Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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How Will Midterm Elections Impact the Market?

Equity investors looking for positive signs on the horizon may find one in an unlikely place: the U.S. midterm elections.

The first point worth mentioning is that the lead-up to midterm elections has historically proven very volatile for the stock market, a pattern that matches what we've seen in 2022. Going back the last 60 years, the average drawdown for the S&P 500 in the leadup to a midterm has been a stout -19% – a sizable correction close to in line with 2022's declines.[1]

It is also true, however, that stocks have staged strong rebounds in the months and years following a midterm election, with positive performance far more than just a seasonal or statistical quirk. Case-in-point: since 1950, there have been 18 midterm elections, and stocks have gone up the following year *100% of the time*. And not only do stocks go up, but they also tend to go up by a lot. From 1950 to 2018, here are the forward returns for the S&P 500 following a midterm election:

- 6 Month Forward Return = +35.5%
- 12 Month Forward Return = +18.6%
- 24 Month Forward Return = +15.2%

I think it's more than just chance that stocks tend to behave this way leading up to and following the midterms. In the run-up to the election, there is usually an increased chance that the party in power will attempt to squeeze legislation through before the balance of power shifts, which adds uncertainty to the business and economic environment. As a rule of thumb in equity markets, uncertainty drives volatility.

But once the midterm elections take place and markets can digest how the balance of power has shifted, the uncertainty fades and corporations (stocks) have a clearer sense of what to expect from Congress in the coming two years. The ideal outcome for markets, in my view, is gridlock – split power in Congress and between Congress and the executive branch significantly lowers the likelihood of sweeping legislation, which reduces uncertainty for businesses when it comes to tax and investment planning.

Gridlock looks like a distinct possibility in this cycle. Since 1946, when a president has had lower than 50% job approval, the party has lost an average of 37 seats. With President Biden's approval rating closer to 40% and Republicans needing only 5 net seats to regain control of the House, Republicans appear poised to take at least one chamber of Congress. Gridlock may provide a tailwind for stocks.

To be fair, there is one key caveat to the 2022 midterm election cycle that we have not seen in years past. This may come as a surprise, but the U.S. economy has never had a recession in year three of a presidential cycle, going back to 1929. This long-standing trend could break in 2023, as leading economic indicators are pointing to a mild recession either now or in the not-too-distant future. The upshot, however, is that bull markets tend to start during recessions, and stocks also historically rally when CPI peaks and comes down. I think these conditions will appear in the year following the midterm election, which only adds to the historical bull case presented above.

Bottom Line for Investors

Stocks are rarely influenced by a single factor like midterm elections, and past returns do not influence future returns. But there is a multitude of other factors working in tandem with the midterm elections that I think should give investors hope looking forward.

The risk of recession has risen with falling profit margins, a weakening housing market, and leading economic indicators that have turned slightly negative. While that does not seem like good news on its face, it is important to remember that bull markets typically start during a recession, around 6-9 months before a trough in earnings. Equity markets have also done very well once CPI peaks and come down, and also when growth is weak but improving (rather than when it is strong but slowing). In my view, we may be closer to reaching these conditions than most appreciate, just as a midterm election is about to take place.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Forbes. October 2, 2022. https://www.forbes.com/sites/michaelcannivet/2022/10/02/the-stock-market-has-risen-after-every-midterm-election-since-1950/?sh=11220dd27c48

IN FOCUS THIS WEEK

- **How inflation is altering the tax landscape for 2023**
- **Heating bills could be higher this winter**
- **Bank of America says that U.S. consumers are in good shape**
- **China's economy slowing**

How Inflation is Altering the Tax Landscape for 2023

Inflation has hit everything from groceries to airline tickets to energy bills, the effects of which are very visible to U.S. consumers. Less visible and understood is the effect inflation is set to have on taxes in 2023. Because of formulas set by Congress, the IRS adjusts key tax code parameters based on inflation, and since inflation is running at 40+ year highs, these adjustments are poised to be significant. For one, the standard deduction is set to rise by 7% in 2023, to $27,700 for married couples and $13,850 for individuals. This adjustment marks the highest upward move to the standard deduction since 1985 when core features of the tax system were first indexed to inflation. Also set to increase are income tax brackets, with the highest 37% tax rate now applying to incomes above $578,125 for individuals and $693,750. On the contributions front, the maximum that can be contributed to an HSA (health savings account) will jump from $2,850 in 2022 to $3,050 in 2023, and changes are likely to come to 401(k) and other retirement plan contributions. Finally, there are estate tax implications coming as well, with the lifetime gift tax exclusion rising to $12.92 million per person from $12.06 million. The annual gift tax exclusion will also rise to $17,000 per year per person from $16,000 in 2022.[1]

Heating Bills Could Be Higher This Winter

Forecasters at the Energy Information Administration (EIA) stated this week that not only should the U.S. brace for a colder winter this year, but also that Americans should expect to pay more to heat their homes. Almost half of U.S. homes are heated with gas-fueled furnaces and boilers, and prices for natural gas are significantly higher now than they were last year. According to the EIA, Americans should expect it to cost almost $1,000 more to heat a typical home from October to March, which marks a nearly 30% increase from the cost to do so during the 2021-2022 winter season. If this winter ends up being colder than forecasters are currently predicting, the bill could increase 50% or more. Households that use electricity or propane to heat homes are likely to fare better, with just 5% and 10% increases over last year expected.[2]

Bank of America CEO Says U.S. Consumer Remains Healthy

There was one notable bright spot in earnings calls this week, which came from Bank of America CEO Brian Moynihan. On the call, Moynihan said the U.S. consumer remains strong and healthy, with stronger-than-expected spending on travel, entertainment, and discretionary items. Bank of America noted solid data in transactions, number of transactions, and deposit balances, adding that debt delinquencies and loan defaults remain historically low. Moynihan's comments followed more bearish comments from J.P.

Morgan CEO Jamie Dimon, who said last week an "economic hurricane" is likely on its way. Major banks have been preparing for a slowdown in economic growth and activity by adding to reserves, which has caused a drag on earnings in Q3.[3]

China's Economy is Slowing, But Few Know by How Much

Economic data coming out of China is notoriously opaque, but analysts and economists faced an even bigger challenge last week in assessing the state of China's economy. The challenge: there is no data at all. Last Monday, China's National Bureau of Statistics canceled the release of quarterly GDP data with no explanation, and days earlier the customs agency withheld trade data with no update for when the data may be released. The withholding of key economic data came just as China was holding a Communist Party congress, with leader Xi Jinping expected to secure a third term which would also rupture the norms established to prevent a Mao-style dictatorship. Economic data that may be weak or point to economic instability in China runs counter to the state narrative that their policies are effective, which arguably leads to their retraction or outright withholding. Many analysts have lately turned to satellite imagery to gauge production and consumption activity, which in 2022 has pointed to significant weakness relative to 2021 and pre-pandemic.[4]

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[1] Wall Street Journal. October 18, 2022. https://www.wsj.com/articles/inflation-causes-irs-to-raise-tax-brackets-standard-deduction-by-7-11666116021?mod=djemRTE_h

[2] Wall Street Journal. October 16, 2022. https://www.wsj.com/articles/higher-heating-bills-poised-to-hit-u-s-households-this-winter-11665805210?mod=djemRTE_h

[3] Wall Street Journal. October 17, 2022. https://www.wsj.com/articles/bank-of-america-ceos-optimism-defies-economic-gloom-11666026195?mod=djemRTE_h

[4] Wall Street Journal. October 18, 2022. https://www.wsj.com/articles/chinas-economic-data-gets-harder-to-find-as-growth-slows-11666092169

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