Election 2020: 75 Days and Counting

August 20, 2020

"Just because you do not take an interest in politics,
doesn't mean politics won't take an interest in you."
– Pericles

The 59th United States presidential election is upon us this fall and the stakes could not feel higher. The global economy experienced one of the sharpest contractions on record in the second quarter of 2020 with a recovery that depends on containing the COVID-19 pandemic and related economic fallout. Policy makers worldwide will likely continue responding with coordinated fiscal and monetary measures that are unprecedented in size, speed, and scope. The economy will be paramount as President Trump and Democratic nominee Joe Biden pitch their case to the voting public. Both candidates share a common goal of getting the U.S. economy back on track as quickly as possible. Here are some observations and key issues we are watching as we count down the days to November 3:

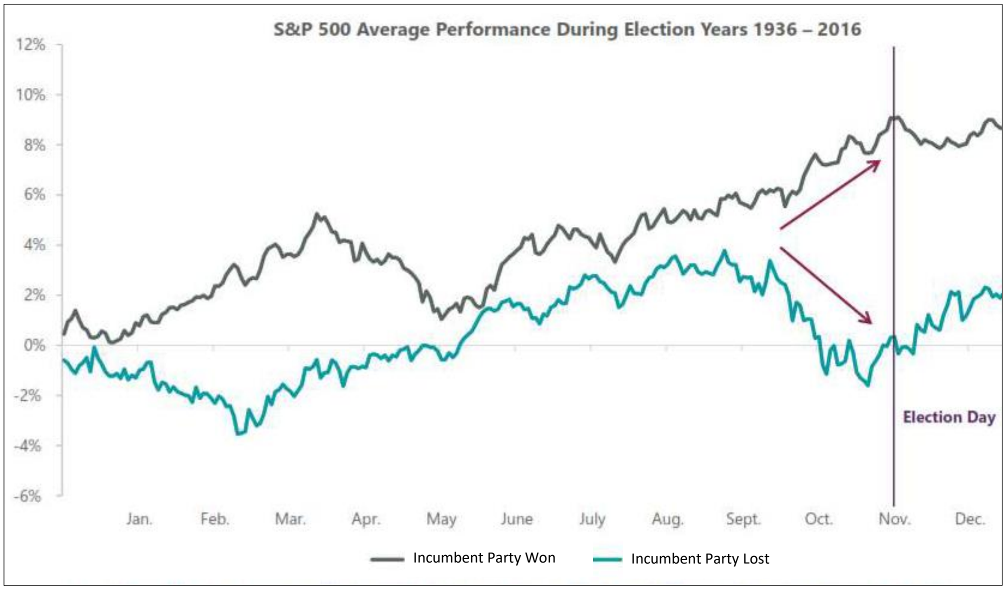
STOCK MARKET PERFORMANCE

One of the most frequently asked questions during election years is how will the stock market perform? Will a new presidential administration or an incumbent victory be good or bad for my portfolio? There have been 23 presidential elections since the inception of the S&P 500 Index. In these election years:[1]

- 19 of the 23 election years delivered positive returns with an average +13.45%
- Average returns of +15.27% when a Republican was elected (11 times)
- Average returns of +11.78% when a Democrat was elected (12 times)
- Average returns of +7.26% when a Democrat replaced a Republican in office (5 times)
- Average returns of +10.7% when an incumbent Republican was re-elected (4 times)

When looking at intra-year price movements for the S&P 500. U.S. stocks have done a good job of 'predicting' presidential elections since 1936. In the three months before the election, stocks have historically fallen ahead of a change in party, and rallied when the incumbent retained the White House.[2]

Notably, this year is different than prior election cycles given the uncertainty surrounding the economy and the S&P 500's past performance is no guarantee that these types of returns will be realized this year. In addition, there exists the potential for increased market volatility as we near the end of the year if the outcome of the election remains unclear for an extended period following voting on November 3.



Source: ClearBridge; FactSet as of June 30, 2020.

[1] Data from Morningstar & Ibbotson Associates
[2] Data from ClearBridge; FactSet as of June 30, 2020

INCOME TAX POLICY

Economic recovery plans will dominate both candidates' campaigns. Tax policy will be a close second as fiscal stimulus and other economic incentives have to be funded somehow, often by changing the tax code. Candidate Biden released his tax plan this summer calling for higher income taxes on wealthy taxpayers (greater than $400k adjusted gross income). Biden's plan supports a lower estate tax exemption from the current $11.58 million per taxpayer to an inflation-adjusted $5.49 million and potentially eliminating the cost basis step up at death. The plan also calls for an increase in corporate income tax to 28% from 21% with a minimum tax rate applied to companies above a certain size.

Biden's plan focuses on more tax breaks for middle-income taxpayers, enhancement of the Affordable Health Care Act, and more tax breaks for senior citizens. Biden has announced he plans to tackle climate change issues and supports a restoration of the electric vehicle tax credit, tax breaks for energy efficiency, and tax incentives for carbon capture.[3]

President Trump has not formally announced a tax policy agenda for his potential second term. Major tax legislation passed two years ago, the Tax Cuts and Jobs Act of 2017, which largely lowered income tax rates for most taxpayers, including small business owners and corporations. As many provisions in the TCJA of 2017 will sunset 12/31/2025, it is assumed President Trump would press for these cuts to be made permanent if he wins a second term.

Corporate tax policy is controversial, but is it a distraction from bigger fiscal issues? According to the Tax Policy Center, corporate income tax receipts are the third largest source of federal revenue at about $230 billion in fiscal 2019, or 6.6% of all receipts and 1.1% of GDP. Corporate income taxes have declined steadily since the 1950s as receipts from personal income taxes and payroll taxes rose significantly.

FIGURE 1

Corporate Income Tax Revenue

Fiscal years 1934 – 2019

Source: Office of Management and Budget. Historical Tables. Table 2.3, "Receipts by Source as Percentages of GDP: 1934–2025."

[3] Joe Biden campaign website. Retrieved August 12, 2020 from http://joebiden.com

Major tax reform is difficult to accomplish. The tax cuts of 2001 and 2003 during President George W. Bush's term narrowly passed with a Republican controlled House and nearly split Senate (many provisions were made permanent with bipartisan support in the American Tax Payer Relief Act of 2012 during President Obama's second term). Most recently, the Tax Cuts and Jobs Act of 2017, which lowered corporate and individual income tax rates, passed with a Republican controlled House and Senate under the Trump administration. Following the TCJA of 2017, the U.S. dropped from the highest corporate tax jurisdiction to the 11th highest today among developed countries in the OECD. Any tax reform to make the U.S. less competitive, especially during a recession, will be met with strong resistance from Republican lawmakers.

TRADE AND FOREIGN POLICY

Candidate Biden has long been a proponent of trade liberalization, but has pivoted recently to a 'Buy American' stance similar to the Trump Administration. Unlike the Trump Administration, however, it is expected a Biden presidency would revert to diplomacy-first trade tactics while attempting to de-escalate the current trade war with China and other trade partners of the U.S. This is a divisive issue, even within political parties. Legacy trade deals have been increasingly scrutinized for benefiting multinational companies ahead of American citizens, while at the same time allowing China to rise to power using unfair trade practices. Breaking the status quo has been a theme in the Trump administration's trade policy. Tariffs were enacted, trade agreements renegotiated, and bilateral action taken to promote an 'America First' trade policy. While tariffs will generate revenues in the short run, it is widely believed to result in a net decline in long-term GDP growth. According to the Tax Foundations calculations, incorporating the Trump administration's imposed, threatened, and retaliatory tariffs would result in a long-run GDP decline of 0.51% annually.[4] Further complicating the analysis, global supply chains are shifting due to the current trend of de-globalization spurned by automation, national security, and public health policy. One year does not make a trend, but U.S. trade of goods and services declined in 2019 on a year-over-year basis in a growing global economy.[5] Both candidates are using this narrative on the campaign trail to advance U.S. based benefactors, including the rebounding U.S. manufacturing sector. This will be an area to watch, as de-globalization should result in lower equity correlations, further increasing the importance of a globally diversified portfolio.

CORONAVIRUS STIMULUS

Both candidates favor additional stimulus to taxpayers until the economy recovers from the current pandemic. Along party lines, Democrats are seeking to continue the generous $600 weekly extra unemployment benefit which expired July 31. Republicans are seeking a continuation of additional unemployment benefits, but at a reduced rate. Both parties agree in principle on an additional round of stimulus checks, but negotiations are at an impasse over the total size of the relief package as well as other issues such as aid to local states and governments. Failure to pass additional stimulus would likely have a large negative impact on our economy due to the fragile state of the current recovery and continued high levels of unemployment.

President Trump declared an executive order on August 8 for a payroll tax cut, student loan relief, an eviction moratorium, and enhanced unemployment benefits. Missing from this executive order was another round of stimulus checks. Congress must approve federal spending matters, such as additional stimulus monies, through legislation. Many state officials have voiced concern about the executive order since part of the funding for enhanced unemployment benefits is supposed to come from already depleted state coffers.

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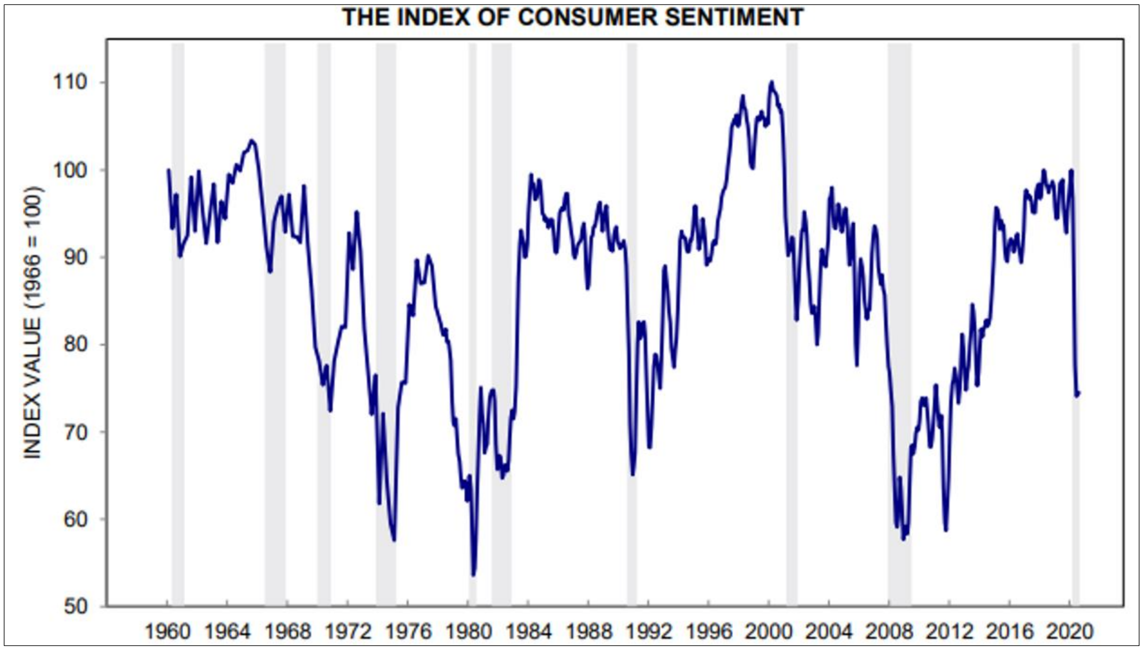
[4] Tax Foundation. Tracking the Economic Impact of U.S. Tariffs and Retaliatory Actions. Retrieved August 12, 2020 from https://taxfoundation.org/tariffs-trump-trade-war/
[5] Kafchinski, J. (2009, April 21). US International Trade Data. Retrieved August 14, 2020, from https://www.census.gov/foreign-trade/data/index.html

The initial Coronavirus stimulus programs appear to have worked well in supporting the U.S. economy. Unemployed workers were largely able to make their credit card, auto, rent, and mortgage payments on time. Small businesses were given a lifeline with PPP loans made available by the CARES Act. Perhaps most important was that consumer sentiment soured, but managed to stabilize in May 2020.



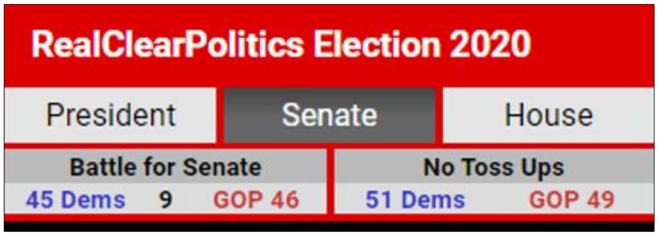
Source: Surveys of Consumers (2020, August). Retrieved August 14, 2020 from http://www.sca.isr.umich.edu/

A similar trend has been seen in the small business optimism index, which has rebounded sharply from the lows seen in April:

Both candidates realize there is a need for additional stimulus spending which investors anticipate will come before the November election. Terms for subsequent relief packages will depend on the Senate elections (more below) and political appetite for additional deficit spending. Worth noting, neither presidential candidate has expressed great concern over our growing national deficit. In the short-run, this should be a positive tailwind for risk assets including equities, but we will be closely watching second order effects like rising inflation and currency depreciation.

WATCH THE HOUSE AND SENATE

Approval ratings for Senate Republicans have been falling over the past few years. Current social unrest, high unemployment, and economic malaise has many incumbent Republicans on edge as they campaign for reelection this fall. Republicans currently have a six-seat advantage in the 116th U.S. Congress (if you include two independents on the Democrats side). There are thirty-five Senate seats up for election this November. Based on current polling data, Democratic candidates have a slight advantage and are expected to pick up 4 seats giving them the majority, but there are as many as nine toss up states that will ultimately determine which party takes the majority.[6]



Polling data suggests Democrats will continue their majority in the House of Representatives this fall with little controversy.

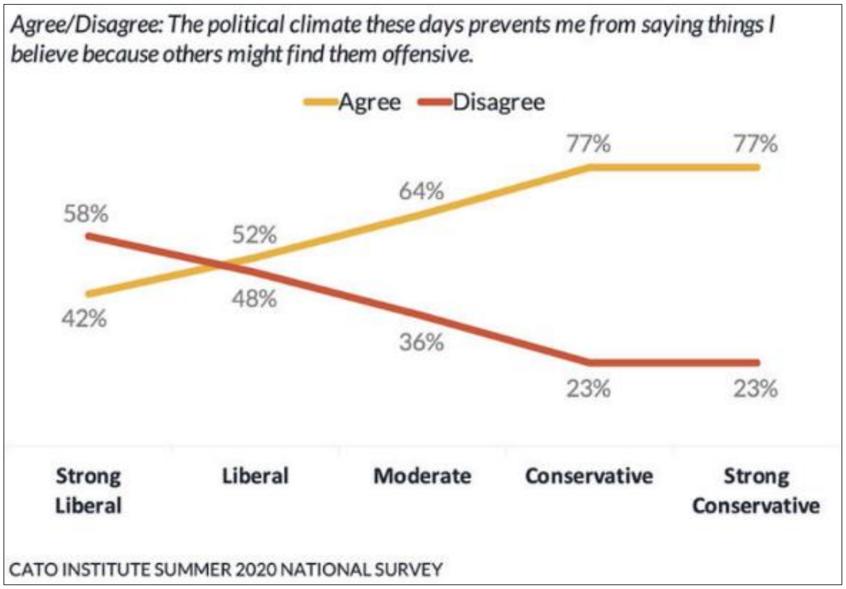
Clearly, a Democratic sweep this fall gives Candidate Biden the best shot at advancing his campaign promises. A common viewpoint is this would have a negative impact on stock prices as higher taxes and increased regulation are viewed as anti-competitive. However, Biden has been leading in the polls for quite some time with little observable impact on downside market volatility. Yes, certain industries may benefit from specific tax incentives or trade policy, but on aggregate, stock market returns are driven by longer-term factors. History shows mixed party leadership is a recipe for good market returns. Since 1950, a Democratic president governing with a Republican led Senate has produced the strongest market returns. Surprising to many, a Democrat in the White House paired with Democratic control of the House and Senate has produced above average equity returns.[7] This data set remains small, but it does illustrate an important point that the global economy is bigger than politics, and supports the notion that **it pays to invest based on long-term secular trends like productivity, technological innovation, and population growth.**

[6] Real Clear Politics. Accessed August 14, 2020 from https://www.realclearpolitics.com
[7] Based on the average performance of the S&P 500 Total Return index achieved during each Congressional cycle since 1950. Data derived from Morningstar.

WILD CARD ITEMS

Will increased usage of mail-in ballots cause headaches, increase voter participation, or both? States like Colorado have long adopted the mail-in ballot approach with increasing success. The New York Times expects that almost 75% of Americans will be able to vote by mail in 2020. The remaining 25% live in eight states that require an excuse beyond COVID-19 for an absentee ballot. [8] Of this subset, South Carolina is the only state that does not solidly lean Republican. States that have newly adopted absentee voting will have to ensure they have functioning infrastructure and staffing in place to accurately process and count absentee ballots. Further complicating the issue is the nearly insolvent United States Postal Service's ability to deliver and return ballots in a timely manner. Senate Republicans and the Trump Administration are against additional funding for the USPS, citing various things, including its inefficient cost structure. Yet, they claim the Postal Service is incapable of processing absentee ballots without additional funding. Expect more controversy on this topic as we get closer to the election.

How accurate are the polls? Current data from Real Clear Politics shows Biden has a 7.7 point lead over President Trump.[9] Recall the 2016 election when Hillary Clinton had a 3 point lead over Trump on Election Day and ultimately lost the election. Data from the Cato Institute indicates many voters who identify as Republicans feel the current political climate has suppressed their willingness to support their own party.[10] Skewed polling data can only lead to more surprises, and likely market volatility, as the presidential race heats up.



The unfolding public health crisis and upcoming U.S. presidential election will remain top of investors' minds for the months to come. Rather than worry about things you cannot control, we advise you to prioritize your wellbeing and health. Remember that we build portfolios to provide reasonable risk-adjusted returns commensurate with client objectives over complete market cycles, which often span multiple presidential administrations and congressional meeting terms. PCM advisors are here to help you identify and implement an asset allocation is appropriate for your risk tolerance and financial circumstances amidst our changing political and economic climate.

[8] Love, J., Stevens, M., & Gamio, L. (2020, August 11). A Record 76% of Americans Can Vote by Mail in 2020. Retrieved August 11, 2020, from https://www.nytimes.com/interactive/2020/08/11/us/politics/vote-by-mail-us-states.html.
[9] Real Clear Politics. Access on August 14, 2020 from https://realclearpolitics.com.
[10] Cato Institute. Summer 2020 National Survey. Accessed on August 10th from https://www.cato.org.