Market Bulletin

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The Investment Implications of the 2020 Election

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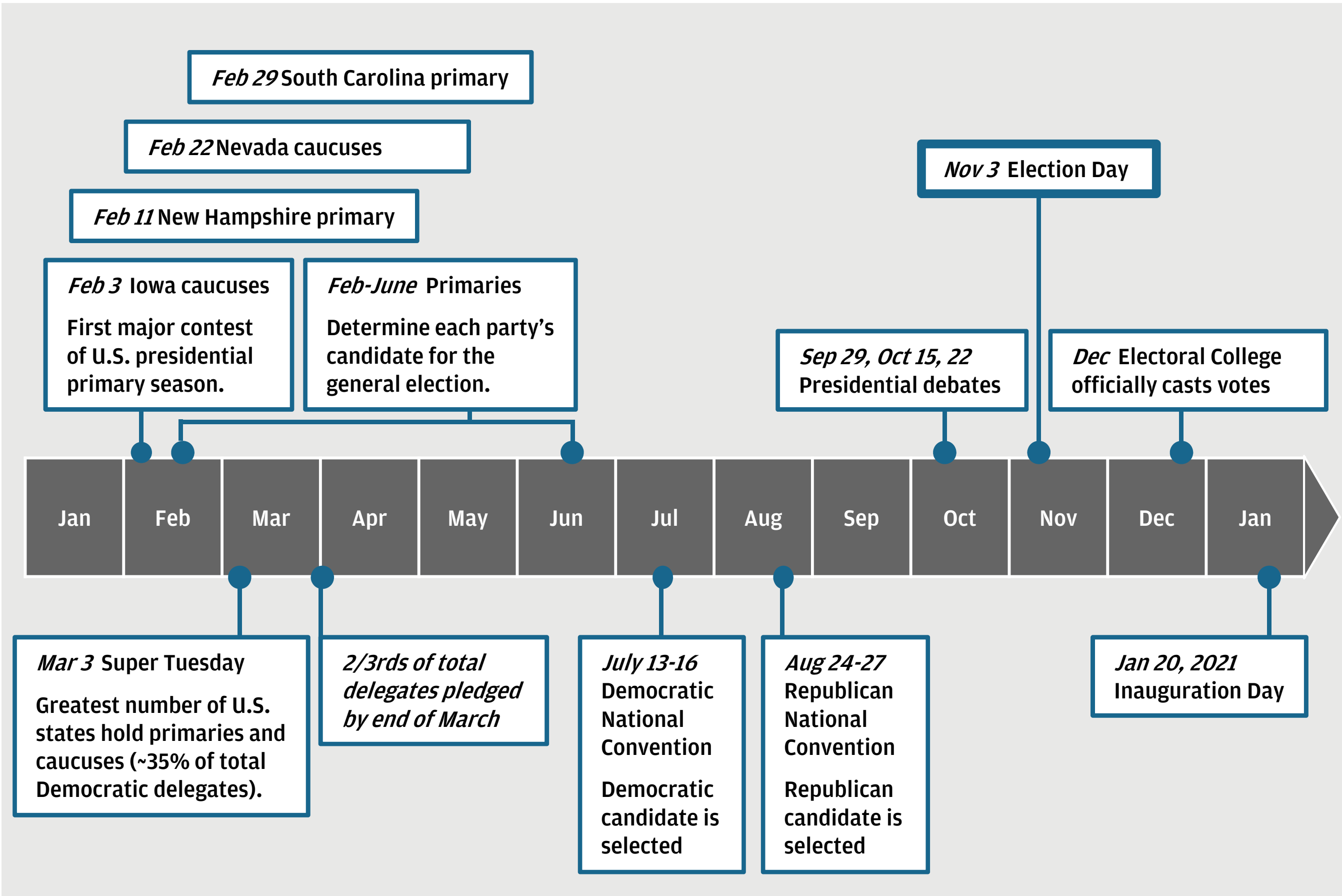
Presidential campaigns are always drawn out in the U.S., but the run-up to the 2020 presidential election has already felt unusually long, with more than 20 candidates vying for the Democratic nomination at its height. Meanwhile, in a politically polarized nation, races for control of both the Senate and the House of Representatives will likely be tight. Although divided government is one likely outcome, maps for the Electoral College and House districts and the Senate seats up for election all favor the Republicans, making a Republican sweep in terms of control a real possibility, even if the Democrats win a narrow victory in the popular vote.

Still, as political temperatures rise, investors should not let how they feel about politics overrule how they think about investing. Despite slightly lower returns and higher volatility in election years, returns have usually been solid. That being said, different political outcomes would result in different policies over the next few years and investors should consider how these policies could impact markets and the economy in the aftermath of the 2020 election.

The road to November 3rd

Voters will head to the polls on November 3rd to elect the next President and Congress, but there are many major milestones that will occur before then **(Exhibit 1)**. The primary season kicks off on February 3rd with the Iowa caucuses which helped launch the presidential campaigns of Jimmy Carter and Barack Obama among others. The Iowa caucuses are followed by the New Hampshire primary, the first actual primary, on February 11th. The Nevada caucuses and South Carolina primary round out the February races, and are both thought to somewhat balance the less diverse Iowa and New Hampshire contests with constituencies that are comparatively more representative of the broader population.

EXHIBIT 1: The likely Democratic nominee may not be clear until mid-year given the wide field of Democratic candidates



Source: Democratic National Committee, Republican National Committee, J.P. Morgan Asset Management. Data as of January 22, 2020.

This sets the stage for Super Tuesday on March 3rd, the biggest single day of races where approximately 35% of the total Democratic delegates, who will eventually go on to represent voters at the Democratic National Convention, are selected. Twenty-nine states and territories vote in the primaries in March, so by the end of the month, around two-thirds of the delegates will have been selected. However, it is important to recognize that Democratic delegates have been selected under proportional representation in this cycle. With such a wide field of Democratic candidates still vying for the nomination, it is quite possible that no candidate will have a majority of the delegates entering the Democratic Convention which is being held in Milwaukee from July 13th to July 16th.

At the convention, while the 3,979 delegates selected in primaries and caucuses are required to vote for their assigned candidate on the first ballot, they will be free to do otherwise in later rounds of balloting. Moreover, in the second and subsequent rounds of balloting they will be joined by 771 super-delegates who are largely party insiders. This could tilt the nomination towards a more moderate Democrat, although the ability of the party to unite around such a nominee could have a big impact on the Democrats chances in November.

The next president of the United States

While there is a great deal of uncertainty surrounding the Democratic nominee, some general observations can be made about his or her chances for victory in November. On one hand, an incumbent president has won re-election 63% of the time, and, since the Civil War, those who lost had an economic recession during their term. However, U.S. President Donald Trump has significantly weaker approval ratings compared to the past six presidents at similar points in their presidencies **(Exhibit 2)**, so at this point, it's too soon to tell.

That being said, each presidential election is unique and the presidency is determined not by the popular vote but by who wins at least 270 of the 538 Electoral College votes. In the 2016 election, President Trump was elected with 306 Electoral College votes to 232 for Hillary Clinton, but actually lost the popular vote, polling 46.1% to 48.2% for Clinton. Ultimately, the three states that effectively determined the election in President Trump's favor were Michigan, Pennsylvania, and Wisconsin. These races were all determined by a spread of less than 0.8% between the candidates. Therefore, on election night, these three states, along with the other 5 tightest races of 2016—New Hampshire, Florida, Minnesota, Nevada, and Maine—will likely determine the outcome. If a Democrat outpolls President Trump by 3% or more they are likely to be elected. If the margin is less than 2% or if President Trump wins the popular vote, he will likely be re-elected **(Exhibit 3)**.

Exhibit 2: Re-election rates in prior presidential elections
1796-2016

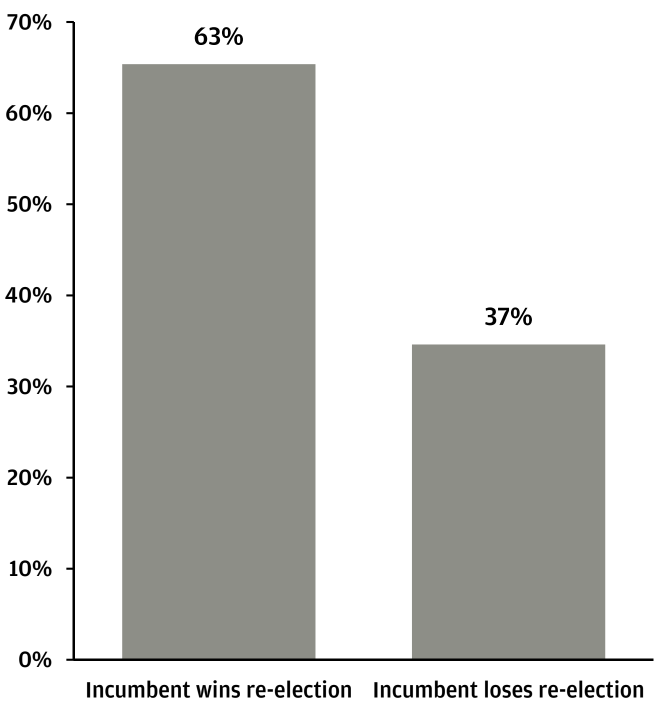
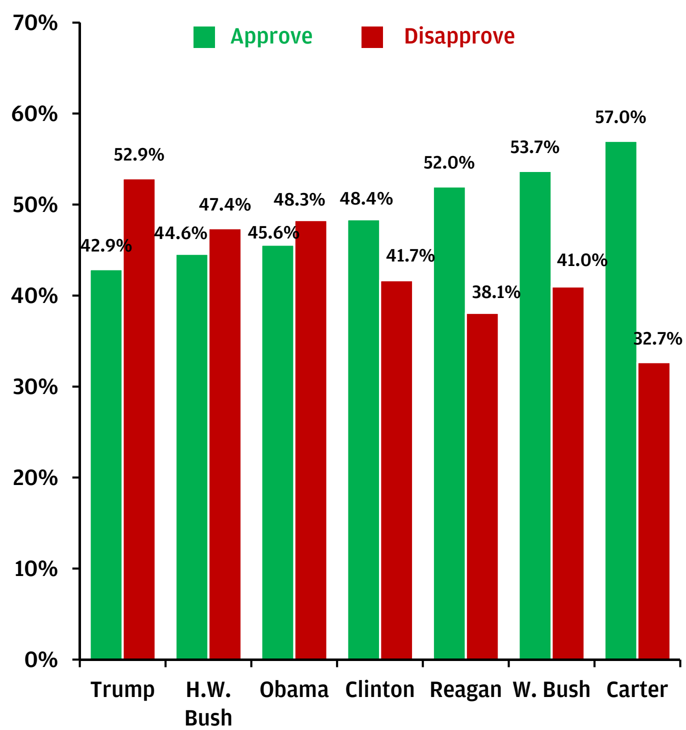
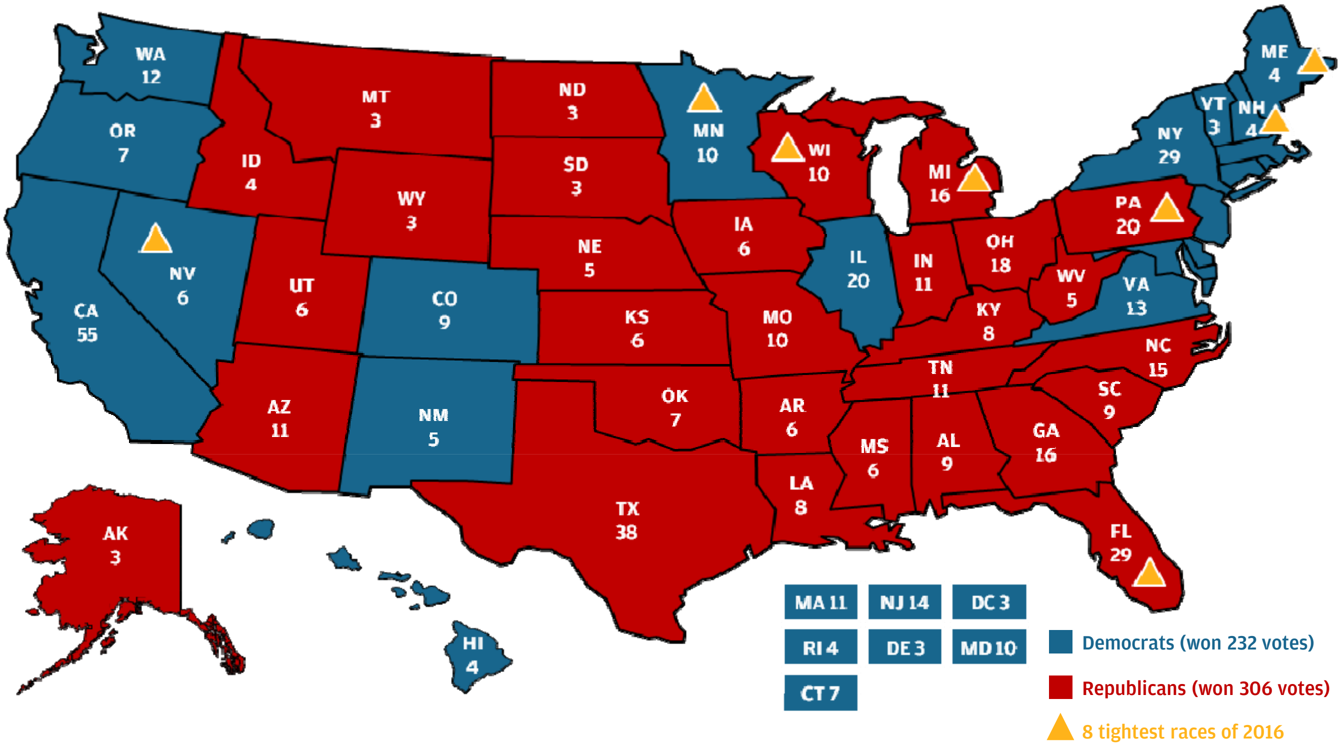


Exhibit 2: Approval ratings on 1,103rd day of presidency
Ranked by approval rating, lowest to highest



Source: Britannica, Five Thirty Eight, J.P. Morgan Asset Management. Of the 56 elections since 1796, 27 were re-election campaigns. Of those, the incumbent won in 17 races, and lost in 10 races. Approval ratings from fivethirtyeight.com. Methodology: uses almost all polls (based on pollsters' historical accuracy in forecasting elections since 1998) but weights them based on their methodological standards and historical accuracy. Polls are also weighted based on their sample size, although there are diminishing returns to bigger samples. The weights also account for how often a pollster measures approval ratings. Data are as of January 28, 2020.

Exhibit 3: 2016 Electoral College map*



Source: 270 to Win, J.P. Morgan Asset Management. *Trump earned 306 pledged electors, Clinton 232. They lost respectively two and five votes to faithless electors in the official tally. These lost votes were from Hawaii (1), Texas (2), and Washington (4). Iowa, Wisconsin, Michigan, Ohio, Pennsylvania, Florida were won by Obama in 2012 and Trump in 2016. Maine and Nebraska allow for electoral votes to be split; otherwise winner takes all. Data are as of January 22, 2020.

A divided Congress?

The Presidential election is the key race on Election Day, but the make-up of Congress will determine how easily the next president can implement their policy agenda. Currently, Congress is divided, with the Republicans controlling the Senate and the Democrats controlling the House of Representatives. This year, there will be 35 seats up for election in the Senate, 23 currently held by Republicans and 12 currently held by Democrats. To win control of the Senate, Democrats would need to keep all of its seats and flip 3 seats if they win the presidency (because the Vice President casts tie-breaking votes), or 4 if they do not. The most feasible path would be to flip three states - Arizona, Colorado and Maine, and then either flip a seat in North Carolina or hold on to a seat in Alabama.

In a strong night for the Democrats this could happen but in a close race at the presidential level the Republicans would likely hold on to the Senate, shown in (**Exhibit 4)**.

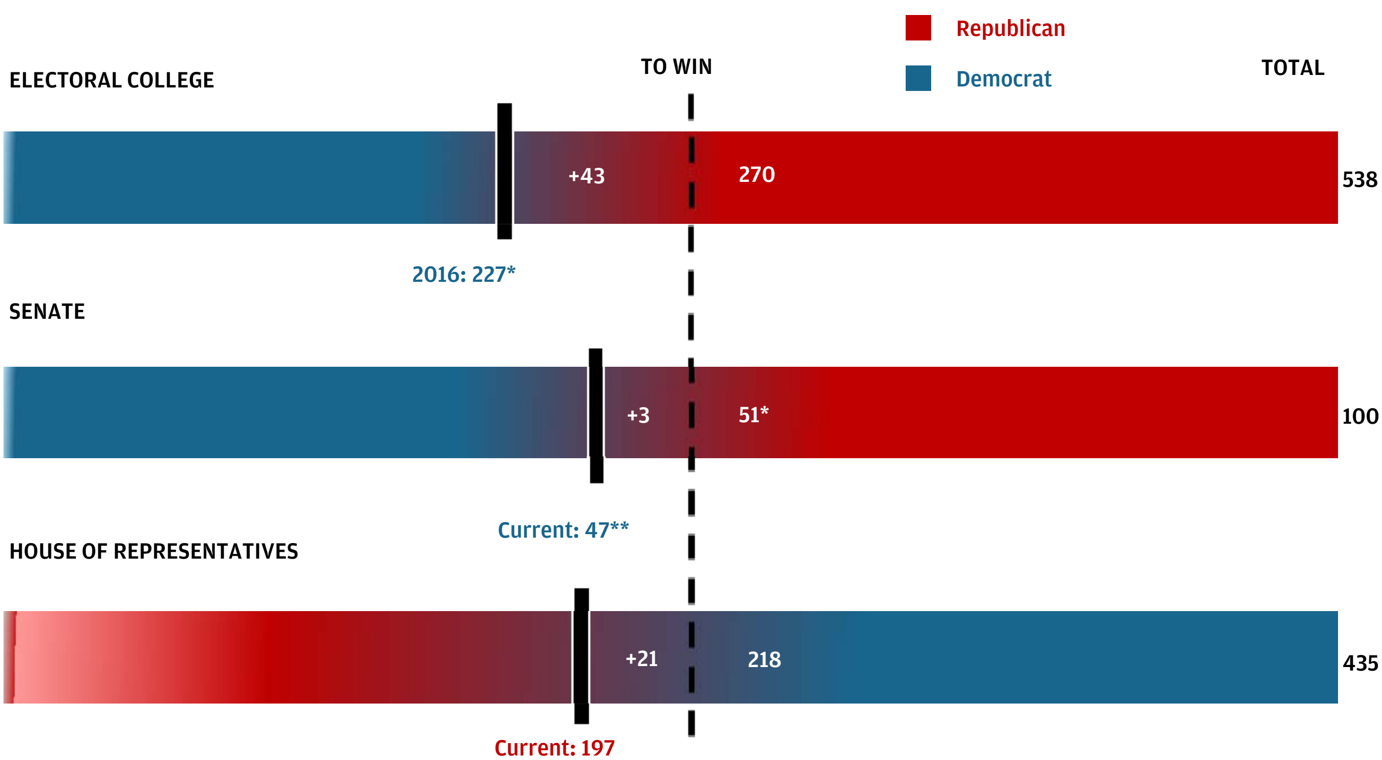
In the House of Representatives, all seats up are up for election, and at least 218 seats out of the 435 total seats are required for control. In order to win control of the House, Republicans would need to win 21 seats, and hold on to two vacant seats that were previously held by Republicans. Typically, the largest swings in the House occur during midterm election years, as these contests are considered referendums on the president’s first two years of the term. Traditionally, the swings in presidential election years are more muted, as voter participation rises and more moderate voters turn out.

However, looking at the last four elections, the challenge for Democrats becomes evident. In 2018, the Democrats won the House with 53.4% of the vote, vs. 44.8% for the Republicans, an 8.6% spread. That seems like a healthy margin, but deeper analysis reveals the weakness of the Democrats' control. Looking at the closest contests, and assuming a smaller swing to the Democrats suggests that the Democrats could have won the national popular vote for Congress by 3.8% and still not gained control. This is actually very consistent with Congressional elections in recent years where, due to district lines, Republicans have significantly outperformed their vote totals in terms of seats won. As with the Senate, if the Democrats win the popular vote in a landslide, they should maintain control of the House. As with the Senate, if the Democrats win the popular vote in a landslide, they should maintain control of the House. However, if the popular vote is close, the Republicans will likely regain control of the House.

Policies, not politics, matter most

While the Presidential race may dominate both media coverage and public discourse in the months ahead, ultimately, it is policies, not politics, that matter most. Moreover, it is worth remembering that the sweeping changes proposed on the campaign trail are usually considerably watered down by political and budget realities once the election is history. Still, there are some stark differences in the approaches of the two

Exhibit 4: Votes or seats in the Electoral College, Senate, and House of Representatives



Source: 270 to Win, The Cook Political Report, J.P. Morgan Asset Management. *Trump earned 306 pledged electors, Clinton 232. They lost respectively two and five votes to faithless electors in the official tally. *51 seats are needed for a simple majority if the dominate party in the Senate is not represented in the White House. If the president and majority party are the same, only 50 seats are needed for a majority because the Vice President casts the tie-breaking vote. **Includes 2 independents that vote with the Democrats. Data are as of January 22, 2020.

main parties so to try to understand the implications of these policies for the economy and markets, we've constructed four possible political scenarios with their implications for policy changes in the years ahead **(Exhibit 5)**.

In this table, it should be noted that the implications of divided government are a good deal smaller than a change to one-party rule. Moreover, even were one party to sweep the presidency and both houses of Congress, there are political and constitutional limits on what that party could achieve.

For example, while greater enforcement of regulations in banking and tech is possible, an outright increase in regulation would be limited. Large tech firms may experience increased antitrust scrutiny, but they cannot be dismantled in short order. Reversing the corporate or personal tax cuts would require Congressional action, which would be unlikely even in a Democrat-controlled Congress. The constitutionality of wealth taxes would face court challenges. However, heavy restrictions on fracking are possible. Still, remember that two of President Trump's signature campaign promises were to build a wall along the entirety of the U.S.-Mexico border, and to repeal and replace the Affordable Care Act. While the Executive Branch has wielded substantial power during its first term, the Administration was unable to fully accomplish these two items. The next president, Republican or Democrat, will face the same constraints.

Investing in an election year

All this begs the question: how should one invest in an election year? It's no secret that political volatility does impact markets. Typically, returns are lower in election years than in non-election years. However, at just shy of 6%, election year returns have been still been solid

Exhibit 5: Policies pursued by the next president will affect the economy and markets

PRESIDENT	DEMOCRAT		REPUBLICAN	
CONGRESS	Senate (D), House (D)	Senate (R), House (D)	Senate (R), House (D)	Senate (R), House (R)
TRADE	Trade stability, but protectionism persists	Trade stability, measured protectionism, but not at forefront	Uncertainty persists, capex and hiring suffer, trade deficit high, dollar strong	Uncertainty persists, capex and hiring suffer, trade deficit high, dollar strong
TAXES	Attempt to add wealth tax and reverse corporate tax cut; efforts blocked	Attempt to reverse corporate tax cut; efforts blocked	No further changes	Additional modest tax cut boosts consumer spending and econ. growth
HEALTH CARE	Affordable Care Act strengthened, but still public/private	Affordable Care Act strengthened, but still public/private	ACA significantly weakened; changes to health care system	Repeal of Affordable Care Act (ACA)
REGULATION	Bank regulations strengthened; antitrust action for tech	Bank regulations strengthened; antitrust action for tech	Continued regulatory rollback on financial and environmental regulations	Continued regulatory rollback on financial and environmental regulations
INFRASTRUCTURE	Bill passes for spending on more traditional infrastructure projects	Bill passes for spending on more traditional infrastructure projects	Bill passes with compromises on border security spending	Bill passes with border security as center piece
BUDGET DEFICIT	Deepens with entitlement spending	Stabilizes as Republican Senate blocks spending increases	Deepens with infrastructure spending and fewer entitlements cuts	Deepens with infrastructure spending, but entitlements cut
IMMIGRATION	Looser stance on immigration aids labor supply and econ. growth; DACA renewed	Looser stance on immigration aids labor supply and econ. growth; compromise on DACA	Strict immigration limits labor supply and econ. growth; compromise on DACA	Strict immigration limits labor supply and econ. growth
ENVIRONMENT	Tougher environmental standards; recommit to Paris Agreement; restrictions on fracking	Tougher environmental standards; recommit to Paris Agreement	Environmental standards eroded	Environmental standards eroded
FOREIGN AFFAIRS	Rely on diplomacy; renew Iran Nuclear Deal	Rely on diplomacy; renew Iran Nuclear Deal	Volatile relations with Iran, North Korea	Volatile relations with Iran, North Korea

Source: J.P. Morgan Asset Management. DACA refers to the Deferred Action for Childhood Arrivals policy. Data are as of January 22, 2020.

and not worth missing. Also, it is hard to solely attribute election year returns to the election itself. As an example, the bursting of the tech bubble in 2000 and the onset of the great financial crisis in 2008 were substantially more important in driving markets in those years than the November election **(Exhibit 6)**.

Unsurprisingly, volatility is higher in election years than in non-election years but only slightly higher. Again, some election years like 2008 are outliers, in which the volatility had much more to do with prevailing market conditions and the economy at the time than the election itself. Moreover, timing the market is a very difficult strategy, and no less so during an election. While this year could be modestly choppier, it is not worth being on the sidelines.

Some investors wonder, how do markets and economic growth fare under Democrats vs. Republicans?

As highlighted in **Exhibit 7**, over the long-run, markets tend to favor Republicans, while economic growth tends to be stronger under Democrats. However, most frequently, we have experienced a divided government—one in which the president, Senate majority, and House majority are not all from the same political party. And still, markets grind higher, achieving positive returns, and the economy continues to grow.

Some ask, in the immediate aftermath of an election, how do markets do when a Democratic president is elected? Over the past nearly 90 years, markets tend to sell off in the period from Election Day to the end of that year, but subsequently perform better under Democrats than Republicans during the first full calendar year of an administration. Yet, much of that cannot necessarily be attributed to the president or party itself during that first year because markets are

Exhibit 6: Returns during election, non-election years
S&P 500 price index, average return, 1932-2019

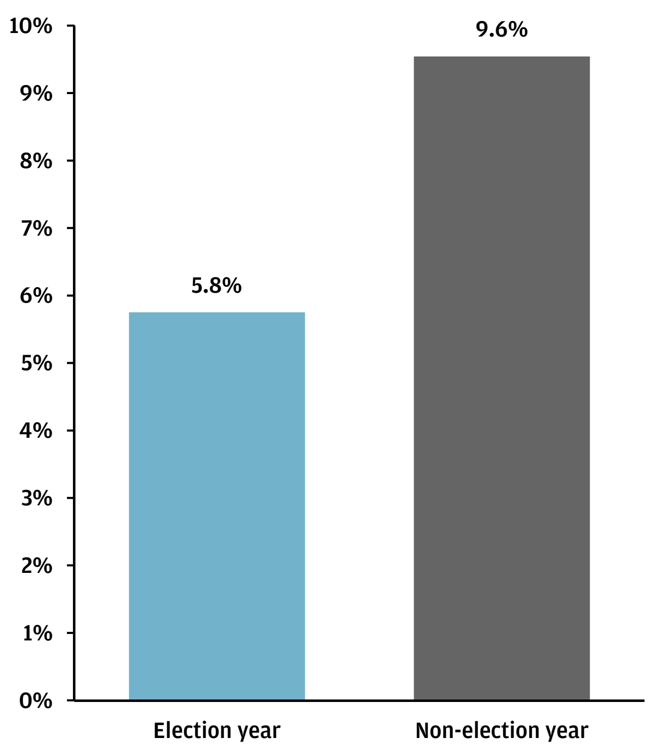
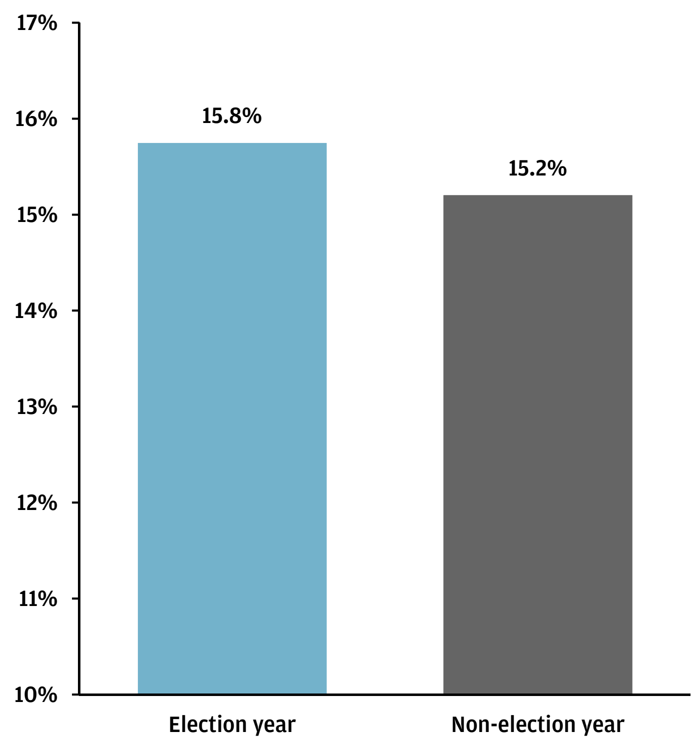


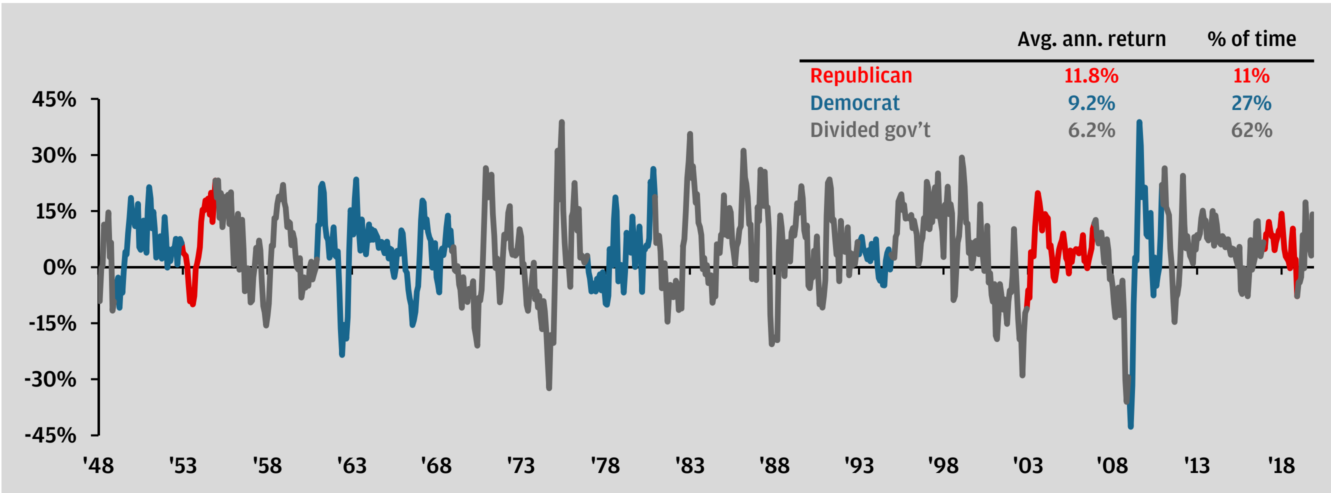
Exhibit 6: Realized volatility during election, non-election years
S&P 500 price index, 52-week standard deviation, 1932-2019



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of January 22, 2020.

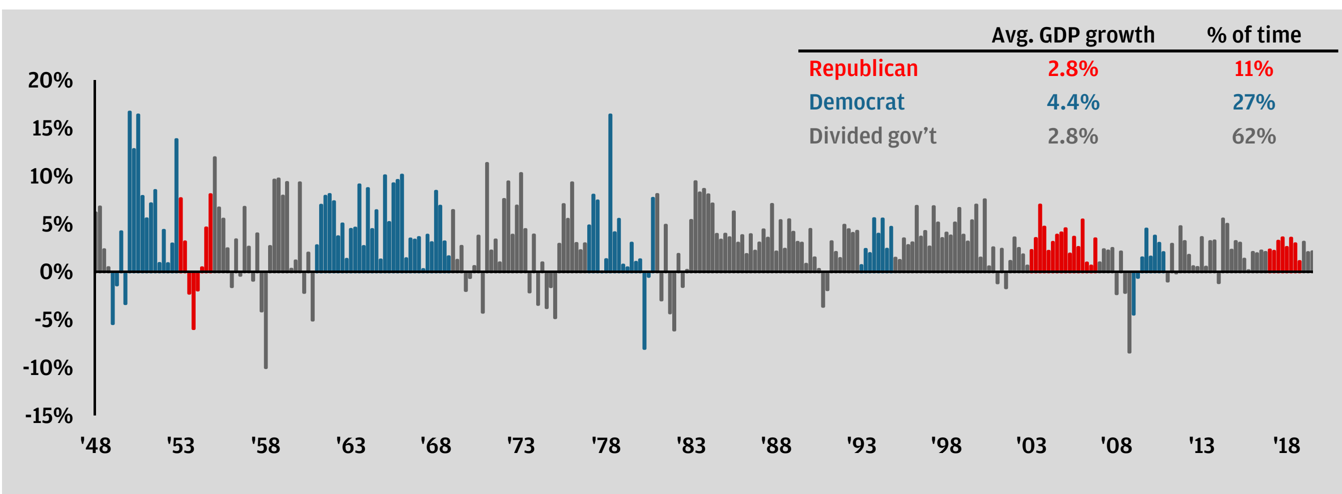
Exhibit 7: Equity market returns and real GDP growth

S&P 500 price index, rolling six-month returns



Real GDP

Quarter-over-quarter % change, seasonally adjusted annualized rate



Source: FactSet, Office of the President, J.P. Morgan Asset Management; (Top) Standard & Poor's; (Bottom) Bureau of Economic Analysis. Top chart shows S&P 500 price returns. Data are as of January 22, 2020.

influenced by many other factors. Once again, consider the trough of the stock market and subsequent rebound in 2009, or the 9/11 attacks and tech collapse in 2001.

Finally, elections can be highly emotional, so for investors, it is important to remember one cardinal rule: *Don't let you how feel about politics overrule how you think about investing.* To illustrate this point,

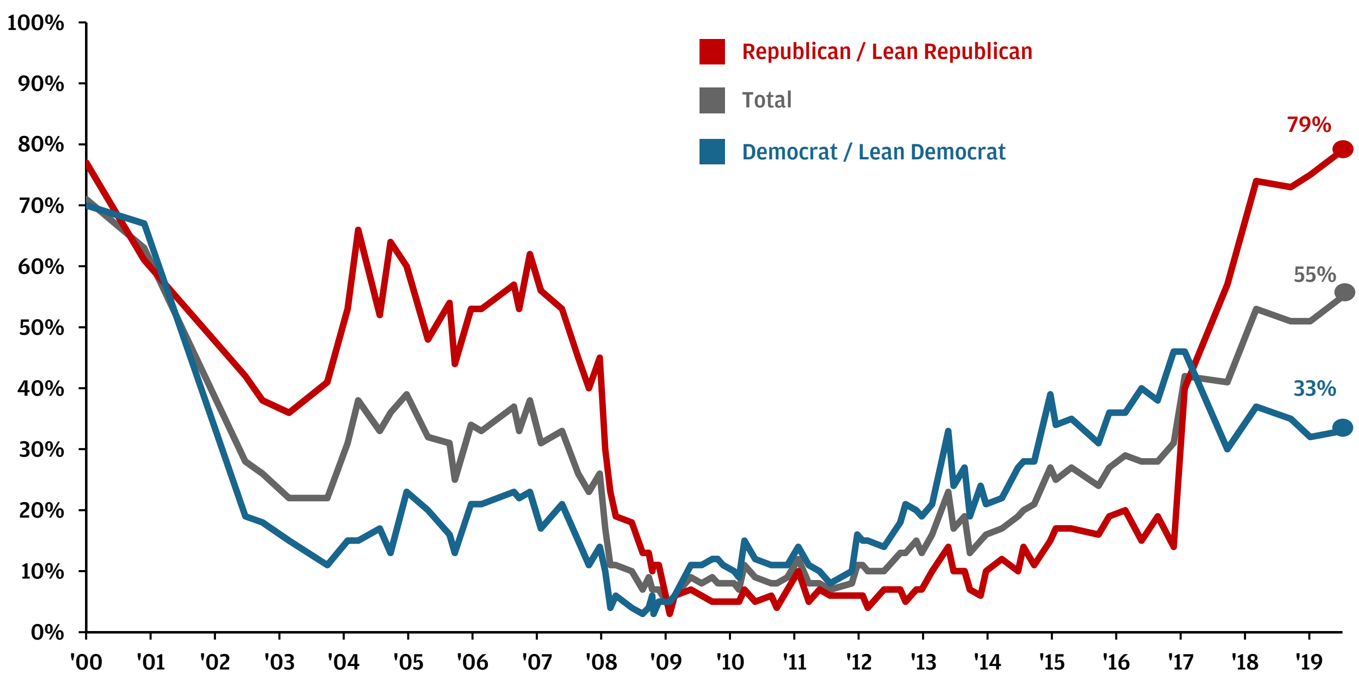
Exhibit 8 shows a poll conducted by the Pew Research Center, which categorizes respondents by political affiliation and asks them to rate present economic conditions. During the 8 years of the Bush Administration and since the start of the Trump Administration, those who are or lean Republican felt positively about the economy while Democrats felt less favorably. The opposite was true during the Obama

Administration. But what's most striking is how much attitudes pivot on Election Day itself, ten weeks before the new president is even inaugurated, and has no direct influence over the economy yet.

One might extrapolate that investors may be under-allocated to risk assets or even pull out of the market if they feel strongly negative about a president. However, U.S. large cap equities (measured by the S&P 500 total return index) experienced 16.3% annualized returns during the Obama Administration, 15.0% during the first three calendar years of the Trump Administration, and 10.6% overall over the past 50 years. This highlights how strong returns have been over the past decade, and how much investors could have missed out on if they let their politics get the best of them and deviated from their investment plans.

The road to Election Day will be long and winding, but investors ought not to get caught up in the twists and turns. Many unknowns still remain, and greater clarity is unlikely to come until closer to the election. Even then, the results may defy the odds. Therefore, investors should instead continue to monitor economic fundamentals, tilt towards quality in both equity and fixed income, and maintain a well-diversified allocation. Investment time horizons extend far beyond election cycles and presidential terms, so, in 2020, sticking to an investment plan is more crucial than ever.

Exhibit 8: Percentage of Republicans and Democrats who rate national economic conditions as excellent or good
Percent



Source: Pew Research Center, J.P. Morgan Asset Management. Pew Research Center, July 2019, "Public's Views of Nation's Economy Remain Positive and Deeply Partisan." Question: Thinking about the nation's economy, How would you rate economic conditions in this country today… as excellent, good, only fair, or poor? *Guide to the Markets – U.S.* Data are as of January 22, 2020.

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