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WHAT MIGHT TRUMP THE ELECTION YEAR PATTERN?

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KEY TAKEAWAYS

Markets do not like uncertainty, and Trump undoubtedly brings that to the table.

Election years are historically good for stocks, though with some volatility until the market gets clarity.

We may benefit from the typical late election year rally as the macroeconomic and earnings backdrops improve.

This week we look at what the upcoming presidential election may mean for markets in 2016.

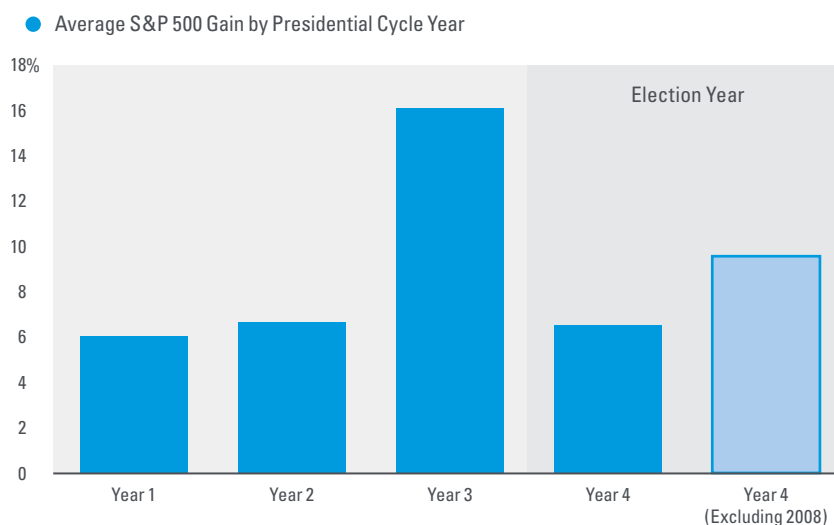
Following last week's somewhat surprising news that both Ted Cruz and John Kasich had withdrawn from the race, Donald Trump will be the Republican presidential nominee. Given that Trump has no formal policy record or political experience of any kind, this election cycle is, needless to say, unusual. Markets do not like uncertainty, and Trump undoubtedly brings that to the table.

Although stocks may be more volatile between now and November as market participants size up Trump and assess his chances against presumptive Democratic nominee Hillary Clinton, we believe the typical election year stock market pattern, our assessment of the more likely potential outcomes in November, and the macroeconomic backdrop all still suggest modest gains for stocks in 2016.

ELECTION YEAR PATTERN

Election years have historically been good for stocks, though not as good as year three [Figure 1]. Year three (the pre-election year) has been the standout performer since 1950, with only one down year out of 17 (flat in 2011 and -0.7% in 2015) and

1 YEAR FOUR HAS BEEN GOOD FOR STOCKS, 2008 ASIDE



Source: LPL Research, FactSet 05/06/16

Study covers 16 election cycles back to 1952.

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

an average S&P 500 gain of 16%. Election years (year four) have also been good, especially excluding the anomaly in 2008, with gains averaging near 10% (better than we expect stocks to deliver in 2016), and positive returns in a solid 87% of years. Since 1960, the only down election years were 2000 and 2008, when the U.S. economy was either sliding into recession or already in one. Bottom line, election years have generally been good for stocks.

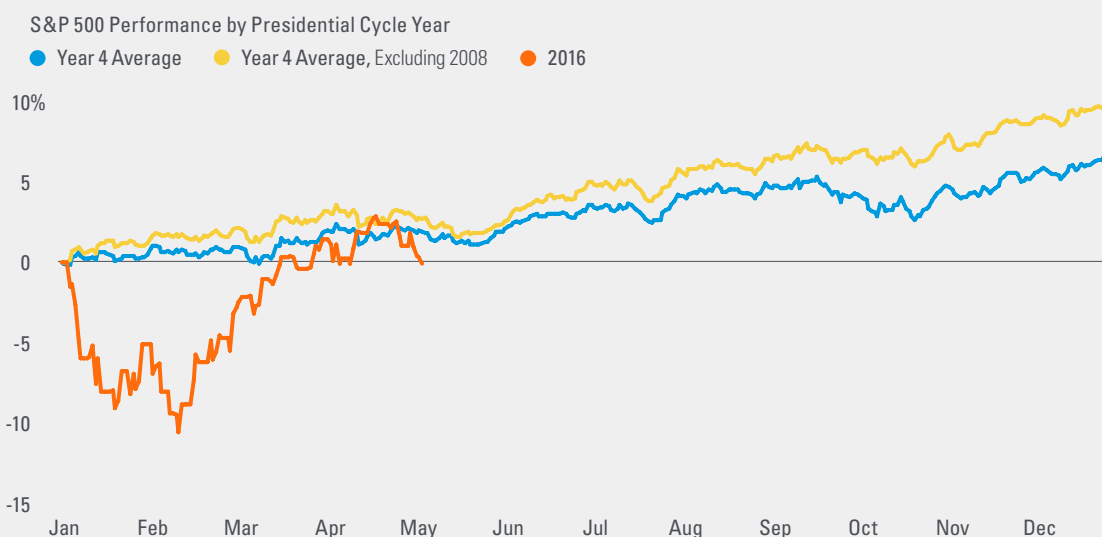
Gains during election years are encouraging, but the path to those gains has historically been volatile. The volatility at the start of 2016 was certainly extreme, but the election year pattern for stocks suggests volatility may persist through the summer months until markets have more clarity on the candidates and their platforms [Figure 2]. Once that clarity arrives, often before the election itself, stocks have typically staged a late-year rally, similar to most years (discussed in our [“sell in May” commentary last week](#)).

Though it’s not official—a third-party run is still technically possible—we assume a Clinton-Trump race at this point (even the odds of a Sanders nomination at this point are not zero). Although the nominees are largely locked in, there is still a lot of uncertainty to clear up in terms of the candidates’ platforms, especially Trump’s, which could lead to market volatility and potential buying opportunities.

We would not take the market’s relatively calm response to Trump’s ascension to the top of the Republican Party as a sign of comfort with the idea of him in the White House; rather, we think it’s more a function of the amount of time between now and November. Also keep in mind that some of Trump’s most controversial proposals during primary season, such as mass deportation of illegal immigrants, will not get through Congress and do not warrant a market reaction. Last, early polling (with an emphasis on early) suggests that Clinton would defeat Trump. Like her or not, Clinton has a long public track record and does not bring the same policy uncertainty.

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PRESIDENTIAL CYCLE PATTERN SUGGESTS VOLATILE SUMMER AND LATE-YEAR RALLY



Source: LPL Research, FactSet 05/05/16

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IS GRIDLOCK GOOD?

The oft-cited market mantra “gridlock is good” suggests that a split Congress, or a President from the opposite party in control of both houses of Congress, would be better for markets. We acknowledge leadership in Washington is only one piece of the story. Historically, the combination of a Democratic President and split Congress has been best for markets, with an average gain of 10.4% for the Dow Jones Industrial Average [Figure 3]. However, that combination has only occurred during the 2010–2014 period (3.5% of all periods), so take those stats with a big grain of salt. Still, this outcome is perhaps the most likely, because—barring a blowout win for Clinton, which could tip the House into Democratic hands—we expect the House to stay Republican and the Senate to follow the White House, where Clinton is currently the favorite. A Republican sweep of the White House and Congress, also a realistic possibility at this point and a fairly common outcome historically (22.6% of periods), has been positive for stocks as well, with an average gain for the Dow of 7%.

3 STOCK MARKET PERFORMANCE UNDER PRESIDENTIAL AND CONGRESSIONAL PARTY COMBINATIONS

	% Gain/Annum	% of Time
Democratic President, Republican Congress	8.6	9.8
Democratic President, Split Congress	10.4	3.5
Democratic President, Democratic Congress	7.2	34.7
Republican President, Republican Congress	7.0	22.6
Republican President, Split Congress	-4.3	10.5
Republican President, Democratic Congress	2.4	19.1

Source: LPL Research, Ned Davis 05/05/16

Dow Jones Industrial Average data back to 1901.

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It's also worth noting that stocks have tended to do better when the incumbent party wins the White House. With Clinton ahead in the polls at this point, one could view that as a positive sign. President Obama's approval ratings have been edging higher recently, which also factors in. But the theory says that the incumbent party wins when the economy is performing well. One could argue, quite rationally, that the economy is disappointing and that Clinton's lead in the early polls is more a function of Trump's higher disapproval ratings than an endorsement of the economy. In other words, we are not sure that a Clinton victory should necessarily be viewed as positive for stocks because of party continuity.

INITIAL POLICY THOUGHTS

A policy discussion at this stage requires a big disclaimer. It is very early. We have little information about Trump's policies. Any policy discussion at this point is speculation. That said, ironically, Trump's and Clinton's stances on several key issues are surprisingly similar:

- Budget deficit and entitlement reforms.** Neither candidate seems to have expressed much concern about the federal budget, including entitlement reforms such as raising the age for social security and Medicare. By not aligning with the conservative movement on this issue and avoiding the controversial topic, Trump may fare better in the general election. And Trump's business record certainly suggests he is comfortable with debt.
- Drug pricing.** Both candidates have expressed support for the government to negotiate drug prices directly with drug companies for the Medicare and Medicaid programs to help control healthcare costs. The issue of high drug prices has been a political hot button, but prices are likely to remain largely in the manufacturers' hands regardless of who wins the White House in November.

- **Foreign trade.** Trade policy has been a major issue in both parties' selection process. Trump has made his distaste for current trade policy well known, calling for higher tariffs and other restrictions, particularly with respect to Mexico and China, to get "better deals" for the U.S. Clinton has officially denounced the Trans-Pacific Partnership and as a member of the U.S. Senate, voted against the Central American Free Trade Agreement (CAFTA), which effectively extends the NAFTA agreement to Central American nations.
- **Infrastructure spending.** Both candidates have supported, at least conceptually, the idea of spending money on public works projects such as fixing roads and bridges to help stimulate the economy and increase employment. In what has in recent years been more of a Democratic position than Republican, the tailwind behind infrastructure spending may get a bit stronger next year.
- **Tax reform.** At times, both candidates have supported higher tax rates. There does appear to be genuine, and relative bipartisan agreement, on many aspects of the tax code, especially on lowering the corporate tax rate, limiting deductions, and eliminating loopholes. Trump and Clinton are both in favor of eliminating carried interest, an exemption that allows hedge fund and private equity managers to pay low long-term capital gains rates on the majority of their compensation. We expect that regardless of who wins, some changes to the tax code will occur.

We are not saying these candidates are the same, even on these issues. Both candidates will refine their policy proposals as the election nears; both have also shown some flexibility on issues due to political considerations, while the rise of populism will likely have more influence. And certainly Congress will have a lot to say about legislation. It's going to be a very interesting six months.

CONCLUSION

Markets do not like uncertainty, and Trump is certainly unpredictable. But election years are historically good for stocks. Although more volatility may lie ahead, we could potentially benefit from a late-year rally as the macroeconomic and earnings backdrops improve. So even if the headlines from the campaign trail lead to pullbacks or corrections between now and November, more likely than not, we would view them as buying opportunities. ■

Thank you to Ryan Detrick and Matthew Peterson for their contributions to this report.

Note: Liberals, conservatives, Democrats, Republicans, and even a libertarian contributed to this bipartisan report.

IMPORTANT DISCLOSURES

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Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Dow Jones Industrial Average Index is comprised of U.S.-listed stocks of companies that produce other (non-transportation and non-utility) goods and services. The Dow Jones industrial averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors, and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore, their component weightings are affected only by changes in the stocks' prices.

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