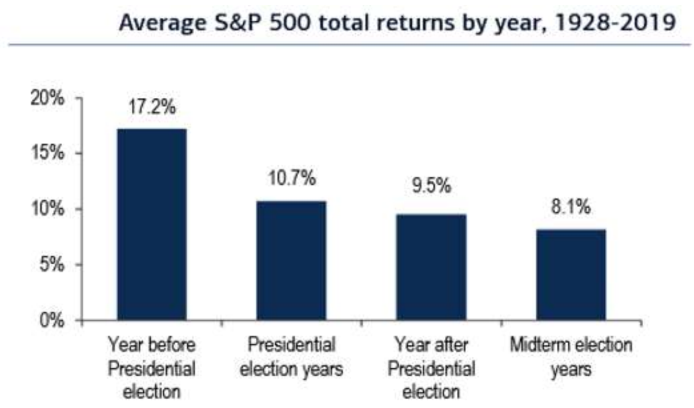
APTUS CAPITAL ADVISORS

Executive Summary:

As summer ends, markets are now confronted by the combination of the ongoing epidemic, macro distress, and US elections. With the ending of the Democratic and Republican National Conventions this past week, we have officially kicked off election season. This year's election feels unprecedented - it is coming against the backdrop of a severe recession, a global pandemic, elevated unemployment, and social unrest. Not to mention, in the background is the contested 2016 election, where Trump won the Electoral College but lost the popular vote to Hillary Clinton. All eyes will be on the key states from last election - whether states that flipped from blue to red (and vice versa) four years ago continue or flip back could have economic implications for decades.



Source: Goldman Sachs

Voters and markets have seen extraordinary environments in previous election years, i.e., the Spanish Flu and Civil unrest in the 1960s. President Trump will be the 12th president since 1900, and sixth since 1950, to run when there was a recession or bear market in an election year.

We are not here to push a political platform, so let's put the 2020 election into perspective for the stock market. Here are some quick facts:

1. Historically, if stocks are higher in the three-month period preceding the election, the incumbent party has won, and if stocks are lower, the opposition party has won.
2. Since 1952, no party has retained the White House when there was either a 20% decline or a recession *during an election year*.
3. When the economy is *in a recession on Election Day*, the incumbent party has lost 80% of the time versus 32% when the economy was in expansion.
4. President Trump sported a 38% approval rating. No president has been reelected with an approval rating that low at the end of June.

In a nutshell, history has not been kind to presidents facing economies and stock markets like 2020. The question is whether voters blame President Trump.

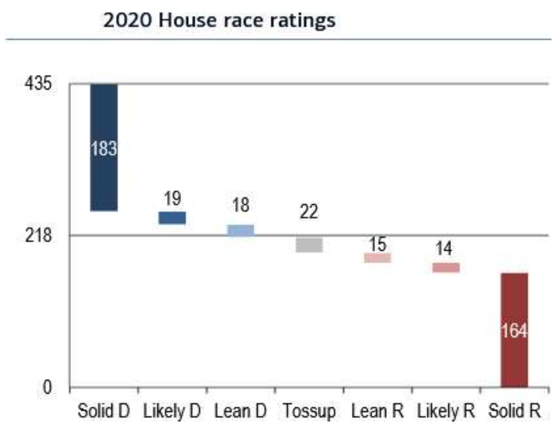
Where Do We Currently Stand?

We believe that there are three outcomes to this year's election:

1. Democratic Sweep (DEM President, DEM Senate, DEM House) – 50% Probability
2. Status Quo (GOP President, GOP Senate, DEM House) – 35% Probability
3. Biden Presidency / Split Congress (DEM President, GOP Senate, DEM House) – 15% Probability

In the event of one-party rule in Congress (one party takes both the House and Senate), we would expect staunch opposition to the current President's agenda if the opposing party's nominee wins the White House. A split Congress, like the current Congress, would likely face many gridlocks and see less successful policy initiatives. In a scenario where there is a clean sweep of both Congress and the White House, we see a greater probability of meaningful policy changes. So, let's look at the current landscape:

- House of Representatives: According to the Cook Political Report, a nonpartisan group of political analysts, the Democrats are currently favored in 218 races, the number of seats necessary for the majority. Moreover, within the 22 "tossup" seats, Democrats hold a strategic advantage in that 16 of the seats have Democratic incumbents. Meanwhile, the Republicans face an uphill battle: Republicans currently poll unfavorably relative to Democrats with the generic congressional ballot showing Democrats favored 50.0% to 39.8% according to RealClearPolitics' aggregate polls and more incumbent Republicans have announced they would not rerun for their House seats than incumbent Democrats, losing the name recognition advantage in the general election.



Source: Raymond James

- Senate: Currently, the Republicans hold a 53 vs. 47 majority implying that the Democrats will need to gain 3 additional seats and the White House to flip control. While Republicans have more seats up for reelection than the Democrats (23 vs. 12), the political map shows most seats reside in "Ruby Red" states, leaving only 4 to 5 seats (e.g. Arizona, Maine, Colorado, North Carolina, and now Montana) truly vulnerable for a Democratic pickup. However, the Cook Political Report moved Montana to "tossup" in mid-June, evidence of increasing competitiveness and more chances for the Democrats to flip. Democrats still face a stiff challenge in Alabama where incumbent Doug Jones is polling behind Trump's pick Tommy Tuberville.

Solid Democrat	Likely Democrat	Lean Democrat	Tossup Democrat	Tossup Republican	Lean Republican	Likely Republican	Solid Republican
Coons (DE)	Smith (MN)	Peters (MI)		McSally (AZ)	Jones (AL)	Sullivan (AK)	Cotton (AR)
Durbin (IL)	Open D (NM)			Gardner (CO)	Perdue (GA)	McConnell (KY	Risch (ID)
Markey (MA)				Collins (ME)	Loeffler (GA)	Graham (SC)	Cassidy (LA)
Shaheen (NH)				Daines (MT)	Ernst (IA)	Cornyn (TX)	Hyde-Smith (MS)
Booker (NJ)				Tillis (NC)	Open R (KS)		Sasse (NE)
Merkley (OR)							Inhofe (OK)
Reed (RI)							Rounds (SD)
Warner (VA)							Open R (TN)
							Moore Capito (WV)
							Open R (WY)

Source: Raymond James

Stocks have risen at the fastest rate when Republicans have controlled both the Senate and House, although they have posted a respectable 5.5% gain per annum under Democrats. The worst combination has been under split Congress.

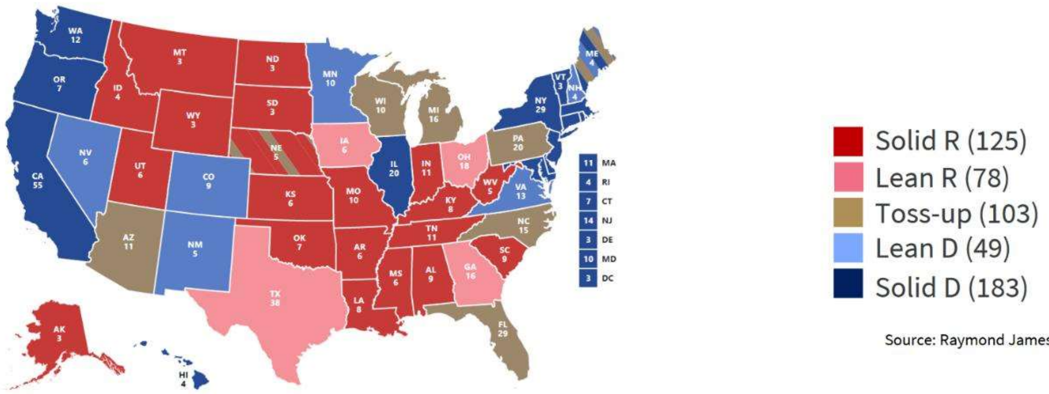
Now, let's move on to the main attraction, the Presidential Election - Biden has surged in the polls since locking up the nomination (as is common of candidates) and the surge in COVID-19 cases. The public gives failing marks to Trump's response to COVID-19 and the protests over the death of George Floyd, causing his approval ratings to dip again well below 50%. We are in unprecedented times with several months remaining, and we expect that the race will tighten. The outcome will likely depend upon both economic and population health recovery in the fall. It is worth noting that at this moment in the 2016 race, Hillary Clinton had a 7% average lead over Donald Trump.

Biden has called for greater support for the middle class to be offset by higher income and corporate tax rates. But the risk of tax increases derailing an already struggling economy may drive a softer stance; while stimulus to combat COVID will likely play a larger role. The deficit should expand regardless of the outcome of the Presidential election, but the degree of budget swelling depends on which party controls the Senate. The most fiscal restraint would come with Biden and a Republican-controlled Senate.

Election Day is Tuesday, November 3, 2020. If it is close, it will likely come down to "swing" states. We recommend keeping a close eye on: Florida, Pennsylvania, Ohio, North Carolina, Arizona, Wisconsin, Nevada, and New Hampshire. Also keep an eye on these increasingly competitive states: Texas, Georgia, Iowa, Colorado, Michigan, Minnesota, and New Mexico.

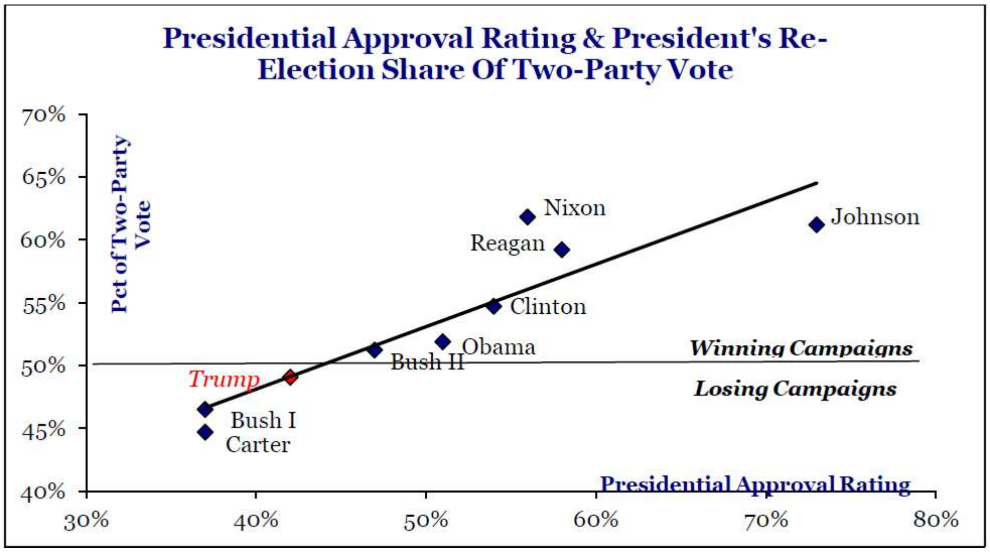
A LOOK AT 2020: ALL EYES ON THE BATTLEGROUND STATES

- Democrats begin with 183-125 base advantage and 232-203 advantage with leaners
- 6 battle ground states: Arizona, Florida, Michigan, North Carolina, Pennsylvania, Wisconsin – Trump won all in 2016 with less than 50%
- 3 states were won by Trump by less than 45,000 votes in 2016
  - Dem flipping these states (MI, PA, WI) likely wins the White House
  - All three elected Dem Governors in 2018



Source: Raymond James Research, 270 to Win

Furthermore, the presidential approval rating provides an interesting perspective because it has more history than other polls. As of June 30, President Trump sported a 38% approval rating. No president has been reelected with an approval rating that low at the end of June. Truman was close at 39%, but no other president has been reelected with an approval rating below 47% (Obama in 2012).



Source: Strategas

Only two presidents since WWII had an increasing unemployment rate in their re-election year, Jimmy Carter and George H.W. Bush. Not coincidentally, these are the only two presidents to lose re-election. For most of the summer, Trump has been hanging out with Carter and Bush I, a sign of near defeat. But Trump is now halfway between the losers and the winners as the number of new COVID-19 cases has fallen. Keep in mind, Trump can win the presidency even if he loses the popular vote by 4 million votes this cycle.

The Key Issues:

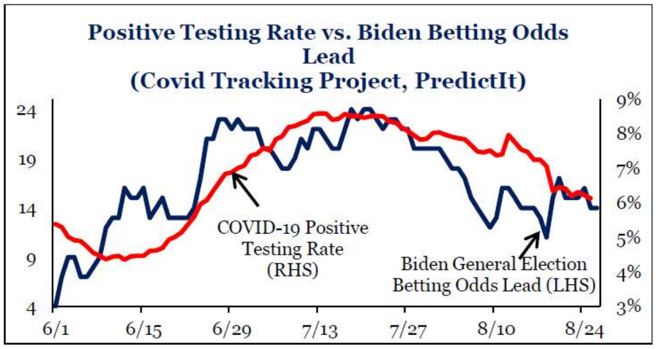
We see three key battles in the election: fight against COVID-19, crescendo in racial inequality issues and China trade war. Traditional legislative rhetoric around taxes and social safety nets may take a surprising back seat. Let's delve through each:

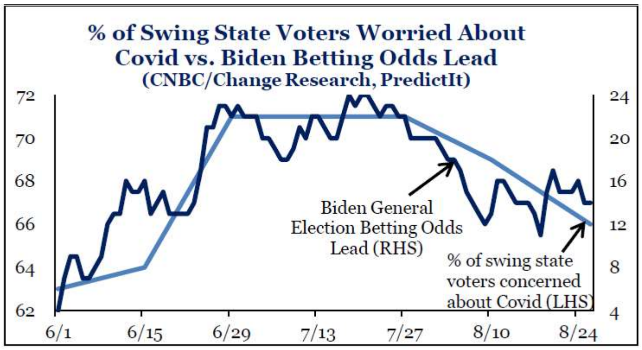
- COVID-19: Containment of the coronavirus is critical, and the differences in each candidate's approach merits consideration. Stocks have recovered since March, suggesting that investors are looking past 2020's recession and valuing companies on out-year earnings. But a meaningful uptick in new COVID-19 outbreaks could reverse this optimism.
- Racial Inequality Issues: Biden prioritizes racial justice as an important agenda item during his first two years in office. He has stated that much of his proposed $7tn government spending over the next 10 years would seek to address racial inequality. This includes $2.25tn in spending on health care, $1.3tn on infrastructure, $0.85tn on Pre-K and K-12, and $0.64tn on Housing - specifically $100bn on building new affordable housing units. The Trump Administration has touted its pro-growth policies as an effort to address racial inequality and has referred to policies intended to curb discrimination (such

as affordable housing rules) as restricting economic growth. The US corporate sector has increased its focus on racial diversity and resolving pay inequality in its adoption of a more holistic role of maximizing stakeholder (employee, customer, supplier, community and shareholder) rather than just shareholder returns. So whereas corporations emphasizing racial equality and fairness might be more aligned with a Biden presidency, efforts in this vein are likely to continue regardless of a Trump or Biden win.

- Chinese Trade War: We believe US-China relations to be on a long-term path towards decoupling regardless of which party wins the election. The presidential election, however, will determine the speed at which this decoupling will occur. Our expectation is that a Biden victory will slow the speed of decoupling, relative to a Trump victory, and therefore benefits companies that generate larger portions of their revenue from China.
- Taxes: Biden's championing of the middle class and his promises to reduce income inequality suggest that tax reform is on the table. Biden has proposed to raise the corporate tax rate to 28% from the current 21%, reversing about half of the benefits from Trump's tax reform, where the tax rate was cut from 35% to 21%. Nearly half of 2018's whopping 23% S&P 500 EPS growth came from tax reform; we estimate reversing half of the benefit would be a mid-single digit hit to EPS. Biden has also proposed 1) reducing the deductions for global intangible low-taxed income (GILTI) and 2) a 15% minimum tax on corporates with book profits >$100mn. The overall tax hit to S&P earnings would likely be in the neighborhood of ~9%, where higher tax rate accounts for 6-7%, the higher GILTI tax ~2%, and the minimum tax ~1%. Finally, an increase in tax rates for the wealthy could hurt luxury retail, residential real estate in high income areas, and other segments of the market exposed to high income spending (although a potential offset could be the state & local tax (SALT) cap rollback, which has received Democratic support.)

Ultimately, we believe that the first item on this list will be the driving force behind who gets elected. The direction of COVID-19 cases this fall will be the most important driving factor. Quietly, Trump and Senate Republicans have bounced higher in the month of August. Trump's betting odds are now at 47%, up from 38% percent two months ago. As the charts below show, we are seeing a correlation between the COVID-19 positive testing rate, swing state polls, and the betting odds. A better COVID situation leads to less anxiety and a stronger economy. As such, the competiveness of the presidential race will likely hinge on how restrained COVID-19 is this Fall and how fast the economy rebounds in the coming months.



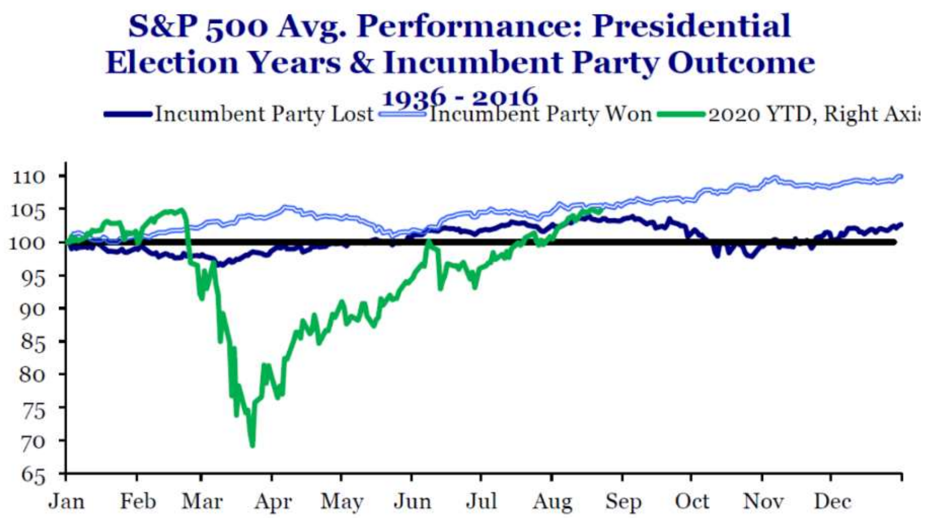


Source: Strategas

History Doesn't Repeat Itself, but it Often Rhymes

The Market Reaction Before the Election:

The S&P 500 has predicted every presidential election winner since 1987 and 87% of the winners since 1928. If stocks are higher in the three-month period preceding the election, the incumbent party has won, and if stocks are lower, the opposition party has won. The timing makes sense to us since investors like to know who will be the vice-presidential nominee and see the conventions before putting book ends around the potential outcomes. As of Friday, August 28th, the S&P 500 is up +6.1% since August 3rd. The chart below shows that, historically, September 5th is when you see the weakness in the S&P 500 when the opposition party wins.



Source: Strategas

Furthermore, since 1900, the incumbent party has won three times and lost eight when there was a 20% decline in the DJIA or a recession in the election year. The last to do so was Truman in 1948. Since 1952, no party has retained the White House when there was either a 20% decline or a recession. Both have taken place in 2020. Note that we often use the DJIA for its longer history, but trends are similar with the S&P 500.

Incumbents are 0-5 When a Recession or 20% Drop in Election Year

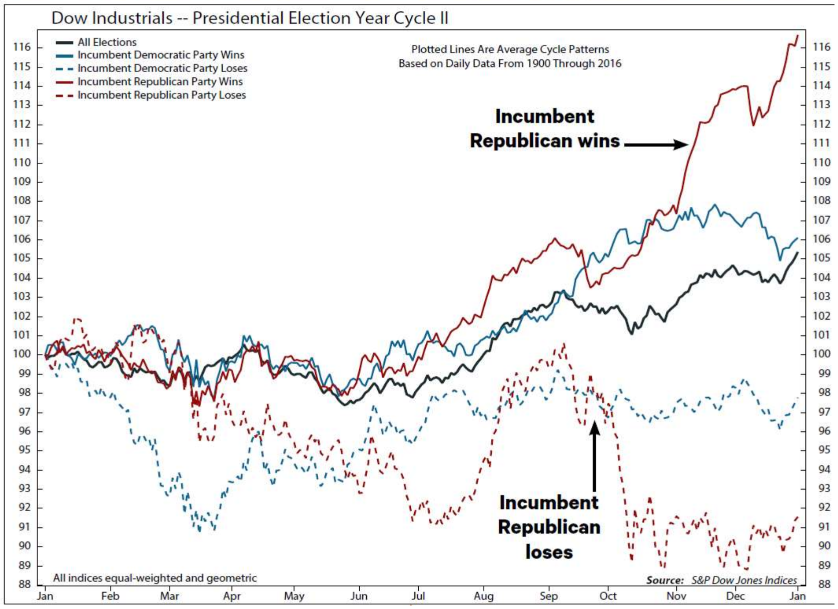
Year	20% decline or Recession?	Incumbent Party	Incumbent Party Win/Lose
1960	Yes	R	Lose
1964	No	D	Win
1968	Yes	D	Lose
1972	No	R	Win
1976	Yes	R	Lose
1980	No	D	Win
1984	No	R	Win
1988	No	R	Win
1992	No	R	Win
1996	No	D	Win
2000	Yes	D	Lose
2004	No	R	Win
2008	Yes	R	Lose
2012	No	D	Win
2016	No	D	Win
2020	Yes	R	??

Source: Ned Davis Research

The Market Reaction After the Election:

If you look at historical data, what is the tendency for the market to perform better- if the incumbent wins, or if the incumbent loses? One chart that seems relevant every cycle is the tendency for the market to perform better when the incumbent party wins than when the incumbent party loses. The trends have been amplified under Republicans, with the strongest gains coming when incumbent Republicans have won and the biggest losses when incumbent Republicans have lost, on average.

Year-end rallies weakest when incumbent Republican has lost



Source: Ned Davis Research

Conclusion

There are more moving parts during this election year than most. The last president to not run for reelection when he could have was Lyndon Johnson in 1968. The last president to lose a reelection bid was George H.W. Bush in 1992. No millennial, and few Gen-Xers, have invested under the cloud of an incumbent failing to win a second term.

This election is unique because the cause of the 2020 recession was an exogenous event. So, this bodes the question, will Americans blame President Trump for his handling of COVID-19 and the current state of the economy?

We will follow this post up next month with an article related to specific impacts the election has on different asset classes and sectors within the market. Stay tuned.

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