Trust Matters – By Dave Helscher

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Iowans will soon begin the quadrennial ritual. No, I am not referring to the celebration of a leap year, which does happen this year, or watching for a rodent's shadow, which is an annual event. Of course, I am talking about the caucuses. Every 4 years we are deluged with ads, phone calls, and polling data. Even after the caucus, we will still have around 280 days before the election. Adding to the data from pollsters was some recent data from offshore gambling odds: indicating a 46% chance of a Clinton victory and 25% for Trump. The University of Iowa business school's Electronic Markets ascribes the change of a Democrat victory at 65%, up from 54% at the beginning of the month. With 9 months to go, anything is possible and the polls and odds of one candidate or party will change.

There are a fair number of myths associated with elections and financial market reactions. One is that markets favor divided government. This concept appears to have its origins in the late 1990s, a period of extraordinary market performance. The theory is that a divided government neuters government interference in the markets and saves both parties from their worst instincts. Data indicates that the late 1990s were the exception rather than the rule. Over the past 114 years, markets have performed better when government was united, although the difference was not statistically significant.

Another myth revolves around market performance and occupant of the White House. Over the past 114 years, there has been a slight outperformance when a Democrat occupies the White House. However, this difference falls well within the range of standard deviation of annual returns for the Dow Jones Industrial Average. Any such effect is small relative to adjustments for normal variations in stock market returns.

There has been one item that reflects correlation between politics and equity market performance: the year of the presidential election cycle. During the second and fourth year of an administration, history shows no statistically significant bias between the political parties. During the third year, the markets performed best. This may be an unintended consequence of incumbent's wanting to be re-elected. It appears that fiscal and monetary stimulus is more noticeable in the 3rd year of an administration. That would be last year, the exception that proves the rule. With a divided government and historically higher federal debt levels, there was little room for fiscal stimulus in 2015. After a series of QE programs and short term rates already at 0%, monetary stimulus was little room for monetary policy priming of the pump.

Despite no clear relationship between markets and political party, the election is still important for investors. Each party has different views on economic, trade, immigration, and foreign policies. Different policies will have different impacts on different sectors of the markets. There is room for compromise as evidenced by the budget deal hammered out in December, extending beyond the election cycle. Some commentators see room for additional compromise in corporate tax reform and some adjustments to the child care credit. There is a wide divergence in individual income tax policy, but there has been some speculation that a "grand bargain" incorporating both corporate and individual tax policy changes might be possible.

Despite this narrow window of compromise, each party is working off of very different agendas. A number of studies have pointed out that the two parties are more ideologically divided than at any point in recent decades. This is reflected in Congressional voting patterns. These agendas differ on immigration policies, individual tax reform, trade, and health care. Regardless of the election outcome, no single party should enjoy a filibuster-proof majority. However, budget and tax reform legislation could pass Congress through a "reconciliation" process, only requiring simple majority votes.

One area that has been noticeably absent has been discussion of entitlement reform: social security, Medicare and Medicaid. Our aging population will require substantial expenditures under current law. Recent budget deficits have decreased, for the time being, but are projected to increase starting later this decade, as the population ages and more baby boomers retire. Also, should interest rates move higher, the servicing of the national debt will become a larger item of the federal budget.

Regardless of your party affiliation, Iowans get to be first to express their preferences for candidates. Each candidate has spoken of their views and some of their prescriptions for some of these issues. The shadow cast by your actions may have more consequences than that of certain rodent on the following day.