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U.S. Midterm Elections: FUNDAMENTALS OUTWEIGH POLITICS IN INVESTMENT OUTLOOK

KEY POINTS

- T. Rowe Price cautions investors on making investment decisions based on election outcomes.
- Fundamental factors such as interest rates, trade policy, oil prices, and corporate earnings should outweigh the impact of the U.S. midterm elections.
- The stock market has generally performed well in years following midterm elections even after political upheavals.
- With monetary policy on track and fiscal policy probably on hold, the election outcome is unlikely to alter the economic outlook.

In the volatile political and market environment leading up to the U.S. congressional midterm elections, many investors wondered how the outcome would influence the economy and financial markets. With the Democrats having recaptured a majority in the House of Representatives for the first time since the 2010 midterm election and the Republicans still in control of the Senate, have we gained any clarity on the answers?

T. Rowe Price managers caution against making investment decisions based on the election results and are focused instead on the more fundamental issues that typically determine market performance. Moreover, they don't expect the election outcome to have a significant impact on U.S. markets or the economy.

Trends in global growth, interest rates, inflation, corporate earnings, and oil prices—along with rising protectionism and geopolitical tensions—are among the developments likely to outweigh the recent changes in Congress. Indeed, the markets this year have been driven by these factors more than by any political expectations.

"It may be tempting for investors to try to link election results to market outcomes, but there is really no consistent relationship between which party is in charge and long-term investment success," says Eric Veiel, the firm's head of U.S. equity.

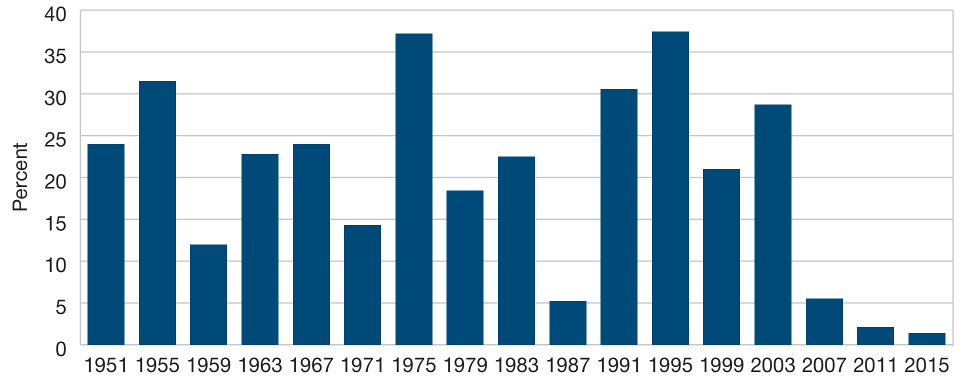
David Giroux, T. Rowe Price's head of investment strategy and manager of the Capital Appreciation Fund, says the 2018 midterm election is "not likely to become a market-moving event. There will probably be gridlock until 2020, so I would not expect to see any major legislation passed over the next couple of years.

"Investors should be paying more attention to what higher interest rates mean for stock valuations, inflation, and corporate profit margins," Mr. Giroux adds. "Also, we've

had very strong economic growth this year, so how much the economy slows is a major consideration. And 2018 has been a banner year for earnings growth, which will probably be up about 20%. Earnings may increase only in the mid-to-high single digits in 2019. The other important thing to focus on is the trade war with China and the broad implications of that for the U.S. and global economy."

FIGURE 1: **Stock Market Performance in Years After Midterm Elections**

S&P 500 Index Total Return: 1951 Through 2015



Source: T. Rowe Price. Market data provided by Zephyr StyleAdvisor.

MONETARY AND FISCAL POLICY LIKELY TO REMAIN ON COURSE

Alan Levenson, Chief U.S. Economist, has not altered his outlook. The Federal Reserve will continue to pursue rate normalization, probably raising rates again in December, with another three or four rate increases next year. "The Fed is an independent institution and will stay on course no matter the election," he says. "Monetary policy over the next 15 months will continue to be set independent of the makeup of Congress."

Fiscal policy is also likely to stay steady. "We're not going to see big fiscal stimulus such as tax cuts or huge spending increases because what has been done so far has already blown a big hole in the budget, and the economy is still strong," he says. "So I don't expect the broad contours of fiscal policy to change much because of the election." Mr. Levenson expects the economy to grow about 3% to 3.25% in 2018, slowing to about 2.5% in 2019 as the Fed continues to raise rates and fiscal stimulus tapers considerably next year.

Levenson also cautions against expectations for restrictions to be placed on President Trump's regulatory and trade policies. "The authority to pursue trade and regulatory policy resides with the executive branch."

AN ENCOURAGING HISTORICAL RECORD

Given these caveats, what does the historical record indicate about midterms? The president's party typically loses congressional seats in midterm elections, particularly in the House, but the stock market has usually performed well the following year. The third year of a president's term (the year after the midterm elections) has historically been the best year for U.S. market performance in the four-year presidential cycle.

For the 17 midterm election years in 1950 through 2014, the S&P 500 Index gained an average of 10.7% with five negative years during that period. Over the same time frame, in the year following a midterm election, the market gained an average of 19.9%. The S&P 500 did not decline in any of those years. From December 31, 1949, through December 31, 2015, the S&P 500 averaged annualized returns of 11.2%.

Even political upheavals have not usually led to market upheavals. In the 1954, 1994, and 2006 midterm elections, the incumbent president's party lost its majority in both the House of Representatives and the Senate. In the year following those elections, the S&P 500 Index gained 31.5%, 37.4%, and 5.5%, respectively.

In the 1994 midterm elections, during President Clinton's first term in office, the Democratic Party lost 52 seats in the House and eight seats in the Senate, but the market gained more than 37% the following year. In the 2010 midterm elections, during President Obama's first term, the Democratic Party lost an astounding 63 seats in the House and six seats in the Senate, leading to a divided Congress. The market gained 2% the following year.

BIGGER CHANGES MAY COME IN 2020

While Mr. Giroux would not advise investors to make portfolio changes based on the 2018 elections, he says it is "never too early" to start considering the impact of the presidential election in 2020. "Going into 2020, investors should be more reticent of the potential for a change in administration and what that could mean for markets, the economy, health care, energy, defense, and merger and acquisition activity," he says.

"We've had a very pro-business, anti-regulation, tax-cutting administration that has been very good for the stock market. Some would argue that's why we've had such strong economic and wage growth this year. If we have a change in regime, that could reverse some of these policies and have a knock-on effect on the economy and stock market. The market is forward-looking, so as we think about 2019 and 2020, that possibility will become a factor."

However, caution is warranted, and investors should not be quick to assume that a Democratic administration would be negative for stocks over the longer term. Indeed, when measured over a full presidential term over nearly the last 100 years, U.S. stock returns have varied considerably during the four-year periods but have generally been favorable. Again, most observers agree that factors beyond the control of any individual in the White House have been at work.

"Investors should not let the political environment weigh too heavily on their investment strategy because stocks have performed well during most presidential terms, or over longer time periods," says Larry Puglia, manager of the Blue Chip Growth Fund.

VOLATILITY MAY BE MORE PREDICTABLE THAN MARKET DIRECTION

While the election outcome is not likely to have a major impact on market performance, the new Congress will probably consider controversial issues that could stir market volatility. These might include:

- A second significant tax reform proposal from the Trump administration that sparks higher growth, larger deficits, and loftier inflation expectations.
- Efforts to place limits on drug prices or another attempt by Republicans to replace the Affordable Care Act, which could impact drug or health care provider stocks, respectively.
- Efforts to boost the minimum wage, which could raise inflation concerns.
- Legislation to restrict immigration, which might threaten both slower growth and higher inflation.
- Potential increases in defense spending, which could boost overall growth and defense stocks, in particular.

These legislative considerations may pose headline risks. But in the fractured political environment, many observers are skeptical as to whether Congress will make much progress on any major initiatives.

FOCUS ON WHAT'S HAPPENING IN YOUR ACCOUNT

While investors may be tempted to react to the political headlines, T. Rowe Price financial planners encourage them to remain focused on their long-term financial goals.

"Investors should maintain a diversified investment portfolio that could provide reasonable returns over time regardless of the political environment," says Judith Ward, a senior financial planner. "Have patience and don't try to time the market. Stick to fundamentals and focus on what you can control. What's happening in the headlines may not be what's happening in your account."

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