Biden Drops Out

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President Biden announced his intent to drop out of the race this past weekend. He promptly endorsed Vice President Kamala Harris to take his place at the DNC. Whether an open convention will be held or not, it appears like Harris has significant leverage over the Democrats' war chest. There is some speculation that she will be challenged by a variety of other potential candidates including Gavin Newsom, Michelle Obama or even Hillary Clinton. Current polls still suggest former President Trump is far ahead of Harris and would likely beat Clinton if given a second chance. It's less clear how Trump would perform against some of the other possible candidates. More important than politics is policy, a critical factor for investors to focus on. In this week's article and episode, we'll explore potential economic outcomes in various political scenarios.

Republican Senate & House, Democrat President – Divided government has been very good for the economy and stock market. Investors like predictability and stability of policy (tax rates & regulation). Assuming Republicans hold their slim majority in the House and gain a lead over Democrats in the Senate, policy should remain somewhat steadfast the next few years, even with a Harris Presidency. In this scenario, its possible the Trump-era tax cuts are extended past 2025, a positive for corporate earnings and our 401(K) balances. Without a Republican in the Oval Office though, tax rates are unlikely to decrease the next four years. We expect divided government to provide a phenomenal environment for equity markets. Less likely, but a possibility, would be less government spending and lower deficits, something that occurred under Bill Clinton reversing course with a Republican heavy Congress. With lower deficits, inflation should moderate, and interest rates should decrease slightly.

Democrat Sweep – Presumably, the least likely of the three scenarios would be Democrats winning the House, Senate and Presidency. If this did happen, we'd likely see a massive regulatory spike, large deficits, choked U.S. energy supply, increased taxes alongside large stimulus bills. When Javier Milei was elected, the Argentine stock market rallied over 50% on hopes of smaller government, less spending, and pro-entrepreneurial policy. The opposite occurred in Mexico when Claudia Sheinbaum, a socialist was elected – the stock market sold off 22%. Markets reward good policy and punish bad policy. However, in the short run, the negative effect of higher taxation could be offset by increased stimulus. We would expect markets to selloff in the short run and recover into the 2026 midterms. With less energy supply, we expect commodity prices to rise and inflation to persist.

Republican Sweep – In a Republican sweep scenario, we expect U.S. oil and gas production to increase, taxes to remain constant or decrease, and a reduction in regulation, a positive for small and medium sized companies. With lower oil prices, we could see commodity prices moderate substantially. On the other hand, President Trump is known for large spending bills that could partially be offset by increased tax receipts. Remember, during Trump's first term, tax collections increased when tax rates decreased. However, increased spending is a negative for inflation and could force the Federal Reserve to keep rates higher for longer. More important than tax rates is the regulatory environment. While rules and red tape are critical for a functioning economy, too much regulation slows down growth. Under this scenario, we expect equity returns to be strong but fixed income returns to struggle as they have the past four years.

Remember, politics and personalities matter far less than policy. We've seen good policy from Republicans, Democrats and more frequently, from divided government across decades of U.S. history. Statistically, divided government produces better economic results than a sweep in either direction. In general, policy that encourages entrepreneurial led growth as opposed to government led spending is better for all of us. Innovation drives up growth and drives down prices but is only possible with reasonable regulation and taxes. Further, the first year of the election cycle (2025) is typically very positive which is also why we're still bullish.

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