U.S. Strategy Snapshot

Preparing Portfolios for the 2022 Midterm Election Cycle

Summary

Omicron's emergence consumed the news cycle over the past two weeks, but initial data suggests the new Covid variant may be less worrisome than initially feared. As more becomes known about Omicron, we expect markets to look ahead to the next big event — 2022's midterm elections. This week's *Strategy Snapshot* separates the political emotion from investing next year by examining the stock market's historical performance during past U.S. election years.

The takeaway — 2022 is likely to be drastically different from 2021. History indicates the S&P 500's volatility will increase and its upside potential is limited in the first half of the year. However, the S&P 500's returns historically improve at the beginning of the 4th quarter as uncertainty eases. Prior midterm election rallies historically carry into the first half of the following calendar year. Next week's tactical idea will focus on an out-of-favor industry we expect to benefit from 2022's political focus and Democrat's push to pass party agenda items — cannabis.

Main Points

- ► The S&P 500's price return drops to +5.9% during midterm years vs +12.1% during non-election years (**Fig 1**).
- ► Year 2 of the presidential cycle offers the weakest returns and lowest percentage (61%) of positive returns (**Figs 2-3**).
- ► Volatility increases around the start of August during midterm years and remains elevated through year-end (**Fig 4**).
- ► The S&P 500 historically trades sideways for the first nine months during midterm years before rallying into year-end (**Fig 5**).
- ► Defensive sectors and factors historically outperform during the first nine months of midterm election years, while cyclical sectors outperform into year-end (**Fig 6**).
- ► Since 1950, the S&P 500's 12-month return after midterms has been positive 100% of the time with a median +13.8% return (**Fig 7**).
- ► The S&P 500's post-midterm rally historically lasts 35 weeks (i.e., through the start of July the following year) (**Fig 8**).
- ► History indicates Democrats will lose seats and control of Congress during the 2022 midterms. The S&P 500's median 6-month return was +11.3% the last four times a party's trifecta was broken during midterms (**Fig 9**).

Report Summary

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Political Influence — Lower S&P 500 Price Returns During Election Years

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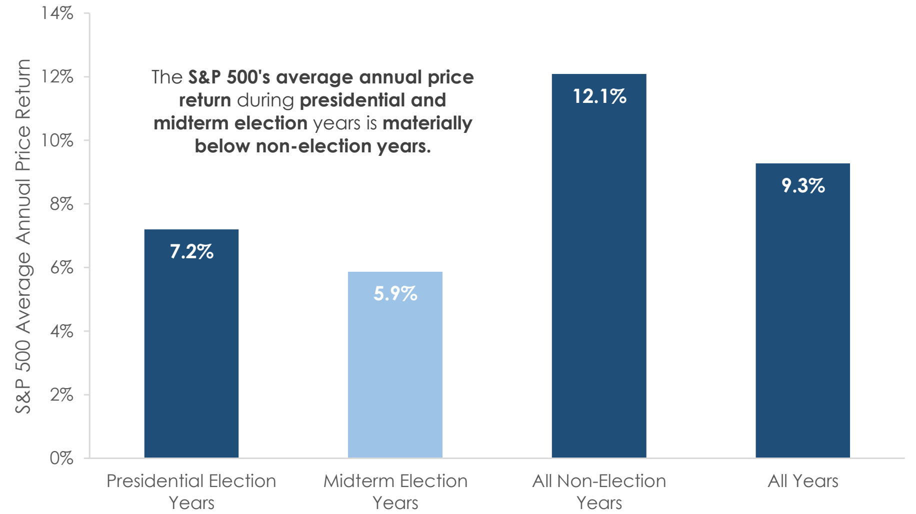
Key Takeaways

● Since 1950, the S&P 500's average annual price return has been +9.3%. Separating the years into election and non-election years shows the S&P 500's average annual price return is historically lower during election years. The average presidential and midterm election year price returns are +7.2% and +5.9%, respectively. Both are significantly below the non-election year average price return of +12.1%.

● 2022 is year 2 of the Biden administration's 4-year presidential cycle. Since 1950, the S&P 500's has produced an average annual price return of +5.9% during year 2, which is the year midterms take place. It's the lowest average price return across the presidential election cycle. Historical analysis shows the S&P 500's year 2 price return is weak regardless of the political party occupying the White House.

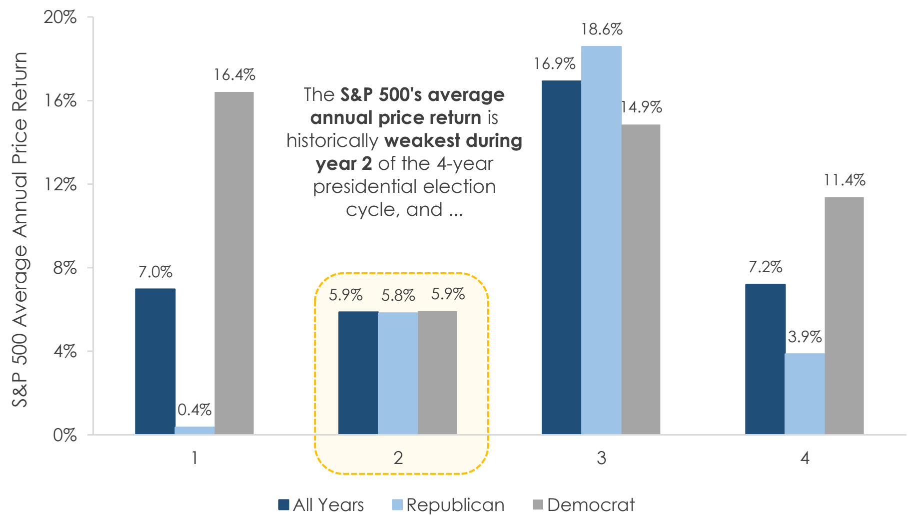
● The S&P 500's win rate is also weaker during year 2 of the presidential election cycle. Since 1950, the S&P 500 has generated a positive return 61% of the time during year 2. While the win rate is above 50%, it's more than -20% below the S&P 500's year 3 and year 4 win rates. Like the average price return (**Fig 2**), the political party occupying the White House does not significantly impact the S&P 500's win rate.

FIGURE 1: S&P 500 Average Annual Price Return (1950-Present)



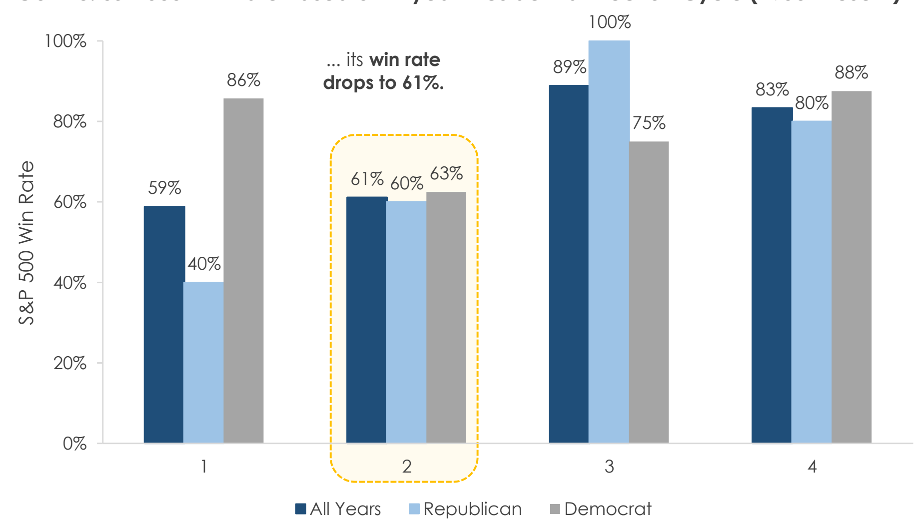
Source: MarketDesk

FIGURE 2: S&P 500 Price Return Based on 4-Year Presidential Election Cycle (1950-Present)



Source: MarketDesk

FIGURE 3: S&P 500 Win Rate Based on 4-year Presidential Election Cycle (1950-Present)



Source: MarketDesk. Win rate is defined as the percentage of positive returns.

Midterm Election Years — Increased Volatility as the S&P 500 Trades Sideways

Strategy Snapshot

December 10, 2021

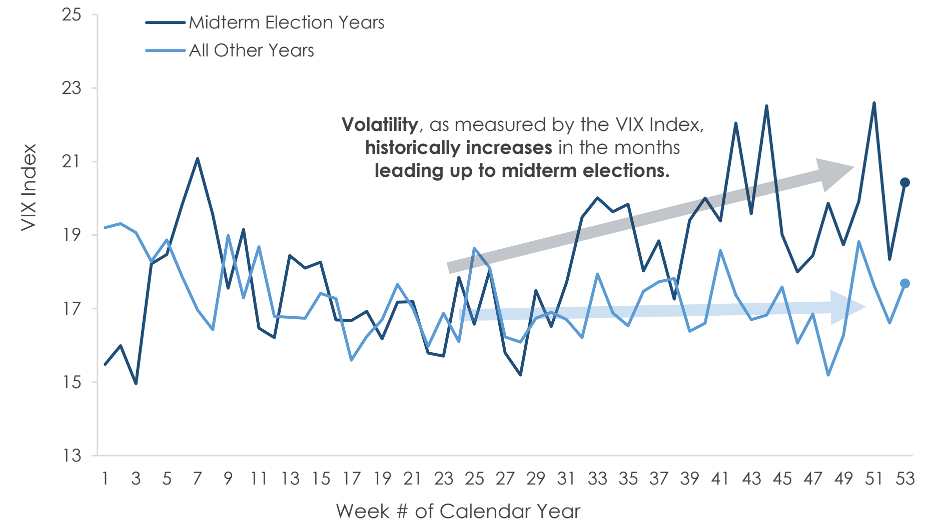
Key Takeaways

- Midterm elections create significant policy and regulatory uncertainty, and investors clearly do not like it. History shows volatility increases around week 30 (i.e., start of August) and remains elevated through year-end. We would note 2022 has the potential to experience above-average volatility as the Fed finishes tapering and prepares to raise interest rates.

- Markets trade differently during midterm years compared to the average non-midterm year. During non-midterm years, the S&P 500 historically trends higher as the year progresses. During the average midterm year, the S&P 500 historically trades sideways through week 39 (i.e., start of October) and then tends to trade higher in the weeks leading up to midterms as results become easier to predict. The S&P 500's rally historically continues into year-end as election results are finalized. Click ' More Info' to see the S&P 500's rolling 3-month forward return path during midterm years.

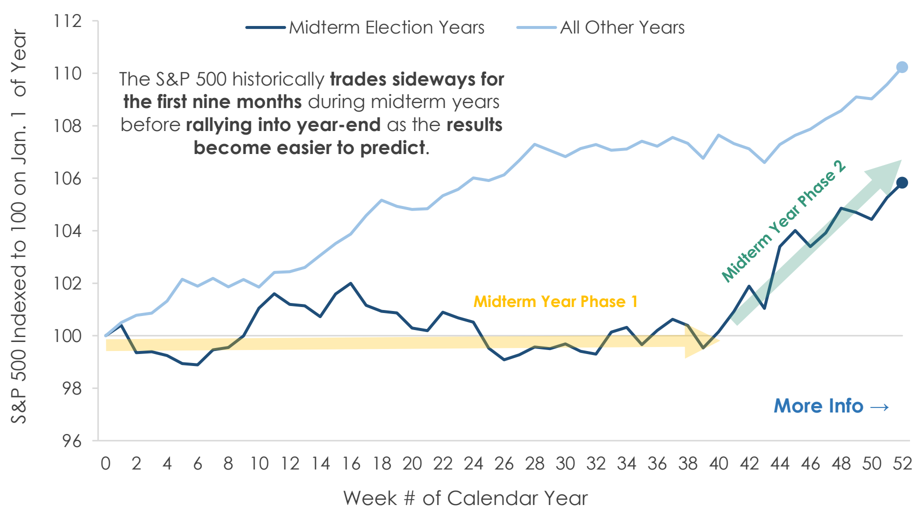
- Based on **Figure 5**, we split the average midterm year into Phase 1 (1/1-9/30) and Phase 2 (10/1-12/31). Defensive sectors and factors tend to outperform during Phase 1 as the market trades sideways, while cyclical sectors and factors tend to underperform. Performance trends historically reverse during Phase 2 as cyclical factors, such as Small Caps and Value, generate slightly higher median price returns.

FIGURE 4: Volatility Historically Increases in the Months Leading up to Midterms



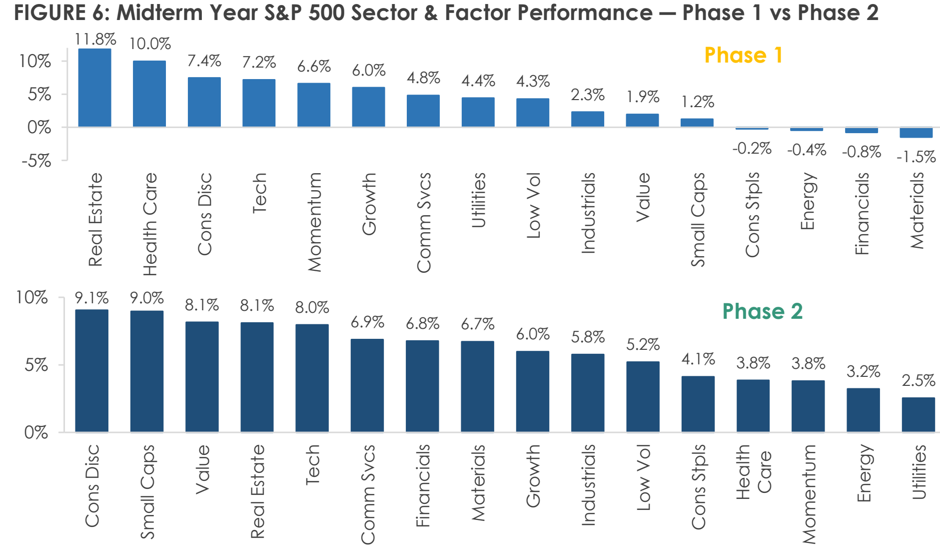
Source: MarketDesk, CBOE. Analysis starts with the VIX Index inception in 1990.

FIGURE 5: S&P 500 Return Path — Midterm Years vs All Other Years (1950-Present)



Source: MarketDesk. Phase 1: Jan. 1 through Sept. 30. Phase 2: Oct. 1 through Dec. 31.

FIGURE 6: Midterm Year S&P 500 Sector & Factor Performance — Phase 1 vs Phase 2



Source: MarketDesk. Analysis starts with the 1998 midterm election cycle.

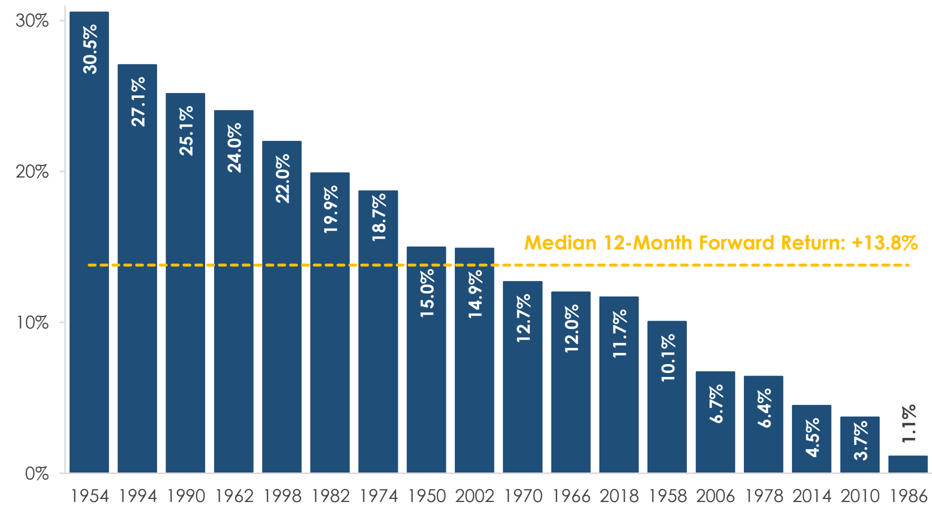
Key Takeaways

● Markets historically bounce back strongly after U.S. midterms. Since 1950, the S&P 500 has produced a positive forward 12-month return 100% of the time with a median return of +13.8%. During non-midterm years, the S&P 500 has generated a positive return 72% of the time with a median return of +10.1%.

● How long does the S&P 500's post-midterm rally (**Fig 5**) last? Figure 8 charts the S&P 500's return path during the 12 months after midterm elections. History indicates the S&P 500's rally continues for 35 weeks before it loses steam and trades sideways. Combining the return path analysis, history suggests the S&P 500 will trade sideways from Jan-Sept 2022 (**Fig 5**), rally from Oct 2022-July 2023 (**Fig 8**), and then trade sideways during 2H 2023 (**Fig 8**). It should be noted this is only a broad investment framework based on prior midterm election cycles, and the actual results will likely differ. Regardless, we view this as a worthwhile exercise to set baseline expectations.

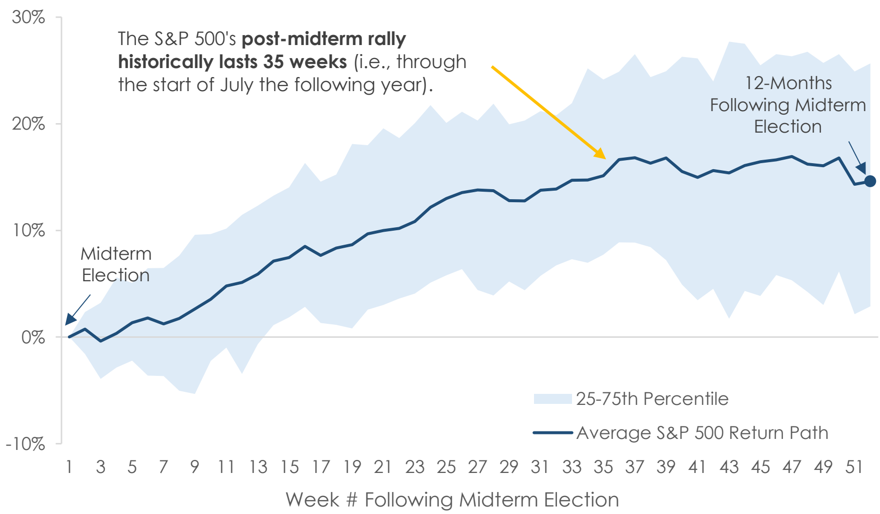
● Democrats have a trifecta currently (i.e., simultaneous control of White House, Senate, and House), but history shows the incumbent President's party historically loses seats during midterms. How does the S&P 500 trade after a party loses its trifecta? Consistent with **Fig 5** and **Fig 8**, the S&P 500 historically trades sideways in the six months leading up to midterms and then rallies during the six months after midterms. The data suggests markets like the prospect of divided government.

FIGURE 7: S&P 500 Price Returns 1-Year After U.S. Midterms (1950-Present)



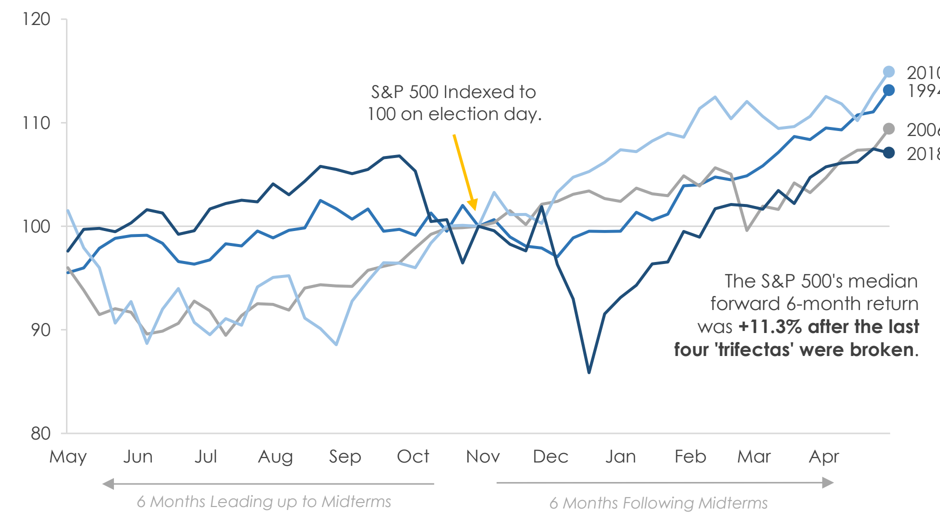
Source: MarketDesk. Price returns cover the period starting on election day through the following 12 months. Years are ranked highest to lowest.

FIGURE 8: S&P 500 Return Path — 12-Months Following Midterms (1950-Present)



Source: MarketDesk. Price returns indexed to 0% the week of midterm elections.

FIGURE 9: S&P 500 Returns Leading Up to and Following Congressional Control Change



Source: MarketDesk. Returns indexed to 100 the week of midterm elections.

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