

Tales From the Emerging World

## The Stock Market Is Not Partisan

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If you have the financial TV news on while working from home, you might be led to believe that recent volatility in the market is a product of growing fear that the election outcome will be disputed or delayed, or that a win for the Democrats would bring socialists into the White House.

AUTHOR



**RUCHIR SHARMA**

*Head of Emerging Markets and  
Chief Global Strategist*

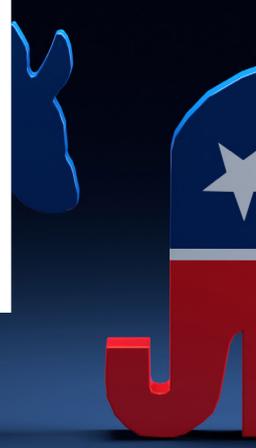
If you listen to history, however, the volatility doesn't look so unusual. The available records go back to the election of 1928 and since then, in the three months before the vote, the median increase in volatility was 15 percent. For the same period this year (through October 6), volatility is up 20 percent, well within the normal range.<sup>1</sup> 2020 just feels crazier than a normal election year in the markets.

The other prevailing assumptions about how the market is responding to the elections are equally questionable. Our view has always been that the stock market is primarily a barometer of economic activity: It reacts to elections only in so far as the winner is likely to change the course of the economy. The market tends to lose momentum when incumbents hang on to power and gain momentum when challengers rise to power, offering hope for change—regardless of their party affiliation. In short, history casts doubt on the assumption that the stock market is ideologically partisan.

Going back to 1869, the dawn of the modern two-party system, the average stock market return over the course of a four-year presidential term was 52 percent under Republicans, compared to 68 percent under Democrats—and that edge has widened a bit since World War II.<sup>2</sup>

<sup>1</sup> MSIM, Bloomberg, Haver, Global Insight. Historical data is from 1928-2016. Volatility is measured using the Volatility Index (VIX).

<sup>2</sup> MSIM, Global Financial Data, Haver, Global Insight. Analysis includes data from 1869-2016 and 1952-2016. Market returns are measured using the S&P 500 Index. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.



Again, our view is that this finding casts doubt on the assumption of Republican bias, not that it confirms a preference for Democrats. The difference in market performance is less well explained by partisan politics than by economic fundamentals, which have tended to be significantly better under Democrats.

Over the course of full presidential terms, median real global GDP growth was 2.9 percent a year under Republicans, 3.4 percent under Democrats—who can hardly take credit for worldwide economic conditions.<sup>3</sup> Real U.S. GDP growth shows a similar edge for Democrats.<sup>4</sup> Inflation also tends to run lower, unemployment tends to decrease rather than increase, and the dollar tends to strengthen more under Democrats.

Presidents can influence but do not determine these fundamentals, which would likely have driven stocks higher under Republican presidents too, had the parties traded terms in power.

Economic uncertainty can foment market volatility, which has accordingly

been more pronounced during Republican administrations. Since World War II, the Dow Jones Industrial Average has fallen by 10 percent or more over the course of a year only nine times, six of those during a Republican administration. It has risen more than 20 percent over the course of a year a total of 17 times, 12 of those also under a Republican.<sup>5</sup>

Broadly, we think markets are less ideological than instinctive. They tend to lose energy the longer incumbent leaders stay in power. Since the 1860s, nine U.S. presidents have lasted two terms. All but one of them (Ronald Reagan was the exception) saw higher market returns in their first term than in their second, often much higher.<sup>6</sup> First-term returns averaged 83 percent, second-term returns just 28 percent. This finding is consistent with research on the “second-term curse,” which shows that underlying economic conditions also tend to decline in a president’s second term.<sup>7</sup>

On the other hand, markets tend to do very well when a newcomer comes

to power. This effect is quite strong in emerging markets, where leaders face few checks on their power, and newcomers can have an immediate and profound impact on the direction of the economy.

More surprisingly, it is also true in the United States, where institutional checks on the president are much stronger. Since 1869, incumbent presidents have sought a second term a total of 16 times.<sup>8</sup> When the challenger won, market returns over the next four years averaged 77 percent, more than double the returns after an incumbent won.<sup>6</sup>

So if the markets have any political bias, it is a general hostility to incumbents and a preference for challengers, regardless of party. In 2020 this is likely to translate into a relatively calm reception—should he win—for Joe Biden, despite the socialist rhetoric of many of his supporters.

The talk on Wall Street points the same way. Though some sophisticated investors are expressing concern over the rise of democratic socialism in the United States, most seem to expect that Biden would govern as a moderate. He would raise some taxes and restore some regulations that Mr. Trump cut, but he would also decrease tensions over immigration, global trade and China. That mix, many say, would have some effect on which economic sectors do best during a Biden presidency, but little effect on the market’s overall direction.

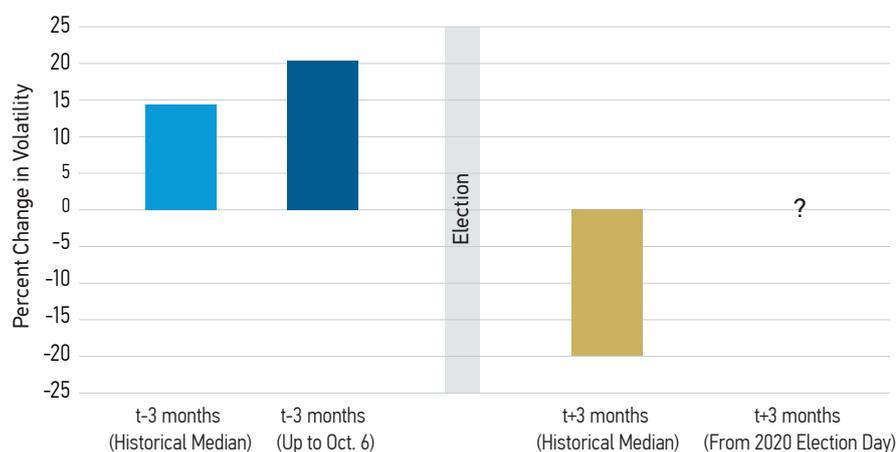
More important, the market now cares less about who occupies the White House than who leads the Fed. Low interest rates have been turbocharging stock prices for years. The U.S. stock market is currently more expensive than at any time other than the dot-com bubble of 1999 to 2000, according to some measures.<sup>9</sup>

What happens next in the market depends more on the direction of the economy and on interest rates than on what happens on Nov. 3. If over the coming months the economy keeps

## DISPLAY 1

### A Normal Case of Nerves?

Market volatility typically rises before elections and falls afterward. This year is typical, so far.



Source: MSIM, Bloomberg, Haver, Global Insight. Note: Historical median includes change in volatility for the three months before and after presidential elections going back to 1928. From 1928–1986, volatility was measured using S&P 500 index and from 1986–2016, volatility was measured using the Volatility Index (VIX). The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

<sup>3</sup> MSIM, Bloomberg, Factset, Haver. Analysis includes data from 1957-2016.

<sup>4</sup> MSIM, Haver. Analysis includes data from 1957-2016.

<sup>5</sup> Ned Davis Research.

<sup>6</sup> MSIM, Global Financial Data, Haver, Global Insight. Market returns are measured using the S&P 500 Index.

<sup>7</sup> MSIM, Bloomberg, Factset, Haver, Global Financial Data.

<sup>8</sup> Incumbents were defined as Presidents who ran again immediately following their first elected term and were in power for at least 5 years in the 2-party era.

<sup>9</sup> MSIM, Bloomberg, Factset, Global Insight. October 2020. U.S. stock market returns are measured by the MSCI U.S. Index.

recovering, long-term interest rates could start to rise rapidly in anticipation of a future Fed rate hike. In that event the market could actually decline—a mirror image of this year’s market boom and economic bust.

Many traders, eager to see the market rally continue, are arguing that if Mr. Biden wins he will bring in leadership at the Fed that will be even more aggressive about keeping interest rates low. That’s another reason Wall Street isn’t too worried about a win for the left-leaning Democrats: It is focused

on the next round of stimulus, more than the next president. With polls now showing a higher probability that the Democrats could sweep the White House and both houses of Congress, that in turn raises the likelihood that the new administration can quickly pass a multi-trillion dollar stimulus bill.

What does all this mean for emerging markets? If a Democratic victory leads to even more monetary and fiscal stimulus, one predictable result is rising U.S. deficits and debt, leading to higher inflation, and a weaker dollar. And a

weaker dollar is typically a boon for emerging stock market returns.

In the coming weeks, an unprecedented battle over the election results could still trigger an unusual reaction in the markets, but the normal pattern is clear. Our research shows that after spiking in the three months before the vote, market volatility typically fades rapidly in subsequent months. With so many other uncertainties looming amid a global pandemic, that doesn’t necessarily foretell a return to normal. Just one less source of craziness.

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