ALGER

Investors shouldn't only focus on the US election

- Alger doesn't expect major impact on markets
- We believe innovation and fundamentals are driving markets
- Regardless of the winner, we believe - cybersecurity and infrastructure expected to profit and pharma to lose

The US election and its impact on the markets are currently the subject of heated debate. More than 83% of the Americans state that the election is very important to them compared to 75% in 2016 (Source: Pew Research). However, the election is less important to the portfolio over the next four years than investors currently assume, says Brad Neuman, Director of Market Strategy at Fred Alger Management.

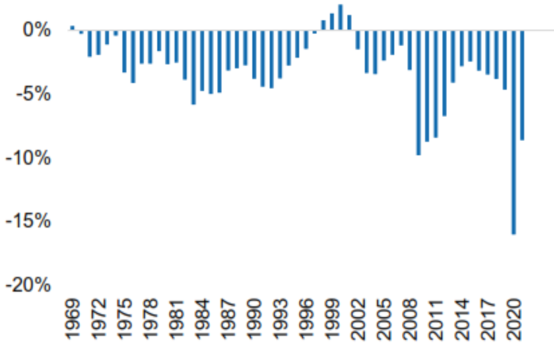
Economic indicators and sympathy values had an impact on US elections in the past

According to market predictions the presidential debate and the corona illness of the current president have shifted the odds clearly in favour of Joe Biden (65%) instead of Donald Trump (42%) (Source PredictIt as of 4 October 2020). Neuman states that there are some indicators that have emerged from previous presidential elections which allow conclusions to be drawn about the chances of a candidate. First, the economy has historically been a good indicator of whether the incumbent will be re-elected. If the economy is growing and there is no recession in the two years leading up to the election, the incumbent has been the winner (e.g. Barack Obama, George W. Bush, Bill Clinton). However, if there has been a recession in the two years preceding the election, then there has been a change in the oval office (e.g. George H. Bush, Jimmy Carter, Gerald Ford). The US has recently suffered from a recession which means that according to this metric, a change in the Oval Office may be likely. Second, approval ratings of higher than 45% have historically led to re-election but history is ambiguous at 40-45% levels. Currently Donald Trump's approval rating is at 40-45%. Thus, a prediction is hardly possible. Third, due to the Electoral College system in the United States an incumbent can win the election without winning the popular vote. In 2016 Trump was elected with less than 50% of the popular vote. This is why a focus on the popular vote is not as meaningful as a state-by-state focus. In 2016 there were only four states that determined the outcome (Florida, Michigan, Pennsylvania, and Wisconsin). Donald Trump won these states by 1% or less. This is why such states are "battleground states." Now they are important, again. Based on current polling, Joe Biden needs to add only three states (Pennsylvania, Ohio and Michigan) to win the election as he is in the lead with 222 votes compared to Donald Trump with 125 votes (Source: Real Clear Politics as of September 2020).

Impact of the US election on the markets

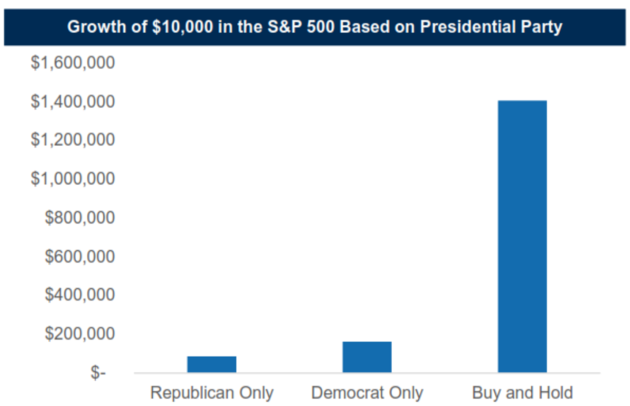
Historically, US equity returns have been higher under a split government (12%) than under a sweep government (9%). Brad Neuman explains that in a split government there is less uncertainty as it is less likely that new legislation will be passed. Investors are prepared and they feel like they know the rules as no new legislation likely will be passed that has an impact on the markets. Though, the odds towards a Democratic sweep (all under one party) is a real possibility in the eyes of the betting market. This means that meaningful legislation like a change in taxes and higher spending would be more likely. Currently, there is growing consensus in both parties that fiscal stimulus, either through lower taxes or higher spending, which results in larger deficits is acceptable and even desirable. Neuman analysed that chances are good that this may benefit the entire stock market more than many expect. As you can see in graph 1 it seems to be the case that especially in 2020 budgets do not matter anymore (e.g. interest rates and inflation will stay low). Higher deficits have been associated with better stock markets returns – more spending on lower taxes have improved corporate earnings. This may benefit the stock market more than many investors appreciate. The proposals of Biden's group go in the same direction – the spending would be much greater than revenues. According to many economists Biden's proposals could speed up economic growth by 200 bps. Neuman states that while the two parties may have divergent ideologies, there are also areas of policy commonality that investors should recognize, e.g. lower drug costs, onshoring and infrastructure. Higher income and capital gains tax rates may have a negative impact on equity valuations but much less than economic drivers such as inflation. According to the analysis of the investment specialist, a Democratic government would likely benefit alternative energy and infrastructure-related companies and hurt those in traditional energy as well as health insurance and banking. Neuman is convinced that the market has already priced in a Democratic win and that it differentiates between stocks that would benefit from a Democrat in office compared to those from a Republican in office. But Neuman has also identified certain groups that he believes may win or lose regardless of who is in power. Potential winners on both sides will be small and mid-growth companies, cybersecurity and infrastructure; pharma is a potential loser on both sides.

Chart 1: Federal Budget Surplus /



Source: Budget statistics from CBO as of September

Chart 2: Investing in politics



Source: Alger, FactSet, Wikipedia, 1968-2019

Focus on politics lead to underperformance in the portfolio

When Donald Trump became president in 2016, he announced his "America First" strategy and passed tax reduction laws to support domestic companies. If one takes a closer look at the S&P 500 shares with high domestic exposure, it is easy to identify that in October 2017, when the tax cut was passed, the performance of domestic companies, which were supposed to benefit most, did not improve. Thus, a US-focused portfolio performed significantly worse than a portfolio that was geared towards innovation, for example. This may mean that innovation and fundamentals are much more important than politics. Neuman concludes that investors should not be influenced by short-term election results and trends. As graph 2 shows, a buy and hold strategy irrespective of who is in office clearly outperformed a portfolio oriented to the political party in power. Utilizing a politically focused investment strategy failed over the past four years and the investment specialist does not believe it will work in this cycle either.

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