

Can midterm elections move markets? 5 charts to watch



Matt Miller
Political Economist

In a year when soaring inflation, the war in Ukraine and a bear market have commanded headlines, the U.S. midterm elections risked becoming an afterthought. But now the election is coming back into focus. And with good reason. Capital Group political economist Matt Miller believes 2022 could be one of the more consequential midterm elections in U.S. history.

"Make no mistake, every move in Washington this year has been carefully calculated with the midterms in mind," Miller says.



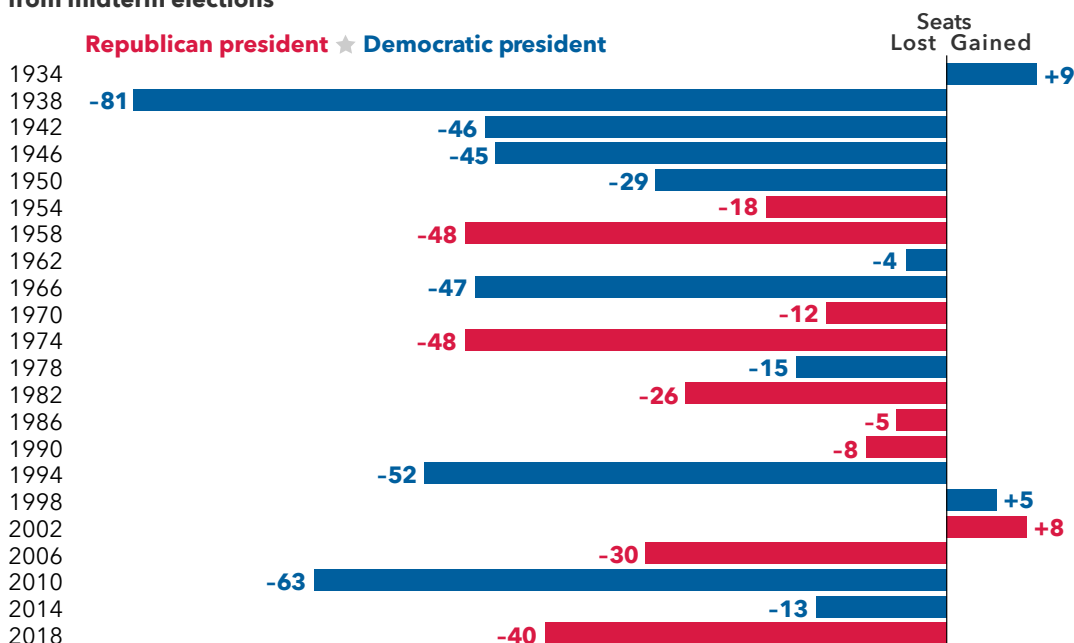
Chris Buchbinder
Equity Portfolio Manager

But while control of Congress may be at stake, do midterm elections have any effect on equity markets?

To find out, we examined more than 90 years of data and found that the answer is yes, markets have behaved differently during midterm election years. Here are five things you need to know about investing in this political cycle.

1. The president's party typically loses seats in Congress

Net change in House of Representatives seats controlled by president's party from midterm elections



Source: The American Presidency Project, "Seats in Congress Gained/Lost by the President's Party in Mid-Term Elections."

Midterm elections occur at the midpoint of a presidential term and usually result in the president's party losing ground in Congress. Over the past 22 midterm elections, the president's party has lost an average 28 seats in the House of Representatives and four in the Senate. Only twice has the president's party gained seats in both chambers.

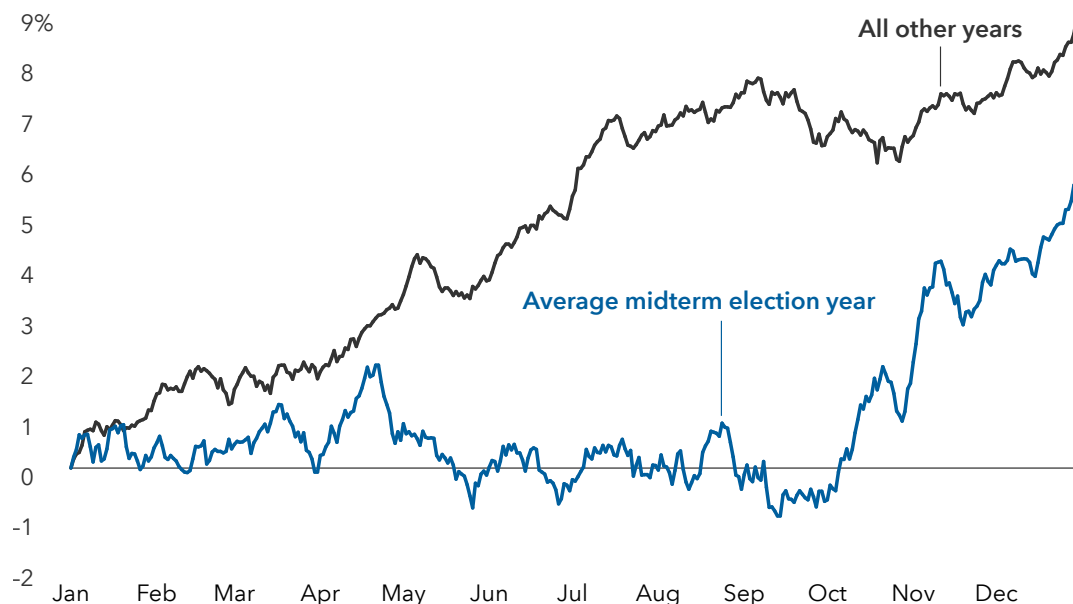
Why is this the case? First, supporters of the party not in power usually are more motivated to boost voter turnout. Also, the president's approval rating typically dips during the first two years in office, which can influence swing voters and frustrated constituents.

"The Senate remains a toss-up, but history suggests we will see a backlash against the party in power that will result in Republicans taking back control of the House," Miller says. "As far as investors are concerned that would end any chance for ambitious Democratic legislation the next two years."

Since losing seats is so common, it's usually priced into the markets early in the year. But the extent of a political power shift – and the resulting policy impacts – remain unclear until later in the year, which can explain other trends we've uncovered.

2. Market returns tend to be muted until later in midterm years

S&P 500 Index average returns since 1931



Sources: Capital Group, RIMES, Standard & Poor's. The chart shows the average trajectory of equity returns throughout midterm election years compared to non-midterm election years. Each point on the lines represents the average year-to-date return as of that particular month and day and is calculated using daily price returns from 1/1/31-12/31/21.

Our analysis of returns for the S&P 500 Index since 1931 revealed that the path of stocks throughout midterm election years differs noticeably compared to all other years.

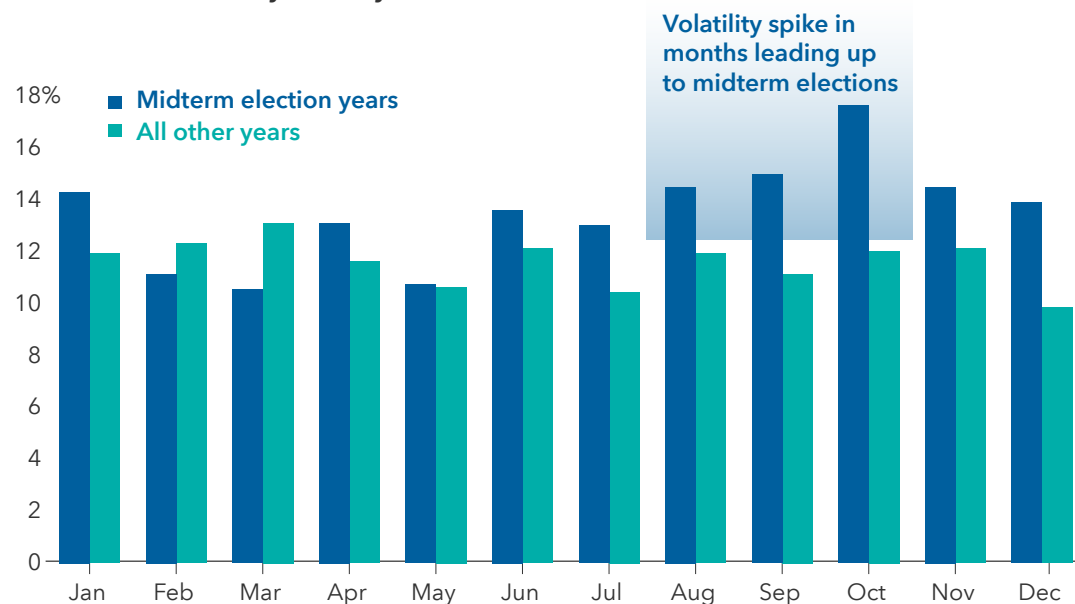
Since markets typically rise over long periods of time, the average stock movement during an average year should steadily increase. But we found that in the first several months of years with a midterm election, stocks have tended to have lower average returns and often gained little ground until shortly before the election.

Markets don't like uncertainty – and that adage seems to apply here. Earlier in the year there is less certainty about the election's outcome and impact. But markets have tended to rally in the weeks before an election, and they have continued to rise after the polls close. So far, 2022 has been another example of a midterm election year with lackluster returns, although the impact of politics has been minimal compared to that of inflation and rising rates.

Despite the uncertainty, investors shouldn't sit on the sidelines or try to time the market. The path of stocks varies greatly each election cycle, and the overall long-term trend of markets has been positive.

3. Midterm election years have had higher volatility

S&P 500 Index monthly volatility since 1970



Sources: Capital Group, RIMES, Standard & Poor's. As of 12/31/21. Volatility is calculated using the standard deviation of daily returns for each individual month. Standard deviation is a measure of how returns over time have varied from the average. A lower number signifies lower volatility. The chart shows median volatility for the S&P 500 Index for each month since 1970, displayed on an annualized basis.

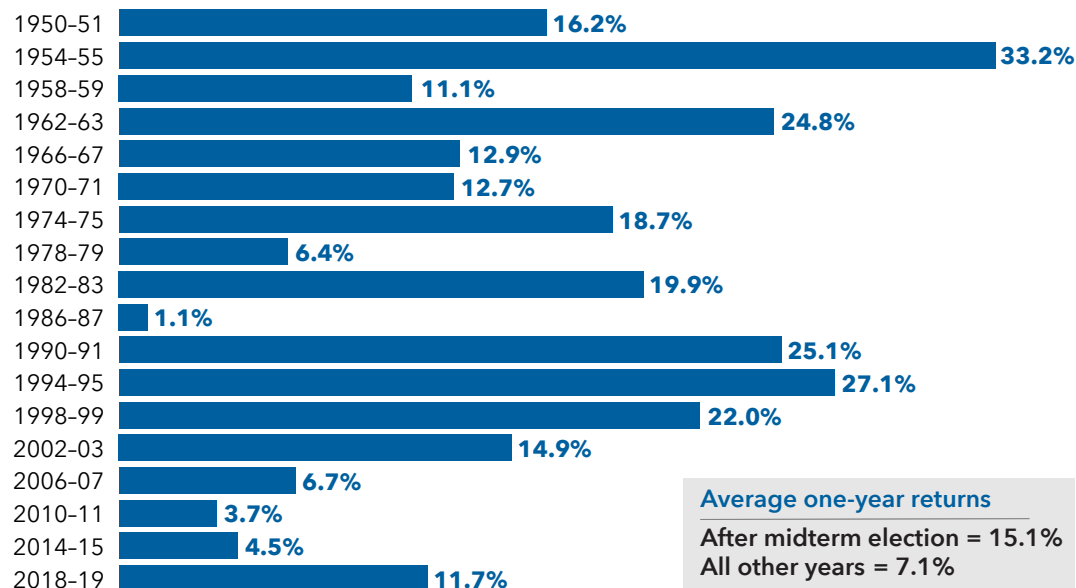
Elections can be tough on the nerves. Candidates often draw attention to the country's problems, and campaigns regularly amplify negative messages. Policy proposals may be unclear and often target specific industries or companies.

It may come as no surprise then that market volatility is higher in midterm election years, especially in the weeks leading up to Election Day. Since 1970, midterm years have a median standard deviation of returns of nearly 16%, compared with 13% in all other years.

"I don't think this election will be any different," says equity portfolio manager Chris Buchbinder. "There may be bumps in the road, and investors should brace for short-term volatility, but I don't expect the election results to be a huge driver of investment outcomes one way or the other."

4. Market returns after midterm elections have been strong

S&P 500 Index price return one year after midterm election



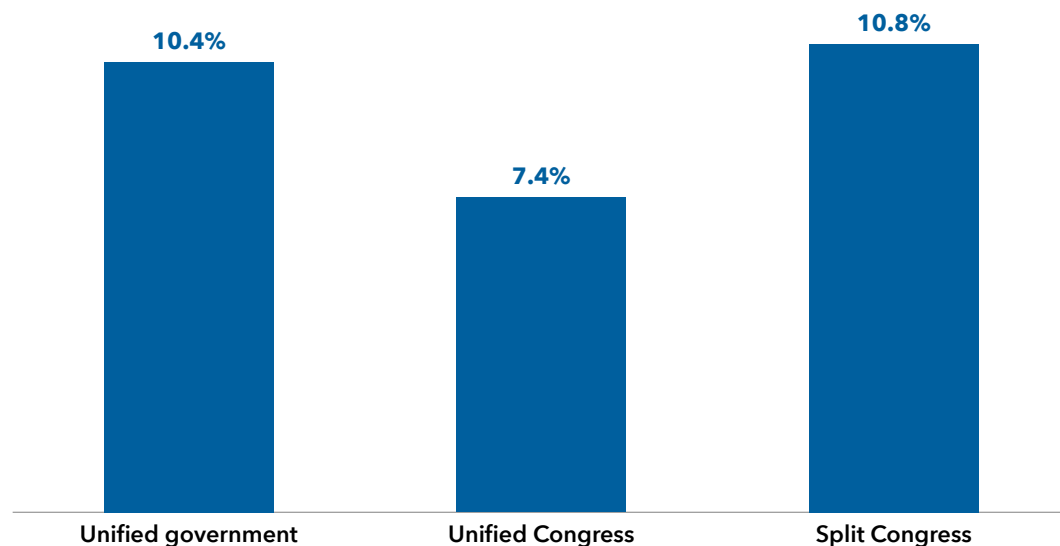
Sources: Capital Group, RIMES, Standard & Poor's. Calculations use Election Day as the starting date in all election years and November 5th as a proxy for the starting date in other years. Only midterm election years are shown in the chart. As of 12/31/21.

The silver lining for investors is that markets have tended to rebound strongly in subsequent months, and the rally that has often started shortly before Election Day hasn't been just a short-term blip. Above-average returns have been typical for the full year following the election cycle. Since 1950, the average one-year return following a midterm election was 15%. That's more than twice the return of all other years during a similar period.

Of course every cycle is different, and elections are just one of many factors influencing market returns. For example, over the next year investors will need to weigh the impacts of a potential U.S. recession and global economic and geopolitical concerns.

5. Stocks have done well regardless of the makeup of Washington

S&P 500 Index – Average annual return (1933-2021)



Sources: Capital Group, Strategas. As of December 31, 2021. Unified government indicates control of the White House, House and Senate by the same political party. Unified Congress indicates control of the House and Senate by the same party, but control of the White House by a different party. Split Congress indicates control of the House and Senate by different parties, regardless of White House control.

There's nothing wrong with wanting your preferred candidate to win, but investors can run into trouble if they place too much importance on election results. That's because, historically, elections have had little impact on long-term investment returns.

In 2020, many investors feared the "blue wave" scenario, or Democratic sweep. But despite these concerns, the S&P 500 rose 42% in the 14 months following the 2020 election (from November 4, 2020, through January 3, 2022).

Going back to 1933, markets have averaged double-digit returns in all years that a single party controlled the White House and both chambers of Congress. This is just below the average gains in years with a split Congress, a scenario which many believe is a strong possibility this year. Even the "least good" outcome – when the president's opposing party controls Congress – notched a solid 7.4% average price return.

What's the bottom line for investors?

Midterm elections – and politics as a whole – generate a lot of noise and uncertainty.

Even if elections spur higher volatility there is no need to fear them. The reality is that long-term equity returns come from the value of individual companies over time. Smart investors would be wise to look past the short-term highs and lows and maintain a long-term focus.



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2019



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2020



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2021

¹Source: Fund Intelligence, February 20, 2020. FUSE Research survey of nearly 600 advisors identifying the “most-read thought leaders.”

²Source: Marketing Support: The Advisor View, June 2020. FUSE Research survey of more than 700 advisors identifying the “most-read thought leaders.”

³Source: Marketing Support: The Advisor View, July 2021. FUSE Research survey of 720 financial advisors identifying the “most-read asset manager thought leaders.”

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

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