BLOG POST
Is Democracy at Risk?
11/3/2020

The rhetoric going into this Presidential election appears to be particularly acrimonious, but is just an example of recency bias that is easy to slip into. I have learned that taking a step back and understanding the narrative is important when performing a scenario analysis of the impact of an unknown outcome. It has been interesting to see how both sides of the political aisle this year are emphasizing to their base that Democracy is what is at risk if their side were to lose. Similar to a sporting event where both teams claim the officiating was not fair, that narrative is almost always wrong.

It was exactly two years ago, November 2018, when the title of the PCM Report was 'Purple Wave'. Democrats in that election took over control of the House while Republicans increased their majority in the Senate. The statistical chances of a Blue Wave or Red Wave, while slightly higher than two years ago, is again remote and we are likely to have a divided government, which tends to be a positive for the markets.

Forecasts are a lot like armpits — everybody has them, and most stink. Historically, about the only people who have avoided bad predictions are those who did not make any. Data is not the deodorant to stinky forecasts as evidenced by the Federal Reserve. No one doubts they have more data and analytics at their fingertips, yet their forecasts are continually shown to be as accurate as asking a Magic 8-Ball.

When the election cycle pauses after November 3rd (sadly only for about 6 months), we will likely find that Democracy was not at risk, regardless of who prevailed. There are stark differences between the candidates and what conservatives, liberals, or moderates believe is best for the country, but our Founders did an amazing job of structuring our Republic in a way that is not fragile. That is something that all people who love our country should be grateful for.

Given the stark difference in economic policies between the candidates and parties, some have argued that the outcome of this election will dictate how investors do over the next four years. This also will likely be shown to be a false narrative. Tax hikes versus tax cuts, increased regulation versus more deregulation, healthcare, foreign trade, and energy policy will be different depending on who wins the election, but are not as certain to dictate market performance as some might believe.

Of concern for investors should be the reality that the stock market may do poorly regardless of the outcome of the election, based on current valuations. The Shiller PE ratio is at 32 today, the 2nd highest level in history, only trailing 1999. The well-known Buffet Indicator, market capitalization of the Wilshire 5000 divided by gross domestic product (GDP), is the highest in history at 152%. This metric formerly peaked at 136% in 2000 and just 105% in 2008. John Hussman and Jeremy Grantham, both highly respected analysts and asset managers, have models suggesting domestic stocks will have negative average annual returns over the next 10 years. I have not suddenly forgotten what I wrote about forecasting above, but the reality of current valuations cannot be ignored.

Presidential Cycle Stock Market Performance

Presidential Elections						
	Average Return in Election Year	Average Return 1 Year Post-Election	Average Return 2 Years Post-Election	Average Return 3 Years Post-Election	Average Return 4 Years Post-Election	Frequency of Positive Return in Election Year
All Presidential	7.15%	6.77%	3.46%	16.96%	7.15%	88.24%
Split Government	13.11%	4.11%	4.47%	15.80%	7.48%	100.00%
United Government	0.44%	9.77%	2.31%	18.27%	6.78%	75.00%
Democrat President	3.74%	14.28%	2.88%	16.21%	12.24%	71.43%
Republican President	9.53%	1.52%	3.86%	17.49%	2.62%	100.00%
Incumbent Wins	11.82%	11.65%	5.88%	15.18%	1.39%	100.00%
Incumbent Loses	2.99%	2.44%	1.30%	18.54%	13.62%	77.78%

Source: Haver as of October 21, 2020 Note: These results are since 1945.
All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary

Setting the glaring differences between the parties aside, there is an area of agreement that all investors are counting on — monetary policy and the Fed. Monetary policy is often among the strongest influences exerted by governmental policy on the markets, and both sides will want the Fed to do everything possible to stimulate economic growth and support the markets. The problem is that the Fed has used most of their ammunition at this point, and may have to resort to unproven and speculative policy actions to support growth. Like an athlete experimenting with steroids to boost performance, the long-term consequences can be far more harmful than the short-term benefits.

The risks associated with a contested election are likely overblown in my opinion, although if that occurs it will likely lead to much higher volatility. In the 2000 Presidential election, the result was unknown for about 6 weeks as the courts decided which Florida ballots were legitimate or disregarded (the infamous hanging chad). The markets fell by around 5% during the period when the country waiting for the results to be affirmed. It was not the uncertainty about the election that caused the Nasdaq to fall 68% and the S&P 500 45% over the next two years. It was unsustainable valuations that have only been exceeded by today's valuations. Those who fail to learn from the past . . .