RJL PCS: INSIGHTS & STRATEGIES

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October 2024 Insights & Strategies: Do U.S. Elections Affect Canadian Markets?

Neil Linsdell, CFA - Head of Investment Strategy; Eve Zhou, CFA - Senior Investment Strategy Analyst

With interest rate easing cycles underway in both Canada and the U.S., focus is shifting to economic growth, employment, and the U.S. election in November. This month, we wanted to gauge the potential impact of the U.S. election on the Canadian stock market. Do Canadian stocks react differently over the 12 months following the election, based on which party is in the White House? Does the composition of Congress and the Senate play into the landscape? We look back at previous U.S. elections to gain insights into what Canadian investors might be able to expect this time.

Key Takeaways:

- **An uptick in volatility ahead of the election is normal** - The 2024 U.S. presidential election is currently a toss up. With uncertainty comes volatility, which would be expected to persist right up to election day, and perhaps beyond if there is a drawn out conclusion, such as with the Florida recount in 2000, or if we have challenges of certain results. Once the outcome is determined, volatility typically declines.
- **Strong post-election performance for S&P 500 and S&P/TSX Composite** - Regardless of who wins the election, both Canadian and U.S. key stock market indices typically perform above their long-term averages in the following 12 months.
- **Main focus should be on policy changes** - We found no clear indications that having a Republican or Democrat winning the presidential election has any immediate impact on the Canadian stock market. What is more important however is specific economic or trade policies, but these can be adjusted considerably from original campaign promises. Key policies like tariffs and fiscal measures take time to play out and have a prolonged impact on market performance.

The bottom line is that investors should stick with well established investment plans and avoid making decisions based solely on short-term noise such as election outcomes.

Anticipating Higher Volatility Leading up to Election Day

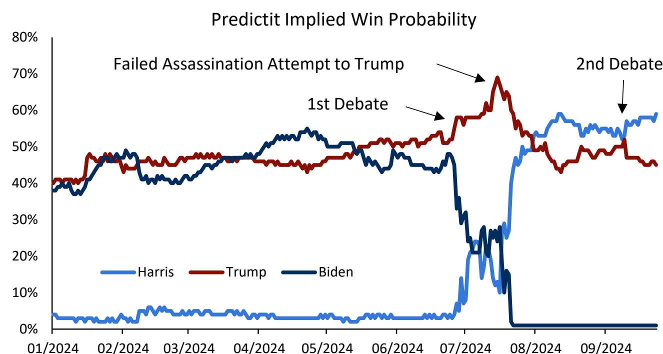
The outcome of the 2024 U.S. presidential election remains highly uncertain, and uncertainty generally leads to volatility in the stock market. The good news is that once the outcome of the election becomes clear, regardless of who wins, we can generally expect volatility to decrease and markets to appreciate over the following 12 months.

This election has been somewhat unprecedented, and based on recent experience there's also the possibility that the outcome might not even be certain on election night, with the likelihood of results being contested or legal challenges being launched, extending that period of uncertainty.

After President Biden's poor performance in the first debate in late June and the first failed assassination attempt on former President Trump on July 13, Trump's chances surged in betting markets, peaking at nearly 70% by mid-July (Chart 1). However, since Vice President Kamala Harris replaced Biden as the Democratic nominee, she has closed the gap in recent polls, particularly after the second debate on September 10. Raymond James Research's Washington Policy Analyst, Ed Mills, and his team recently updated their election forecast, now putting the odds at 50/50 for the presidency. Democrats are slightly favoured to win the House (55% vs. 45% Republicans), while Republicans are expected to take control of the Senate (70% vs. 30% Democrats).

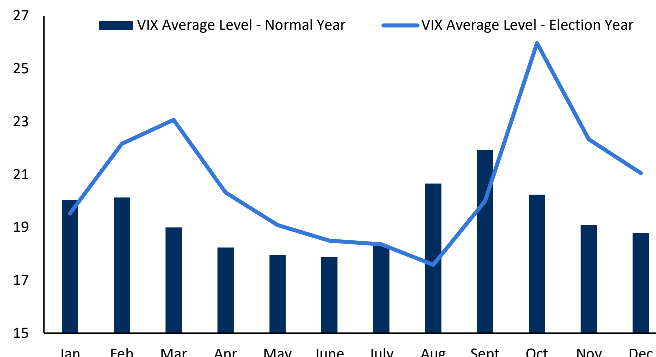
Market volatility has also increased compared to the first half of this year, which is typical as elections approach (Chart 2). The good news is that once the election results are known, both the S&P 500 and S&P/TSX Composite tend to outperform their long-term averages over the following 12 months, regardless of which party wins.

Chart 1 - Markets Suggest Election Is a Toss-Up



Source: Predictit; Data as of September 23, 2024.

Chart 2 - Market Volatility Tends to Peak Before the Election



Source: FactSet; Raymond James Ltd.; Data as of August 31, 2024.

Strong Post-Election Performance for the S&P 500 and S&P/TSX Composite

There is no denying the fact that there are significant economic ties between the U.S. and Canada. About 78% of Canada's merchandise exports go to the U.S., and nearly half of its merchandise imports come from there. The U.S. is also the largest source of foreign direct investment (FDI) in Canada and the top destination for Canadian investment abroad. There's also a strong 80% correlation between the S&P 500 and the S&P/TSX Composite, the leading equity indices for each country. Furthermore, around 30% of the revenue generated by companies in the S&P/TSX Composite comes from the U.S. Given these close ties, it's worth analyzing how both markets perform in the 12 months following U.S. elections.

Historically, market optimism tends to rise once election uncertainty clears. Since 1980, the S&P 500's total return in the 12 months following a U.S. election has exceeded its 40-year average of 12.1% in 7 out of 11 periods. Similarly, the S&P/TSX Composite has outperformed its long-term average of 7.8% in 9 out of 11 periods. Years where returns fell short were usually tied to major economic disruptions, such as the early 1980s recession, the dot-com crash in 2001, and the slow post-2008 recovery (although the S&P/TSX had a stronger rebound during that time due to Canada's milder recession). The only other exception was the S&P 500 performance after the 2004 U.S. election, but even then, returns were still solid at around 9.4%. Given the expectation of a soft landing for both the U.S. and Canadian economies, historical trends suggest that reducing political uncertainty in the U.S. typically has a positive effect on both equity markets. So, it's important to stick to your long-term plan and avoid reacting to short-term market volatility.

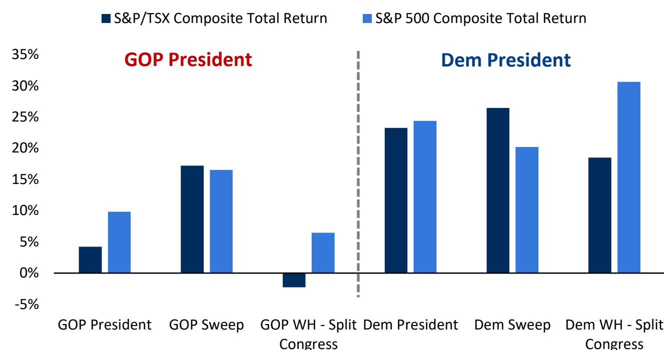
Does the Winning Party Matter?

This is a natural question to consider. At first glance, when comparing 12-month market returns after different election outcomes, it appears that returns following a Republican win, especially when paired with a split Congress, are notably weaker than under Democratic leadership (Chart 3). However, a closer look reveals that two major market downturns occurred during Republican presidencies with a split Congress: the early 1980s recession and the 2001 dot-com bubble.

Neither of these downturns can be directly linked to the party in power at the time they occurred. In the early 1980s, the recession was triggered by an oil shock from the Iranian revolution, which led to surging energy prices and inflation. Central banks responded with aggressive interest rate hikes, causing the recession. The dot-com bubble had been inflating for over a decade and burst in 2001, with little the newly elected party could do to prevent it.

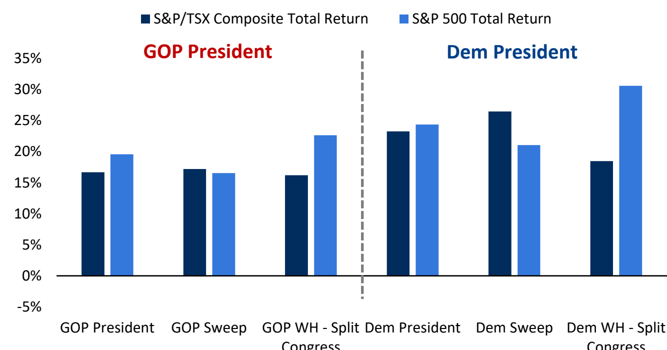
When excluding these two periods, the returns under different election outcomes are much more balanced (Chart 4). Furthermore, given the small sample size (e.g., only two instances of a Democratic White House with a split Congress), there isn't a strong case for significant differences in how the U.S. and Canadian equity markets perform under different political scenarios. Additionally, if we divide each 4-year presidential term into two congressional terms (due to potential changes in the House or Senate at midterms) and conduct the similar analysis over the following 24-month period (Charts 5 and 6), the results across both indices become more evenly distributed.

Chart 3 - Index Average Total Returns 12 Months After General Election Day Since 1980



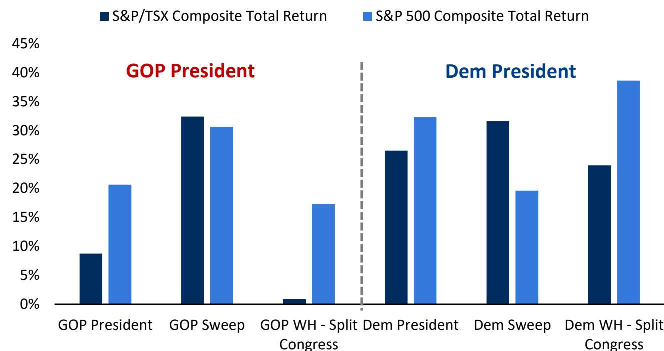
Source: FactSet; Raymond James Ltd.; Data as of September 20, 2024. Total returns in local currency.

Chart 4 - Index Average Total Returns 12 Months After General Election Day Since 1980, Excluding Major Market Corrections*



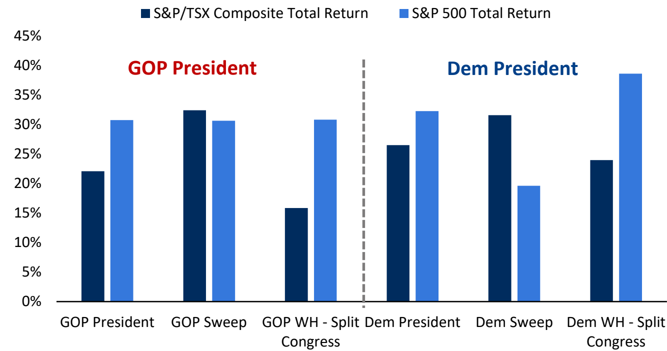
Source: FactSet; Raymond James Ltd.; Data as of September 20, 2024. Total returns in local currency. *Major Market Corrections: 1981, 2001.

Chart 5 - Index Average Total Returns 24 Months After General/ Mid-term Election Day Since 1980



Source: FactSet; Raymond James Ltd.; Data as of September 20, 2024. Unannualized total returns in local currency.

Chart 6 - Index Average Total Returns 24 Months After General/ Mid-term Election Day Since 1980, Excluding Major Market Corrections*



Source: FactSet; Raymond James Ltd.; Data as of September 20, 2024. Unannualized total returns in local currency. *Major Market Corrections (Canada): 1981, 1989, 2001, 2007; Major Market Corrections (U.S.): 2001, 2007.

Long-Term Market Impact Hinges on Policies, Not Election Results

Perhaps a better way to approach the market is to focus on policy changes and their long-term effects rather than just the election results. Some policy changes only fully materialize years after a president leaves office. In Chart 7 on the next page, the S&P/TSX Composite performance is overlaid with the political landscape since 1980, highlighting the primary causes of major market corrections. It reveals that major market corrections are rarely tied directly to election outcomes, with index performance typically impacted by broader factors such as domestic and global economic conditions, commodity prices, and external disruptions, which build up over time and are definitely less predictable than election dates.

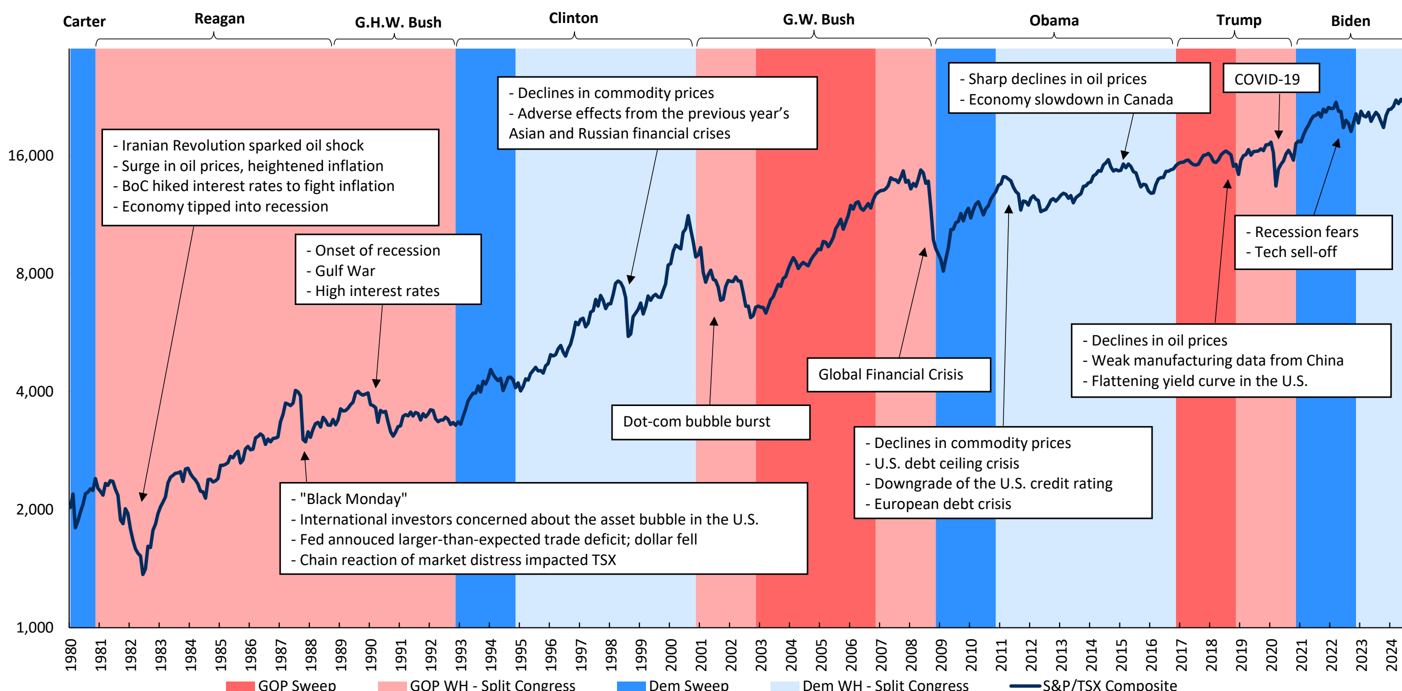
Given the U.S.'s dominant role in global markets and its position as Canada's top trading partner, its policies inevitably influence Canada's economy from multiple angles. For example, systemic shocks originating in the U.S., like Black Monday, the dot-com crash, and the 2008 global financial crisis, affect Canadian markets significantly. U.S. economic health impacts Canadian exports, especially in energy. While U.S. trade agreements, tariffs, and dollar strength can directly influence Canadian businesses, U.S. fiscal policies indirectly affect Canada as well. Additionally, U.S. diplomatic policies, particularly in an increasingly fragmented world, play a role in shaping Canada's trade relations with other countries. All of these factors can influence the valuations and/or earnings of Canadian companies.

Areas that most relevant to Canadian markets are U.S. trade policy, fiscal policy (debt ceilings, tax hikes/cuts), policies around clean and traditional energy. However, it's important to remember that new policies take time to be fully implemented, and many initial proposals are often watered down. Therefore, while closely monitoring developments is essential, it's wise not to overreact to the anticipated election results, especially given the increasingly polarized policy proposals from both parties.

Note of upcoming webinar:

October 23, 2024 (1-2pm ET) - Join Raymond James' Neil Linsdell, Head of Investment Strategy, Ed Mills, Managing Director, Washington Policy, Eugenio Aleman, Chief Economist, and Tavis McCourt, Institutional Equity Strategist, for a quarterly update on financial markets and insights into what to expect with the upcoming U.S. presidential election. For a Client Insights Webinar invitation, please reach out to your financial advisor at Raymond James Ltd.

Chart 7 - Historical Performance of the S&P/TSX Composite Index (1980-Present)



Source: FactSet; Raymond James Ltd.; Data as of September 20, 2024. Y-axis in logarithmic scale. Election day typically occurs in early November of the general/mid-term election year.

Exhibit 1 - U.S. Party Division and GDP Growth (% y/y), Selective Index Total Returns Index Average Total Returns 24 Months After General/Mid-term Election Day Since 1980

Election Year (Y0)	President	President Party	Senate	House	Divided/ Unified	U.S. GDP (Y1)	U.S. GDP (Y2)	Canada GDP (Y1)	Canada GDP (Y2)	S&P 500	S&P/TSX Comp	SPGSCI Index	Comm Svc	Cons Discret	Cons Staples	Energy	Finan-cials	Health Care	Indus-trials	Info Tech	Mate-rials	Real Estate	Utilities
1980	Reagan	R	R	D	Divided	2.5%	-1.8%	3.4%	-3.2%	22.6%	-18.2%	-32.4%	--	--	--	--	--	--	--	--	--	--	--
1982	Reagan	R	R	D	Divided	4.6%	7.2%	2.6%	5.9%	29.9%	26.9%	-0.9%	--	--	--	--	--	--	--	--	--	--	--
1984	Reagan	R	R	D	Divided	4.2%	3.5%	4.7%	2.1%	56.1%	26.7%	-19.0%	--	--	--	--	--	--	--	--	--	--	--
1986	Reagan	R	D	D	Divided	3.5%	4.2%	4.1%	4.4%	19.3%	6.2%	5.1%	--	--	--	--	--	--	--	--	--	--	--
1988	G.H.W. Bush	R	D	D	Divided	3.7%	1.9%	2.3%	0.2%	19.2%	-6.3%	48.9%	4.5%	-12.9%	3.3%	21.8%	-12.0%	4.4%	-11.6%	20.3%	-13.0%	-39.3%	-1.7%
1990	G.H.W. Bush	R	D	D	Divided	-0.1%	3.5%	-2.1%	0.9%	46.1%	10.4%	-26.5%	18.2%	27.8%	22.9%	-15.9%	25.1%	20.7%	-17.3%	72.4%	0.9%	-38.9%	4.3%
1992	Clinton	D	D	D	Unified	2.8%	4.0%	2.7%	4.5%	17.9%	31.3%	-1.7%	9.4%	10.3%	-13.2%	36.4%	13.6%	42.7%	32.0%	21.4%	64.4%	11.4%	16.9%
1994	Clinton	D	R	R	Divided	2.7%	3.8%	2.7%	1.7%	60.5%	39.3%	12.6%	27.7%	22.5%	36.8%	27.8%	66.0%	100.4%	44.5%	85.7%	14.6%	5.4%	13.7%
1996	Clinton	D	R	R	Divided	4.4%	4.5%	4.3%	3.9%	64.2%	16.8%	-26.9%	61.1%	33.2%	78.0%	-4.1%	44.2%	-16.4%	15.6%	21.3%	-26.9%	12.4%	31.2%
1998	Clinton	D	R	R	Divided	4.8%	4.1%	5.1%	5.1%	28.6%	55.6%	61.9%	146.8%	27.0%	51.5%	29.8%	29.0%	59.9%	50.1%	232.1%	-15.6%	-8.9%	-11.7%
2000	G.W. Bush	R	D	R	Divided	1.0%	1.7%	1.9%	3.0%	-33.6%	-30.6%	-14.0%	-46.3%	-25.3%	40.5%	28.9%	-2.5%	-39.5%	-34.0%	-89.8%	20.6%	21.8%	28.1%
2002	G.W. Bush	R	R	R	Unified	2.8%	3.8%	1.8%	3.1%	29.7%	43.8%	67.2%	26.1%	22.6%	17.4%	67.9%	60.0%	-17.7%	9.8%	95.5%	33.4%	36.1%	23.6%
2004	G.W. Bush	R	R	R	Unified	3.5%	2.8%	3.2%	2.6%	25.5%	42.3%	24.5%	40.9%	33.5%	8.3%	70.4%	43.3%	-18.5%	45.8%	-9.7%	59.0%	47.5%	41.5%
2006	G.W. Bush	R	D	D	Divided	2.0%	0.1%	2.0%	1.0%	-26.2%	-16.3%	0.2%	8.2%	-25.5%	-10.9%	-17.0%	-20.2%	-33.1%	-9.8%	-5.1%	-19.1%	-37.9%	2.9%
2008	Obama	D	D	D	Unified	-2.6%	2.7%	-2.9%	3.1%	27.2%	35.5%	26.4%	9.1%	30.8%	23.2%	27.1%	27.2%	79.3%	27.0%	0.0%	98.0%	42.5%	30.9%
2010	Obama	D	D	R	Divided	1.6%	2.3%	3.1%	1.8%	20.6%	1.0%	6.0%	39.6%	2.4%	26.1%	-3.1%	10.6%	96.9%	19.8%	-53.3%	-17.4%	12.9%	14.8%
2012	Obama	D	D	R	Divided	2.1%	2.5%	2.3%	2.9%	48.4%	25.1%	-17.8%	26.7%	81.5%	72.5%	15.4%	46.0%	109.5%	74.9%	82.4%	-38.3%	21.3%	7.8%
2014	Obama	D	R	R	Divided	2.9%	1.8%	0.6%	1.0%	9.4%	6.0%	-33.9%	26.0%	11.4%	42.9%	-11.9%	12.4%	-75.2%	3.5%	29.3%	17.8%	5.8%	18.1%
2016	Trump	R	R	R	Unified	2.5%	3.0%	3.0%	2.7%	36.7%	11.1%	26.1%	10.5%	16.3%	4.0%	-6.1%	19.1%	62.6%	35.0%	39.3%	-8.7%	23.7%	3.2%
2018	Trump	R	R	D	Divided	2.5%	-2.2%	1.9%	-5.0%	22.6%	9.1%	-22.2%	2.7%	0.7%	22.1%	-34.1%	-2.3%	-58.1%	24.6%	137.6%	59.0%	-2.7%	48.1%
2020	Biden	D	D	D	Unified	5.8%	1.9%	5.3%	3.8%	13.8%	28.0%	85.0%	28.5%	29.3%	30.2%	145.5%	40.9%	-57.8%	25.0%	-36.2%	-11.6%	10.2%	8.1%
2022	Biden	D	D	R	Divided	2.5%	--	1.2%	--	--	--	--	--	--	--	--	--	--	--	--	--	--	--

Source: FactSet; Raymond James Ltd.; Data as of September 20, 2024.

Note: Election Day typically occurs in early November. For example, if the election year is 1980, Election Day would be in early November 1980. Y1 would correspond to 1981, and Y2 to 1982. All index total returns are unannualized, in local currency, measured over a 24-month term after Election Day. Unshaded rows indicate general election years, while light blue shaded rows represent midterm election years.

Fed Announces Interest Rate Cut

Joshua Lucchetto - Fixed Income Associate; Charlotte Jakubowicz, CMT, CIM - Vice President, Fixed Income and Currencies

The United States Federal Reserve (Fed) has officially made their first interest rate cut since March of 2020, joining other major economies in a rate-easing cycle. The rate cut of 50 bps was a shock to many, given that just six weeks prior, the Fed decided against a 25 bp reduction, stating that they were not yet on track to their target. On September 18, Fed Chair Jerome Powell stated, “the committee has gained greater confidence that inflation is moving substantially toward 2 percent.” The U.S. is the last of the G7 countries to cut its policy interest rate (with the exception of Japan that already had negative interest rates, and is now hiking) since the surge of rate hikes due to abnormally high global inflation.

Different Mandates

The U.S. Fed and the Bank of Canada (BoC) operate under two different mandates, which help to inform each central bank’s focus when evaluating the need to modify interest rate policy.

Bank of Canada: The BoC has a single mandate that solely prioritizes price stability and keeping inflation in the target range of 1% to 3%.

The Federal Reserve: The Fed, on the other hand, has a dual mandate - maximum employment (achieve the highest level of employment without causing inflation) and stable prices (maintain low and stable inflation over the long term).

After the Fed announced its 50 bp rate cut, Chair Powell mentioned numerous times that they were pleased with the strong labour market numbers recently, possibly justifying why they chose to proceed with the outsized rate cut.

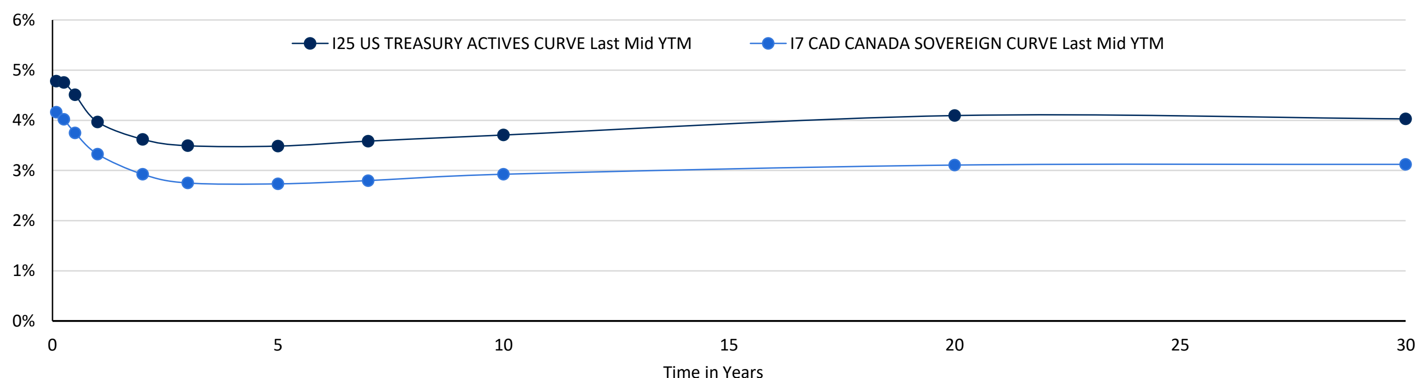
Implications

Interest rates have numerous effects in the country in which they are amended, but beyond borders as well. The lower U.S. overnight rate should be encouraging for Canada’s central bank as a much-discussed concern was the maximum interest rate difference permissible between the two countries. When rates are not held is a suitable band, exchange rates may pay the price, causing goods to be more/less competitive internationally. Since maintaining a balanced exchange rate is crucial for sustaining competitive pricing and supporting the export market, we must observe not just Canada’s benchmark interest rate alone, but in relation to its key trading partners. The removal of this headwind, in addition to Canadian inflation improving and staying within the target range of 1-3%, should provide the BoC the room to continue with rate cuts.

The U.S. yield curve is projected to flatten and eventually normalize over the next year, with a total of nine rate cuts anticipated by July 2025. Similarly, Canada is expected to implement seven rate cuts within the same timeframe. As a result, short- and mid-term rates in the U.S. are likely to drop significantly. It is recommended that investors begin extending their investment terms to about five years for both Canadian and American bonds. If possible, extending out to ten years may be even more advantageous. Investors could consider adopting a laddered approach, gradually extending the term, and reinvesting as issues mature.

Despite these anticipated changes, a gap remains between the Canadian and American yield curves as shown in the graph below. Currently, the five-year yield is approximately 75 basis points higher in the U.S., while the two-year yield is about 70 basis points higher. Investors with U.S. cash or U.S. accounts should consider locking in these higher rates while they are still available. This disparity underscores the ongoing differences in economic conditions and monetary policies between the two countries.

Chart 8 - Canadian and American Yield Curves



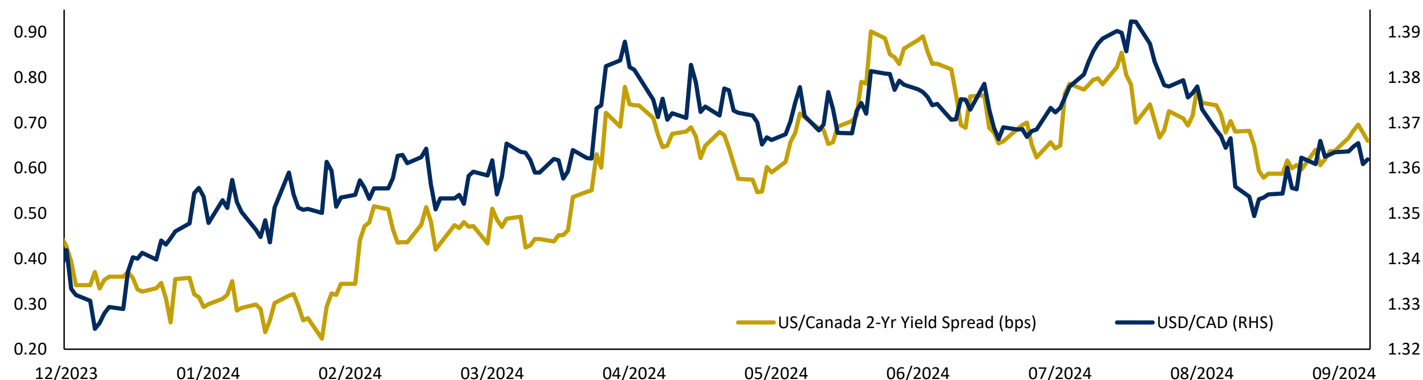
Source: FactSet; Raymond James Ltd.; Data as of September 18, 2024.

USD/CAD Implications as the Fed Officially Joins the Policy Easing Party

Ajay Virk, CFA, CMT - Head Trader, Currencies

As the Fed officially kicks off its easing cycle, the relative U.S. vs. Canadian yield differential may begin to swing in the loonie's favour. However, as other major central banks begin to catch up with the BoC with their own respective policy easing cycles, the additional quarter-point rate cut from the BoC at their September 4 meeting, adding to the cumulative 50 bps of cuts since June, actually did little to weigh on the loonie.

Chart 9 - USD/CAD In Lockstep With US/Canadian 2-Year Yield Differentials



Source: FactSet; Raymond James, Ltd.; Data as of September 20, 2024.

Since the BoC kicked off its easing cycle in June, USD/CAD is down roughly 1.5% at the time of writing, coinciding with the narrowing of the two-year US/Canadian yield differential to 65bps from a high of 90bps back in June.

Market participants initially had a more dovish outlook for the BoC than the Fed early on in the year, which gradually lifted USD/CAD, but the outlook now appears to be shifting to some degree as the Fed officially joins the policy easing party.

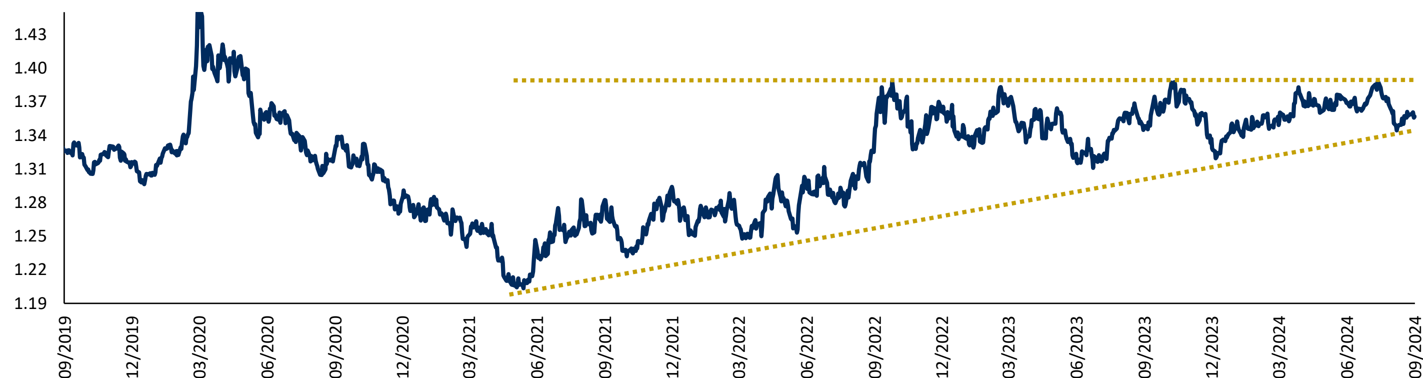
The Fed Comes Out Swinging

Despite the Fed coming out of the corner swinging with a 50 bps cut, the market is currently expecting nearly three more cuts for their last two policy meetings of the year, at the time of writing. This suggests that we may very well get another outsized 50 bps cut.

If history is indeed our guide, then we believe it is important to note that while previous Fed easing cycles resulted in varying outcomes for the broader USD, the USD has actually managed to, on average, appreciate in the one-to-two years following the first Fed rate cut. This occurred back in 2007 and 2019.

One particular reason for this may be in part due to the fact that most Fed easing cycles tend to begin in anticipation of economic headwinds or recessions. As a result, this may explain the subsequent bid in the USD as safe-haven demand increases.

Chart 10 - USD/CAD Trending Upward Since 2021 but Finds Itself Getting Pinched & Approaching Trendline Support



Source: FactSet; Raymond James, Ltd.; Data as of September 20, 2024.

USD/CAD Implications

It appears we are now on the verge of a shift in narratives as the divergence between central bank easing policies, which was apparent at the start of the year, is no longer the central narrative. Fed expectations will be the central theme and broader moves in the USD may very well have more of an influence on the direction for the other major G10 currencies.

As for USD/CAD, we previously highlighted that speculative short-CAD positions hit their highest levels on record back in June, according to data from the U.S. Commodity Futures Trading Commission. However, while still heavily short, there has been a modest unwind of some of those bearish bets on the loonie. At the same time, speculators shaved their net long USD positions to their lowest levels since May. While it may be a bit premature to discern this as a definitive change in speculative trends at this time, it is something we will be keeping an eye on going forward.

Going forward, U.S. election risk coupled with ongoing tweaks to Fed expectations will surely be at the forefront. As for key technical levels for USD/CAD, we have long-term support at 1.3440 that we are keeping an eye on to the downside for now, and 1.3650 as our key level of resistance to watch for on the upside.

IMPORTANT INVESTOR DISCLOSURES

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