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- **COVID-19 could have a significant impact on the 2020 elections.**
- **Historically, a recession within the 2 years prior to the election has resulted in the incumbent being unseated.**
- **Equity markets can sometimes tell us more than polls.**

US Election Insights with Dan Clifton

Recently, we had the opportunity to get some updated insights on the November elections from Dan Clifton, the Head of Policy Research at Strategas. In the coming months, we believe investors will shift their focus away from COVID-19 and begin to pay closer attention to the upcoming, high-stakes 2020 election season in the US.

Q: What do you think will be the greatest impact on the political landscape from COVID-19 as we head into the elections? If conventions were cancelled or voting was strictly by mail, do you think the election outcomes will be different?

COVID-19 has significantly altered the US political landscape. Given the wide-ranging health and economic effects of COVID-19, policymakers have been focused on getting those responses right. But politically it feels like a volcano is building under the surface and ready to erupt as the political season comes front and center in late summer. As a starting point, the entire traditional political process we are accustomed to is eroding. Everything from how we evaluate the candidates to how we vote for the candidates is changing. Conventions will be virtual or socially distanced. I have been involved in politics for 25 years and the conventions are seminal events that are central to the standings of the candidates. Both conventions are in mid-August and may have less impact on the election than in years past. We also anticipate that the debates will not have live audiences and could be just the two candidates in a room by themselves. There will be more voting by mail, lots of it. The good news is that more people are likely to vote this year than ever before. Traditionally this has helped Democrats but there is enough advance warning that Republicans will know they will need to adapt. From a bigger picture perspective, COVID-19 has increased unemployment, which traditionally has led to incumbent presidents losing. This may be more important than the conventions or voting by mail in term of impact.

Q: Historically, a recession has been a catalyst to unseat the incumbent president. With just a few months to go before the election, do you think this time will be different?

Looking back over 100 years, every president who avoided a recession two years before their re-election, went on to win re-election. Conversely, every president who had a recession two years prior to their re-election went on to lose their re-election. It is a pretty simple formula: avoid a recession and your chances of getting re-elected is nearly 100 percent. President Donald Trump was in a good position coming into 2020. He had a strong economy, Democrats were somewhat divided, and the outlook in the US was actually accelerating in Q1 pre-COVID-19. But the COVID-19 associated lockdowns will lead to one of the largest economic contractions in US history. Unemployment is increasing and, not coincidentally, the President's polling has deteriorated. Some of the decline in the President's numbers are due to non-economic factors like his handling of COVID-19 and the recent protests. However, we see these factors as second derivative effects of what happens when 20 million people lose their jobs. There is a frustration and anxiety among the public and 70 percent of voters believe the country is headed in the wrong direction. In that environment, it is really tough to be an incumbent. Still, the race is not over. We believe how the virus and the economy are handled in Q3 will be the largest determining factor of the race. For example, some economic forecasts suggests the increase in Q3 GDP will be in the range of 20 percent. If so, that means a lot of people who previously lost their jobs will be re-entering the labor force. The challenge for the President is not to sink into quicksand before the race starts such that he never recovers.

Q: Joe Biden has been more moderate than some of his former opponents. What do you believe he will need to do to appeal to those voters who supported candidates such as Elizabeth Warren and Bernie Sanders?

Joe Biden seems to be worried about what we call the 'Mitt Romney' problem. In 2012 when Romney was running against President Barack Obama, Romney failed to attract the grassroots of the Republican Party and some Republican voters stayed home. Biden is constantly doing outreach to the more progressive wing of the party. Some of this is personnel related. For example, a key ally of Elizabeth Warren was placed as a senior member of Biden's transition team. This ensures that progressive-minded personnel will fill some of the key slots in the Biden Administration. In my experience, personnel is policy so this is a big deal should Biden win the presidency, and suggests that the regulatory initiatives could be more left of center than Biden has governed in his 44-year career. Another way Biden has reached out to progressives is by having Bernie Sanders chair Biden's climate advisory committee. My experience suggests the process will not be smooth and you can see some of these fissures developing around the platform committee of the Democratic Convention, the Vice-President selection, and Biden's policy statements made during the heat of the campaign. However, we have been impressed with the progressives being more practical this cycle realizing that Biden is not their ideal candidate, but he is the avenue to replace President Trump.

Q: Do you see Biden's choice for his Vice-Presidential running mate as having an impact on the markets and/or the election results?

Every presidential cycle, investors obsess over the Vice-President selection for months. Then the selection is made, and no one really pays attention to the person afterwards. How much attention did Mike Pence and Tim Kaine get in the Fall of 2016? The presidential race was about Donald Trump and Hillary Clinton and that is true in nearly every presidential result. Still this is the first major decision Joe Biden will make since winning the Democratic nomination. The selection gives you a window into Biden's decision-making process and how he will thread the needle among the party establishment and more progressive wing of the Democratic Party.

There is a case to be made that this cycle has greater importance with respect to the Vice-President nominees. The first rule of Vice-President picks is "do no harm." We have found that Vice-Presidents can hurt the presidential candidate more than help them. If Biden selected someone that dramatically helps him win the White House, say Michelle Obama, stocks will begin to price in a Biden win. Conversely, if Biden selected someone who would hurt his chances to win, the market will begin to price in a better chance of Trump winning.

We can see an impact in different equity sectors based on Biden's VP pick. For example, if Biden selected Elizabeth Warren to be his VP, this would raise the prospect of greater financial regulation. Healthcare will also have similar concerns but for different reasons given Warren's support for Medicare for All. Although it is not politically correct to discuss, I will say it outright: Voters see both candidates approaching 80 years old in a very stressful job. The chances of either one of the VP's becoming president before 2024 is not zero. If Warren is VP, investors will need to price more risk into the health care sector.

Q: If President Trump wins re-election and the incumbent parties retain control of the House and Senate, do you think the market will react positively?

In the short run, the equity market likes incumbents. When a president runs for re-election, their probability of winning re-election is correlated to stocks. This is not because the market likes their policies per se but because stocks reflect the economic outlook. If the economic outlook is positive, the chances of being re-elected increases. In the short-run, Trump being re-elected would be a sign that the US economy is healing following the COVID-19 shutdowns. A Republican sweep means the 2017 corporate tax changes remains in place and raises the possibility of pro-growth individual income tax relief in a second term. Stocks are currently giving Trump a 48 percent chance of winning re-election. So a Trump win will see Trump levered stocks, like companies with higher tax rates, move higher, all else being equal. Conversely, financial markets will need to reflect an acceleration of the US decoupling from China and likely greater trade tensions with Europe.

Q: The chances of a Democratic sweep have increased in the past several months. What, if any, type of market dislocation would you expect if that happens?

As I mentioned earlier, stocks like incumbents in the short-run. We know this because the S&P 500 has predicted every presidential election winner since 1984 and 87 percent of the winners since 1928. It's a pretty simple formula. If S&P 500 returns are positive in the three-month period before the election, the incumbent party has generally won. And if the returns are negative in that three-month period, the opposition party has won. Hence if the Democrats are going to sweep, we would expect equities to come under pressure before the election. Now this is not a perfect indicator and it could turn out that the economy is recovering, Biden is viewed as a healer for the country, and stocks rally even with a change in political parties. I can tell you we hear this from our non-US clients repeatedly. But the equity market will need to grapple with Biden's proposal to take corporate taxes back to 28% which could have a meaningfully negative impact on S&P 500 profits. You will also see macro pressure from the risk of a clamp down on oil and gas production, which in the past created well-paying jobs and lowered energy prices for US consumers. We would also expect to see more financial regulation. Offsetting this would be an increase in infrastructure spending and more safety net spending.

Q: The polls during the 2016 campaign weren't accurate as to the outcome. How much efficacy do you put in polling sites and stat sites like fivethirtyeight.com? What polls do you follow to get the best read on the various races? Do you value the "odds" based betting sites? Is there any point in looking at these polls until the debates begin?

Polls alone are not sufficient in close races. This is why we use financial market indicators to supplement polling data. On Election Day 2016, Strategas had a 43 percent probability that Donald Trump would win. The betting odds were less than 20 percent. Stocks were telling us that Trump had a better shot to win than the consensus thought at the time. The S&P 500 was down nearly two percent in the final three months of the election, a sign that the opposition party was likely to win. But more importantly we were seeing significant rallies in financial and energy stocks. If you thought Hillary Clinton was going to win in 2016 would you be purchasing banks and frackers? Probably not.

While polling is generally frowned upon these days, in our retrospective review of 2016, the national polls projected Hillary Clinton would win the popular vote by 3 percent and she won by 2 percent. 45 of the 50 states had accurate polls to a certain extent. But the 3 states that we needed to be accurate were not: Michigan, Pennsylvania, and Wisconsin. Let's face it, this is not a national election. It is a state by state election. Trump can lose the popular vote by 5 million votes this cycle and still win the Electoral College. So, we need to get the state data right.

I have been impressed by the improvements made to the polls. In 2018, the Congressional district level polling, which is the hardest to get right, was in the correct range. This makes me a bit more comfortable, but the golden era of polls is over which is why we use alternative data sources to supplement the traditional methods.

Q: One of the portfolios you manage is constructed based on corporate lobbying activity. Why should investors pay attention to which companies are investing in lobbying? Are you seeing any changes in allocations to lobbying on the part of corporations in the post COVID-19 environment?

Pre-COVID-19, our thesis was that economic volatility is creating political volatility. The US has held 7 national elections since the financial crisis and the voters in this country have removed the party in power in 6 of those 7 elections. This is the most political volatility we have experienced in 100 years of the modern political system. Think about trying to operate a business, and in 2017, Congress lowers the US corporate tax rate and eliminates the double taxation of foreign source income. Then, in 2021 those tax changes reverse. It is difficult to get certainty if we are changing political parties every two or four years. So, at the very least, companies need to be at the table, to better understand the potential risks and opportunities that arise from all of this political volatility.

Just as important, we believe that companies are increasingly generating earnings from policy changes and as a result those earnings are mispriced in the equity market. Our portfolio is designed to capture those companies with these mispriced earnings that can accrue from policy changes.

COVID-19 has produced such a massive policy response, and not coincidentally, companies are rushing into to be part of that process. The result has been a surge in lobbying in Q1 and we expect an even larger Q2 lobbying boost.

About Strategas: Founded in 2014, Strategas Asset Management (SAM) is a macro thematic investment manager. SAM leverages "top-down" research and quantitative security selection to offer a suite of thematic and tactical investment strategies. SAM, which operates independently, is wholly owned by Baird Financial Corporation and as a result, is an affiliate of RiverFront Investment Group.

Dan Clifton is the Managing Director and Head of Policy Research for Strategas. He serves as Partner and Portfolio Manager for Strategas Asset Management. The views expressed are Dan Clifton's and not necessarily those of RiverFront Investment Group.

You cannot invest directly in an index

Standard & Poor's (S&P) 500 Index *measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.*

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Lobbying "intensity" is defined by large-cap U.S. companies with the highest lobbying strength based on (1) the aggregate amount of dollars spent on lobbying activities by that company relative to (2) the size of the company measured by reference to several fundamental factors (reported in quarterly corporate filings) and market factors (market capitalization, liquidity).

Model Risk: Any imperfections, limitations, or inaccuracies in a model could affect the viability of that model portfolio. By necessity, model portfolios make simplifying assumptions that may limit the model's effectiveness. Models that appear to explain prior market data can fail to predict future market events. Further, the data used in models may be inaccurate (because, for example, the data is supplied by third parties) and/or may not include the most current information available. As discussed above, the POP model is not produced by RiverFront. If STS or SAM can or no longer wish to deliver the model to RiverFront, RiverFront will not be able to make the RSPO portfolio available to clients. With respect to the RSPO model, companies are responsible for reporting their lobbying expenses and, if this data is reported inaccurately it could cause a company to be included in, or excluded from, the portfolio when it would not otherwise be included or excluded. Additionally, errors in reporting could cause the model to not perform as expected.

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Factor Risk: Factors considered in the model, including the dollar amount spent on lobbying activities, fundamental factors and market factors are not necessarily predictive of company stock performance.

Political Risk: US federal law imposes obligations on companies to disclose certain information on lobbying spend. If the law were to limit or eliminate such disclosures, that change could have a material, negative impact on the ability of SAM to gather information regarding corporate lobbying spend. In addition, federal law governing corporate taxes has been relatively stable for decades. The US federal government is evaluating possible reforms to corporate taxes. It is unclear at this time whether and to what extent the federal government will amend corporate tax law.

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