance of the small-cap segment of the US equity universe

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