THE Wealth REPORT

HOW TURMOIL AND GRIDLOCK IN WASHINGTON IMPACTS THE MARKETS

Overview

The investment markets hate uncertainty. Therefore, no news is good news. The chances of market volatility are lower when the government is unlikely to pass radically new legislation, or make drastic fiscal or policy changes. In times of political stability, investors can focus on their holdings and company performance, rather than worrying about extraneous factors.

However, the U.S. is in the midst of an all-new environment of divided politics. This makes it unclear how the economy, investors, politicians, consumers, company executives and even the world at large will react to the perpetual news cycle of astonishing statements that dictate changes to decades of U.S. policy and precedents.

Political division in the federal government is traditionally viewed as a good thing for the stock market. That may no longer be true. A Republican president and Senate, combined with the Democrats' takeover of the House, creates questions about how a split government in Washington will impact the nation's economy.

Historical Market Performance

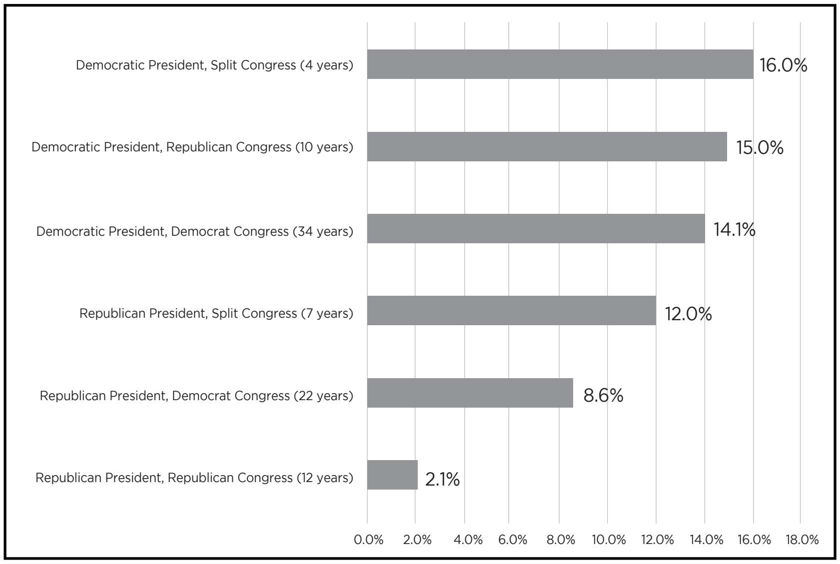
Since the 2016 election, Republicans have held majority power in both chambers of Congress and the White House. During that time, a massive tax bill was passed, promising tax savings to the middle class and corporations. There was also widescale deregulation to promote business interests, and the stock market continued to soar on an eight-year bull run that ended late in 2018.

So, what caused the downturn? From one perspective, the mid-term elections, in which Democrats took over the House of Representatives with a resounding victory. With the Republican stronghold broken up, a gridlock for new legislation will inevitably last until at least the 2020 elections.

It's worth taking a look at historical precedence for a yardstick of what to expect in the stock market over the next two years. Here's how the S&P 500 fared under various political party configurations since 1928:[1]

- The 12 years Republicans controlled the White House and both chambers in Congress yielded an average annual return of 2.1%.
- The seven years a Republican president was seated with a split Congress yielded a 12% average annual return.
- Since the 1800s, Barack Obama was the only Democratic president with a split Congress, but the four years of federal government gridlock were the best for the market, with an average annual return of 16%.

Historical S&P 500 Returns Based On Political Party Control[2]
1928-present



Budget Appropriations

Another way to gauge stock market activity is to identify the policy priorities of the dominant party. Over the past two years, the Trump administration prioritized military and homeland security spending, with mixed results.

Looking ahead, the current upsurge in the federal deficit and a split Congress is not likely to stoke a large budget allocation to specific industries that will benefit. With that said, there is still one area in which Republicans and Democrats agree on: infrastructure. If the two parties can work together to generate a strong infrastructure bill, and get the president to sign on, the industrials and materials sectors would gain the greatest advantage.[3]

Outlook on Monetary and Fiscal Policy

Apart from political influence, another reason the stock market has enjoyed long-term outperformance is because interest rates remained remarkably low up until a couple of years ago. Despite the Federal Reserve's efforts to curb an overheating economy with gradual rate hikes, the stock market continued to grow.

Many experts anticipate a slowdown in the economy, which may halt the rise in interest rates. This is likely good news for corporations that benefit from capital spending and expansion at low rates.

However, there are headwinds to consider. Despite the president touting additional tax breaks for the middle class, it's unlikely Congress would consider them, given its split status and the growing deficit. It's also difficult to tell how the markets might react to ongoing trade tensions between the Trump administration and China, but it's important to remember Wall Street does not like sustained uncertainty, and the U.S.-China deal falls under this status.

House Democrats have made it clear they will embark on what is certain to be a lengthy, headline-filled oversight investigation into Trump's finances and tax returns; border security policies; former cabinet members; staff security clearance protocols; and foreign relations policy, military treaty and sanctions decisions. Increased scrutiny of the Trump administration's agenda and the news headlines that follow could disrupt market performance and increase day-to-day volatility.[4]

"If we have a Democratic House and a Republican Senate, together with a politically damaged president, nothing will get done in Washington – preserving the lower corporate tax rates and more or less continuing the deregulatory environment." [5]

Final Thoughts

While we can expect political gridlock in Washington for at least the next two years, this scenario is not the be-all and end-all in terms of stock market performance. Historical equity market performance has been all over the place in years of divided government, but there is evidence gridlock can at least reduce day-to-day volatility.

Just look at the end of 2018. Republicans were still in power, yet in the last two weeks of the year, the market experienced historic volatility and a dramatic correction. The Dow Jones Industrial Average (DJIA) dropped by more than 350 points six times in a 10-day period before its largest gain on record: 1,000 points in one day. However, after a considerably positive year, all three major equity indexes ended 2018 in the red:[6]

- Dow -5.6%
- S&P 500 -6.2%
- Nasdaq -4%

While political uncertainty may continue in 2019, fundamental economic indicators remain strong, including job and GDP growth. It's possible the business cycle has entered a mature phase and will slow down now that the impact of the tax stimulus has worn off and a potential trade war continues to loom large. There is also the very real possibility that — on the heels of the longest-running bull market in history — a bear market could be right around the corner.

Looking ahead, investors may wish to consult with their financial advisor to deploy strategies designed to help mitigate the impact of potential negative market performance, considering their personal circumstances, risk tolerance and financial objectives.

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[1] Fred Imbert. CNBC. Nov. 5, 2018. "Here's why investors should hope for Washington 'gridlock' on Election Day." https://www.cnbc.com/2018/11/05/market-history-shows-investors-should-hope-for-gridlock-on-election-day.html. Accessed Feb. 4, 2019.
[2] Ibid.
[3] Ibid.
[4] Lauren Fox. CNN. Feb. 4, 2019. "Democrats prepare for week of blockbuster hearings into Trump." https://www.cnn.com/2019/02/04/politics/house-investigations-congress-big-week/index.html. Accessed Feb. 4, 2019.
[5] Ben White. Politico. Aug. 23, 2018. "Why markets ignore Trump news." https://www.politico.com/newsletters/morning-money/2018/08/23/why-markets-ignore-trump-news-325222. Accessed Feb. 4, 2019.
[6] Craig Hawley. U.S. News & World Report. Jan. 28, 2019. "5 Ways for Investors to Profit Despite Volatility." https://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/articles/5-ways-for-investors-to-profit-despite-volatility. Accessed Feb. 4, 2019.