Triweekly Series

Ideas and Nuggets of News You Can Use!

LINDNER INSIGHTS

Bulls, Bears, Donkeys and Elephants

Stop trying to predict the direction of the stock market, the economy or elections.

Warren Buffett

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"Big enough to deliver, small enough to care" *by* Chris Briggs, CFP®

Bulls, Bears, Donkeys and Elephants

Now that the contentious Supreme Court nomination and approval process is completed we can get on to real fireworks, the mid-term election. We are about to endure a three week long assault on our senses. Every form of media and communication will be used to provoke an emotional response from you and your clients. It is our job as advisors to help our clients understand politics is mostly noise when it comes to investing.

All 435 House seats and 35 of the 100 Senate seats are up for election. There are three possible outcomes of the midterms, 1) Republicans hold Congress, 2) Democrats take the House, 3) Democrats take the House and Senate, let's look at each and the possible market moving outcomes.

1) Republicans hold Congress – If the Republicans maintain control of both houses of congress, a "follow on" tax bill is likely the first priority. The way the current tax law is structured, individual tax rates are scheduled to revert back to the prior brackets in 2025. Under Republican control, congress will likely move to make the current individual rates permeant. They would also make some "technical fixes" to the current law, specifically to the issue of corporate interest deductibility. The market would likely have little or no reaction, particularly to the individual rates becoming permeant, as that is seven years away.
   Health care, energy and financials are the market sectors whom have the most gain from a Republican Congress. Further deregulation and tough trade talk would continue. Emerging markets could be among the potential losers in this scenario.[1]
2) Democrats take House – At the time of this writing, polls indicate this as a highly likely outcome. A "follow on" tax bill is probably out of the question, but the two houses could possibly come together on some modest infrastructure spending. Deadlock is often the result of a split Congress. The "status quo" created has been a relatively good environment for the stock market.[2]
3) Democrats Take House and Senate – The "blue wave" as it is referred to in the media, is highly unlikely given the Senate seats up for reelection. This, for all intents and purposes, would result in gridlock as the Democrats would not get a veto proof majority. Likely are congressional actions to limit executive power on trade and a vote to stabilize the ACA. Infrastructure spending would be one of the few positive outcomes of this scenario. This would likely bring on a political shift to a focus on social welfare. Fixed income could face headwinds as higher taxes reduce future potential growth. The additional spending needed to fund social welfare programs

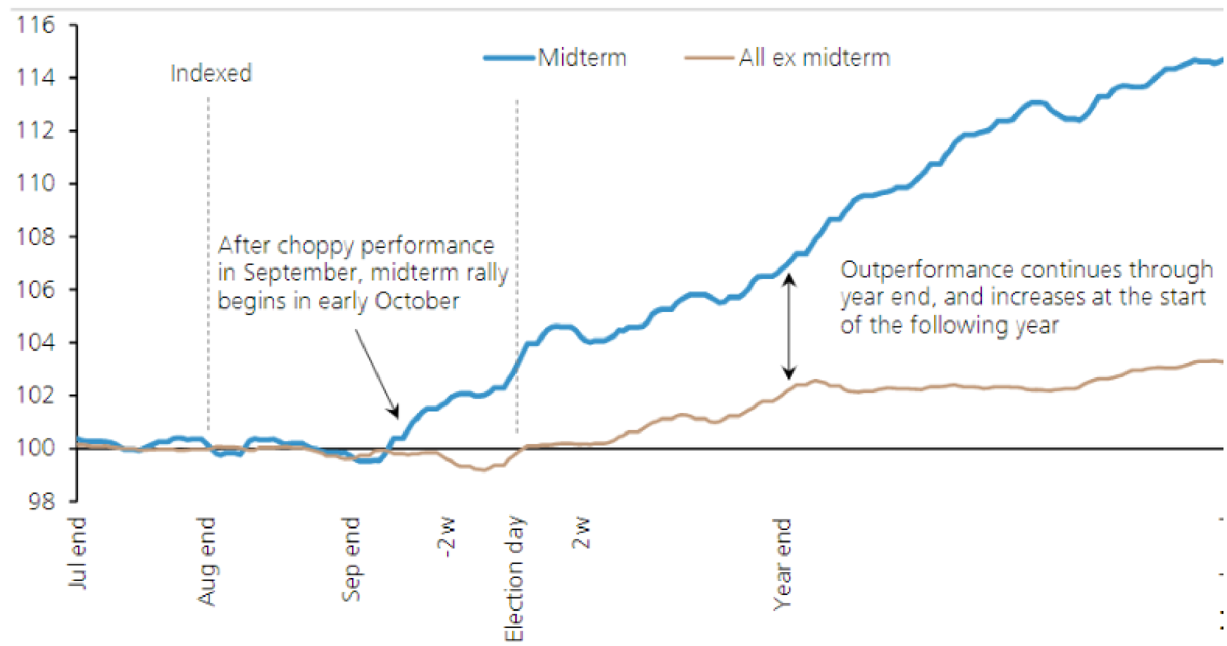
[1] https://hsl-pnw-downloadable-files.s3.amazonaws.com/1181/otm_oct_2018-0d305434c81a498aa513fe073c10caec.pdf
[2] https://hsl-pnw-downloadable-files.s3.amazonaws.com/1181/otm_oct_2018-0d305434c81a498aa513fe073c10caec.pdf

far into the future would hurt bond prices on the fear of increased supply. Of the three scenarios, this carries the largest risk for all markets.[3]

The cost of capital, earnings and earnings growth drives stock prices. As you are aware, interest rates (the cost of capital), have been rising for almost three years now. Interest rates remain at historically low levels and have yet to materially impact corporate borrowing. If rates remain at historically low levels, with gridlock of some sort the likely outcome, I am constructive on the business environment.

This chart from UBS shows the average performance of the market leading up to and following the midterms.

Figure 1: S&P 500 performance around midterms vs all other years (average)



Source: Haver, S&P, UBS
UBS

[4]

The research team at Deutsche Bank suggests cation, they suggest history is only a guide. Deutsche's analyst Binky Chadha, believes the markets performance around the midterms is more of a coincidence than a rule. Chandra suggests the presence of more traditional drivers being present such as strong earnings growth and low cost of capital, like I referenced above. He points out that S&P 500 returns, around the time of midterm elections have had a remarkable correlation to changes in the Institute of Supply Management's activity index (76% correlation in fact). Basically, if demand is high and growing around a midterm election, stocks do well. When you throw in the seasonally strong consumer demand

[3] https://hsl-pnw-downloadable-files.s3.amazonaws.com/1181/otm_oct_2018-0d305434c81a498aa513fe073c10caec.pdf
[4] https://www.marketwatch.com/story/midterm-elections-usually-give-stocks-pause-in-september-but-pave-way-for-later-gains-2018-09-01

of the holidays, you have strong equity performance. “This suggests that it was growth and not the midterm elections per se that was the key driver of the rallies” says Chadha.[5]

Looking further at history, the period after a midterm election has been good for stocks. The average gain for stocks in the 22 periods following midterm elections since 1930 has been 12.9%. With the elections of 1930 and 1938 being the only negative returns on record (both during the Great Depression).[6] With that said, history is only a guide here. Interest rates are up and look to be heading higher. Inflation pressures are beginning to build due to low unemployment, higher fuel costs and trade tensions. The market is in the midst of its longest bull run in history and we should definitely be communicating that to our clients. The time to be aggressively buying equities is when no one else likes them. I don’t believe the US market has reached a euphoric phase of the cycle but it is getting close.

Now more than ever clients need diversification. At some point the US market will pause. It will not be because one party takes or maintains control as result of the election in a few weeks. It’s because things can’t get much better than they are now for US equities. For this reason, all of our equity portfolios maintain diversified exposure to equities worldwide. Please call Leo or myself if you would like to discuss the current environment and how to better coach your clients through the next few weeks. Thank you for your business.

[5] https://www.marketwatch.com/story/midterm-elections-usually-give-stocks-pause-in-september-but-pave-way-for-later-gains-2018-09-01

[6] https://hsl-pnw-downloadable-files.s3.amazonaws.com/1181/otm_oct_2018-0d305434c81a498aa513fe073c10caec.pdf

About LCA...

Lindner Capital Advisors, Inc. is a federally Registered Investment Advisor based in suburban Atlanta, Georgia, with representation throughout the United States. Our investment platform provides access to institutional fund strategies and exclusive money managers that are not readily available to the retail market. Our portfolios are designed to be consistent with a client's unique investment objectives, individual time horizon, and tolerance for risk. LCA has been CEFEX certified since 2006 and is committed to our fiduciary responsibility.

Ask your Relationship Manager for a copy of "The Educated Investor" written by Robert Lindner.

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