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2014 U.S. Midterm Elections: A Win for Stocks?

With the 2014 U.S. midterm elections behind us, investors wonder what the political gridlock will mean for the markets. If we consider historical trends and recent earnings, we could actually see a prolonged bull equity market.

Unless you have been living under a proverbial rock for the past few weeks (though unlikely if you are reading this), you know that the midterm elections in the United States saw a Republican sweep, with enough senatorial seats gained to take control of the Senate, more seats added to their majority in the House, and a few extra governorships picked up along the way.

Investors, of course, immediately began to ask what the implications might be for markets. That can seem like a variant of “yes, but what does this have to do with me” question. Investors can often be faulted for trying to game out market moves from real world events that should matter on their own right, from wars to disease (hence those tone-deaf television segments about “stocks to own after an oil spill” or “which companies benefit from ISIS?”). Still, politics matter to markets because they can shape the regulatory and legislative framework that impact businesses, and hence why so many of us are so quick to look at what the potential effects of the midterms on stocks, bonds, interest rates, wages, and earnings.

What goes up may not go down

The short answer is that stocks have done extraordinarily well in the one and two years following midterm elections, and since 1970, with the exception of the two years post-2006 (which encompass the beginning of the financial crisis of 2008–2009), U.S. equities have never gone down. The average gain in equities since 1901 is in the high single digits.

Zachary Karabell
Head of Global Strategy
Envestnet, Inc.

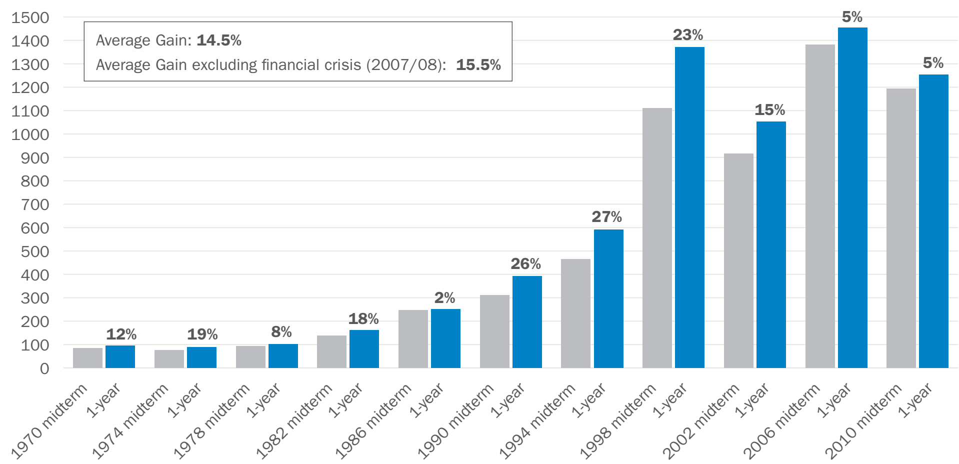
It would be hard to find a stronger trend. Since the 1970s, in the one year following midterm elections, stocks are up an average of 14.5% (Figure 1). For the combined two years, the average is 24.9% (Figure 2). If you take out the declines of 2008, the average is 30%. Going back even farther, the averages are only slightly less gaudy.

You would be hard pressed to find a more powerful pattern. And it holds, as Standard & Poor's helpfully charted, regardless of whether there is a split Congress, a unified Congress under one party with a president in the White House of a different party, or a unified Congress and a White House controlled by the same party (Figure 3). Stocks went up the one and two years following.

Especially relevant for the next two years: the best scenario for equities has been when there is a unified Congress under the Republican Party and

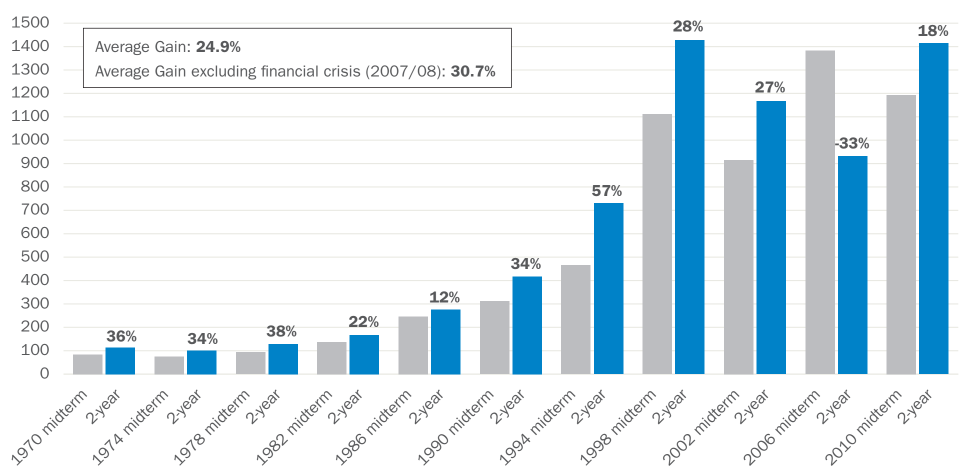
Stocks have done extraordinarily well in the one and two years following midterm elections. There is no historical pattern for bonds.

Figure 1:
Gains in S&P500 one year after midterm elections



Source: Bloomberg

Figure 2:
Gains in S&P500 two years after midterm elections



Source: Bloomberg

a White House controlled by a Democrat. That is what we will have for the next two years, and since 1945, that has been true for just eight years. But those eight years have averaged 15.1% equity market returns.

The pattern is less clear for bonds. In fact, there isn't one. The past precedent for equities is strong. The past precedent for bonds doesn't exist.

What the next two years might hold

It's a powerful equity pattern. That doesn't mean it will hold, of course, and nowhere does the line "past performance is no guarantee of future results" hold more true. Just because something went up in the past in certain conditions in no way means that it will again in the future.

But this unusually strong past pattern does support other arguments for why equities might continue their run of the past five years.

Take third quarter earnings, which the bulk of companies have recently reported. According to FactSet, earnings grew by over 7%, rather more than expected, and revenue grew more than 4% for the companies of the S&P500, and those numbers were higher still if the negative drag of the consumer discretionary sector is taken out. That compares to national GDP growth in the U.S. of less than 2.5% and not substantially more than that globally. Even without central banks in the equation (which they are, but not as much perhaps as many investors appear to believe), it should not be so surprising that stocks are doing well in the U.S. and sovereign bonds are still at very low yields.

But it is still curious why equities have been strong so often after midterm elections through radically different periods economically and historically. One reason could be that investors have a chemical (and at times immature) aversion to uncertainty, and looming elections are a recipe for uncertainty. Who will win? What will they do? Faced with that unknown, many investors hedge their bets, or wait until the election is settled. Then, once the outcome is clear, any outcome, they begin to return to the market and look for opportunities.

It also may be that investors get just as distracted by the noise of elections as the media and the chattering classes. That noise can obscure and distort how other, non-political information gets filtered. Of course, in U.S. midterm elections, not many people actually vote. This time, about 36% of the electorate voted, and of those, 52% voted Republican, which meant that the winning party won with 18% of the eligible vote. That is hardly unusual for the midterms. Even so, political news dominates in the month before, along with the usual hyperventilating hyperbole. Perhaps that weighs on investing decisions in incalculable yet tangible ways.

Figure 3:
Stock performance (S&P500) during U.S. political unity and gridlock

	1901–2014		1945–2014	
	% Change	# Years	% Change	# Years
Unified Government	7.6%	66	10.9%	28
> Democratic President	8.4%	38	9.8%	22
> Republican President	6.4%	28	15.1%	6
Unified Congress	6.2%	34	7.6%	30
> Democratic President	8.6%	12	15.1%	8
> Republican President	4.9%	22	4.9%	22
Split Congress	6.0%	14	6.7%	12
> Democratic President*	13.0%	4	13.0%	4
> Republican President	3.2%	10	3.5%	8
All Years	**7.0%**	**114**	**8.8%**	**70**

* 12/31/2010 to 10/31/2014
Source: Standard & Poor's Equity Research. Chart shows S&P500 calendar year percentage changes during selected periods from 12/31/1900 to 10/31/2014.

As for why stocks then do better with a split government characterized by a Democrat in the White House and a Republican Congress—that will have to remain unanswered, especially given that it has only been true for a grand total of eight years.

What might lie ahead

Given the particular dynamics of this period, it is difficult to see how much might change in Washington itself as a result of the recent election. As many have noted, this group of Republicans and the particular Democrat in the White House do not seem eager to find common ground for needed legislation. The picture in state house and state governments is less grim, but what will happen is more of a state-by-state story than a national narrative that has explicit or clear investing implications.

There are three areas cited as propitious for some action: movement on negotiating stalled

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trade pacts such as the Trans-Pacific Partnership; movement on U.S. domestic energy regulations including authorization for the much-debated Keystone Pipeline from Canada to the Gulf of Mexico; and a revision of the corporate tax code that would see the overall rate decrease to be more in-line with international averages and a closing of loopholes that would result in more overall corporate tax being collected.

Also mulled but in our view much less likely are some movement on immigration reform and meaningful changes to the Affordable Care Act (a.k.a Obamacare). And even in the three areas above where the chances of movement appear decent, the sheer partisan and acrimonious climate of contemporary Washington may just preclude even that.

We are left, then, with a static and locked political scene with a key element of uncertainty removed. While it is unclear whether the federal government will act incrementally on the issues, it is clear that the federal government is not about to enact sweeping new taxes, expansive new regulations, or innovative new approaches to the continued challenge of wages and jobs. As a result, investor and market attention will and should focus primarily on whether companies are delivering sustainable financial returns, led by skilled management and driven by growing end-markets.

On that score, markets are at the least poised to continue the trends of the past years, with low rates (perhaps not as low as the Fed likely begins raising short-term rates sometime in 2015) and strong earnings. While this bull market has been robust since mid-2009, we should not forget that since 2000, equities have hardly been on a bull run, with the Nasdaq still below its all-time high set in March 2000 and the other indices only a tad above that. Multiples are hardly egregious, and as mentioned, rates are low.

Past performance and past trends are not at all a guarantee of future trends. But for the next two years, it is difficult to make the case that the trend of past midterm elections will be broken. As long as the global financial system does not encounter a crisis, equities seem likely to continue their rise, as they have in all but one case after midterms over many, many decades.

Advisor Take-Away:

Knowing that politics matter to markets, what's to expect from the recent midterm elections? History has shown repeatedly that stocks do very well in the one and two years following midterms. Furthermore, stocks have done best under a Democratic White House with a unified Republican Congress—which is what we will have for the next two years. Of course *past performance does not guarantee future results*, but if history repeats itself, we could be in for a continued bull equity market. Rather than rely on this however, investors should continue to focus on fundamentals and make decisions based on whether companies are delivering sustainable financial returns, led by skilled management, and driven by growing end-markets.