Midterms and Markets

With the 2020 presidential election barely in the rear-view mirror, it's hard to believe the 2022 midterm elections are a few months away. Austin Schaul, Head of Research for the Avantax Portfolio Management Group, discusses the upcoming elections and takes an historic look at what midterm elections mean to the market.

What's at stake?

The Democrats have a five-seat majority in the House of Representatives and the Senate is split 50/50. In the upcoming midterms, 35 Senate seats are up for election, 21 currently held by Republicans and 14 held by Democrats. All 435 House seats are up for election. History does not generally favor the political party in power, as the president's party has lost House seats in 17 of 19 midterm elections since World War II and lost Senate seats in 13 of 19, with an average of 27 seats lost in the House and three to four seats lost in the Senate[1].

Buckle Up for Volatility on the Horizon

Every couple of years, the twist and turns of the U.S. elections drive more than their fair share of volatility in the markets. The force behind the increased volatility rarely stems from the election outcomes themselves, but the uncertainty leading up to the election. While markets generally are very efficient at pricing in known factors, it is the unknown factors and perceived uncertainties that fuel instability and volatility. This data indicates the exacerbated volatility during election years is the norm, not the exception. This allows investors to be proactive rather than reactive. Armed with properly calibrated expectations, investors can prepare for the turbulence ahead.

S&P 500 Index annualized monthly volatility since 1970[2]

Sources: Capital Group, RIMES, Standard & Poor's. As of 8/31/18. Volatility is calculated using the standard deviation of daily returns for each individual month. The median volatility is then displayed in the chart on an annualized basis. Standard deviation is a measure of how returns over time have varied from the mean. A lower number signifies lower volatility. Results in USD.

Tale of Two Markets

Election outcomes, and the ensuing market response, can be quite unpredictable. Historically, stocks have underperformed during the 12 months leading up to the midterm elections and outperformed during the 12 months after. According to Bloomberg, the average annual return for the S&P 500 in the 12 months leading up to a midterm election is 0.3% – substantially lower than the historical average of 8.1%. The silver lining for investors is that markets tend to rebound strongly following elections. On average, the S&P 500 has rallied 16.3% in the 12-month period following a midterm election. Importantly, the party or parties controlling Congress – and whether they change after a midterm election – historically are not an indicator of market performance. The markets are much more concerned with putting the elections in the rearview mirror than they are with the outcomes themselves.

Midterm Election Year Stock Market Performance Since 1962[3]

Year of midterm	President	Party	President's party: House seats	President's party: Senate seats	Before-midterm S&P 500 price performance Nov. 1–Oct. 31 (12 months)**	S&P 500 price performance Nov. 1–Jan. 31 (3 months)	S&P 500 price performance Nov. 1–Apr. 30 (6 months)	S&P 500 price performance Nov 1.–Oct. 31 (12 months)
1962	John F. Kennedy	D	-4	+3	-17.6%	17.1%	23.5%	30.9%
1966	Lyndon Johnson	D	-47	-4	-13.2%	8.0%	17.2%	17.1%
1970	Richard Nixon	R	-12	+2	-14.4%	15.1%	24.8%	13.0%
1974	Gerald Ford (Nixon)	R	-48	-5	-31.8%	4.2%	18.1%	20.5%
1978	Jimmy Carter	D	-15	-3	0.9%	7.3%	9.2%	9.3%
1982	Ronald Reagan	R	-26	+1	9.7%	8.7%	23.0%	22.3%
1986	Ronald Reagan	R	-5	-8	28.5%	12.3%	18.2%	3.2%
1990	George Bush	R	-8	-1	-10.7%	13.1%	23.5%	29.1%
1994	Bill Clinton	D	-52	-8	1.0%	-0.4%	9.0%	23.1%
1998	Bill Clinton	D	+5	0	20.1%	16.5%	21.5%	24.1%
2002	George W. Bush	R	+8	+2	-16.4%	-3.4%	3.5%	18.6%
2006	George W. Bush	R	-30	-6	14.2%	4.4%	7.6%	12.4%
2010	Barack Obama	D	-63	-6	14.2%	8.7%	15.2%	5.9%
2014	Barack Obama	D	-13	-9	14.9%	-1.1%	3.3%	3.0%
2018	Donald Trump	R	-40	+2	5.3%	-0.3%	8.6%	12.0%
Average seat change:			-23	-3				
				Midterm average:	0.3%	7.3%	15.1%	16.3%
				Non-midterm average*:	10.7%	2.9%	4.2%	6.4%

Flip to Republican control | Flip to Democrat control

Data source: Bloomberg data, Oct. 31, 1961 to Dec. 31, 2021

* The average monthly price return on the S&P 500 in three-month, six-month and 12-month increments, starting in the month of November of every year since 1963 where there wasn't a midterm election held in that November.

** The average 12-month price return of the S&P 500 in the 12 months preceding a midterm election, where the last date of the price close as of Oct. 31 is several days before the November midterm election.

The Bottom Line: Politics and Portfolios Don't Mix

The key takeaway here is the political party in power is only one of many variables that impact markets. Significant events such as the 2008 Financial Crisis and the COVID-19 pandemic were well beyond the control of any political party. Voters had very strong opinions about the prior two presidents, but average annual stock market returns during the Trump and Obama administrations were nearly identical at 16.0% and 16.3%, respectively, and well above the average over the last 30 years. Short-term volatility or eventual election outcomes should not overrule your financial plan. Over the long-term, markets are driven by fundamentals, not politics, and at Avantax our investment horizons extend far beyond any specific presidential administration or election cycle.

1-https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/investment-outlook/midterms/
2-https://www.capitalgroup.com/advisor/ca/en/insights/content/articles/us-midterm-elections-and-market-moves.html
3-https://www.usbank.com/investing/financial-perspectives/market-news/stock-market-performance-after-midterm-elections.html#:~:text=Stock%20market%20performance%20in%20midterm%20election%20years&text=The%20S%26P%20500%20Index%20has,the%20historical%20average%20of%208.1%25