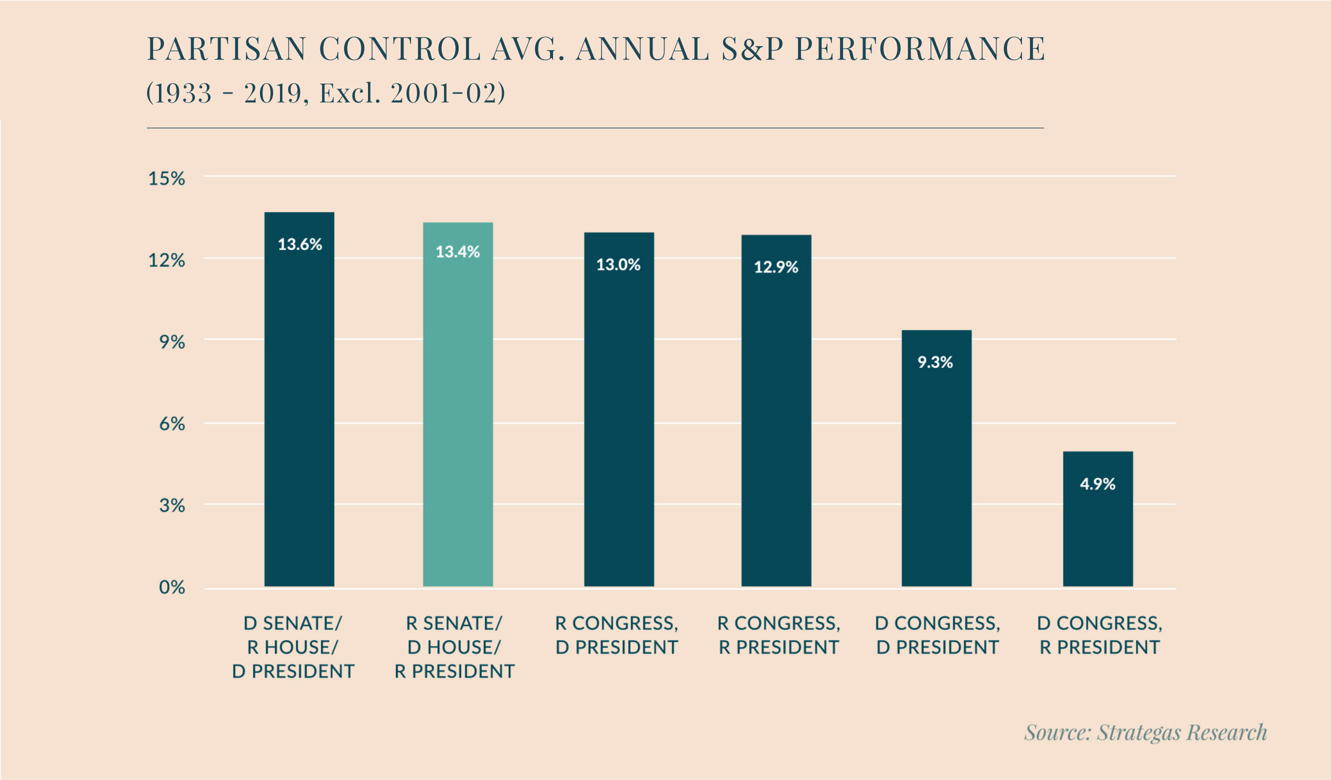
WEIGHING THE IMPACT OF A HISTORIC U.S. PRESIDENTIAL ELECTION

FALL 2020

Investing during an election year can be emotionally charged, amplifying our biases and undermining our confidence in market resiliency. It is tempting for investors to assume their political party is better for the stock market, or that some specific division of power is best—or worst—for asset prices. The reality is that the stock market has shown virtually no political preference over the years and the bottom line is that US stocks have trended up whether a Democrat or Republican has won the election.

THE MARKET TRENDS HIGHER, EVEN AS POWER CHANGES HANDS OFTEN[1]



Data frequently cites that Democratic presidents are better for equity market returns. Since 1933, for example, Democratic presidents have experienced higher stock market returns than Republican presidents. But if we strip-out the outsized gains during the 90's tech boom (Clinton) and the dot-com bust and 2007-2008 Financial Crisis (Bush), then the difference in returns between Democrats and

[1] *2001 and 2002 are excluded because control of the Senate changed hands three times in that period.*

Republicans is essentially zero. Market and business cycles over the long-term matter far more than political parties do.

What matters most to your investment returns, however, is time in the market. While it is understandable that anxious investors are inclined to sit on the sidelines and take a "wait and see" approach, committing to a long-term investment plan based on individual investment objectives is the preferred course of action. As is often the case with investing, and election season is no different, the key is to put aside short-term distractions and focus on long-term goals.

POLICY PROPOSALS

Presidential policy-setting can influence market and business cycles however, so it is worth surveying proposals and the likelihood of enactment.

The prevailing sentiment is that a Biden win would mean higher corporate and top-end tax rates, which is a perceived negatively for earnings and equity markets. History does not fully support this conclusion. The biggest sustained increase to corporate tax rates occurred in the 1940s and 1950s, with the tax rate topping 50%. As corporate tax rates soared during and after World War II, the stock market was hardly fazed. During the 1940s, the S&P 500's total return was +143.10%, and during the 1950s the index jumped +467.40%.

Biden's campaign has proposed raising individual tax rates for those earning over $400,000 to 39.6% from 37%, and moving corporate tax rates up to 28% from 21%. These proposed changes are hardly dramatic or unprecedented—tax rates were at or above these levels just four years ago, when the economy was growing just fine.

Biden has also proposed raising Social Security payroll taxes, which are not collected on income greater than $137,700. Biden's plan would keep the cap at $137,000 but re-impose the tax on incomes exceeding $400,000, creating a barbell-like structure. For those earning more than $1 million, it is possible that long-term capital gains and qualified dividend tax rates could bump up to ordinary income tax rates. A Biden administration may also pursue ending the step-up provision upon death for estate plans, which could significantly increase tax burdens for heirs. Taken together, these changes would almost certainly warrant adjustments to tax and estate planning strategies on an individual level, but they seem far less likely to impact or change long-term economic growth trends.

The viability of Joe Biden's tax plan depends on Democratic control of the House and Senate. Because of fast-track procedures, however, a filibuster-proof 60-seat Senate majority is not needed to raise taxes. Democrats only need a net four seat gain to reach 51, but with a Biden win they could raise taxes in a 50-50 Senate (the vice president casts the tiebreaker vote). The Senate races to watch in November are Alabama, Arizona, Colorado, Georgia, Iowa, Maine, Montana, and North Carolina. Interestingly, there has not been a Democratic president, Democratic House, and Republican Senate since 1886.

The impact of marginally higher tax rates could be offset by additional spending. Biden's plan calls for $400 billion to buy American goods, $300 billion for research and development, $50 billion in worker training, and a $2 trillion, four-year infrastructure plan designed to promote energy efficiency and make the U.S. carbon neutral by 2035.

While higher taxes on the wealthy and big spending programs frame the vision for a Biden White House, it is important to remember that campaign proposals are designed to generate voter enthusiasm—very few are enacted as advertised. We saw this outcome in 2010 with the Affordable Care Act and in 2017 with the Tax Cuts and Jobs Act. The pieces of legislation signed by Presidents Obama and Trump, respectively, were far more moderate than the original proposals.

If President Trump emerges victorious in November, he will almost certainly encounter a divided Congress. Republicans in the House face a significant uphill battle to gain a majority. With a divided Congress, the probability of meaningful, business-impacting legislation remains low, and governing by executive order has many limitations. For his part, President Trump faces an uphill battle to re-election: only one president (Calvin Coolidge) in U.S. history won re-election when there was a recession at least two years before an election. Bush I, Carter, Hoover, Ford and Taft all lost re-election bids under similar circumstances.

ANTICIPATING HIGHER VOLATILITY

These are not normal times, and this will not be a normal election. For investors, it is impossible to know how the next six months will shake out, though it appears increasingly likely that the election result will be contested or accompanied by some level of controversy. Short-term volatility seems assured.

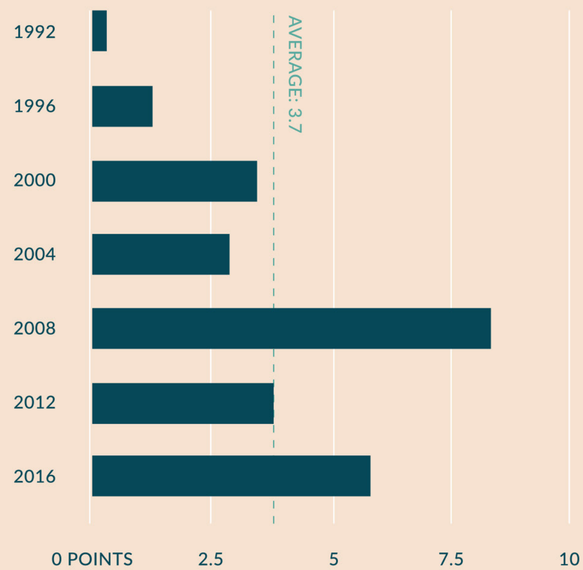
Even without the pandemic and voting concerns, equity markets have displayed increasing volatility in October and November. Looking back at the last seven U.S. presidential elections, the CBOE Volatility

Index (VIX) has risen an average of approximately four points in the month leading up election day. Investors should reasonably expect some bumpiness this time around, too.

POLITICAL TUMULT

The Cboe Volatility Index, or VIX, has risen an average of about four points the month before presidential elections.

CHANGE IN VIX FROM THE MONTH AHEAD OF AN ELECTION DAY TO THE DAY BEFORE AN ELECTION



Source: Dow Jones Market Data

Long-term investment strategies should not attempt to factor-in the possibility of short-term volatility, and in our view, the fear of election mayhem may ultimately be far more dramatic and worse than the actual outcome. The disconnect between expectations and reality has already been a feature of 2020, with 'worse than the Great Depression' pandemic forecasts not coming to fruition. Corporate earnings and revenues, for example, took big hits in Q2 2020 and were down 31.8%, but the pandemic's impact on earnings was not as bad as most feared. In fact, 84% of S&P 500 companies beat consensus earnings-per-share estimates and 65% beat revenue estimates[2]. A few companies are left to report, but if 84% is the final percentage, it will mark the highest percentage of S&P 500 companies reporting a positive earnings surprise since 2008.

[2] *FactSet Earnings Insights, August 28, 2020*

We hold a similar view on the election. New legislation is rarely—if ever—enacted exactly as proposed during a campaign, and the stock market over time responds more to long-term earnings and economic growth trends—not to changes in political leadership. We will have time to assess new legislation as it is proposed, determining the likelihood of enactment and identifying the potential winners and losers in the process.

IN SUMMARY

Election season is a challenging time for investors to maintain a long-term perspective. Strong emotions are understandably evoked by politics, and campaign headlines will magnify the divisive issues that are important to us all. There is no precedent for this 2020 election, marked by an amalgamation of a global pandemic, an uncertain economy, social and civil unrest across major US cities and natural disasters that are displacing people from their homes. The uncertainty and market volatility, however, should not deter investors from maintaining a long-term focus. What matters most for your investment return is not the outcomes for this year, but it is to stay on track with your investment plan. We have written this letter to assess the political climate while also reminding our clients of the importance of maintaining a long-term asset allocation when establishing investment goals and objectives. As always, we wish you health and safety. These are difficult times. We remain confident in the market's resiliency, and as always we welcome your questions and thoughts.