How Do Elections Typically Impact Stock Markets?

A: While it's true that elections can drive market volatility and shifts in investor sentiment in the short term, history shows that, over the long run, fundamentals like economic growth and corporate earnings tend to be far more important drivers of stock returns.

That said, there are some interesting historical trends around stock market performance during election years, especially years when an incumbent president is running for reelection.

According to our analysis, for the last 10 election years in which an incumbent was running, the S&P 500 Index has ended the year in positive territory, with an average return of 17.4 percent. That's well above the average annual return of around 10 percent for all years.

Why might markets tend to perform better in incumbent reelection years? A big part of the answer likely comes down to the incentives for incumbents to take pro-growth policy actions to boost their reelection prospects. Fiscal and monetary policy may become more stimulative in these years, as incumbent administrations work to keep an economic expansion going.

We've already seen some of this dynamic play out, with large fiscal packages like the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act, the Inflation Reduction Act, and the resumption of tax credits like the Employee Retention Credit injecting billions of dollars into the U.S. economy. Despite being an election year, the Federal Reserve has signaled that it will base its rate decisions solely on economic data rather than political calculations.

However, it's important not to overstate the impact of elections on markets based on these data points alone. Underlying economic fundamentals like consumer spending, the labor market, earnings growth, and productivity gains tend to be more powerful drivers of stock returns over time. The rollout of artificial intelligence tools and their potential productivity benefits could be a strong tailwind for markets this year, regardless of the presidential election's outcome.

Moreover, markets can certainly climb or sell off sharply in election years for reasons wholly separate from elections. For instance, the 2008 financial crisis triggered a major sell-off late in that election year, while the extraordinary stimulus response to the COVID-19 pandemic sent stocks soaring into year-end 2020 after the November election.

While elections tend to garner outsize attention, they are just one of many inputs for markets. Investors would be wise to look past the political noise and partisan narratives and remain focused on the fundamentals that drive long-term returns. Diversification, discipline, and sticking to your plan should be top priorities, regardless of who occupies the White House.