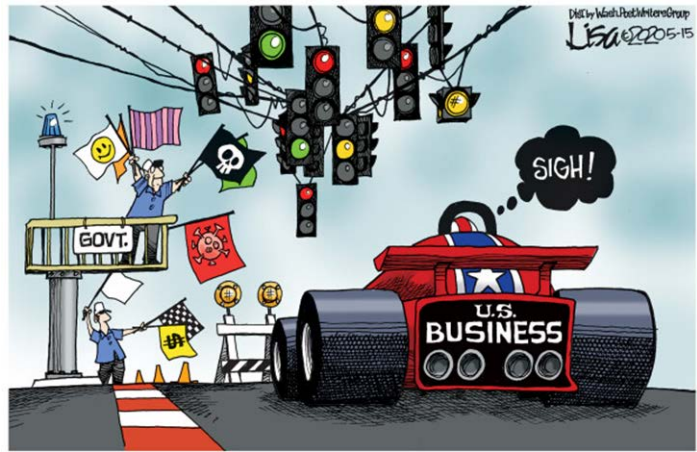


Don't Worry, America's Got Talent: Our Thoughts on the 2020 Elections

Top of mind for many investors these days is the outcome of the 2020 elections. While we have always believed politics (i.e., fiscal policy) can shape the tone and influence behavior within the business operating environment, we have also insisted it is only one factor among many affecting the growth of our economy in general and stocks in particular.

With November 3rd fast approaching, we thought it an appropriate time to summarize (and reiterate) our thoughts on the 2020 elections as it relates to our strategy. We present them in a question and answer format, because, like you, we're searching for answers we think will maximize our probability of success together.



Q: What impact do you think the November elections will have on the stock market?

A: Because we don't yet know how important a role mail-in ballots will play in its outcome, we think it's prudent to prepare for the possibility that a presidential election winner might not be clear in November, perhaps longer. Equally important, we may not know which party captures each chamber of Congress by then either.

The outcomes of all three elections – the presidential, the Senate, and the House – are important because each influences probabilities of change in tax and spending priorities. Those priorities shape investment decision-making by small and large businesses alike. History repeatedly reminds us that stock and bond markets aren't fond of this kind of uncertainty. Frequently lost in that history, however, is the understanding that uncertainty doesn't affect all assets within these markets to the same degree.

Let's put aside the timing issue for a moment and think about the kinds of businesses you'd want to own in the current environment. If Democrats occupy the executive branch and control the legislature, does that mean the trend toward electronic payments will decelerate, efforts to digitize health records will reverse, or elective medical procedures will be postponed indefinitely? If Republicans recapture control of one or more branches of government, does that assure they can effectively control the social unrest in many American cities threatening the pace of new business formations (the foundation of economic growth and wealth creation)?

Either way, while it's certainly possible for the stock market to give up its gains due to lingering election-related, fiscal policy uncertainty, or further social unrest, it is equally plausible to see stocks recover – especially the stocks of businesses we favor – rather quickly as we move into 2021.

Q. So, are you saying there are reasons to be optimistic regardless of which party wins the White House or wins the majority in Congress?

A: Yes, that's right. A Democrat-secured win of the executive and/or legislative branches doesn't spell demise for the stock market any more than a Republican win ensures another uninterrupted bull market run.

Bespoke Investment Group, whose data-driven research insights we follow, believes the impact of which party wins the presidential election is overrated. Their research shows that since World War II, the average return for The Dow Jones Industrial Average under Republican-led administrations is around 6%, while under Democrats it's around 7.5%.¹

Some argue that if Democrats win the presidency and the Senate, 10% annual returns for the market (S&P 500) are still possible (the average for the past 94 years) especially if some anti-immigration policies are eased and trade tensions deescalate. A surplus of capital as well as the strength of many American businesses especially from a standpoint of technology and global competitiveness are supportive factors.²

Q. But what about taxes? Aren't tax increases bad for stocks?

A: Taxes eat into a company's profits. Profits are the primary driver of stock prices over time so in an absolute sense, higher taxes are a limiting factor. That said, one of the longer bull markets for stocks began after the 1992 election in which Democrats controlled both chambers of Congress and the presidency. By 1994, Republicans gained control of both the House and the Senate during mid-term elections, and the stock market went on to register double-digit gains for the next five years (1995-1999). During this period the corporate and individual income tax rates as well as the capital gains tax rates were much higher than they are now.

Despite the rhetoric from both sides, we think the probability of a meaningful tax increase – given the pace and uneven distribution of economic recovery throughout the country – is low at this point. If Democrats win the Oval Office and the Senate, observers believe any tax increase isn't likely to have much bite to it. Rates would probably go back to where they were prior to The Tax Cuts and Jobs Act of 2017. Calls for substantial tax increases will likely require more support than an Administration calling for them can muster.³

And then there is the Federal Reserve (The Fed). Both its current Chairman, Jerome Powell, as well as his predecessor, Janet Yellen, have been vocal about the need for complementary monetary and fiscal policy relief to combat the self-imposed economic recession. "The Fed makes sure the credit backdrop supports growth; Congress and the president make sure families and businesses have enough money in their pockets," former Fed Chair Yellen wrote recently.⁴ As such, it seems broad-based tax increases appear to

¹ *Bespoke Investment Group*, "Chart of The Day", August 5, 2020.

² "Get Ready for the Biden Stock Boom," *Wall Street Journal*, August 10, 2020.

³ "Brian S. Wesbury & Robert Stein, "Biden's Tax Hike Agenda," *First Trust Economics* (blog), August 17, 2020, <https://www.ftportfolios.com/Blogs/EconBlog/2020/8/17/bidens-tax-hike-agenda>

⁴ "The Senate is on Vacation While Americans Starve," *New York Times*, August 24, 2020.

be a lower probability event, at least in the near term. And, by the time the near term is over, the 2022 midterm elections will be upon us which could alter probabilities yet again!

Q: If you're not worried about the elections, what are you thinking about?

A: History shows us that since before The Great Depression, stock market results have been positive nearly three out of every four years. History is on the patient investor's side. While charting that history – as we've often said – volatility is sometimes the price to be paid for rewarding returns.

As investment professionals, one of the most difficult (but honest) answers to questions about growth we have to offer is: "We don't know." As in: we don't know exactly where growth is going to come from, nor do we know what path it's going to take. No one does. But we're confident the American economy is filled with the talent it needs to find new and innovative ways to grow.

A like-minded investment professional recently wrote:

" . . . the biggest innovations rarely occur when everyone's happy and safe, or when the future looks bright. They happen when people are a little panicked, worried, and when the consequences of not acting quickly are too painful to bear. That's when the magic happens."

- Morgan Housel
("When the Magic Happens," *Collaborative Fund* (blog), August 20, 2020,
<https://www.collaborativefund.com/blog/when-the-magic-happens/>)

A like-minded non-investment professional offers a final perspective:

"[The American] trusts fearlessly in his own powers, which he believes to be equal to any situation. Suppose a person conceives of an idea for a project that has a direct bearing on the welfare of society. It would never occur to him to call upon the authorities for assistance. Instead, he will publicize his plan, offer to carry it out, enlist other individuals to pool their forces with his own, and struggle with all his might to overcome every obstacle. No doubt his efforts will prove less successful than if the state had acted in his stead. In the long run, however, the overall result of all these individual enterprises will far outstrip anything government can do."

- Alexis de Tocqueville (*Democracy in America*, 1835- 1840)

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