

2020 Elections: Forget the hype, focus on fundamentals

It has been said that the upcoming U.S. elections might be the most important in recent memory. While this is a bold statement, clearly the outcome will have significant implications for the economic and market outlook. We frame our analysis around four pillars: political outcomes and market reaction to them, the economic impact of policy, persistent market uncertainty and the investment implications.

As 2020 continues to unfold, the U.S. is dealing with a series of historic events: the COVID-19 pandemic, a deep recession, social unrest and now an election that could likely bring about major changes to the country. Some election outcomes could be more impactful to the economy and financial markets than others. Even so, don't get caught up in the hype. Companies have proven to be adept at adjusting to the underlying environment over time, and markets have historically moved higher on average regardless of which political party gains control. Going forward, the investment landscape should benefit active managers that can identify companies that either benefit from these potential changes or are able to adapt to the changing environment.

“BLUE WAVE” OR STATUS QUO?

While sentiment could shift, former Vice President Joe Biden has been the clear favorite since winning the Democratic nomination. Following the first presidential debate and the announcement that President Donald Trump had contracted COVID-19, Biden's status as the frontrunner appears to have further improved. The race to control the Senate is close according to polling data and betting odds. Republicans currently hold 53 seats in the Senate. At this point it looks like Republicans could take a Senate seat in Alabama from the Democrats. If the Alabama seat flips and Biden wins the presidency, Democrats need to win four seats to gain control of the Senate. A difficult task but not impossible.

Here are our thoughts on the economy and markets for each possible scenario:

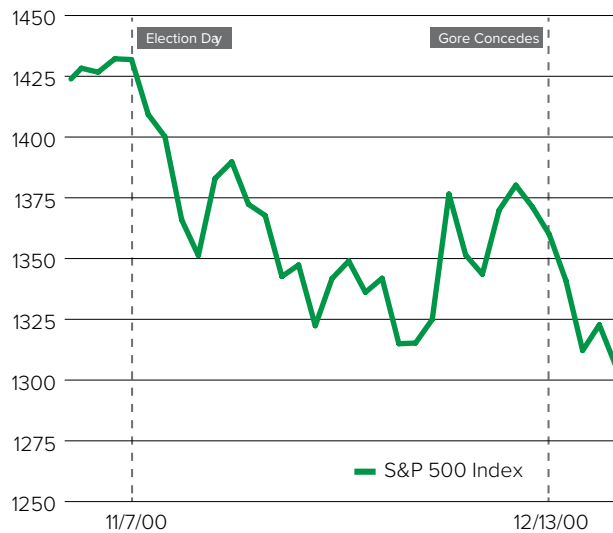
Democratic sweep. While not a guarantee, we view a Democrat sweep of the presidency and both houses of Congress as the most impactful outcome for markets and the economy. A “blue wave” would likely mean higher taxes and a move towards a tighter regulatory environment, which would clearly be market negative. However, the countervailing forces of a push for more stimulus to boost economic growth, infrastructure spending and an attempt to address the wealth and income gaps would help cushion the negative impact to the economy and markets. The order and timing of legislation would be important to determine the impact as well.

It is likely that the increase in government spending would eclipse the increase in taxes in 2021. If that is the case, then the near-term impact could be positive. However, we believe that any delay in raising taxes would be brief, with higher taxes becoming a drag the following year. Biden has been clear that he would reverse the deregulation of the last four years. His desire to tackle climate change and accelerate the use of green technology would likely squeeze traditional fossil fuels. We also believe Biden would continue to pressure China and its trade practices but could likely try to build a global coalition to address the issues instead of continuing the go-it-alone strategy of the Trump administration. Legislation around onshoring of manufacturing would be a possibility. We would also expect Biden to address health care, including an expansion of the Affordable Care Act and action to reduce prescription drug pricing.

Divided government. A Biden presidency coupled with a Republican Senate and Democratic House would probably result in little legislation. Attempts to significantly increase taxes would likely be stopped by the Republican-controlled Senate. Compromise legislation combining infrastructure spending with slightly higher taxes would be possible but unlikely. The biggest change versus the current environment would be a President Biden that pushes his agenda via regulation, as well as differences in how he addresses China's unfair trade practices. We believe this outcome would be neutral-to-positive for markets and the economy, with some clear winners and losers by industry.

Status quo. If President Trump is re-elected and Congress remains divided, we believe he would like to continue the policies from his first term, including lower taxes. However, we would expect little compromise from the legislative side as a Democratically controlled House of Representatives would likely block any serious attempts to lower taxes. A compromise on infrastructure spending would be possible but unlikely. We could also see an attempt to lower drug prices. Trump would likely continue to focus on deregulation. We would also expect his administration to continue to put significant pressure on China, which has bipartisan support and could result in some general legislation around onshoring of manufacturing. We would expect this election outcome to be positive for economic growth and markets, though would add to longer-term risk by doing little to address the wealth and income gaps.

EXHIBIT 2: THE 2000 ELECTION – A PREVIEW OF THINGS TO COME?



Source: Macrobond, Ivy Investments. Data shows S&P 500 Index performance between Nov. 7-Dec. 13, 2000. Past performance is not a guarantee for future results.

A DISPUTED RESULT?

One area of uncertainty for this election has to do with the timing of the outcome. Mail-in ballots are being used much more than previous elections due to fears around COVID-19. As of Oct. 26, more than 60 million voters had cast their ballots, surpassing the total number of advance voters in 2016 by 12 million. Not only has this raised concerns around voter fraud, but some states have laws that could make it difficult to count mail-in ballots in a timely manner.

EXHIBIT 1: WHERE THE CANDIDATES STAND ON KEY ISSUES

ISSUE	TRUMP	BIDEN
Corporate taxes	Keep 21% tax rate	Raise tax rate to 28% Minimum tax on corporate profits
Personal taxes	Reduces personal tax rate	Increase income taxes on top earners Increase capital gains taxes
Infrastructure	Increase infrastructure spending	Large infrastructure spending with a focus on green technology
Government spending	Increase on defense	Increases on education, housing
Trade	Maintain pressure on China, including tariffs and technology bans Incentives to bring manufacturing back to U.S.	Partner with allies to address countries with unfair trade practices Incentives to bring manufacturing back to U.S.
Regulation	Continued focus on deregulation	Roll back Trump Administration's deregulation Focus on fossil fuels and clean energy Greater scrutiny for Big Technology possible
Healthcare	Drug pricing reform	Expand Affordable Care Act Introduce a public health insurance option Drug pricing reform

Source: Ivy Investments.

If the vote count is close in some states, it could take weeks before we know the outcome. Following the 2000 election between Al Gore and George W. Bush and the contested vote count in Florida, it took five weeks and a U.S. Supreme Court ruling before Gore conceded. During that time, the S&P 500 Index plunged by as much as 8% (see Exhibit 2.) We believe we could see similar market volatility if there are significant delays in determining the outcome.

MARKET OUTLOOK: DON'T GET CAUGHT UP IN ELECTION YEAR HYPE

This year has been a tale of two markets with strong performance in both risk-seeking and risk-averse asset classes. In the equity market, growth and high quality have performed well, while cyclical sectors have lagged. In fixed income, we have seen ever-tighter spreads due to policy support. On an absolute basis, bond yields remain low and real U.S. Treasury yields, or yields adjusted for inflation, are actually negative. This confluence of risk tolerance has produced a curious set of returns, as investors in both large-cap equities and fixed income have seen high single-digit returns year to date. This has occurred in an environment where risk, or volatility, remains well above the long-term averages.

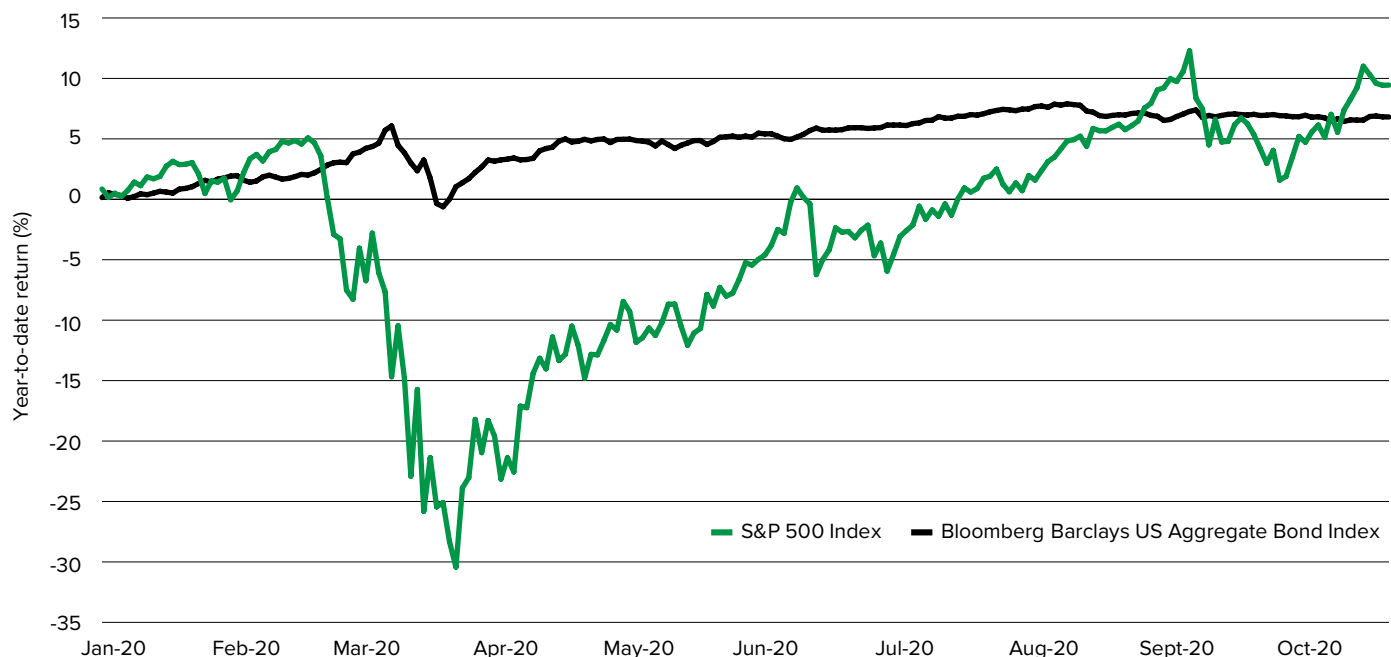
Just as the markets rebounded sharply from this spring's pandemic-induced decline, we also see a V-shaped

recovery in corporate earnings. While the recession was extreme, we believe it will be very brief and likely among the shortest on record.* We appear to now be in recovery and the market is supported by both extensive fiscal and monetary policy. The peak earnings drawdown (-30%) occurred during the second quarter. Moving into the third quarter earnings season, we anticipate an improvement from -30% to -20%, with consensus that in 2021 earnings power will be back to calendar 2019 levels.

However, the shape and complexion of those earnings may be very different. Stronger businesses in areas like environment, technology, health care and consumer services have seen accelerated growth during the pandemic. On the other end of this bifurcated market, asset-intensive cyclical businesses have been challenged by negative earnings and balance sheet issues.

While the S&P 500 Index remains top heavy, it is not led entirely by the narrow FAANG (Facebook, Amazon, Apple, Netflix and Google) regime. More than 30 companies are expected to post double-digit sales growth and margin expansion of 50 basis points or greater for the third quarter. These stocks - from six sectors - have posted a median year-to-date return of 31%. This exemplifies our belief there are pockets of opportunity in the market, but active investors need to pick their spots carefully.

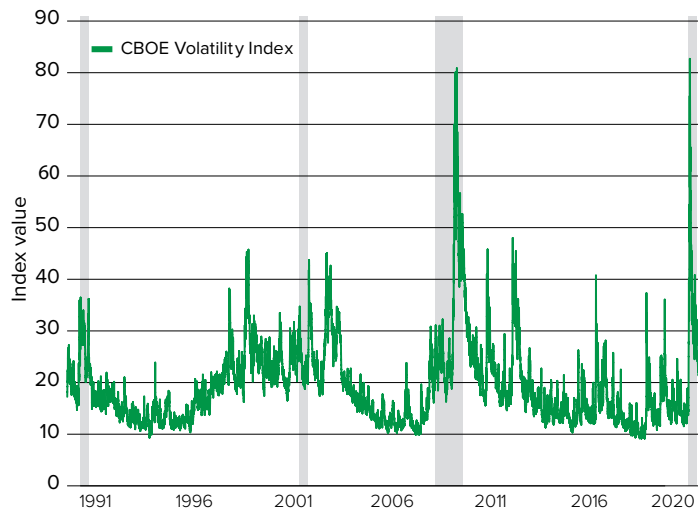
EXHIBIT 3: RISK ON OR RISK OFF? STRONG RETURNS FOR FIXED INCOME AND EQUITIES



Source: Macrobond, Ivy Investments. Data shows 2020 year-to-date performance of the S&P 500 Index and the Bloomberg Barclays U.S. Aggregate Bond Index. **Past performance is not a guarantee of future results.**

*The National Bureau of Economic Research, which is charged with determining the beginning and ending dates for recessions, has not officially set a timeframe for the 2020 economic activity decline. The average length of recessions post World War II is six quarters.

EXHIBIT 4: VOLATILITY STILL WELL ABOVE LONG-TERM AVERAGES.



Source: Macrobond, Ivy Investments. Chicago Board Options Exchange (CBOE) Volatility Index. Data shows the historical measurement of expected market volatility based on the expected level of price fluctuation in the S&P 500 Index options from 1991–2020. The higher the value, the more the expected volatility. Shaded areas show periods of recessionary conditions. **Past performance is not a guarantee of future results.**

The 2020 elections are a considerable source of uncertainty, which can trigger market volatility. We have seen volatility retreat sharply from the extreme spikes in March, but it remains high by historical standards (see Exhibit 4.)

Elevated volatility is a set-up for stock picking and as we pass through these periods of uneasiness, we remain vigilant for opportunities we believe the market has mispriced. One thing we know with certainty is the dust will settle over time and we will get greater clarity with regards to both the impact of the election outcomes and the prognosis for COVID-19. That clarity is a better set-up for markets, whose underlying fundamentals are likely to stay strong going forward.

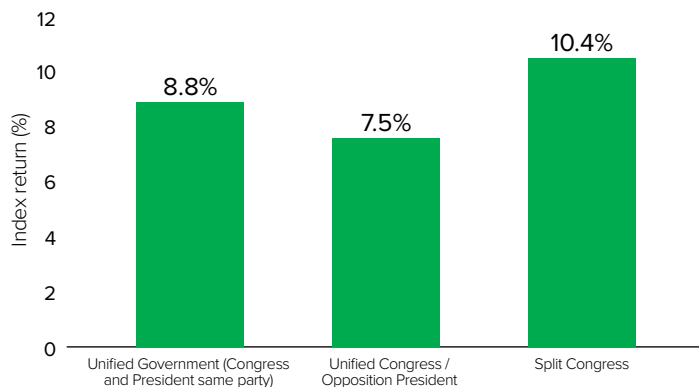
While we certainly pay attention to the short-term factors like elections, our focus as long-term investors remains finding investable opportunities that create shareholder wealth over time. Since 1965, the best average market returns came when Congress was split between the two parties (see Exhibit 5.) However, we would note that double-digit returns have also occurred in the other two scenarios: 1) Congress was unified under a president of a different party, and 2) Congress and the White House

controlled by the same party. As the focus of uncertainty has shifted from the virus to the resulting economic lockdown and now to the elections, we believe it’s important to note equity investors historically have seen strong returns in myriad scenarios of partisan control in Washington. Whether the elections result in a blue wave or the status quo, history shows it pays to stay invested.

There is a prevailing view that Washington gridlock is good for the markets. This is spun from the point of view that when gridlock exists, it means there is less of a chance for legislation coming out of the Beltway that could create headwinds for the economy. We take a slightly different view. We believe gridlock can lead to more balanced inputs, which drives better decision making. When you have diverse voices, we believe it can lead to better outcomes, both in politics and investing. We want to see diversity in the companies we own, from the boardroom to management ranks, and believe that it can be a catalyst for growth.

Investing requires the effective balancing of inputs. The key drivers in 2020 – a global pandemic, a consequential election and recessionary economic conditions – are collective inputs, but we again advise to not get caught up in the hype. As active investors, we maintain a balanced, disciplined process that incorporates all of these factors in shaping our investment decisions. Our focus is always on the underlying fundamentals of the businesses we own and the price we’re paying from them.

EXHIBIT 5: IT PAYS TO BE INVESTED, NO MATTER WHO IS IN CHARGE



Source: Strategas, Ivy Investments. Data shows S&P 500 Index performance under partisan control scenarios from 1965 through 2019. Data excludes 2001-02 due to a senator changing party allegiance. **Past performance is not a guarantee of future results.**

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The S&P 500[®] Index is a float-adjusted market capitalization weighted index that measures the large-capitalization segment of the U.S. equity market. The Bloomberg Barclays U.S. Aggregate Bond Index measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market and includes Treasuries, government-related and corporate securities, as well as mortgage-backed, asset-backed and commercial mortgage-backed securities. The Chicago Board Options Exchange (CBOE) Volatility Index is a measurement of expected market volatility based on the expected level of price fluctuation in the S&P 500 Index options. It is not possible to invest directly in an index.

The impact of COVID-19, and other infectious illness outbreaks that may arise in the future, could adversely affect the economies of many nations or the entire global economy, individual issuers and capital markets in ways that cannot necessarily be foreseen. In addition, the impact of infectious illnesses in emerging market countries may be greater due to generally less established healthcare systems. Public health crises caused by the COVID-19 outbreak may exacerbate other pre-existing political, social and economic risks in certain countries or globally. The duration of the COVID-19 outbreak and its effects cannot be determined with certainty.

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