Wealth Management
& Capital Markets Perspective

Wealth Management
Dominion Securities

For the clients of Grimes Handscomb Asset Management of RBC Dominion Securities | Fall 2022

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Equities and the election effect

by Kelly Bogdanova

Will the U.S. midterms be a pivot point for equities? We examine historical performance surrounding such elections, and what that may be signaling.

- U.S. equity returns in previous midterm election years were the most muted. However, gains in the following year were the most robust.
- An important nuance is often overlooked: there was typically a strong rally from the low point reached in the midterm election year through the peak reached the following year.
- Did U.S. stocks perform better when a particular party controlled Washington? The short answer: the market often welcomed gridlock, but not always.
- Historical return data are useful to consider, but the reality is that election results are not the only or even the main driver of equity prices. The Fed, the economy, and corporate trends matter more.

If the last U.S. midterm election cycle in 2018, which took place in the middle of the Trump administration, was the most anticipated in a generation, the tension surrounding the 2022 midterms on November 8, has the potential to surpass that.

The country is even more politically and ideologically polarized now compared with then, particularly following the 2016 and 2020 presidential elections, the January 6, attack on the U.S. Capitol, landmark Supreme Court decisions, increases in crime, disagreements about social values, and the population's diminished trust in American institutions. And let's not forget or minimize discontent about inflation and the economy overall.

All of this has resulted in pessimistic attitudes about the direction of the country. While there is a partisan split, even attitudes among Democratic voters have become much gloomier. The proportion of Democrats who say the country is moving in the wrong direction surged from only 22% in January 2021 to 72% in July 2022, according to an Associated Press-NORC poll.

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Among all voters, the percentage has increased from 49% to 83% during the same period.

Four-year performance pattern

For starters, it's important to consider that the stock market has historically traded in a four-year cycle, and these cycles correspond to election years.

Stock market returns in midterm election years tend to be the most muted of the cycle, with the S&P 500 rising 5.8% on average in those years since 1932. However, gains in the year following the midterms tend to be the most robust, with the index rising 16.3% on average.

As is typical with historical market data, there was much variation in the returns in the year following the midterms. While the average was a 16.3% advance, the lowest return was a decline of 5.2% and the highest was a gain of 41.4%.

The market's midterm election idiosyncrasies

Within the four-year cycle, there is an important nuance that isn't captured by the annual performance data — one that is associated with midterm elections.

The historical performance in the period before and after the midterm elections for the U.S. House of Representatives and Senate is among the most pronounced of the seasonal equity market cycles we track. It has persisted regardless of what is or isn't occurring in Washington, and regardless of which party was in power or was gaining or losing momentum.

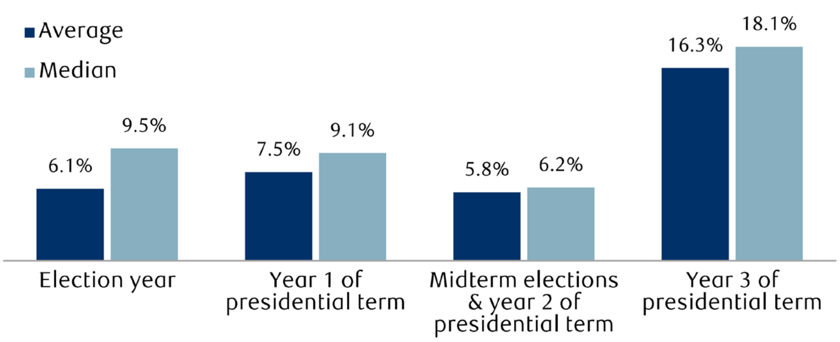
In the 22 periods we examined stretching back to 1934, the S&P 500 typically pulled back or corrected at some point during the 12-month period before the midterm elections. The index declined 20.6%, on average. This cycle has been no different, as the S&P 500 corrected 23.6% from its January 2022 peak to the June 2022 trough.

Historically, subsequent rallies more than made up for the downside, quite often. In those 22 instances since 1934, the market was higher at some point in the year after the midterm elections by almost 47%, on average. Interestingly, it usually reached a peak level in the latter half of that year — often in the fourth quarter. The market was able to exceed its previous high in 77% of the 22 occasions.

However, the nearly 47% average rally following the midterm-year low doesn't tell the full story. The return data that make up the average were rather wide — from 14.7% at the low end to 87.1% at the high end.

Midterm election years tend to be weak, but the following year is typically strong

S&P 500 performance during election cycles since 1932



Source - RBC Capital Markets U.S. Equity Strategy, B include dividends

As of this writing, the S&P 500 is up close to 6.6% from the mid-June low. We think there will be additional gains between now and the end of 2023. But we doubt the market will go up in a straight line, and a super-sized rally is by no means guaranteed given the lingering inflation challenges that have yet to be tamed by the U.S. Federal Reserve (the Fed) and the broader economic headwinds, including elevated recession risks.

It's notable that during seven previous midterm election periods accompanied by inflation challenges, the market reached a new high in the year after the midterm elections less frequently than during non-inflationary periods.

Gridlock can be good

A question that individual investors often ask is, does the market typically do better when a particular party controls Washington?

The short answer is that the market has often welcomed certain forms of gridlock in Washington —otherwise known as split or divided government between the two major parties — but not always.

A study by RBC Capital Markets going back to 1932 found that S&P 500 returns have historically been the highest in three cases:

- When Democrats have controlled the presidency, and the two parties have split control of the House of Representatives and the Senate (S&P 500 +14%, on average);
- When a Democratic president has served alongside a Republican-controlled Congress (+13%); or
- When Republicans have controlled the presidency and both chambers of Congress (+13%).

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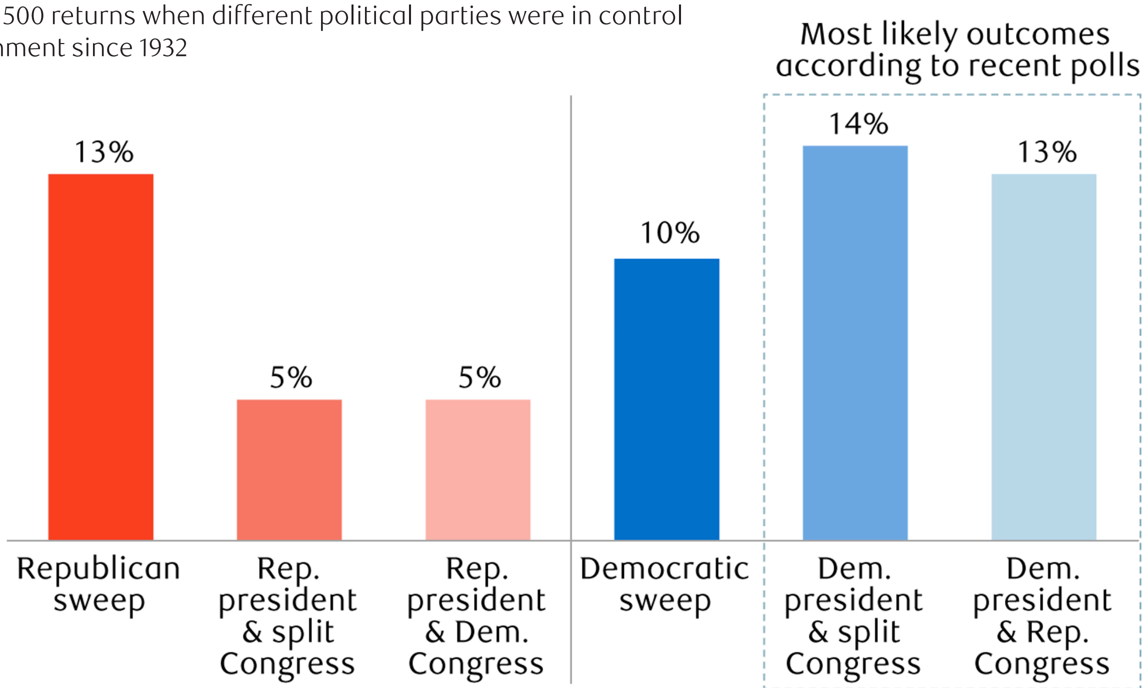
The U.S. market has performed well during periods of divided government

Average annual S&P 500 returns when different political parties were in control of the federal government since 1932



Note: The 2000 election resulted in a 50/50 tie in the Senate, with a Republican vice president acting as the deciding vote after inauguration. However, midway through 2001, one Republican senator left to become an independent and caucus with the Democrats.

Source - RBC Capital Markets U.S. Equity Strategy, Haver Analytics; based on price returns and does not include dividends.

Returns have historically been somewhat less robust in the case of Democrats controlling the presidency and both chambers of Congress (+10%). By contrast, returns have been much more muted with a Republican president and either a split or Democratic-controlled Congress, as the chart above shows.

Markets tend to like checks and balances

Given that recent polls have been forecasting a Republican takeover of the House, and Senate control is too close to call, we think it's useful to dig a little deeper into historical market returns when congressional control was split between two parties. This scenario is actually less common than one might think in American history. It has occurred in only six of the two-year periods since 1932, with all of those coming after 1980. In other words, a split Congress has been a much more frequent phenomenon in the modern era.

We found that the S&P 500 outperformed in four of the six instances of a split Congress, with three of those periods racking up annualized gains of more than 20%. For all six periods, it rose 13.4% annualized, on average, compared with an 8.9% average annual gain in all years since 1932.

Fundamentally, it comes down to fundamentals

If history is a guide, the past performance surrounding midterm elections and the potential for gridlock in Washington following the November 8 vote could bode well for the market. The data demonstrate there are indeed market performance patterns associated with election years that we believe are worth paying attention to and respecting, especially those that surround midterm elections.

But investors should keep in mind that elections are not the only, or even the main, drivers of U.S. stock prices. We think market performance actually has greater linkages to the Fed's monetary policy decisions, the ebb-and-flow of the economy, and related corporate earnings trends than it does to actions that emanate from the White House and Capitol Hill. These factors are currently in flux, which is why we think the market has been volatile recently.

It's prudent to keep the compass pointed toward domestic economic fundamentals, and specifically to the path of forward-looking recession indicators — especially given the current uncertainties. We believe recessions and the corresponding movements of corporate profits matter more to investment returns than political party control in Washington. Recessions are usually responsible for ushering in equity bear markets. Then, during periods of economic duress — often when headlines are at their worst and investor sentiment is rather negative — early hints of economic green shoots typically spark new bull market cycles even before recessions end.

Administrative corner

RBC WM Online adding RRIF/LIF payment information

Beginning in September, Registered Retirement Income Fund (RRIF)/Life Income Fund (LIF) payment information will be available on WM Online. This enables you to access up-to-date RRIF/LIF payment details at any time, which is particularly helpful for those who receive full payments prior to the annual information being available at the end of January.

First home savings account

In the 2022 Federal Budget, the government proposed to create the First Home Savings Account (FHSA), a new registered account to help individuals save up to $40,000 on a tax-free basis to purchase their first home. The government is currently working with financial institutions with the goal of having the infrastructure in place for individuals to be able to open an FHSA and start contributing to it at some point in 2023. Stay tuned for more details!

Benchmarks

Equity market 12-month trailing return (for month ending September 30, 2022)	
S&P/TSX composite total return index	-5.4%
S&P 500 total return estimate (C$)	-7.8%
S&P 500 total return estimate (US$)	-15.5%
DJIA total return estimate (C$)	-5.6%
DJIA total return estimate (US$)	-13.4%
Nasdaq composite price return (C$)	-20.2%
Nasdaq composite price return (US$)	-26.8%

RBC CM Canadian bond market indices 12-month trailing return (for month ending September 30, 2022)	
Short-Term Index	-5.1%
Intermediate Term	-10.3%
3 month T-Bill (C$)	0.5%
3 month T-Bill (US$)	0.3%

What I did this summer

by Shelley Knox

Thanks to gracious hosts who held onto my deposit and allowed me to book, and subsequently cancel, each year due to COVID, I was finally able to complete my biking trip in Western Canada this summer. The long term goal: to mountain bike in each province and territory across our beautiful country. I can happily say that after this summer, I have another two locations checked off my list: Canmore, AB, and Revelstoke, BC!

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