MIDTERM ELECTIONS —WHAT DO THEY MEAN FOR MARKETS?

November 2022

It's almost Election Day in the U.S. once again. Every two years, the full U.S. House of Representatives and one-third of the Senate are up for reelection. While the outcomes of the elections are uncertain, one thing we can count on is that plenty of opinions and prognostications will be floated in the days to come. In financial circles, this will almost assuredly include any potential for perceived impact on markets. But should long-term investors focus on midterm elections?

ELECTION RESULTS TYPICALLY DON'T LEAD TO CLEAR-CUT OUTCOMES FOR INVESTORS

We would caution investors against making short-term changes to a long-term plan to try to profit or avoid losses from changes in the political winds. For context, it is helpful to think of markets as a powerful information-processing machine. The combined impact of millions of investors placing billions of dollars' worth of trades each day results in market prices that incorporate the aggregate expectations of those investors. This makes outguessing market prices consistently very difficult.[1] While surprises can and do happen in elections, the surprises don't always lead to clear-cut outcomes for investors.

The 2016 presidential election serves as a recent example of this. There were a variety of opinions about how the election would impact markets, but many articles at the time posited that stocks would fall if Donald Trump were elected.[2] The day following President Trump's win, however, the U.S. stock market, as measured by the S&P 500 Index, closed 1.1% higher. So even if an investor would have correctly predicted the election outcome (which was not apparent in pre-election polling), there is no guarantee that they would have predicted the correct directional move of the stock market, especially given the narrative at the time.

But what about congressional elections? For the upcoming midterms, market strategists and news outlets are still likely to offer opinions on who will win and what impact it will have on the markets. However, data for the stock market going back to 1926 shows that returns in months when midterm elections took place did not tend to be that different from returns in any other month. Regardless of which party won the election, Congressional election month returns have historically been randomly distributed and well within the typical range of stock market returns. (See **Figure 1**.)

MIDTERM ELECTIONS AND U.S. STOCK MARKET RETURNS, HISTOGRAM OF MONTHLY RETURNS JANUARY 1926–JUNE 2022

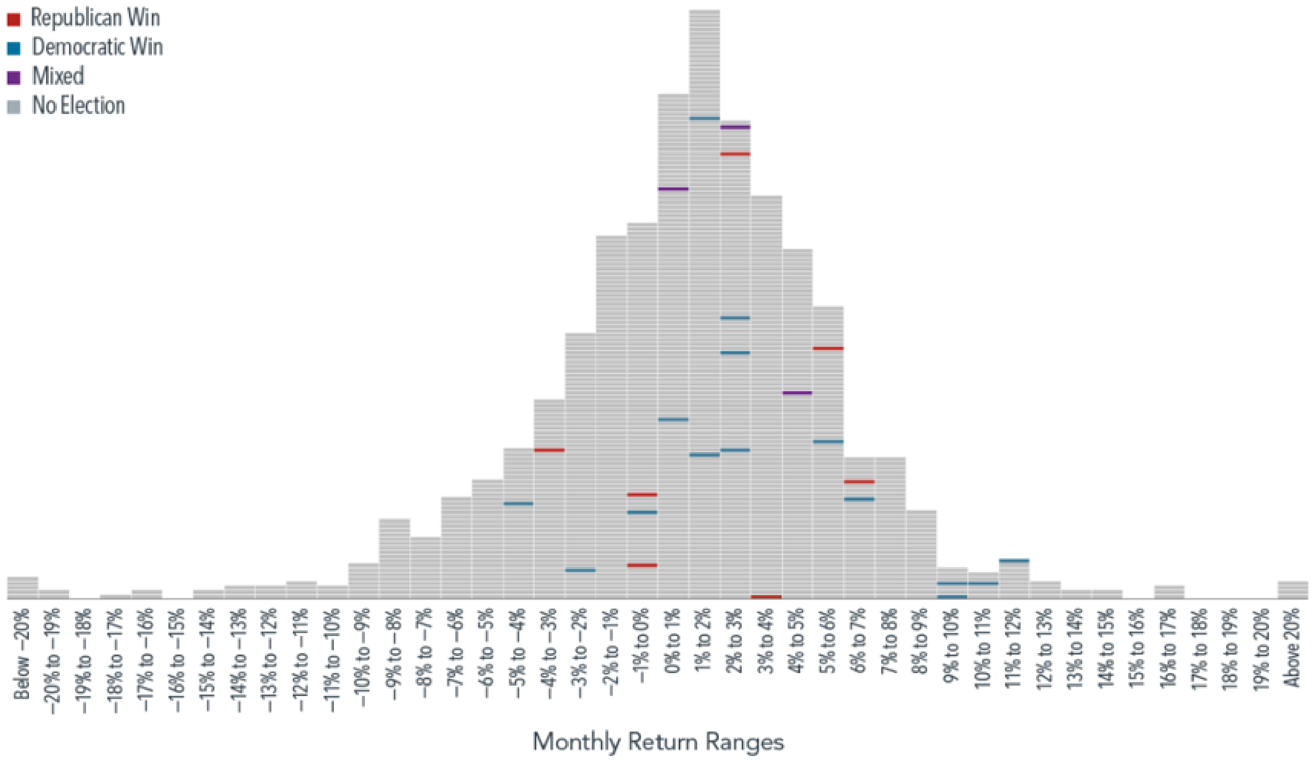

FIGURE 1. This chart shows the frequency of monthly returns (expressed in 1% increments) for the S&P 500 Index from January 1926–June 2022. Each horizontal dash represents one month, and each vertical bar shows the cumulative number of months for which returns were within a given 1% range (e.g., the tallest bar shows all months where returns were between 1% and 2%). The blue and red horizontal dashes represent months during which a midterm election was held, with red meaning Republicans won or maintained majorities in both chambers of Congress and blue representing the same for Democrats. The purple horizontal dashes indicate mixed control, where one party controls the House of Representatives, and the other controls the Senate, while gray dashes represent non-election months.

SOURCE: DIMENSIONAL FUND ADVISORS LP, 2022 S&P DOW JONES INDICES LLC, A DIVISION OF S&P GLOBAL. ALL RIGHTS RESERVED. NOTES: U.S. STOCK MARKET IS REPRESENTED BY THE S&P INDEX.

IN IT FOR THE LONG HAUL

While it can be easy to get distracted by month-to-month returns, what really matters for long-term investors is how their wealth grows over longer periods of time. (See **Figure 2**.)

HYPOTHETICAL GROWTH OF $1 INVESTED IN THE U.S. STOCK MARKET AND PARTY CONTROL OF CONGRESS JANUARY 1926–JUNE 2022

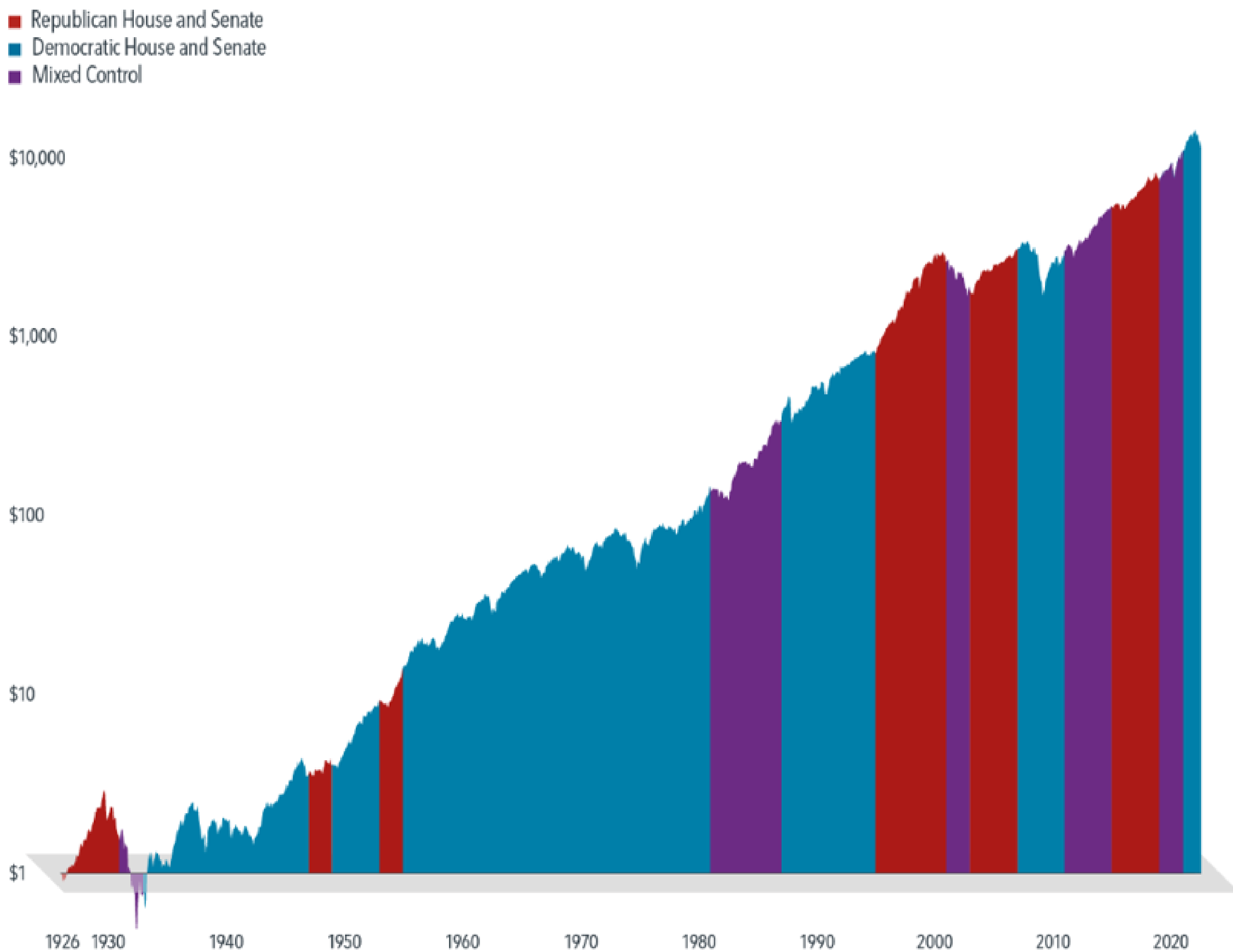

FIGURE 2. **This chart shows the hypothetical growth of wealth for an investor who invested $1 in the U.S. stock market in January 1926. In addition, the chart lays out party control of Congress over time.**

SOURCE: DIMENSIONAL FUND ADVISORS LP, 2022 S&P DOW JONES INDICES LLC, A DIVISION OF S&P GLOBAL. NOTES: U.S. STOCK MARKET IS REPRESENTED BY THE S&P INDEX.

Both parties have had periods of significant growth and significant declines during their time of majority rule. However, there does not appear to be a pattern of stronger returns when any specific party is in control of Congress or when there is mixed control, for that matter. Markets have historically continued to provide returns over the long run, irrespective of which party is in power at any given time.

Stock markets can help investors grow their assets, and we believe investing is a long-term endeavor. Trying to make investment decisions based on the outcome of elections is unlikely to result in consistently better returns for investors. At best, any positive outcome based on such a strategy will likely result from random luck. At worst, it can lead to costly mistakes. Accordingly, there is a strong case for investors to rely on patience and portfolio structure rather than trying to outguess the market to pursue investment returns.

Sources & Endnotes:

[1] This is known as the efficient market theory, which postulates that market prices reflect the knowledge and expectations of all investors and that any new development is instantaneously priced into a security.

[2] Examples include: "A Trump win would sink stocks. What about Clinton?" CNN Money, 10/4/16, "What do financial markets think of the 2016 election?" Brookings Institution, 10/21/16, "What Happens to the Markets if Donald Trump Wins?" New York Times, 10/31/16.

Source: Dimensional Fund Advisors LP.

Disclosures:

In USD. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

Please remember that different types of investments involve varying degrees of risk, including the loss of money invested. Past performance may not be indicative of future results. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, including the investments or investment strategies recommended or undertaken by Capstone Financial Advisors, Inc. ("Capstone") will be profitable. Definitions of any indices listed herein are available upon request. Please contact Capstone if there are any changes in your personal or financial situation or investment objectives for the purpose of reviewing our previous recommendations and services, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. This article is not a substitute for personalized advice from Capstone and nothing contained in this presentation is intended to constitute legal, tax, accounting, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. Investment decisions should always be based on the investor's specific financial needs, objectives, goals, time horizon, and risk tolerance. This article is current only as of the date on which it was sent. The statements and opinions expressed are, however, subject to change without notice based on market and other conditions and may differ from opinions expressed by other businesses and activities of Capstone. Descriptions of Capstone's process and strategies are based on general practice, and we may make exceptions in specific cases. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request.