ON OUR MINDS

The Presidential Election: Economic and Investment Issues

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Markets have been remarkably calm over the past couple of weeks, despite an onslaught of news stories that might have shocked investors in any other year. After a tumultuous presidential debate, a major Covid-19 outbreak at the White House that infected the President and two dozen advisors, a civil but barbed vice presidential debate, and the on-again, off-again collapse of negotiations on a new stimulus bill – after all of that, the bond market has barely budged, and the stock market has edged its way back toward its recent record highs.

Yet these events were still important, not least because they may sway the outcome of the national election three weeks hence. So why are the markets so calm? Even the CBOE Market Volatility Index – the so-called VIX "fear gauge" – has held steady in the mid-20s ever since midsummer (Chart 1). While that's higher than the index's pre-pandemic mid-teens readings, it is still well within the historical range for "normal" times. In other words, investors just do not see much reason to be terrified today.

Chart 1: CBOE Market Volatility Index

Source: StockCharts.com

Seemingly oblivious to the market's calm, Wall Street pontificators have been flooding my inbox recently with all manner of hyperbolic commentary, most of it focusing how they think markets will react to various election outcomes. But I think these analyses, for all their impressive statistical wizardry, miss the basic point: Markets are already telling us that investors are comfortable with what they see ahead for the election and its aftermath.

Four years ago, we had a symmetrical election, without an incumbent seeking another term. Both candidates in that campaign had staked out clearly defined legislative and executive branch agendas. That framework is not the case today. In this election, the incumbent is playing defense: He does not need to create a new agenda, since the ballot is essentially a referendum on his performance in office thus far. The challenger, on the other hand, must articulate an alternative agenda and persuade voters that his program will be better for America; he must play offense.

This dynamic is evident in the way each candidate has appealed to voters: On economic issues, former Vice President Biden has attacked the Trump record and advanced a detailed set of action items. President Trump has defended his economic record, but he has not offered many specifics about what he might want to accomplish in a second term. Most of his campaign rhetoric, at least regarding the economy, sounds much like Alice Cooper's:

> *I'm top prime cut of meat, I'm your choice*
> *I'm a Yankee Doodle Dandy in a gold Rolls Royce*
> *I wanna be re-elected!*

A side-by-side comparison of the two candidates' views isn't a purely conjectural exercise, as it had been four years ago. President Trump's agenda is already the base case; markets must focus instead on Mr. Biden's plan and evaluate how much of it he could realistically implement if he is elected. The table below summarizes both candidates' views on individual taxes:

	Joe Biden	**Donald Trump**
Individual Taxes	• Raise top bracket to 39.6% (was 43.6% until 2017)	• Extend 37% top rate beyond 2025 expiration
	• Retain $137,700 ceiling on Social Security taxable income, and reinstate tax on incomes over $400,000	• Reduce payroll taxes, but no detail about how to fund Social Security
	• Raise long-term capital gains tax to 39.6% for incomes over $1 million; retain at current levels for all others; eliminate basis step-up rules for inherited assets	• Retain current long-term capital gains tax at 15%
	• Eliminate $10,000 limit on itemized state and local tax deductions, and introduce refundable tax credit of up to $15,000 for first-time home buyers.	• Retain $10,000 limit on deductions for mortgage & home equity interest and state and local taxes.

The Trump plan is essentially to retain the current tax law. Biden's plan charts a partial return to Obama / Clinton ideas, focusing more on redistribution than on overall revenue levels. Three of the Biden proposals – regarding the top bracket, capital gains, and Social Security taxes – would affect only the highest-earning families. Taxes would not rise for anyone earning less than $400,000. The SALT and first-time homebuyer credits, among others, would offset some of the higher tax burden on upper-income brackets.

The total tax increase on individuals, net of additional credits and deductions, would be about $1.5 trillion over ten years.[1] Nearly two-thirds of that total – $962 billion – would come from reinstituting the Social Security tax on incomes over $400,000; the elimination of capital gains rates for incomes over $1 million would raise another $448 billion. The increase in the top rate to 39.6% would raise a comparatively tiny $143 billion. Whether any of these tax changes could be enacted in the current political climate is an entirely separate question, to be addressed below.

Shifting to corporate taxes, the table below notes the key points of the Trump and Biden plans:

	Joe Biden	**Donald Trump**
Corporate Taxes	• Raise corporate income tax from 21% to 28% (was 35% under Obama,); impose minimum 15% tax on GAAP income	• Retain current rate of 21%
	• Create 10% "offshoring penalty tax" on profits from goods or services imported to the U.S.	• Create tax credit for companies onshoring jobs from China
	• Reinstate Obama tax breaks for electric cars and other items that reduce emissions; repeal fossil fuel drilling and depletion tax deductions	• Preserve existing fossil fuel tax deductions

Both Trump and Biden want to use the tax code to create incentives for companies to bring previously offshored manufacturing and services jobs back to the United States. But their agendas are otherwise starkly divergent. Biden wants to use tax and regulatory policy to encourage development of alternative energy sources, while Trump has done exactly the opposite, favoring fossil fuel extraction in his tax and regulatory regime. The total dollars aren't likely to be large, but the competitive balance among different energy sources would clearly be affected by the outcome of the election.

The biggest single number in Biden's tax proposal is the corporate income tax rate. He argues that the 21% rate implemented in 2017 went too far, and that a 28% corporate rate would not place American companies at a competitive disadvantage against global firms. This increase would generate about $1.3 trillion over ten years. The "alternative minimum tax" (i.e., the minimum 15% tax on "book" income as reported under Generally Accepted Accounting Principles) would raise only $166 billion over ten years from companies that otherwise would pay little or no taxes. Raising taxes on foreign subsidiaries of U.S. firms (the offshoring penalty tax) would generate another $309 billion over a decade.

[1] All figures cited here come from the nonpartisan Tax Policy Center. Independent calculations from other nonpartisan groups, including the Penn Wharton Budget Model and the Congressional Budget Office, produce similar numbers. Organizations that typically lean Republican or Democratic show minor variations in the calculations but are still reasonably close in aggregate.

The corporate tax provisions have attracted intense interest among Wall Street analysts concerned about how they would affect the profits of individual companies; the emerging consensus is that raising the corporate tax rate to 28% (and implementing a corporate AMT) would dent S&P 500 earnings by about 5% to 12% in the year implemented.[2] The impact would be larger on capital-intensive industries that depreciate their fixed assets more quickly for tax purposes than they do for GAAP accounting; this includes many technology, industrial, and communications infrastructure firms.

Beyond taxes, neither candidate has provided many specific economic proposals. The following table summarizes their proposals:

	Joe Biden	**Donald Trump**
Spending Plans	• Expand Obamacare subsidies and establish public option	• Repeal Affordable Care Act, but no replacement proposed
	• "Lite" Green New Deal including $1.7 trillion for rebuilding transportation infrastructure, universal broadband access, 5G wireless, alternative energy sources, energy-efficient buildings, sustainable agriculture	• Unspecified major infrastructure legislation (probably over $1 trillion)
	• Free public college for all families with income under $125,000; two years of community college without debt; increase support of public schools, teachers, and HBCUs	• No comparable proposal
	• Expand Social Security benefits, reform drug pricing, expand Medicaid	• Reform drug pricing

In his debate with President Trump two weeks ago, Biden disavowed the Green New Deal sponsored by Senator Ed Markey and Representative Alexandria Ocasio-Cortez. Yet his own plan isn't very different: The dollars and ambition are smaller but directionally aligned. Compared with the Markey/AOC plan, the Biden plan focuses more closely on projects with high GDP multipliers, giving it more credibility as a jobs creator. Still, the Biden plan – including $2 trillion in spending – is largely aspirational but not practical: He talks of building critical infrastructure; he hopes to add a million automobile industry jobs and to upgrade four million buildings with energy-efficient technology; he would like to see zero-emission public transit in every American city with over 100,000 population. But he has not yet described how exactly these objectives can be brought to fruition. President Trump, for his part, has been touting a big infrastructure bill consistently for four years, but he has nothing yet to show for it.

[2] The 2017 Tax Cuts and Jobs Act similarly boosted S&P 500 EPS by about 10% in the first year, and then had essentially no impact thereafter. The Biden plan would, in a sense, restore EPS to their pre-2017 trajectory.

Indeed, the biggest question facing markets today is just how seriously investors should take *any* of Biden's or Trump's economic ideas. The political climate probably won't be any less toxic in 2021 than it is today; neither side has much interest in helping the other achieve bipartisan success in addressing America's challenges.

At a national level, there are five possible outcomes from next month's election:

- Trump wins, and Republicans hold the Senate (status quo)
- Trump wins, but Democrats take the Senate (split government)
- Biden wins, but Republicans hold the Senate (split government)
- Biden wins, and Democrats take the Senate (blue wave)
- Inconclusive or disputed results (constitutional crisis)

Of these five possible outcomes, the first three are well understood by investors. The status quo outcome wouldn't change anything, and markets would soon turn their attention back to anticipating the trajectories of the Covid-19 pandemic and the economy's recovery. The two split-government outcomes are also unlikely to cause much worry: Gridlock means that the regulatory and legal framework will remain stable, so investors can focus on individual companies' outlooks. Markets have historically done well in split-government years.

It is the last of the possible election outcomes that scares investors most, and yet it shouldn't. There are all sorts of permutations of how the election might be disputed and how the ensuing fracas might play itself out; as a general guess, one could surmise that stock markets might initially drop and Treasury bonds might rally in a flight to safety, but eventually the disputes would be resolved and *someone* would wind up as the President. In that interval, companies will sell goods and services, consumers will buy things, and the prospect of a Covid-19 vaccine may draw nearer; the markets will ultimately reflect these realities. Thus, aside from a short interlude of perhaps a few weeks or months, markets can safely ignore the fear of a disputed election.

Finally, some investors are also concerned about the possible market impact of a "blue wave" election in which Democrats win the Presidency and control of the Senate. The raw numbers of Biden's tax and spending proposals are certainly daunting (perhaps less so in an era of trillion-dollar Covid-19 bills). But a blue wave is not a blue tsunami: It is inconceivable that Democrats could gain a 60-vote filibuster-proof chokehold on the Senate this year.

Without a 60-vote supermajority, several features of the Biden agenda will be dead on arrival in the Senate. Most notably, any changes to Social Security – retirement age, benefits, or taxes – will be off the table. Likewise, the proposed changes to capital gains taxes would most likely be impossible to enact.[3] Conversely, Biden probably does have a good chance of pushing through a higher corporate tax rate, and he should get broad support for those aspects of his plan that actually reduce taxes (changes to the SALT deduction caps, for example). And even if the tax side of his plan is severely compromised, he may still find bipartisan support for an infrastructure spending bill – particularly one that doesn't lean too heavily on Green New Deal ideas.

[3] Capital gains have been taxed at lower rates than ordinary income for decades; the last time that capital gains rates were as high as 39% was during the Carter administration.

If the Republicans retain control of the Senate, almost all of Biden's tax proposals can be flushed into the Tidal Basin. His spending priorities – on infrastructure, especially – may yet be enacted, if Republicans in Congress see it in their interest to deliver massive projects to their districts. The beauty of infrastructure spending is that it carries a high multiplier effect; that is, they are job creators that recirculate money through the economy many times as contractors hire workers, purchase materials, hire subcontractors, and so on. As with both Republican-led and Democratic-led Congresses of the recent past, the knotty problem of how to pay for these spending programs would likely be left to another day. Because these programs would have a powerful positive effect on GDP, it's theoretically possible that they may come close to paying for themselves in increased income tax revenues over time.

Biden can also exert significant influence on the economy through the executive branch, regardless of which party is in control of Congress. If elected, he would likely attempt to reverse most of President Trump's deregulatory agenda, especially with respect to fossil fuel extraction. New regulatory dockets would likely also encourage use of alternative fuel sources and green construction materials. The energy industry, more than any other, will look very different in a Biden world than in a continuation of Trump's administration.

Technology companies may also face a different reckoning in a Biden presidency than if Trump is reelected. If Biden wins, look for more antitrust scrutiny over the FANMAG companies that dominate the stock market today, although a mostly Republican judiciary would make it difficult to enforce any structural overhaul of these companies; the most that Biden could hope would be to effect superficial or behavioral change. Technology companies may also face increased regulatory scrutiny regarding cybersecurity, foreign interference, and trade policy.

It may seem unfair to focus so much on the possible implications of a Biden presidency, without devoting equal attention to the Trump agenda. In an asymmetrical election, however, this is necessary: We already know President Trump's economic and tax policy, and it's doubtful that much would change in a second term. Further, even ignoring recent polls showing Biden ahead, it has consistently been the challenger's agenda that has been driving the market conversation.

Ultimately, the reason that markets have been calm lately is that they are – correctly, in my view – recognizing that any possible outcome of the national election will probably result in only modest evolution of the current economic climate. Even in the "blue wave" scenario, it is highly doubtful that Democrats would be able to enact their most market-unfriendly ideas.

And even if the election's outcome remains uncertain for weeks or months of legal wrangling, the nation will still have a President and Congress in place by next January. No one knows with certainty today who will occupy those offices; likewise, no one can be sure what the President, Congress, or Federal Reserve will do next year – and no one can predict how markets will respond, either.[4]

[4] It's probably fair to suggest that the stock market's latest uptick, along with the slight increase in Treasury yields over the past week, are tied to a diminishing risk of a disputed election.

So while the inbox may be stuffed with investment advisers recommending this strategy or that one, based on their own expectations of how the election will play out, we have taken a different tack with our clients' portfolios. We don't recommend taking *any* action today in anticipation of a *possibly* adverse change that *might* occur next year; the result could be quite painful if the change doesn't occur, or if markets don't respond as anticipated.

To take one example of how markets often confound investors: Conventional wisdom holds that markets do better under "business-friendly" Republican Presidents, and President Trump frequently touts the stock market's strong performance in three of his four years in office. The historical record, however, shows the opposite to be true: Since the end of World War II and the emergence of the industrial U.S. economy, stock markets have posted average annual returns about four percentage points better under Democratic Presidents than under Republicans.[5] The chart on page 8 has full details of the historical record; it is an open question whether the next four years will extend or break the pattern.[6]

So go out and vote for your favorite candidate, and do so with an awareness that neither President Trump nor Joe Biden can unilaterally alter the long arc of the stock market's performance. For a short while, the outcome of the election may drive volatility in prices and corporate profitability. Over the full length of the next presidential term, though, the occupant of the Oval Office won't matter to stock prices as much as the progress we make toward a Covid-19 vaccine and toward economic recovery.

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[5] Since markets anticipate future economic well-being rather than reflect current conditions, it's not truly fair to assign credit or blame for stock performance to the party in power in any given year. But people often do so anyway.

[6] Analysts at Ned Davis Research have taken this analytical framework an additional step, measuring stock market performance in every combination of party control of the White House and Congress (Democrat President with Republican Senate, Democrat President with split Congress, and so on). Of the six possible combinations, the split-government regimes enjoyed the best stock market performance, though the differences among all six combinations were quite small. In addition, the sample sizes are small, rendering any conclusions essentially speculative. In other words, history really isn't a useful predictor of how markets will respond to any of the possible outcomes from the current election.

S&P 500 Performance by Party , 1946-2020

Year	Democratic President	S&P500 Return	Year	Republican President	S&P500 Return
1946	Truman	-11.90%	1953	Eisenhower	-6.60%
1947	Truman	0.00%	1954	Eisenhower	45.00%
1948	Truman	-0.70%	1955	Eisenhower	26.40%
1949	Truman	10.30%	1956	Eisenhower	2.60%
1950	Truman	21.80%	1957	Eisenhower	-14.30%
1951	Truman	16.50%	1958	Eisenhower	38.10%
1952	Truman	11.80%	1959	Eisenhower	8.50%
1961	Kennedy	23.10%	1960	Eisenhower	-3.00%
1962	Kennedy	-11.80%	1969	Nixon	-11.40%
1963	Kennedy	18.90%	1970	Nixon	0.10%
1964	Johnson	13.00%	1971	Nixon	10.80%
1965	Johnson	9.10%	1972	Nixon	15.60%
1966	Johnson	-13.10%	1973	Nixon	-17.40%
1967	Johnson	20.10%	1974	Nixon	-29.70%
1968	Johnson	7.70%	1975	Nixon/Ford	31.50%
1977	Carter	-11.50%	1976	Nixon/Ford	19.10%
1978	Carter	1.10%	1981	Reagan	-9.70%
1979	Carter	12.30%	1982	Reagan	14.80%
1980	Carter	25.80%	1983	Reagan	17.30%
1993	Clinton	7.10%	1984	Reagan	1.40%
1994	Clinton	-1.50%	1985	Reagan	26.30%
1995	Clinton	34.10%	1986	Reagan	14.60%
1996	Clinton	20.30%	1987	Reagan	2.00%
1997	Clinton	31.00%	1988	Reagan	12.40%
1998	Clinton	26.70%	1989	Bush	27.30%
1999	Clinton	19.50%	1990	Bush	-6.60%
2000	Clinton	-10.10%	1991	Bush	26.30%
2009	Obama	23.50%	1992	Bush	4.50%
2010	Obama	12.80%	2001	Bush	-13.00%
2011	Obama	0.00%	2002	Bush	-23.40%
2012	Obama	14.60%	2003	Bush	26.40%
2013	Obama	32.40%	2004	Bush	9.00%
2014	Obama	13.70%	2005	Bush	3.00%
2015	Obama	1.40%	2006	Bush	13.60%
2016	Obama	12.00%	2007	Bush	3.50%
			2008	Bush	-38.50%
			2017	Trump	21.80%
			2018	Trump	-4.40%
			2019	Trump	31.50%
			2020 YTD	Trump	7.63%
Annual Average		**10.86%**			**7.08%**

Returns show change in price during each calendar year, and exclude dividends.
Returns are not adjusted to reflect exact dates of change of party control.
Annual average is a simple mean of annual performance data. (Through October 9, 2020.)
Sources: Thomson Reuters, Morgan Stanley Research, FactSet