Portfolio Management, LLC

Building Wealth Wisely

Meet the New Boss
Same as the Old Boss

November, 2020

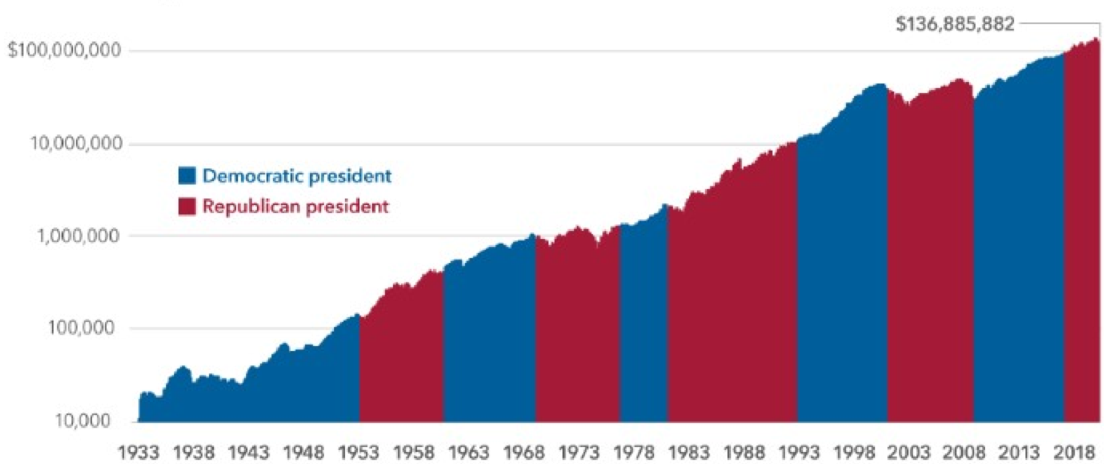
Many commentators proclaimed this month's election as the most important one in modern history. Given the mixed results so far, it looks like the impact will be more subdued than anticipated. While our firm continues to take a somewhat cautious approach with client portfolios, we believe investors have no reason to change their long-term plans.

Election season can be a tough time for investors to maintain a long-term perspective, given the strong emotions often evoked by politics. Campaign rhetoric tends to amplify negative and divisive issues. This election, in particular, has been unprecedented in modern times – marked by the combination of a serious pandemic, a global economic recession, political polarization, widespread civil unrest, and extreme market volatility.

Moving to the sidelines would have been an understandable approach for anxious investors. As history has shown, however, this is usually a mistake. What matters most are not election results but staying invested in a diversified portfolio that is properly designed to meet one's long-term needs and objectives. Stocks have tended to go up regardless of which party controls Washington.

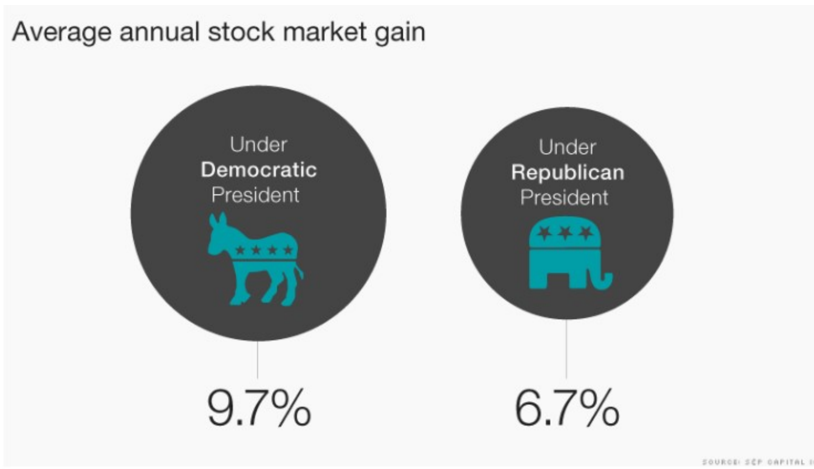
Stocks have trended higher regardless of which party has been in office

Growth of a hypothetical $10,000 investment in S&P 500 Index



Sources: Morningstar, Standard & Poor's. The start date is March 4, 1933, and the end date is June 30, 2020. Dates of party control are based on inauguration dates. Values are based on total returns in USD. Shown on a logarithmic scale.

Perhaps surprisingly, the stock market has tended to perform better under Democratic rather than Republican administrations. Since 1945, the average annual gain under Democratic presidents is 9.7%; under Republican presidents, it's only been 6.7%. This outcome might be because Democrats tend to spend more money, thereby stimulating the economy during their reign.



Many of the factors that will govern the future path of the financial markets – interest rates, inflation, debt levels, demographics, divisiveness, and the coronavirus – won't change much no matter who is in charge in Washington.

Regardless of politics, interest rates and inflation will most likely stay low as our nation's economy recovers from the effects of the pandemic. The Federal Reserve expects to keep interest rates near zero for several years. When it comes to the economy, many people think Federal Reserve Chairman Jerome Powell has more impact than the President.

Federal deficits will remain high no matter who wields power in Washington. Both Democrats and Republicans have become addicted to the elixir of deficit spending. This walk on the wild side with government spending has tripled the nation's deficit within just the last year. The Congressional Budget Office recently projected that outstanding federal government debt will reach 100% of gross domestic product (GDP) next year.

As a share of economic output, the annual deficit is now the largest since 1945 – when our country was financing immense military operations to help end World War II. Historical studies indicate this level of government debt leads to lower economic growth.

Demographics, one of the primary secular drivers of growth, will remain a drag on the U.S. economy as our population continues to age and birth rates stay persistency low. Political divisiveness appears to be with our nation for some time to come. Instead of blue waves or red waves we're likely to have more of a purple haze.

While our firm hasn't changed its view for the long-term, we do recognize a change in Washington might yield a rocky road in the interim. The Democrats have proposed meaningful changes that would affect our economy. A Biden White House could reinstate many of the regulations eased by President Trump, as well as try to enact some of the Green New Deal by executive order.

The Democratic Party has proposed $11 trillion in new spending over the next decade. This would be the largest expansion of government spending since Lyndon Johnson. The Democrats plan to pay for part of this new spending with $3.6 trillion in new taxes over the coming decade, which would represent the largest permanent tax increase since World War II.

Biden has proposed increasing the corporate income tax rate – currently a flat 21% – to 28%. This tax hike could reduce after-tax corporate earnings by close to 10%. For individual taxpayers, the Democrats' plethora of changes includes:

- Returning the top individual tax rate to 39.6%;
- Taxing capital gains and dividends at the highest tax rate for those earning over $1 million;
- Imposing payroll taxes on incomes over $400,000;
- Increasing the estate tax; and
- Equalizing the tax benefit for contributing to a retirement savings plan.

However, details on many of these tax changes have been sparse, and there is almost no chance they would be enacted as one large package. The path from campaign proposal to actual legislation is a long and winding road. Most new administrations are only able to pass a few significant pieces of legislation during their honeymoon periods.

Although we might not know which party controls the Senate until after the Georgia runoff elections in January, most experts anticipate Republicans will end up with the advantage. Under a narrow Republican Senate majority, we would expect no major tax increases. It may turn out that stimulus becomes the most important priority of the new administration.

No matter who controls the Senate, there are structural impediments to radical change. Although diminished, the Senate filibuster rule still requires 60 votes to allow consideration of most non-budgetary items. While there has been talk of eliminating the filibuster entirely, many senators on both sides of the aisle appear reluctant to remove this key protection against far-reaching partisanship.

Once the election outcome is certain and policy objectives become more firm, businesses will be able plan more effectively. Policy certainty was not a strong suit of President Trump. Uncertainty hinders the decisions of both businesses and families. But if the rules are known, all stakeholders can adapt and put their best plans in place. This is why the US economy has performed well over the years despite the shenanigans that often emanate from Washington.

The potential for less confrontation by a Biden White House with our trading partners – combined with a more multi-lateral approach – should lead to less overall market volatility tied to trade, particularly for companies dependent upon operations in both the U.S. and China.

The world isn't coming to an end. This year's recession could turn out to be one of the deepest – but also one of the shortest – in post-WWII history. Our country's second quarter GDP was -31% annualized, but the third quarter GDP numbers rebounded strongly with a +33% annualized increase. Overall, the economy looks to be in recovering from recession.

Although COVID-19 remains a major destructive force, trends toward better management and treatment of the disease, potentially culminating in a vaccine, should provide for a much improved economy next year.

The circumstances might be different this time around, but we know from history that our country perseveres and our markets rebound. Investors can survive the ups and downs in financial markets the same way hikers survive an encounter with a bear: remain calm and don't make sudden moves.

We would encourage investors not to get too caught up with the policy vagaries coming out of Washington. Most investors, us included, have zero edge in correctly predicting the impact on equity markets. That's why attempts at market timing typically prove costly, whereas ensuring one's portfolio is appropriately balanced for any outcome is the wiser strategy.

Whether one prefers Republican or Democratic rule, our government is built on a system of checks and balances. This makes it difficult for any party to govern for too long, especially more extremist ones. If one doesn't agree with the majority party currently in command, there is a good chance power will tilt back towards the opposition party in the next election.

A regime change in Washington usually doesn't affect the long-term trajectory of financial markets. Despite all of the drama and trauma surrounding this year's election, it might turn out to be another case of meet the new boss, same as the old boss.