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Within *Focus* we comment on extraordinary market events and analyse capital market related special topics.

US elections likely to cause volatility in equity markets

"Super Tuesday" is crucial for finding a Democratic presidential candidate

The next US presidential election will take place on 3 November. In addition, the entire House of Representatives and one-third of the Senate will be up for election. Currently, the Democrats hold the majority in the House of Representatives, as do the Republicans in the Senate. This month the Democrats have started their primary elections in keeping with tradition in Iowa. Most delegates are elected on "Super Tuesday" (3 March), when primaries are held simultaneously in several states. After the primaries, the Democrats will officially nominate their candidate at a nominating party convention on June 13-16. The Republicans will follow suit on 24-27 August, and it looks like a mere formality that they will again nominate Donald Trump. Although we do not yet know which Democratic candidate will face Donald Trump in the election campaign, it is not too early to start thinking about what the election will mean for investors.

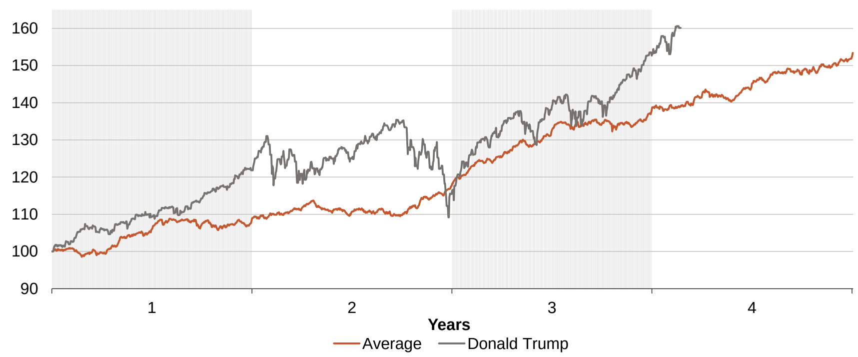
The fourth year of the presidency is statistically a good one for US equities

Since 1792, Americans have always elected a new president every four years, without exception. From this, a so-called presidential cycle for the stock markets can be constructed (see Figure 1). On average, the best year for the US stock markets is the third year of government. In the 22 previous presidential cycles, the S&P 500's median gain (including dividends) was 21.8%; in only 9% of the cases did the S&P 500 end the third year of the cycle with a loss. Statistically, it is therefore not surprising that 2019 was a good year for US equities, being the third year of the cycle. The fourth year of the cycle also tends to be good for US equities, with a median gain of 11.5% for the S&P 500 over the past 22 cycles and a positive return in over 80% of all cases. One reason for the solid performance in the fourth year is that the incumbent president normally does everything possible to get re-elected – and this usually has a positive impact on equity markets. In addition, the Fed usually keeps a low profile in order not to influence the economy and thus the election outcome.

However, stock market performance in election years is usually divided into two parts. On a median, US equity markets have shown a volatile sideways movement in the first five months of an election year since 1928, before climbing steadily from

Fig 1: The presidential cycle suggests rising but volatile markets in 2020

S&P 500 performance (total return) depending on the four-year presidential cycle since 1928, 1 January in the first year of the presidency = 100



Time period: 01/01/1928-21/02/2020
Sources: Bloomberg, own calculations

May until the end of the year. Over the past half century, volatility has typically increased in the first half of the election year and peaked about four to six months before the election. This tends to coincide with the timing of the primaries, when the content of the respective parties' programmes becomes clearer. In addition, history shows that stock market volatility is higher when the race for the US presidency is close – and such a scenario looks likely this year: the polls as well as the priced probabilities on the betting markets point to a neck-and-neck race between Democrats and Republicans.

Upside potential of the stock market is limited in the fourth year of a Republican government

If we analyse US election years according to the party to which the incumbent president belongs, huge differences emerge. The median S&P 500 gain in the fourth year of a Democratic administration is 16.2%, compared with just 7.1% for a Republican one. In statistical terms, the upside potential for the stock markets under a Republican US president in an election year is thus lower than under a Democrat.

US elections have a major impact on the markets

A moderate democratic candidate would be positive for the markets

The forthcoming US election is likely to be relevant to the markets for several reasons. First, it will probably reduce the likelihood of a renewed escalation of the trade dispute before the election, as a significant setback in the markets would reduce Trump's chances of re-election. Moreover, we think that a moderate Democratic candidate would probably be positive for the equity markets overall – especially for the equity markets outside the US, which should benefit from an abandonment of Trump's "America First" principle. As long as a moderate Democratic candidate does not raise taxes excessively or significantly reduce the deregulation measures implemented by Trump, the net effect should be positive. In the best-case scenario, there will be a decrease in volatility, greater investment security, and an increase in corporate investment spending and in global trade.

By contrast, a progressive leftwing democratic candidate would pose a significant downside risk, especially for the US markets. A tax on share buybacks could then be on the agenda, for example. Should such a tax in fact be imposed, it would weaken an important driver of US equities. After all, US companies are currently the biggest buyers of US equities in the market. However, radical leftwing domestic policy ideas are unlikely to be implemented, as it is unlikely that the House of Representatives and the Senate will be in the hands of just one party. In the House of Representatives, the Democrats currently hold the majority, but the Republicans look likely to maintain their grip on the Senate. Although the House of Representatives enjoys the right to initiate budget proposals, all legislation, including tax reforms, must pass through both chambers.

A progressive left Democratic candidate would have little chance of winning the presidency

Moreover, the election of a progressive leftwing candidate for US president is unlikely for three reasons. First, US elections are usually lost or won by "swing voters" in swing states (including Florida). These swing voters mostly voted for Donald Trump in the last election. Trump skillfully wooed the white working class with his protectionist agenda and fears about immigration. In addition, older voters, especially white ones, have been moving towards the Republicans for several years. It is therefore highly unlikely that they will turn their political worldview from relatively far right to far left. More likely would be a shift to a moderate Democrat. Should the Democratic primaries nevertheless produce a progressive leftwing candidate, the likelihood of Trump's re-election would rise sharply. Polls show that progressive leftwing candidates are likely to lose to Trump in the swing states, while moderate candidates would have a better chance of winning. According to polls by Predictit, Bernie Sanders, who is considered the left counterpart of Donald Trump, is currently leading the field. He has a national polling average of 65% as a democratic presidential candidate. In second place is the moderate latecomer Mike Bloomberg with 14%, who has recently lost ground, followed by Joe Biden (moderate) with 13%. Pete Buttigieg (moderate) and Elizabeth Warren (progressive left) have fallen far behind. Should none of the democratic presidential candidates have a majority of delegates, a "contested convention" would be held. In this case, the delegates will negotiate and vote until a majority is reached. The moderate candidates could try to nominate one of their own as a candidate to oppose Sanders, who has done best by far in the first three primaries and is ahead in the current polls. These internal power struggles could not only endanger a possible victory over Donald Trump, but also split the Democratic Party into different camps for a long time.

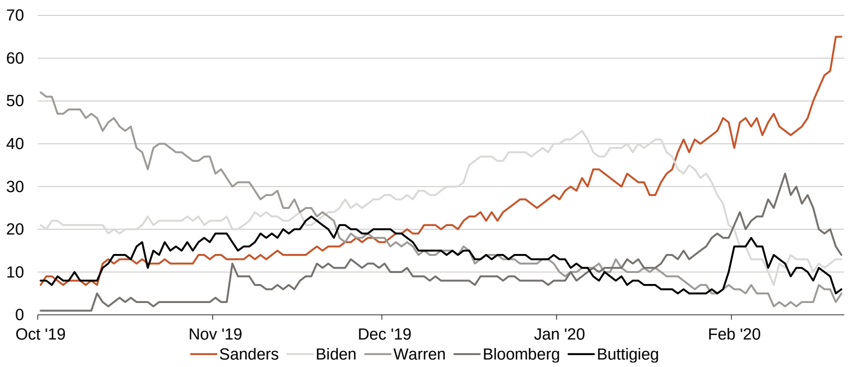
Trump's chances of re-election are not bad

All in all, it can therefore be assumed that Donald Trump or a moderate Democrat will emerge as the winner in the US elections. In any case, the probability of a Trump victory should not be underestimated. His approval rate of 42.6% at the turn of the year is the worst since Gerald Ford in 1976, but election night is still a long way off. His probability of winning is currently over 50%. In addition, the president of the United States is not elected directly by the people, but by an electoral college. Each state sends a number of electors depending on the size of its population. In the US, all states except Maine and Nebraska use the majority vote system. The candidate winning a simple majority of the votes in a state always receives all the state's electors. This means that whoever wins a simple majority in a state wins all the electors of that state – even if the lead is only narrow. So if Donald Trump does well in the hotly contested swing states, his chances of re-election are not bad. In 2016 he had fewer votes than Hilary Clinton, but thanks to the "winner-takes-all" principle he won the election.

History teaches us that there is often increased volatility in the run-up to US elections, which tends to decrease over time. Once election uncertainty has subsided, equity markets are likely to continue to climb. At least that is what the US presidential cycle suggests. This time, however, things could be different. Should Trump win the elections, it could well be that the trade dispute between the US and China will intensify again. In any case, the equity market year promises to be volatile.

Fig 2: Betting markets see Bernie Sanders as democratic challenger to Donald Trump

Probability of becoming the democratic presidential candidate (in %) according to Predicit



Time period: 04/10/2019-23/02/2020
Sources: Predictit

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IMPORTANT NOTICES

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