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Elections & Markets

What Investors May Want to Know

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In a healthy democracy, elections play a pivotal role in impacting policy, governance, and finances. For investors, election day can be nerve-wracking, as political uncertainty often triggers market volatility as some investors attempt to predict potential financial ripples before an election and are quick to make changes after the results of an election. Many investors try to predict financial shifts before elections and react swiftly once results are in.

As election news dominates the headlines, investors may feel driven to act. Yet, data suggests the potential pitfalls of short-term election-driven trades tend to result in sub-par outcomes.[1] We recommend staying focused on the stability of long-term investment strategies.

The Nature of Elections & Free Markets

Elections form the bedrock of a representative democracy, providing a vital avenue for citizens to exercise their power and influence in shaping their nation's laws and policies. Government "of the people, by the people, for the people" promotes a system where the population can choose its government through regular, free, and fair elections.

However, our democratic process is not unrestrained; it is tempered by a constitution guaranteeing individual freedoms and rights, ensuring no single interest group unfairly dominates or exploits others.

Democracies have proven to be powerful engines for driving economic growth, particularly when coupled with markets free to efficiently allocate capital for its best use in providing goods and services, including education, health, and infrastructure.

In a recent study, economists established a causal relationship between democracy and economic development. Their study, which analyzed 175 countries from 1960 to 2010, revealed a "significant and sizable" effect that democratization has on the economy relative to other options, enhancing GDP per capita by an impressive 20% to 25% over 25 years.[2]

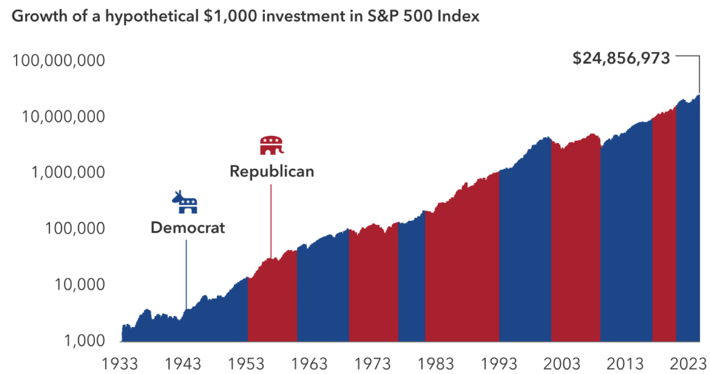
1 Bialkowski, J., Gottschalk, K., Wisniewski, T.P., "Stock Market Volatility Around National Elections," Working Paper Series, No. 2006,2, European University Viadrina, The Postgraduate Research Programme: Capital Markets and Finance in the Enlarged Europe, Frankfurt (Oder), 2006

2 Acemoglu, D., Naidu, S., Restrepo, P., Robinson, and J. A., "Democracy Does Cause Growth," National Bureau of Economic Research (Working Paper 20004), 2014, https://www.nber.org/system/files/working_papers/w20004/w20004.pdf

Election-Based vs. Long-Term Investment Decisions

Historical evidence suggests that election results have shown little influence on financial markets' medium to long-term performance. Market returns tend to reflect economic and inflation trends more than electoral outcomes.

While stocks have been historically known to appreciate over a long period, indicating a consistently upward trend in data, there is variation in market outcomes across the election cycle.



Sources: Capital Group, RIMES, Standard & Poor's. Chart shows the growth of a hypothetical $1,000 investment made on March 4, 1933 (the date of Franklin D. Roosevelt's first inauguration) through June 30, 2024. Dates of party control are based on inauguration dates. Values are based on total returns in USD. Shown on a logarithmic scale. Past results are not predictive of results in future periods.

Observing the average and median total returns for the S&P 500 during U.S. presidential election years reveals interesting patterns: returns are typically higher up to the election than non-election years. However, the picture changes post-election, with one-, six-, and 12-month returns tending to be significantly lower than similar periods in years without a presidential election.

Despite beliefs that market returns are driven by who is elected president, findings reveal a compelling link between the economy's health and presidential terms. The first year of a president's mandate often seems to coincide with a challenging economic period. A striking 54% of presidential elections over the study period cited above were followed by a U.S. recession within the next 12 months, according to data from the National Bureau of Economic Research (NBER).

This pattern of economic turbulence in a president's initial year stands out, especially compared to subsequent years in office, reporting significantly lower recession incidences—29% in the second year, 17% in the third, and 25% during elections. This pattern suggests that the stock market might be anticipating or reacting to weaker economic conditions toward the close of a presidential election year, with an increased possibility of a subsequent recession.

Interestingly, the traditional belief that a political "sweep" by Republicans or Democrats would disrupt the market does not hold true, as per the data. The divided government scenarios have shown a substantial correlation with market performance. Historical data illustrates a consistent positive performance of stocks[3], regardless of the political landscape in Washington.

3 Source: Haver, FactSet, FMR as of November 14, 2023. U.S. stocks have averaged returns of 9.1% in election years. Data spans from November 30, 1950 to November 14, 2023. Years represent the 12-month period from November 30 to November 30 following a U.S. presidential or midterm election. The chart depicts the average, minimum, and maximum price return achieved during this period. Stocks are represented by the S&P 500®. Indexes are unmanaged. It is not possible to invest in an index.

Election-Based vs. Long-Term Investment Decisions (Cont.)

The chart below shows an analysis of market data going back to 1948, using average three-month returns following each election outcome and comparing those with the average three-month return during the full analysis period, demonstrating the statistical significance (t-statistic) of the relationship between political control and market performance.

Historical election outcome scenarios and market performance

Scenario	White House control	Congress control	Outcome	Average 3-month S&P 500 return during period	Average 3-month return relative to all periods	Statistically significant (>95%)?
1			One party (D)	2.20%	+0.02%	No
2			Divided	3.85%	+1.67%	Yes
3			Divided	3.93%	+1.75%	Yes
4			Divided	1.19%	-0.99%	Yes
5			One party (R)	2.67%	+0.49%	No
6			Divided	1.62%	-0.67%	No
			All one party (D or R)	2.33%	+0.15%	No
			All divided	2.08%	-0.10%	No

Source: U.S. Bank Asset Management Group.

The data uncovered a statistically significant relationship between three divided government outcomes. Two scenarios showed positive absolute returns in excess of long-term average returns, while one scenario demonstrated positive absolute returns modestly below long-term average:

- Democratic control of the White House and full Republican control of Congress
- Democratic control of the White House and split party control of the Senate and House
- Republican control of the White House and full Democratic control of Congress

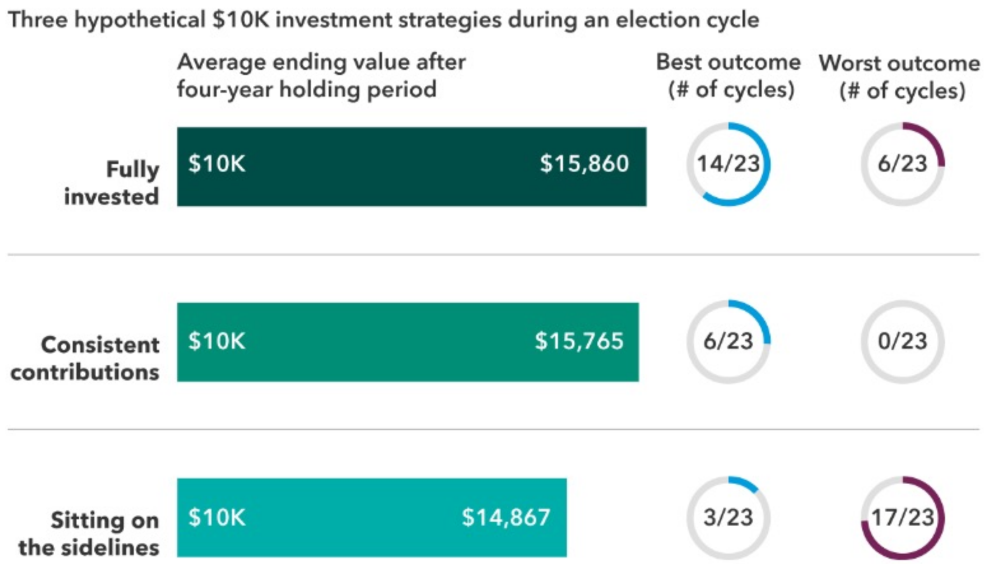
Navigating Election-Based Opportunities and Risks

Exploring the potential investment opportunities surrounding election periods reveals interesting insights. During election years, investors tend to exercise more caution, resulting in higher investment flows directed toward safer money market funds, while equity funds experience lower inflows. However, timing the market based on election cycles has rarely proven successful. Staying invested or maintaining consistent contributions during these politically charged periods can potentially yield better results, underscoring the importance of adhering to a personalized, long-term investment plan.

4 "How Elections Move Markets In 5 Charts," Capital Group. (n.d.)., July 18, 2024, https://www.capitalgroup.com/advisor/insights/articles/how-elections-move-markets-5-charts.html

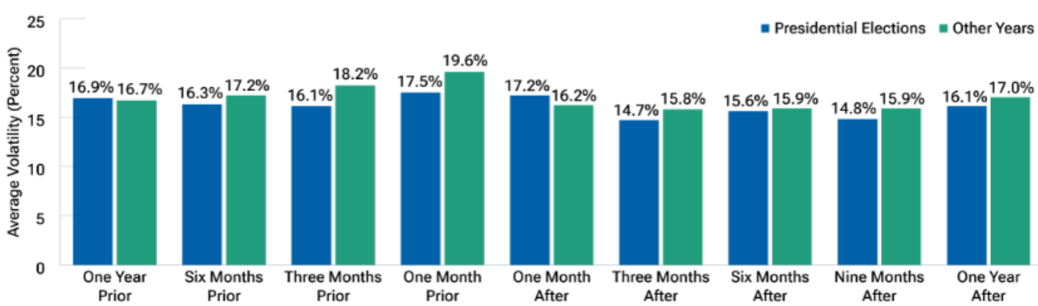
Navigating Election-Based Opportunities and Risks (Cont.)

Take the analysis below, for example. Three hypothetical investors, each with unique investment approaches, remain fully invested (buy & hold), steadfastly make monthly contributions (systematic contributions), and go to cash on the sidelines over the last 23 election cycles. Buy & hold came out on top with superior average portfolio balances over a four-year period. In contrast, investors who stayed on the sidelines, remaining in cash, saw less favorable outcomes on 17 out of 23 occasions. The benefits of steadfast investing are likely even more significant when looking at longer time frames. Take the hypothetical analysis below, for example.



Sources located at bottom of page

Past observations have reported amplified stock market volatility during election weeks. The uncertainties and unpredictability of election results can trigger adverse stock market reactions. Additionally, pre-election political uncertainty could influence the real economy directly, impacting stock market valuations, and shifts in government can trigger changes in foreign policy and international relations, effectively influencing stock prices.



Source: T. Rowe Price analysis of data from Bloomberg Finance L.P. December 31, 1927, to December 31, 2023.

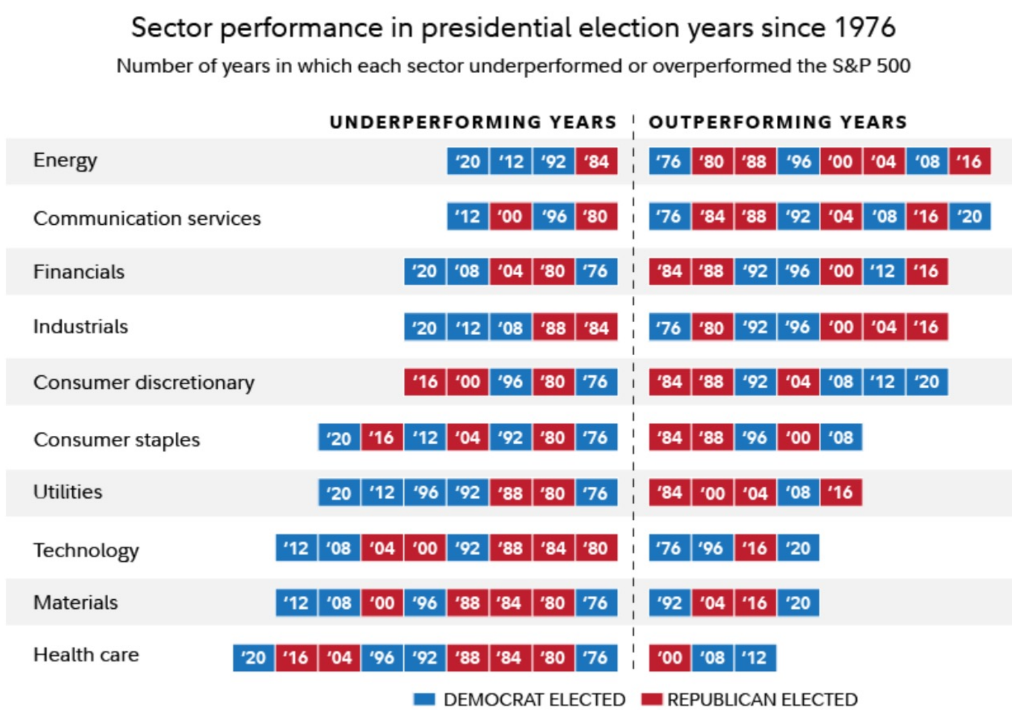
Sources: Capital Group, Board of Governors of the Federal Reserve System (U.S.), RIMES, Standard & Poor's. The three hypothetical investors each have $10K to invest during an election cycle and are invested in a combination of equities and cash at all times. "Fully invested" is always fully invested in equities. "Consistent contributions" starts with $1K in equity and $9K in cash. At the start of each of the next nine months, this investor reduces cash by $1K and makes a $1K contribution to equities, after which they will have made the full $10K contribution to equities. "Sitting on the sidelines" is entirely invested in cash during the first year. At the start of the second year, this investor reduces cash by $10K and makes a $10K contribution to equities. S&P 500 Index used for equity returns and reflect the reinvestment of dividends. Three-month Treasury Bills used as a proxy for cash returns and reflects the reinvestment of interest. Returns and portfolio values are calculated monthly and in USD. Analysis starts on January 1 of each election year and reflects a four-year holding period. Past results are not predictive of results in future periods.

Navigating Election-Based Opportunities and Risks (Cont.)

The S&P 500 has historically experienced reduced volatility during election years, except for the 12 months leading up to the election and the immediate month post-election. This trend may seem surprising considering the higher frequency of recessions following these election years. Regardless of whether it's an election year, data suggests the market experiences similar seasonal effects every year, with volatility typically rising just before the first Tuesday in November, which is the U.S. presidential Election Day.

Investors may be tempted to take advantage of the rise in volatility around elections and attempt to time exposures to assets they anticipate will do well based on who is elected.
Yet, given the complexity and unpredictability of the political landscape, it's challenging to forecast with precision what industries or stocks may reap benefits from the upcoming administrative policies. Evidence from historical data supports this unpredictability, demonstrating a lack of consistent trends in sector performance during election years.

As the chart below demonstrates, there are very few consistent patterns of relative sector returns in election years, which makes placing bets around election outcomes very risky.



Source: Fidelity. Each box represents one calendar year of performance for a calendar year that included a U.S. presidential election. Underperforming indicates that price performance was lower than the S&P 500; while outperforming indicates price performance exceeded the S&P 500. Color of each box indicates whether a Democrat or Republican candidate was elected to the presidency that year. Real estate is omitted due to a lack of sufficient performance history, as it was not established as an independent sector until 2016. Each sector is represented by companies included in the S&P 500 that are classified as members of that sector. Source: Strategas Research Partners, as of November 5, 2023.

Conclusion

Political transitions often bring uncertainty, which can lead to emotional decision-making. However, investors must stay steady and maintain their investment approach during these times. The evidence shows that markets have generally trended upward despite political shifts during election years.

Historical data illuminates the downsides of making investment decisions based on election results. Such reactive methods may not go hand in hand with your wealth-building goals in the long run. Short-term, election-oriented financial decisions can breed volatility and unpredictability, potentially leading to negative financial outcomes.

Market timing, primarily based on political changes, can negatively affect long-term portfolio returns. This was evident in the case of investors who remained invested or consistently contributed during elections. They fared better than those who transitioned to cash during these periods.

In conclusion, we have examined the relationship between election cycles and financial market performance, deriving key insights from historical data and market trends. Our findings suggest that election outcomes potentially have minimal impact on overall market performance in the medium to long term.

While politics can shape individual sectors and industries, the global market often maintains its progress[5], regardless of the reigning political party. Therefore, investors are advised to focus more on economic and inflation trends rather than election results when shaping their investment strategies.

We encourage investors to remain steady and committed to long-term investment strategies, cautioning against knee-jerk reactions to short-term political events, including elections. The practice of timing the market around elections could result in missed opportunities, potentially diminishing long-term portfolio returns.

We believe investors may better navigate election cycles by remaining invested and adhering to a tailored financial plan that aligns with personal investment goals. We believe this approach, rooted in patience and consistency, tends to yield superior results over the long haul compared to speculative trading.

5 "Presidential Elections Matter But Not So Much When It Comes to Your Investments," Vanguard, September 5, 2024, https://investor.vanguard.com/investor-resources-education/article/presidential-elections-matter-but-not-so-much-when-it-comes-to-your-investments