Milliman FRM Insight

ACTIONABLE PERSPECTIVES ON TOPICS THAT IMPACT WEALTH

Election 2020

Politics in the U.S. can't get much more contentious than they've been in 2020. The year began with the Senate's impeachment trial of President Trump, only to be followed by highly politicized responses to both the coronavirus pandemic and civil unrest. Not surprisingly, capital markets have exhibited above-average volatility for most of the year, notwithstanding unprecedented fiscal and monetary stimulus.

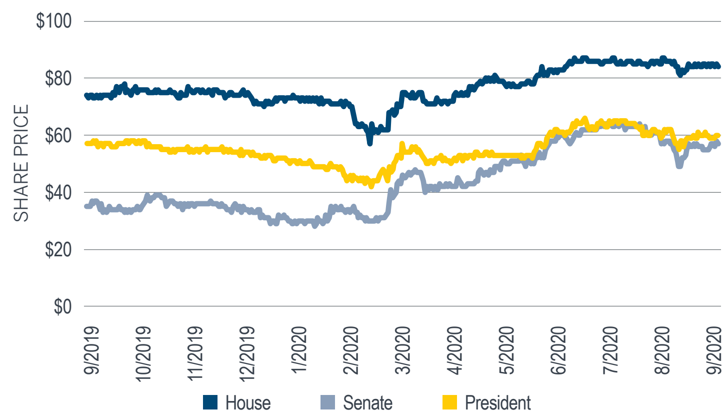
Heading into the fall, political tension, societal angst, and market uncertainty are all running high; the outcome of the elections will have significant implications across all three dimensions.

As Election Day draws nearer, campaign rhetoric grows stronger, media coverage broadens and intensifies, and the eye of the voting public is increasingly focused. In addition to the frequently reported political polls, another way of gauging candidate strength or voter sentiment is the political markets run by PredictIt, a platform that allows participants to trade shares on the outcomes of political events ranging from election results to Supreme Court decisions.

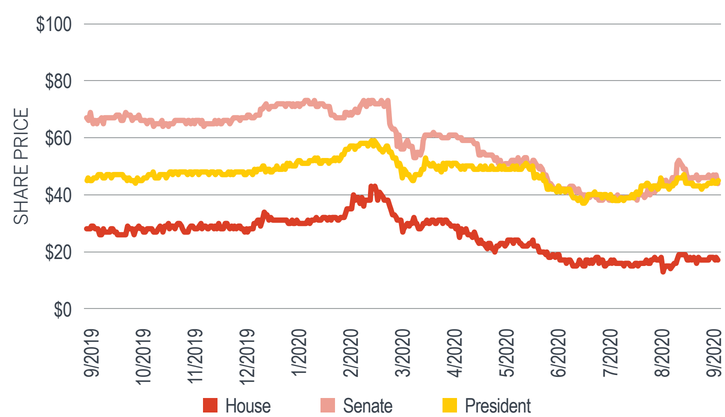
For example, PredictIt offers a market on whether or not the US economy will achieve an annualized growth rate of 5% during any quarter in 2020. As of late September, the 'Yes' contract was trading at $0.95 (up from $0.66 in July), while the 'No' contract was trading at $0.05. If the economy achieves a 5% growth rate in 2020, the value of the 'Yes' contract goes to $1.00 and the value of the 'No' contract goes to $0.00. If the economy fails to achieve a 5% growth rate in 2020, the value of the 'Yes' contract goes to $0.00 and the value of the 'No' contract goes to $1.00.

With respect to the outcome of the November elections, PredictIt markets, during the first half of the year, reflected steadily improving odds of the Democrats winning the White House, the Senate, and the House of Representatives:

Democratic Party Win



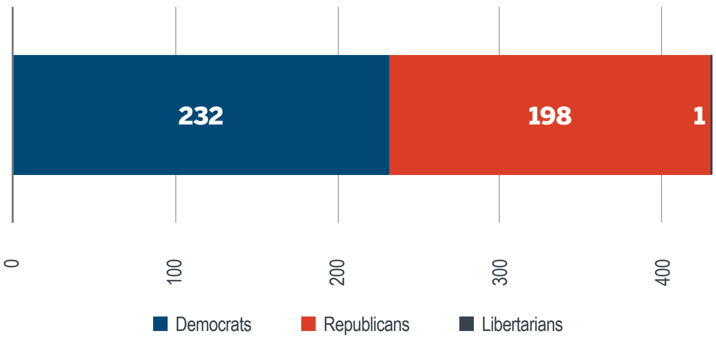
Republican Party Win



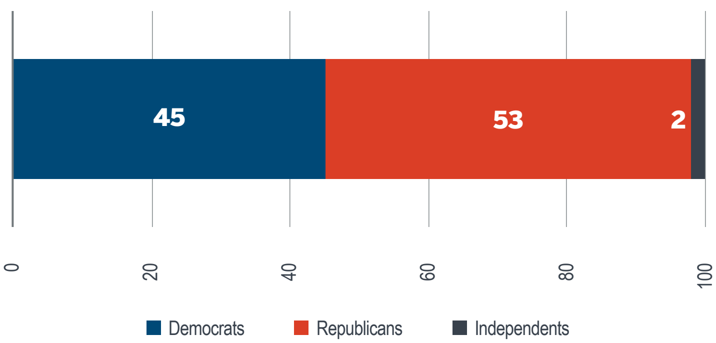
Source: Predictit.org, as of September 22, 2020

Heading into October, Democrats held 232 House seats, while Republicans held 198. Democrats would have to lose 18 seats to Republicans in order to lose control of the House.[1] In the Senate, the 45 Democrats would need to take five seats from the 53 Republicans in order to gain control:[2]

U.S. House of Representatives by Party



U.S. Senate by Party



While national polls are one way to assess voter sentiment on political candidates, the numbers from PredictIt offer an interesting perspective in that they're not based purely on asking a random sample of unsuspecting people who they're likely to vote for. Rather, the numbers are based on the prices of shares that individuals can buy and sell.

To be clear, the size and amount of participation in these markets make it reasonable to question their predictive power – the last presidential election is a case in point. In the summer of 2016, they were indicating that then-candidate Trump had just a 30% chance of winning the November election. Still, given that the projections are based on individuals taking an unsolicited interest and using real money, the information these markets generate can offer a valuable alternative perspective to the polling data.

POLITICAL PARTIES AND STOCK MARKET RETURNS

One question that often arises in the run-up to elections is how stock market returns are related to election outcomes, if at all. A look back to 1928 (the start date of the S&P 500's index history) reveals a mixed bag. Since 1928 there have been 46 two-year terms. Over that period, Democrats have controlled both houses of Congress a majority of the time, while Republicans have held the White House just slightly less often than Democrats:

S&P 500 Average Annualized Return

	Democrats	Republicans
Senate	6.40%	7.00%
House	6.10%	7.60%
President	9.80%	3.10%
All 3	8.50%	5.40%
Split (not all held by same party)	7.80%	

Percent of Time Under Party Control

(12/31/1928 - 12/31/2020)

	Democrats	Republicans
Senate	67%	33%
House	72%	28%
President	52%	48%

Source: Bloomberg, https://pdba.georgetown.edu/Executive/USA/pres.html, https://history.house.gov/Institution/Party-Divisions/Party-Divisions/, https://www.senate.gov/history/partydiv.htm

The S&P 500 has generated higher returns when Republicans have held the House and the Senate and when Democrats have held the Presidency. It's worth noting that during the four-year depression-era presidency of Republican Herbert Hoover, during which the House and Senate were also under Republican control, the S&P 500 fell 92%. Absent his presidency, the average return under Republican presidents is much higher, although still well below that under Democratic presidents.

Interestingly, the returns of the S&P 500 have been higher when the White House and Congress were all controlled by the same party than when they were split.[3] They were of course split in 2020, but if the sentiment currently expressed in the PredictIt charts plays out in the elections, the political balance may look quite different after the November elections.

Regardless of the election outcome, investors may do well to moderate their 2021 return expectations, not merely on account of 2020's strong YTD returns, but also because of both the high valuations at which stocks have been trading for much of the year and the potentially heightened uncertainty surrounding the outcome of the elections.

1 Source: https://pressgallery.house.gov/member-data/party-breakdown
2 Source: https://www.senate.gov/history/partydiv.htm
3 Source: Bloomberg

THE OCTOBER EFFECT

When it comes to monthly stock market returns, the month of October has been nothing to write home about. Dating back to 1928, the S&P 500's average calendar month return has been 0.6%; the average return in October has been just slightly lower at 0.5%.

Where Octobers get interesting, however, is in the level of volatility they tend to exhibit. When it comes to S&P 500 calendar month volatility, no month has been more volatile than October:

Average S&P 500 Return and Volatility by Calendar Month (JANUARY 1928 - AUGUST 2020)

	All	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Average Return	0.60%	1.20%	-0.10%	0.50%	1.40%	0.00%	0.80%	1.60%	0.70%	-1.00%	0.50%	0.70%	1.30%
Average Volatility	15.60%	14.00%	14.60%	15.80%	14.90%	15.30%	15.60%	14.60%	14.80%	16.80%	19.50%	16.90%	13.90%

Source: Bloomberg

Another interesting component of the October effect is that October is always the last full calendar month before the November U.S. Presidential elections. Here once again, it isn't the calendar month returns that are noteworthy, but the volatility.

As indicated below, the average October return in election years is within one percentage point of the average return for all Octobers. Additionally, the max and min October returns in election years are well within the range of October returns across all years.

When it comes to volatility, however, this is where investors may do well to take notice. Average October volatility in election years is 10 percentage points higher (i.e. 50% higher) than the average volatility across all Octobers:

Average S&P 500 October Returns and Volatilities
(JANUARY 1928 - AUGUST 2020)

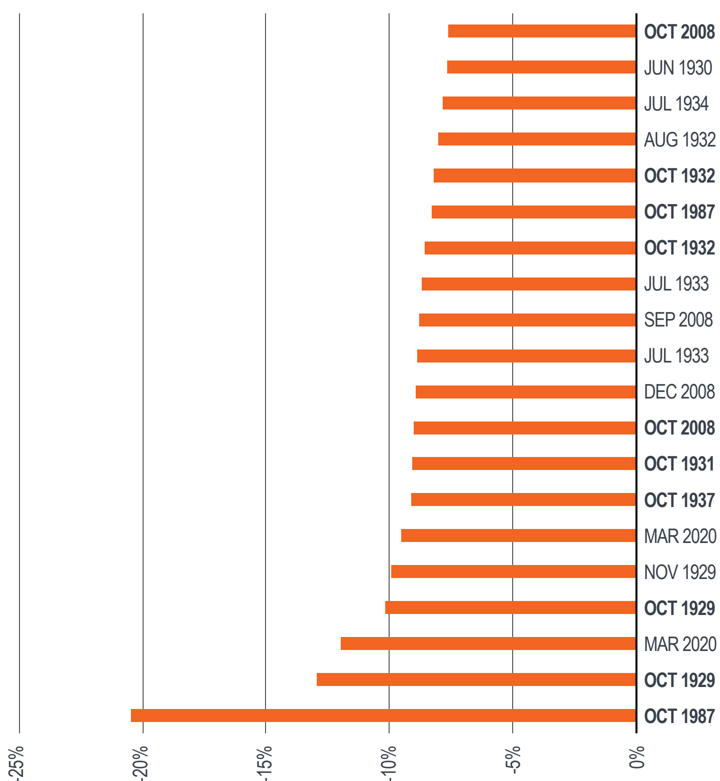
Average October Return	0.47%
Max October Return	16.30%
Min October Return	-21.80%
Average October Volatility	19.50%
Max October Volatility	105.70%
Min October Volatility	4.60%
Average October Return in Election Year	-0.20%
Max October Return in Election Year	7.60%
Min October Return in Election Year	-16.90%
Average October Volatility in Election Year	29.60%
Max October Volatility in Election Year	60.70%
Min October Volatility in Election Year	4.70%

Source: Bloomberg

One reason that the average volatility in October is so much higher is that the 1987 crash happened in October. On October 19, 1987, the S&P 500 fell 20.5% in a single day; moreover, only seven of the 22 trading days that month saw an absolute change of less than 1%.

But it's not just the 1987 crash that pushes the average October volatility higher. As it turns out, six out of the top 10, and 10 of the top 20 largest single-day declines from 1928 to 2020 all occurred in October:

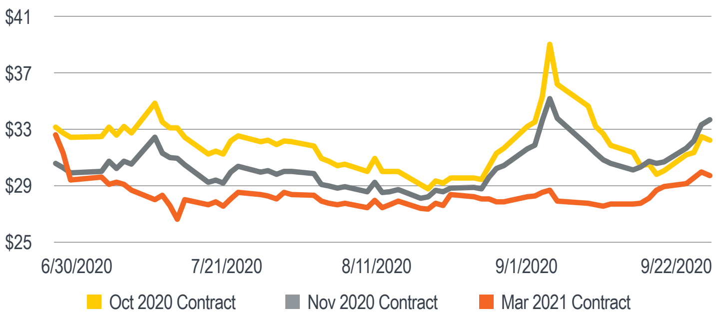
20 Largest Single-Day Declines: S&P 500 (1928-2020)



Source: Bloomberg

As of the end of September, 2020 has already had two days make this top-20 list. With a contentious election still ahead, investors may reasonably wonder if there will be any more days in 2020 that make the list. During the second half of the year, the futures market for the Cboe Volatility Index (VIX) has been consistently pricing in expectations that volatility will be higher around the time of the election than it will be months after the election:

VIX Futures Contract Prices



Source: Bloomberg

PREVENTION VS. CURE

To quote Benjamin Franklin, "an ounce of prevention is worth a pound of cure." In the world of investing, this translates to mean that small steps taken to avoid or mitigate participation in volatile market downturns can prove to be as valuable as the time and effort required to recover from them. This is especially pertinent to those in or near retirement, who are relying on their investments as a source of income and are exposed to the sequence of returns effect.

Of course past performance is no indication of future results and October 2020 may turn out to be the least volatile October investors have seen yet. But in the event that history decides to do a bit of rhyming and 2020 further solidifies October as the most volatile month, investors who have an established investment risk management strategy in place may find themselves feeling relieved to have taken on 'an ounce of prevention' and not needing 'a pound of cure.'

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Chicago
71 S. Wacker Drive
31st Floor
Chicago, IL 60606
United States
Tel: +1 312 726 0677

London
11 Old Jewry
Third Floor
London, EC2R 8DU
United Kingdom
Tel: +44 207 847 1500

Sydney
Level 5
32 Walker Street
Sydney, NSW 2060
Australia
Tel: +61 2 8090 9100

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