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The New EPS: Election + Pandemic + Stimulus

November 2020

Elections & Volatility

As expected, financial markets have been volatile leading up to the election. Heightened uncertainty is a drag on stocks, and the emotions surrounding an election can be quite strong, creating skittish markets that tend to weaken when elections are tight. Markets around the last presidential election were similar. In 2016, the stock market fell 9 straight days before the election. Afterward, a "certainty rally" ensued and the S&P 500 advanced by almost 5% through year end. This year, worries intensified as the election approached. Stocks fell by 7.5% in the last two weeks of October. Although this electoral cycle may not be immediately concluded, much of the anxiety is now in the rear-view mirror.

Government Stimulus Has Been Effective

The 2020 economic downturn was the first ever "recession by government decree," meaning stay at home orders resulted in less spending and eventually a recession. Governments around the world implemented major stimulus packages to fill the holes caused by the virus. The response was massive and implemented swiftly. Congress passed a $3 trillion stimulus that represented 12% of GDP. Most other major governments took similar actions. This was effectively wartime level spending minus the war.

So far, these actions seem to be effective. The fastest economic contraction in history led to the fastest bear market in history. Historically, drawdowns of 30% or more take years to recover, while the 2020 recovery took just 4.5 months.

Bear Markets

S&P 500, 2000-2020

Market Peak	% Loss	Days to bottom	Days to recover
01/14/2000	-34.1%	616	N/A
03/19/2002	-33.6%	204	764
10/09/2007	-56.8%	517	1480
04/29/2011	-19.4%	157	144
05/19/2015	-14.0%	268	148
02/12/2020	-33.8%	40	142

Source: Bloomberg

Despite the Pandemic, Incomes are Up

Although the economic recovery may not be as widespread as hoped (small businesses are suffering more than large, industries such as travel and real estate are still lagging), it is meaningful in aggregate. The inner workings of the economy are quite complex, but a simple way to gauge economic health is to examine cash flow such as disposable personal income.

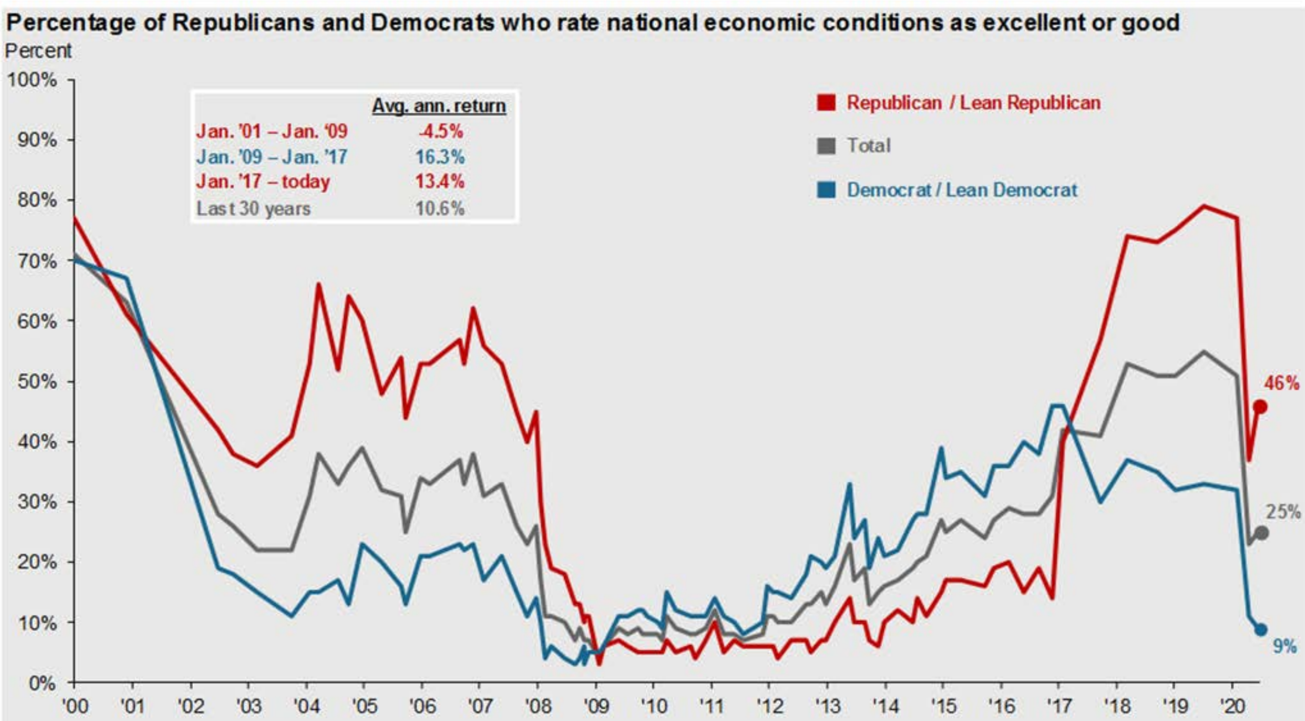
While "disposable personal income" sounds like a term that only an accountant would love, it represents after-tax income. In aggregate, it is the amount that U.S. residents have left to spend or save after paying taxes. Despite the challenges of the pandemic, in 2020, disposable personal income has increased. The multitude of programs passed by Congress this year have prevented a painful downward spiral by keeping incomes positive.

Source: FRED, Federal Reserve Bank of St. Louis

Another round of stimulus from Congress is likely needed to help the economy bridge the gap until vaccines are widely available. Given the status of the election, it may take a while for such a package to pass. While a delay is not optimal, it can be absorbed. Our colleagues at BCA Research posit, "Households built a war chest of savings that may be able to tide them over for longer than the consensus of observers assume. Investors have benefited from betting on policymakers so far this year, and we will continue to do so. We expect that the next round of stimulus, whenever it arrives, will turn out to be bigger than it needs to be. That may not be ideal for markets and the economy in the long run, but we expect it will be very good for the former over the next year or two."

Politics & Perception

Elections are emotional because they are important. The fight or flight instinct that helped our ancestors is not the same asset it was thousands of years ago. In particular, the limbic system, or emotional part of the brain, can sometimes have too strong an influence over our perceptions. This is evidenced by survey data from the Pew Research Center (see below).



Source: Pew Research Center, J.P. Morgan Asset Management

Note the strong correlation between party, president and perceived economic conditions. From 2000-2008, when George W. Bush was president, Republicans consistently rated the economy better than Democrats. The difference in survey results between the parties was 20-40% during most of the period. From 2008-2016, when Barack Obama was president, Democrats consistently rated the economy better than Republicans. Not surprisingly, the script was flipped again after 2016, when Donald Trump became president. While emotional responses are to be expected, it can be helpful to understand how they impact our perception of the world.

Checks in Washington

While it may be days or weeks until certain elections are concluded, it appears that Biden will win the presidency and Republicans will maintain control of the Senate. Democrats will retain the House, and the legislative branch will be split. Historically, such a split has been a positive for the stock market. A Democratic president with a Congressional check on their power (split or full Republican) has generated better returns than when Democrats held all three houses.

President	Congress	% gain / annum	% of time
Democratic	Republican	5.2%	10%
Democratic	Split	8.0%	3%
Democratic	Democratic	3.0%	33%
Republican	Republican	7.1%	23%
Republican	Split	-4.8%	11%
Republican	Democratic	-2.1%	18%

Source: Ned Davis Research

Anecdotally, this occurs because a president cannot enact major legislative changes (which can be disruptive to financial markets). Note, the sample size is small. There is only one period with a Democratic president and split Congress (Obama from 2011-2015).

Risks & Opportunities

At any given time, concerns exist about which risks are most serious and what the potential impacts from them could be. In the near term, the biggest risks are a trio of the election, virus, and another round of stimulus. How clear will the election be, and what direction comes next out of Washington? How serious is the third wave of the virus, and what will the impact be on the economy? Will another round of stimulus be passed in time to bridge the economic gap?

Each of these risks is important and worrisome. Consequently, in the near term, markets may continue to be volatile. A definitive conclusion on the election is still elusive and could create some instability. Looking ahead into 2021, those issues are likely to be resolved. Of course, there are no guarantees. However, government stimulus has been effective so far at bridging the economic gap caused by the virus. If such measures continue, the economy should be able to stand on its own later next year. In the meantime, the Federal Reserve has pledged to keep interest rates low for years. Oil and commodity prices are low. There is significant pent up demand in many areas depressed by the pandemic (people want to travel, attend events, and return to a sense of normalcy at restaurants, with friends, etc.) and that should be realized when the economy opens up more fully.

Investment Positioning

Since the financial crisis, there have been periods of fiscal stimulus and easy monetary policy. However, not since 2009 have significant fiscal and monetary stimulus both occurred at the same time. The combined stimulus should go a long way to help the economy make it through until the pandemic is over.

To match the positive outlook on a six-month basis, portfolios have been reallocated to their maximum equity position. As the market digests the election and Congress wrestles with additional stimulus, there may be some turmoil and volatility in the near term. Looking forward into 2021, the economy and markets should continue to improve.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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