U.S. elections: how might the stock market react?

Week in review

The return of record highs

It happened—this week, the S&P 500 closed at its first all-time high since February. The record close on Tuesday marked the fastest round trip between all-time highs – with a 20% or more selloff in between – on record. It took just 181 days for the index to go from its pre-crisis highs to down -34% at the depths of the COVID crisis to its new record this week.

Since bottoming in March, *42 of its constituents have doubled in price*…but we'd be remiss not to point out that, at the same time, 292 are still down year-to-date. Heading into Friday, the S&P 500 is up +0.4% this week, reflecting that we continue to live in a "market of stocks," which are acutely aware of the good, the bad, and the uncertainties that lie ahead.

A few market dynamics that caught our eye this week:

1. Thank tech for the rally. This week brought a spattering of developments—Apple briefly crossed $2 trillion in market cap (the first time *ever* for a U.S. company), Intel (the world's largest chipmaker) is considering a $10 billion share buyback, Amazon announced plans to expand offices in six cities and hire 3,500 people, and Uber and Lyft got a boost from a court ruling that'll keep them operating in California. It seems tech's winning streak continues—after all, the NASDAQ 100 also made its 37th new record this year (and 20th since the market bottom).

2. Clean energy is in, while old energy is out. Tesla (owners of which, by the way, now have their own dating app) continued to make new all-time highs and gained another $65 billion in market cap this week (roughly the size of toothpaste maker Colgate). Meanwhile, the traditional energy sector (-5.5%) was the worst performer in the S&P 500. When could the old energy sector present value? It already does apparently to oil company insiders. Insider buys haven't been higher in the last 10 years!

3. The summer doldrums. The S&P 500's trading volume is roughly 25% below its 30-day average. In other words, a small drop in the pond can create a big ripple. Which is one reason why markets took a step back later in the week when…

4. The Fed played it coy. Minutes from the central bank's July meeting showed that policymakers stopped short of specifying a timeline for potentially raising interest rates (which, in case you haven't heard, are still at record lows). Markets seemed to be looking for more direction and were skittish after the minutes, but we wouldn't read too much into it. We still expect a very accommodative Federal Reserve for the foreseeable future.

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5. Turns out, **only 7 states (representing 6% of Americans) have signed up for the additional $300 of weekly unemployment benefits**, according to FEMA. Arizona, Colorado, Iowa, Louisiana, Missouri, New Mexico, and Utah are those that sought the assistance brought on by Trump's executive order, which comes after the $600/week federal subsidy from Congress expired. More states are expected to follow, but the real development will come once Washington ends its stalemate on a more comprehensive stimulus bill. Speaking of Washington…

Bonus: Joe Biden's Democratic nomination for president became official. With the election now only 74 days away, investors are chomping at the bit for clarity on candidate policy platforms and how the stock market might react when results hit. Read on for our thoughts…

Spotlight

How will the U.S. stock market react to the upcoming election?

The election is growing ever closer, and as it currently stands, the polls are signaling that Democratic presidential candidate Joe Biden may win the White House and Democrats may take control of Congress. History tell us that markets react to regime changes with less compelling returns in the first few months after a new party takes control.

Yet today's economic recovery dynamics suggest that—no matter who wins the election—markets might keep grinding higher:

- **A Democratic sweep (i.e., a "blue wave" across both the White House and Congress) may produce a neutral market reaction.** Biden's proposal to increase fiscal spending might help counterbalance the potential negative earnings impact of his plan to increase corporate tax rates.

- **A Trump victory with continued Republican control of the Senate might be marginally positive for markets.** Keeping the status-quo likely means a continuation of lower taxes and relaxed regulations (e.g. for the Financials and Energy sectors). These market-friendly factors could offset potential headwinds created by ongoing trade tensions.

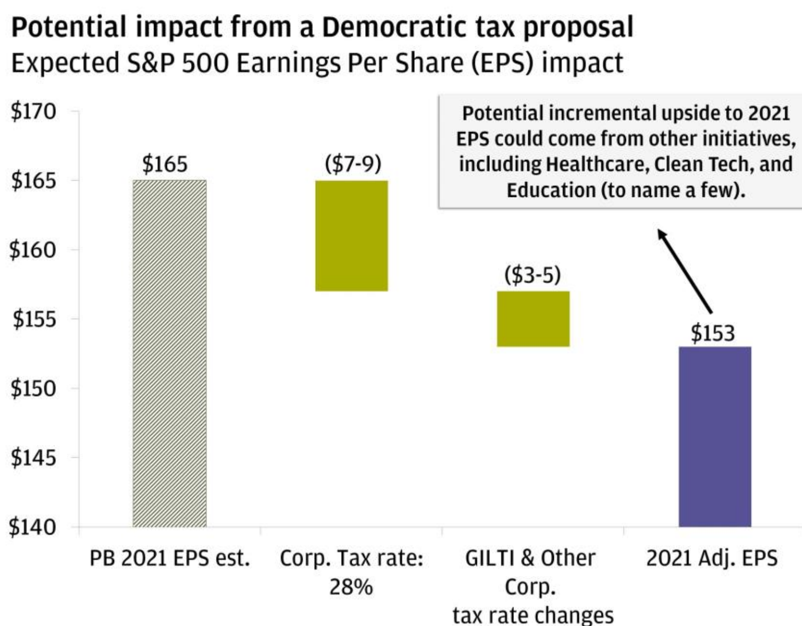
If we do see a "blue wave," what aspects of the Democratic agenda might change the status quo and affect the investment landscape at large?

The discussion is complex and varied, but higher corporate taxes stick out to us. As we explored in our article discussing tax policy stances, candidate Biden proposes to lift the corporate tax rate from 21% to 28%, impose a 15% minimum tax on book income, and double the existing minimum tax to 21% on profits earned by foreign subsidiaries of U.S. firms (a.k.a. GILTI, global intangible low-taxed income).

We estimate the net effect to be a $10-14 hit to S&P 500 earnings (based on our rule of thumb: every percentage point change in S&P 500 statutory corporate tax rate has an estimated ~$2 impact on earnings per share).

Still, we also expect that a President Biden would not raise the statutory corporate tax rate higher than 24-26%, as he'd face too great a need for corporate growth to help support the economic recovery from the pandemic.

A higher tax rate would take the largest toll on sectors that have higher domestic revenues (like Financials, Consumer Discretionary, and Communication Services). Multinationals, which tend to derive their revenues from low-tax jurisdictions face the proposed GILTI tax increase. Tech looks exposed here, given 56% of its revenues come from outside the US and could face restrictions on intellectual property moving abroad. Utilities and Real Estate could be less affected, given their revenues are primarily domestic and are able to pass the increases on to consumer and investors.



But while higher corporate taxes could be a headwind for U.S. stocks, other features of the Democratic platform might help positively offset the impact.

- Trade with China: Many expect that Democratic control of the White House to bring a change in U.S.-China relations. While Biden has a "tough on China" mentality, he may be less inclined to use tariffs as a negotiating tool. It's possible we could see some tariffs rolled back, and even growth in trade between the U.S. and China under a Biden administration.
- Fiscal spending: Biden has expressed an intention to ramp up fiscal spending in areas such as infrastructure, clean energy and tech, healthcare, and education. This could be a tailwind for areas of the market involved in those industries, and potentially help support the broader U.S. economy as it continues to recover from the COVID-19 crisis.
- Higher minimum wage: Biden proposes raising the minimum wage to $15/hr. We think this is "neutral" for the broad market, as higher labor costs might be offset by potential increased consumer spending. That said, industries are likely to react to such a change differently. For example, high labor-intensity and lower-wage paying industries such as Restaurants, Hotels, Retail and Transports (which account for ~10% of S&P 500 market cap) could face pressure on their margins. On the other hand, companies with more global supply chains and greater operating scales could be relatively insulated from the change.

Nonetheless, some sectors look more politically exposed than others.

Candidates' policy proposals could have wide-ranging implications for some areas of the market. We believe the most acutely exposed sectors are: Financials, Energy, Tech, and Healthcare:

- Financials (particularly Banks): A "blue wave" may mean more stringent regulation, which could in turn dampen

corporate profitability and equity returns. For example, progressive Democrats have expressed desire to reverse the Trump administration's easing of large bank capital and liquidity requirements, and potentially restore Glass-Steagall (which separates trading desks from commercial banking operations).

- Energy: One of Biden's campaign pillars is to set the U.S. on a course to be a carbon-neutral economy by 2050. That could mean increased subsidies for clean energy versus fossil fuels, which could lead to weaker demand for oil and gas.
- Tech: Regulation has been touted by both parties, and much of the conversation focuses on antitrust, privacy, and platform liability concerns.

- Healthcare: Both parties have voiced support for finding ways to lower drug pricing and healthcare costs.

But for all the political rhetoric, recent history shows that major reforms—particular those impacting Tech and healthcare—are likely to be difficult to pass, even if one party controls both the White House and Congress.

Our best advice? Keep your eye on the big picture and stay invested to achieve your financial goals.

For investors, our best advice is: review your portfolio allocations and consider where it may have outsized exposure to potentially vulnerable sectors or companies.

And remember: the primary drivers of your decisions about asset allocation should continue to be your financial goals, your time horizon and your ability and willingness to take risk. At J.P. Morgan, we partner with our clients to build portfolios that are diversified and fine-tuned to navigate the ever-changing investment backdrop—even in election years.

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