

## Follow Data, Not Emotions

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### In a Nutshell

One issue both sides of the political spectrum can agree on is that elections in the U.S. last too long. In other developed countries the election cycle runs for a few months, unlike U.S. elections, where campaigning persists for nearly two years. At this point, the exhaustion has set in, and the likelihood of bad decisions is nearing its peak. However, do not let your investment portfolio be one of those bad decisions; investing based on the political party in control is foolhardy. For your investment portfolio, the election is no different than any other day on the calendar. Although it does not take a rocket scientist to figure this out, based on our analysis this year's election will be exceptionally close, with margins even thinner than in 2020. Proceed accordingly. In other news, U.S. small caps, international developed, and emerging markets remain incredibly cheap, with valuations among the most favorable in 20 years. On top of the evident cheapness, lower interest rates benefit U.S. small caps, which typically carry more leverage and have less access to favorable financing terms than their large-cap peers. Additionally, as interest rates fall the dollar becomes less attractive, so investors shift funds to higher-yielding currencies. A weak dollar makes investments domiciled in a foreign currency more valuable, serving as a tailwind for international developed and emerging markets. Consider this dynamic against the backdrop of expensive U.S. large caps, and there is not much to contemplate.

### The Most Wonderful Time of the Year

With the presidential election swiftly approaching, I am sure everyone will miss all the television attack ads, unsolicited text messages, and mailboxes stuffed with flyers full of false and misleading statements. Like it or not, this is apparently the best method to convey one's message to voters during the quadrennial spectacle when people with differing opinions gather, united as Americans, to exercise their privilege to vote for the next president. Or something like that.

This is also the time of year to dust off the election forecasting model I introduced for the 2020 presidential election. The exercise is strictly a forecast, not an endorsement of a particular candidate, and the model is based solely on data to ensure objectivity. The model assumes polls have an inherent bias toward one candidate. When comparing polls leading up to the election with the actual results, you will often find the polling overestimates the margin by which a candidate is in the lead. The polling error, defined as the difference between the actual results and the polling estimates, forms the basis of the forecast. The model looks at the historical polling error to derive an adjustment factor for the state-level polls. The model then utilizes the adjusted poll margin to forecast which candidate will win the electoral votes in a particular state.

Before getting ahead of ourselves, one might ask how the model performed in the 2020 election. The model forecasted ten battleground states and was correct in six contests. Not bad for government work. Although a failing grade, where the model was accurate, it was decisive. Including a couple against the consensus calls and tremendous accuracy in predicted win margin. For example, with fifteen days until the election, the polling average in Florida was Biden +1.4, the model forecast was Trump +3.6, and the actual result was Trump +3.3. In Iowa, the polling average was Biden +1.2, the model forecast was Trump +6.3, and the actual result was Trump +8.2. In Georgia, the polling average was Biden +1.2, the model forecast was Biden +0.1, and the actual result was Biden +0.2.

Since the results indicate the forecast has significance beyond a random chance, I will take another swing at it. For most states, we already know the outcome and will not waste our time there. Instead, we will focus on the battleground states which will decide the election. It all comes down to seven states with 93 electoral votes up for grabs.

Figure 1.

Battleground States Forecast			
State	Electoral Votes	RCP Average 7 Days to Go	Model Forecast
Arizona	11	Trump +1.3	Trump +1.1
Georgia	16	Trump +2.3	Trump +2.4
Michigan	15	Harris +0.3	Trump +3.1
Nevada	6	Trump +0.7	Trump +2.0
North Carolina	16	Trump +0.9	Trump +2.1
Pennsylvania	19	Trump +0.4	Trump +2.4
Wisconsin	10	Trump +0.5	Trump +4.4

The forecast implies a decisive victory for Trump, taking all 93 electoral votes for a projected total of 312, leaving Harris with just 226 electoral votes. However, I will urge extreme caution when interpreting the results. The margin by which a candidate leads in most states polling is less than +1, a statistical coin flip. In fact, any win margin less than +6 is a coin flip. Since all the estimates are within the typical margin of error, the takeaway is the results will be close. Perhaps even closer than in 2020.

However, in addition to the forecasting model, I introduced an alternative gauge for the election outcome in 2020, called the Cornhusker Indicator. As a refresher, Nebraska and Maine award electoral votes based on congressional district, which opens the possibility for a split electoral vote in each state. In this scenario, the states allocate electoral votes among both candidates based on the winner of each congressional district. This method contrasts with the winner-take-all system that all other states have adopted. So, the Cornhusker Indicator is simply the candidate awarded the electoral vote from the Second Congressional District in Nebraska. The district consists primarily of Omaha, the largest city in the state and home to an urban population, which contrasts with the remainder of the state, characterized by small towns and agriculture.

The predictive power of the district is explained by its Cook Partisan Voting Index rating of EVEN, which measures the partisan bias of a district relative to the nation as a whole. An EVEN rating means

the district votes in the same manner as the national electorate, while a R+5 rating means the district votes 5% more Republican. There are 435 congressional districts in the country, and Nebraska's Second Congressional District is one of only seven with a rating of EVEN, making it a great indicator of how the nation is likely to vote.

Nebraska began using the congressional district method in 1992, and a split electoral vote has occurred twice. The first split vote was in 2008, when the district split from the state, allocating one of the five electoral votes to Barack Obama. This was a significant departure for the historically solid red state and marked the first time since 1964 that a Democratic candidate received an electoral vote from Nebraska. The second split electoral vote occurred in 2020, when the district again split from the state, awarding an electoral vote to Joe Biden. The significance is that a Republican candidate has never reached the Oval Office when Nebraska's Second Congressional District awards its electoral vote to the Democratic candidate. The current poll average for Nebraska's Second Congressional District is Harris +10.0, and the model forecasts Harris +9.9.

With starkly different signals from the Cornhusker Indicator and the model forecast, which one do you trust? I will spare you my typical long-winded answer and say bad polling data may skew either prediction. Here is my suggestion for election night: polls close at 8 p.m. local time in Nebraska; if the race is called for Harris in the Second Congressional District by 9 p.m., you can turn off the television. If called in favor of Trump within one hour of the polls closing, proceed with your nightly routine but keep the television on in the background. Nebraska will most likely have enough votes counted to call the Second Congressional District the following morning. If Harris wins by a margin of more than seven, you can proceed with your daily life. However, if the margin is slim for either candidate, you must stay glued to the television for the next several days. In this scenario, look to Pennsylvania, North Carolina, and Michigan; the candidate who wins at least two out of the three will likely be the next president.

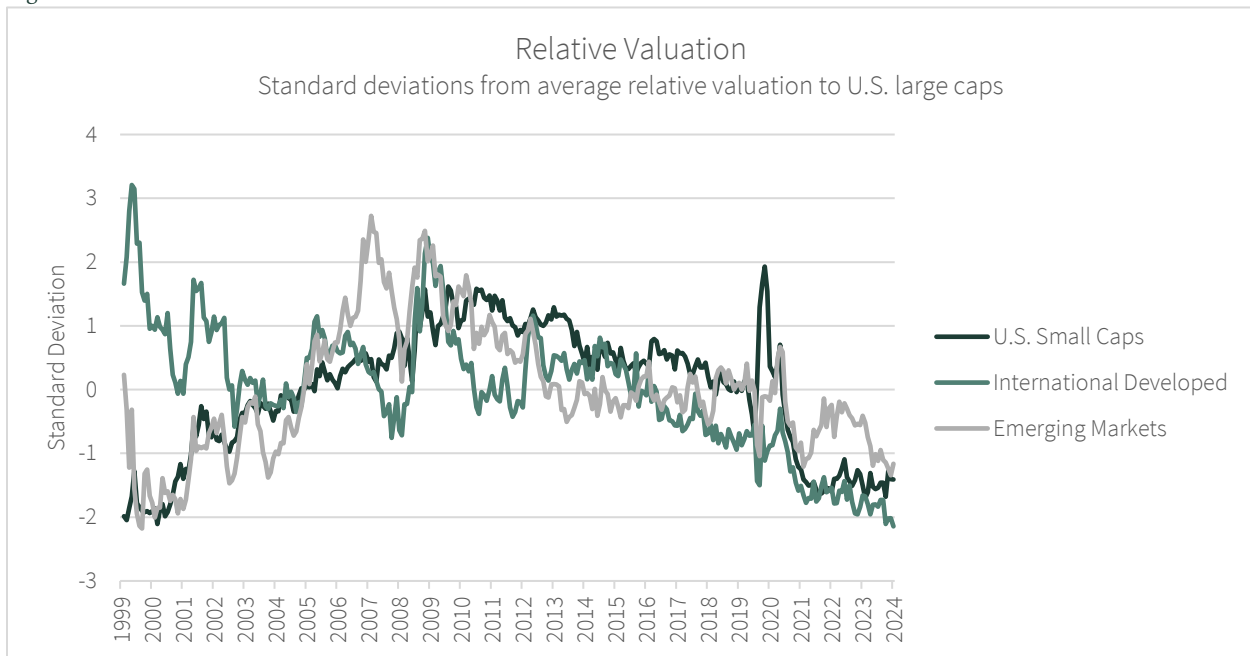
What should one do with this information pertaining to the stock market? Absolutely nothing. Making bold changes like moving investments to cash or some other bad idea based on the outcome of an election is foolish. Many people overemphasize the positive impact their horse (or the negative impact the other guy's horse) may have upon reaching the winner's circle. By design, presidents do not have that much power. If they did, our economic system would be called communism. We live in a capitalist society characterized by free markets, private ownership, and the profit-motive. In economics, the profit motive is the motivation for a firm to maximize profits. This includes figuring out how to succeed regardless of the political party in power.

To assess the effectiveness of businesses adapting to various political environments, we can look at the performance of the S&P 500 over an extended timeframe. Since 1960, we have had twelve presidents, of which six were Democrats and six were Republicans. A \$10,000 investment in the S&P 500 in 1960 would be worth \$6,279,190 by the end of September 2024, which equates to an annualized total return of 10.5%. Clearly, the other guy's horse is not that bad for the stock market. Given the outstanding performance over this period, investing based on the political party occupying the White House lacks merit. Especially considering if you missed the five best trading days, the investment would be worth \$3,963,355 at the end of the period, a 37% haircut for missing just 0.03% of the 16,303 trading days.

## If Not Now, When?

At the end of the third quarter, the S&P 500 traded at a 22x forward P/E ratio, a 30% premium to the historical average. Starting valuations at that level are historically associated with mid-single-digit annualized returns over the subsequent ten years. The outlook is unpleasant, given you can buy a ten-year Treasury Note yielding 4.25% today. However, there are very compelling alternatives sitting in plain sight. U.S. small caps, international developed and emerging markets are all trading at reasonable valuations and a steep discount to U.S. large caps. Those asset classes have been attractive for over three years, and all are trading at discounts to U.S. large caps that are among the most favorable in at least 20 years. In Figure 2, the relative valuation for each asset class is converted into standard deviations to describe the magnitude of the variation from its historical average. For example, the valuation of international developed relative to U.S. large caps is currently two standard deviations below the historical average, an event with less than a 5% likelihood of occurring. This opportunity is not one you want to pass you by.

Figure 2.



As if attractive valuations are not enough on their own, each asset class has additional tailwinds to get excited about. The Fed embarked on a well-telegraphed rate-cutting cycle in September, lowering the Fed Funds rate by 0.50%. And the market is pricing an additional 1.50% worth of rate cuts by the end of next year. Lower interest rates benefit small caps to a much greater degree than their large-cap counterparts. Small caps are more leveraged, more likely to have floating-rate debt, and typically have weaker balance sheets. So, lower interest rates will reduce borrowing costs, improve financial health, and boost profitability. All good things.

Investors often look to the dollar to gauge the attractiveness of investments outside the U.S., with a strong dollar favoring U.S. stocks and a weak dollar favoring non-U.S. stocks. For example, if you own shares of a non-U.S. company domiciled in a foreign currency, and the dollar weakens (foreign currency

strengthens), when converting the shares back to dollars you will receive more dollars per unit of the foreign currency. This scenario will boost the returns of a U.S.-based investor.

The dollar has experienced a bull market for over a decade supported by negative interest rates in Japan and Europe, making the dollar more attractive to foreign investors. More recently, during the Fed tightening cycle, when the Fed Funds rate increased 5.25% in 16 months, the dollar rapidly strengthened as demand increased. However, this is a two-way street. With the Fed starting to cut interest rates, the dollar will become less attractive. And a weak dollar will serve as a positive catalyst for international developed and emerging markets stocks.

Valuations for U.S. small caps, international developed, and emerging markets are among the most attractive in at least 20 years. Further, lower interest rates will benefit U.S. small caps through more favorable borrowing costs, while a weaker dollar will serve as a tailwind for international developed and emerging markets. It does not get much better than this. So, if not now, when?

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**Figure 2.** U.S. Large Caps represented by the S&P 500, U.S. Small Caps represented by the S&P SmallCap 600, International Developed represented by the MSCI EAFE Index, and Emerging Markets represented by the MSCI Emerging Markets Index. Relative Valuation (RV) is calculated monthly for each asset class versus U.S. Large Caps. RV equals the reference index forward P/E ratio divided by the S&P 500 forward P/E ratio. The dataset is standardized so the values plotted on the chart represent deviations from the mean [ $RV\ Deviation = (RV - Average\ RV) / Standard\ Deviation\ of\ RV$ ].

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**MSCI EAFE Index:** Measures the performance of large- and mid-cap equities across 21 developed markets countries, excluding the U.S. and Canada, and covers approximately 85% of the free float adjusted market capitalization in each country. **MSCI Emerging Markets Index:** Measures the performance of large- and midcap equities across 26 emerging markets countries and covers approximately 85% of the free float-adjusted market capitalization in each country. **S&P 500:** Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization. **S&P SmallCap 600:** Measures the performance of U.S. small-cap equities and is comprised of 600 companies across sectors.

Sources: Cook Political Report, CME FedWatch, Ibbotson SBBI, RealClearPolitics, The Wall Street Journal, WisdomTree, YCharts.

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