Notes From the North: Market Outlook

August, 2020

Hopefully, the November election will prove to be the crescendo of this 2020 symphony, and when it's over, at least some of the *sturm und drang* will fade away. The national election cycle always increases the emotional content of the national discussion, but this year that normal level of intensity has been heightened by pandemic, a phenomenon that has driven us all to look more regularly and more closely at our news feeds. What we've seen hasn't been particularly pleasant, and just adds to the general feeling of un-ease.

Just what does a federal election mean for the markets? Of course we ponder, and read, and consider strategies, but like every other future event that remains uncertain, always in the back of our mind is the fact that we can't *know* in advance.

One theory of election cycles posits that an administration seeks to "juice" the economy in the year prior to an election (to aid in reelection, obviously) and "allows" an economy to slow in the early years following an election (to make it easier to step on the accelerator at the appropriate time). If this theory holds true, one would expect the year prior to an election year and the election year itself to produce better market returns than the other two years. Lo and behold, since 1927 the average return of the years prior to and including the election year is 50% greater than the average return of the second half of the cycle. This makes it sound as though one should exit the markets after the election and return two years later. However, the average return for the "weak" two years is still a hefty 9.5%. Note that we won't be able to collect enough data in our lifetime to discern whether this is statistically significant or a data blip.

The 2020 election year certainly feels apocalyptic, but perhaps it won't be. In Barrons' overview of analyst prognostications recently, the range of market reactions to different outcomes ranged from

- a 2-5% decline in response to a "Blue Sweep"
- a 2% gain in response to a Trump victory and status quo in the Senate
- an 8% possible gain with a divided government, should Biden win and the Senate retain its Republican majority.

(No one gives much credence to the possibility that the Senate would flip to the Democrats if conditions are such that Trump wins the presidency).

The discussion of the potential impact of the different administrations on the economy is normally a lively discussion. Pharmaceuticals? Health insurance? Defense stocks? Energy stocks? This conversation, at least amongst the strategists we follow, has actually been unusually unremarkable. Biden would likely raise taxes but would likely also spend more, a net economic "wash" on the overall economy (although not for individual taxpayers). Clean energy and infrastructure stocks are often mentioned as beneficiaries of a Blue Wave, and companies that benefit from non-unionized labor forces would face a headwind (McDonalds and Uber come to mind). Trump would likely continue to cut taxes and deregulate but offset these economic tailwinds with further trade uncertainty and a continued embrace of general unpredictability. Smaller companies as well as technology, financial, and energy firms might benefit, while retailers (and Apple) would be more negatively impacted. In our view, none of these outcomes would "surprise" the market.

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What to do, then, to prepare a portfolio for this seemingly apocalyptic election? If it was possible to know for sure that the election would be apocalyptic and would have an apocalyptic effect on the market, the easy answer would be to go to cash now, wait until stocks are priced for the end-times, then buy back in. Unfortunately, it is not possible to know this, and the track record of anyone who says it is possible should be studied very carefully.

Knowing what we can't know, we recommend the basics. After all, it's more important to avoid being precisely and 100% wrong in investing than it is to succeed at being precisely and 100% right. Here's a reasonable game plan:

- Identify near-term needs. Any amounts one may need in the next three years should not be invested in stocks. (If you're not sure we've taken care of that for you, please call!)
- Revisit your most recent experience with significant market volatility. It should be fresh! If you were losing sleep in March, now is a good time to look at reducing your equity exposure.
- Diversify. Assume you can't know what the future holds and take advantage of the benefits of diversification.
- Tilt. Depending on your anxiety level, security selections can be tilted to reduce (or enhance) market sensitivity.

Jamie Dimon (JP Morgan CEO) suggests that "The range of outcomes for the economy in the second half is incredibly wide. No one knows what comes next." Any number of pots simmering on the stove top right now could have a dramatic impact on the market; a successful vaccine or treatment development, the justice department moving forward with a break up of the big tech companies, a blow-up of the tensions between the U.S. and China, just to name a few that are currently in the works. Focusing just on the election could lead in the wrong direction. With the steps above in place, however, you should be able to sit back with a little less worry, and try to enjoy the show. It will be interesting!

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