PGIM QUANTITATIVE SOLUTIONS

MANAGING THROUGH ELECTION CYCLE VOLATILITY & BEYOND

August 2024

Like a broken clock chiming every fourth year, the US presidential election season is upon us. The nominations were seemingly locked up early, leading to a wait-and-see period. However, following President Biden's perceived poor performance at the first debate and his eventual withdrawal from seeking a second term and the assassination attempt on former President Trump, the race has started to get more exciting. Attention will continue ramping up on the big question: four more years for Democrats or the restoration of former President Trump? Critical as well: who will control the House of Representatives and Senate?

The expanding role of government in shaping and supporting the economy has increased the importance of elections for financial markets over the past decades, both in the US and globally.

While markets may attempt to read the tea leaves, the wisdom of the crowd is a powerful force; even the most sophisticated investors are occasionally caught flat-footed. The strong US stock market rally following Trump's 2016 election victory may have caught many by surprise. Perhaps rather than reading tea leaves, the prudent investor should just be a prepared investor. And gleaning insights from the long history of US elections can help investors navigate the aftermath of the 2024 election, regardless of potential surprises. Our core message is that while there have been historical patterns of asset class behavior over election years, investors would likely do better by thinking beyond the immediate term volatility and focus on the medium- to long-term environment in adopting strategies to position their portfolios.

US Presidential Cycle, Fiscal Policy, and Equity Markets

The state of the economy, and in particular the labor market, has historically been a key factor in swaying election outcomes. When the economy is strong, jobs are plentiful, and the stock market is rising, voters are more likely to think their lives are getting better and seem to be less likely to want to see a change in political leadership.

Since World War II, the odds of an incumbent US President getting re-elected have been 78% in the absence of a recession in the calendar year of election. However, those odds drop to just 33% in the presence of a recession. For example, the weak economy played a role most recently in George H.W. Bush's failed re-election bid in 1992 when the unemployment rate stood close to 7.5%.

Politicians have long understood this linkage between the economy and election outcomes and have worked—when in power—to tweak fiscal policy to encourage the economy to run a bit hotter in the lead-up to elections. Roughly, they aim to boost the economy with incremental fiscal measures one to two years prior so that the economy and labor markets are supported in the months running up to the elections.

With investors anticipating these policies to boost the economy, the S&P 500 posted stronger real total returns on average (around 14%) in the third year of presidential cycles starting in 1968, significantly higher than the average for the other years. The sweet spot of the cycle happens in a seven-month window between the second and third years when the S&P 500 posts a significantly strong annualized return of around 25% between the October of the second year and April of the third year compared with just around 3% annualized in the rest of the cycle.

Economic growth has been strong in the past year or so, partly boosted by leftover pandemic savings and Biden administration initiatives, including those boosting investments in green technology and semiconductors. With President Biden dropping out of the race, Vice President Harris is the incumbent by proxy, in effect representing the Biden administration's successes (or failures) in this election. However, while the economy and the labor market are solid, inflation has turned out to be sticky and may have put a wrinkle in the incumbent's prospects for re-election.

The stock market this cycle has followed the broad presidential cycle pattern fairly closely, posting moderate returns in the first year, relatively weaker returns in the second, strong gains in the third, and now seemingly on track for solid gains in this last year of the cycle.

Fed and Monetary Policy Over Presidential Cycles

In recent decades, the Fed has emphasized its independence, projecting an image of itself as run by neutral technocrats, steering the economy but without excessively stimulating or tightening ahead of elections. Fed Chair Powell reiterated that view in an early April 2024 speech, noting that Fed policymakers "serve long terms that are not synchronized with election cycles," and that "our decisions are not subject to reversal by other parts of the government, other than through legislation. This independence both enables and requires us to make our monetary policy decisions without consideration of short-term political matters." He doubled down on the sentiment from these comments when asked about the election at the press conference following the early-May meeting of the Federal Open Market Committee.

In order to evaluate the stance of monetary policy during election years, we employ a Taylor rule based comparison to get a sense of whether the Fed policy had been easy or tight over the years since 1964. The Atlanta Fed Taylor rule utility provides a transparent rules-based measure that can be used to gauge Fed policy. More importantly, the 1993 version of the rule also provides a sufficiently long enough history to analyze monetary policy. For this analysis, we have excluded the post-COVID years as they significantly distort the historical averages.

In the fourteen presidential cycles since 1964, the Fed has been relatively tight with its monetary policy in the first two years of the presidential cycle and a relatively relaxed policy in the final year of the cycle. In some ways, this could be thought of as the Fed pursuing a policy counter-cyclical to fiscal spending. Over this period, the median Fed policy was about -0.7% to -1.0% lower than the Taylor rule implied policy rates in the first three years of the presidential cycle and eased to -1.5% on average in the fourth year.

Expectations were for the Fed to start cutting rates this year after aggressively hiking rates in 2022 and 2023, the second and third years of this cycle. While the Fed had hiked rates significantly in the past two years, real rates were still very low historically due to surging inflation. With inflation easing over the course of 2023, the high nominal Fed funds rates have become only modestly restrictive in early 2024 compared to the recommended Taylor rule policy. In the first half of 2024, sticky inflation has led market participants to pare back expectations of rate cuts, and the Fed is expected to keep policy tight, in contrast to its usually accommodative stance in the last year of the presidential cycle.

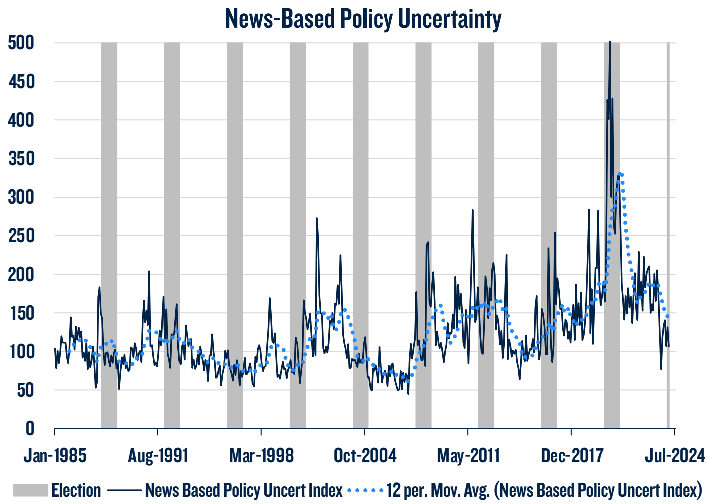
Policy and Uncertainty

US presidential elections are typically seen as occasions for significant policy changes that have wide implications for financial markets. Policy uncertainty typically keeps equity markets range bound or volatile in the months leading up to elections, and once the results become apparent, the uncertainty dissipates and a relief rally typically follows.

Historically, there has been an increase in policy uncertainty (Figure 1) as presidential leadership changes across parties, especially after the second term of a president. For example, there was a significant step-up in policy uncertainty in the run-up to the 2000, 2008, and 2016 elections. While the spike in policy uncertainty in the run-up to the 2020 election was more attributable to COVID and the policy response, the uncertainty in the run-up to the second term of a president had historically been stable.

In the current scenario, in addition to the fact that we have a former president up for re-election, we also have a unique situation in which both the candidates and their policy stances are fairly well known by the electorate. Thus, we see a decline in policy uncertainty in the run-up to the 2024 election despite expectations of a close contest this November.

Figure 1: Policy Uncertainty Typically Rises in Run-Up to Elections

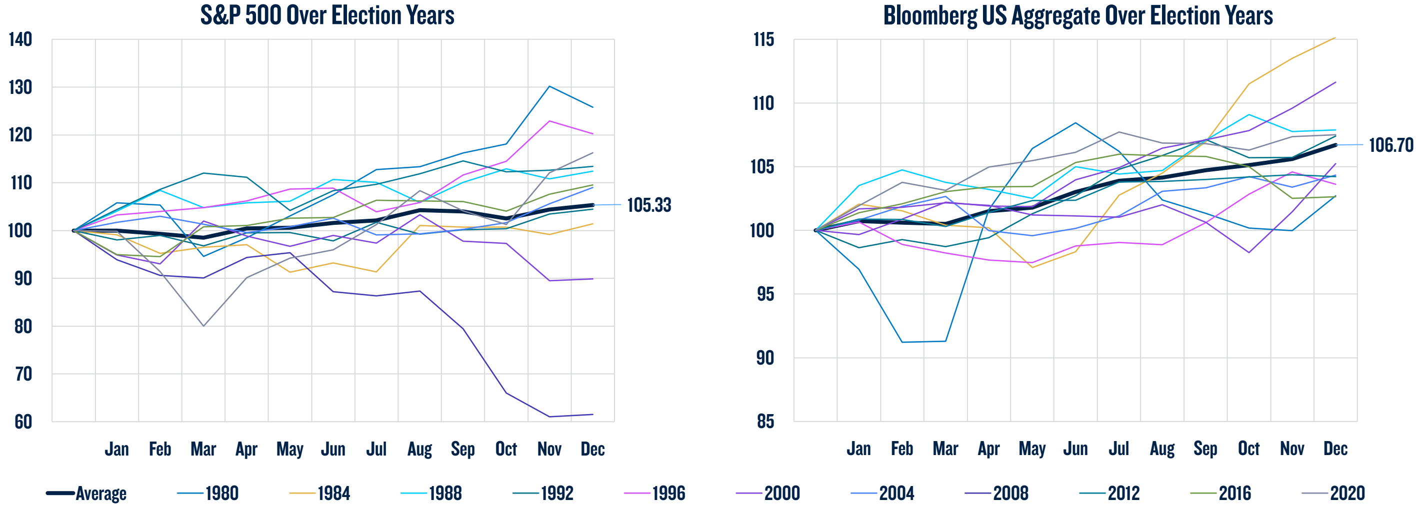


Source: 'Measuring Economic Policy Uncertainty' by Scott Baker, Nicholas Bloom and Steven J. Davis at policyuncertainty.com, PGIM Quant Solutions As of 7/31/2024

Markets During Election Years

There has been lot of ink spent on analyzing historical market performance during election years. On average, equity markets have posted moderate gains during election years (Figure 2), although lower than historical annual averages. It can be difficult to isolate the effect of elections on equity market performance due to diverse macro and policy environments over the many election years. The increased volatility during election years has made stocks move up gradually for most of the year, usually followed by a relief rally in the final two months as the uncertainty lifts. Among equity factors, quality and low risk factors perform relatively better during election years. While value has done well during election years, its best performance is usually during the initial part of the presidential cycle. Growth factors typically do well later in the cycle. Momentum factors, such as those based on price and earnings, also perform well mid-to late-cycle.

Figure 2: Historical US Stocks & Fixed Income Performance Over Election Years



Source: FactSet, PGIM Quant Solutions As of 7/31/2024

Meanwhile, fixed income assets (Bloomberg US Aggregate Index) outperform stocks on average during election years. As mentioned above, and despite Chair Powell's protestations, the Fed tends to set policy a little looser during election years, putting downward pressure on interest rates. Combined with increased volatility in risk assets, the environment for fixed income is relatively more favorable.

Thoughts on the Current Pre-Election Environment

The current election season is unique in several respects. The primary season seemed to wrapped up unusually early for both parties. In a normal election season, this would give the candidates a chance to move toward the center. However, this election season has proven anything but normal. Former President Trump remains a well-known entity and has only modest room to maneuver around the edges. While Vice President Harris is not bound by President Biden's positions, stepping into the top spot has given her room to reshape the narrative and move to the center compared to her 2020 primary candidacy. For instance, she favored banning fracking in 2020, but has since adopted the Biden administration's more moderate position. With so many surprises this election season, it is clear that the outcome is far from locked up. The July 30th Real Clear Politics polling average showed Trump having a +1.9 spread advantage over Harris compared to the +3.1 spread Trump had over Biden just before he withdrew. In the immediate aftermath of the withdrawal of Biden, the betting odds are pretty much in flux!

Compared to the 2020 election, when COVID was front and center of voters' concerns, economic issues are now in the forefront of voters' minds. According to Gallup, 36% of April 2024 survey respondents identified economic issues as the most important ones facing the US, more than three times higher than the level in November 2020 when Trump and Biden last faced off. While it is not unusual for voters to focus on economic issues, it is usually high unemployment that drives attention.

However, the economy remains solid despite slowing from the earlier strong pace. Unemployment is still near historically low levels; and, even after moderating from the post-COVID recovery, nominal GDP is still rising one percentage point faster than the post-GFC trend. Such historically low levels of unemployment typically coincide with record wins for the incumbent. Unfortunately for the incumbent, the favorable labor environment has contributed to the unfavorable inflation environment.

The post-COVID inflation surge followed expansionary fiscal policy, begun under the Trump administration and expanded under Biden's. COVID stimulus checks provided support to households during the crisis, sending real disposable income on average 5% above the post-GFC to February 2020 trend in the two years following the lockdowns. Heading into the election, the impact from expansionary fiscal policy is still being felt on economic growth and low unemployment in the form of the CHIPS act, the Infrastructure and Jobs Act, the Inflation Reduction Act, and student loan forgiveness.

Nevertheless, inflation has fallen significantly from the summer 2022 highs. However, voters care more about price levels, particularly relative to their paychecks, than price changes. Of the 36% from above who list economic issues as the most important facing the country, roughly a third picked inflation and cost of living as most concerning. Of course, fiscal policy alone is not responsible for the inflation environment; monetary policy has played a notable role as well. Belatedly, central banks raised rates significantly, helping to get inflation under control.

Tighter monetary policy has meant the post-Global Financial Crisis low interest rate environment has given way to a higher interest rate regime. This has upended some important relationships that asset allocators rely on. During the low interest rate periods of the 2000s and 2010s, stocks and bonds had relatively low or even negative correlations. Increasing the allocation to bonds in a portfolio had a diversifying effect. In the higher interest rate regime, the correlation between stocks and bonds has turned positive. Bonds have less of a diversifying effect. At the same time, US stocks remain expensive relative to bonds with the four quarter forward earnings yield of the S&P500 at 4.76% as of Aug 2, 2024. While the 10-year yield has eased to 3.90%, the earnings yield gap remains narrow relative to its levels since the mid-2000s, suggesting a less favorable long-term outlook for equities.

On the foreign policy front, Vice President Harris, the Democratic nominee, will inherit the Biden administration's difficulties in achieving party unity on the Israel-Palestine conflict. While Trump favors taking the restrictions off Israel's military, the isolationist wing of the Republican Party is warier. Meanwhile, the war in Ukraine thus far has not been as much of a wedge issue as the war in the Middle East has. Similarly, both parties are relatively united in their posturing toward China.

For investors, the rise in geopolitical conflict and potential for trade disruptions is generally a negative. However, there might be specific industries that can benefit from such conflict. President Biden signed the CHIPS and Science Act in 2022 in order to subsidize semiconductor production, partly driven by concerns about disruptions that the US economy would face if TSMC production is disrupted. This is a positive for domestic semiconductor producers, but there's no free lunch to industrial policy.

Overall, what is fairly likely in looking towards the post-election environment is that the US would continue to run significant fiscal deficits in the upcoming years as it pursues policies to strengthen its strategic position under either candidate. Elevated and sticky inflation is likely to keep the Fed cautious in cutting interest rates significantly. We are already seeing changes in some of the historical patterns of asset class movements such as positive stock-bond correlation, which makes building a diversified portfolio more challenging.

Strategies for Investors

The traditional option for investors is to de-risk and diversify their portfolios. Increasing the allocation to conventional conservative asset classes alone might not be fully effective given the changing asset class co-movement patterns. Other options to achieve diversification include expanding the range of asset classes under consideration. De-risking portfolios can have important implications for investors seeking to hit return objectives. For example, while the risk-reward characteristics of bonds have become more favorable as interest rates have risen, they aren't able to match the expected returns of stocks over the long run. Reducing the allocation to stocks can reduce expected returns and make it more difficult to achieve client goals.

For institutions, a portable alpha overlay, which is an uncorrelated and unfunded separate source of excess returns generated by alpha management, could be another alternative. In contrast to other alternative allocations, portable alpha overlays can be implemented in existing portfolios without changing underlying portfolio allocations and/or existing active managers. A well-designed portable alpha overlay strategy with a low correlation to traditional asset class exposures can provide diversifying, additive returns when asset owners need them most.

A more tactical approach to manage portfolios in the post-election environment is another possibility. There can be a place in investor portfolios for products that help mitigate the downside, while maintaining some exposure to the upside. Market participation strategies can combine long-term call options with conservative investments to participate in a larger share of the upside, while protecting the downside. A recent development along similar lines are buffered ETFs. These products buy a series of option contracts that have a payoff profile that blunts the impact of downturns while allowing the investor to participate on the upside, up to a cap.

Options can provide an effective complement to a portfolio for investors seeking to protect from downside risks. For instance, tail risk hedging often involves the purchase of out-of-the-money put contracts that can provide a floor on returns. Alternately, covered call writing can provide income to investors that helps weather volatile market environments, although at the cost of not being able to fully participate in the upside.

Financial market volatility and macro uncertainty are likely to be elevated in the run-up to and even post-2024 elections. Investors will continue to grapple with more or less the same set of sticky issues regarding growth prospects, deficits, the trajectory of inflation and geopolitical tensions. The general theme running through many of the strategies we outlined above is that limiting portfolio risk also limits the potential reward, especially given this challenging environment. Thus, the appropriate course of action not only depends on the investor's investment outlook but also on the client's horizon and risk tolerance.

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