In the wake of the U.S. mid-term elections, market pundits have been offering investment advice that’s mainly thematic in nature. Which sectors might benefit from potential cooperation between a newly minted Democratic House of Representatives, the still-Republican Senate, and a Trump White House? And which won’t?

Infrastructure and drug pricing have been the most touted areas for cooperation, particularly after Trump told a press gaggle that his administration and Democratic lawmakers “have a lot in common on infrastructure” and “lowering drug prices.” The former, of course, is said to be bullish for construction and engineering stocks, while pharma companies are expected to get squeezed on drug pricing.
Politically driven thematic investing is easy to pursue nowadays, given the growing legions of sector and industry exchange-traded funds. But investing on U.S. electoral outcomes is risky, as sector returns over the last few years show.

Two years ago, after Trump’s surprise victory and the Republican sweep of Capitol Hill, market pundits also opined that infrastructure, defense, and banking stocks, among others, were poised to benefit from the new political forces in Washington, DC, while technology stocks were supposed to suffer.

Heading into the 2016 election, Trump had talked a lot about infrastructure investment, which would naturally benefit construction and engineering companies. So the S&P 500 Construction & Engineering Index relative to the broad S&P 500 benchmark jumped nearly 20% following the November 8, 2016, balloting. But just as “shovel-ready” projects were hard to find in 2009, public–private partnerships to upgrade infrastructure haven’t proven that plentiful over the last few years, either. Two years after Trump was first elected, the subindex is back where it started.

A similar dynamic was on display with S&P 500 Pharmaceutical Sector performance relative to the blue-chip index. In the year preceding the 2016 election, the sector index essentially treaded water on expectations that Hillary Clinton would win and expand the government’s role in health care, including in drug-price negotiations. It jumped 5% in the vote’s aftermath, presumably on the view that a Republican effort to “repeal and replace” the Affordable Care Act would result in a more market-friendly
framework for health care providers and drug makers, which were also positioned to benefit from Trump’s tax reform agenda. But the optimism quickly faded as the market considered candidate Trump’s assertion that “$300 billion a year could be saved” were Medicare to directly negotiate prices with pharmaceutical companies. He also had a strong ally in Senator Chuck Grassley, a Republican who had long championed lower drug prices and, as head of the Senate Judiciary committee, sponsored legislation to boost competition in the sector.

CHART 2: S&P 500 PHARMACEUTICAL INDEX RELATIVE TO S&P 500 INDEX

On the flip side, Trump’s open animus toward Silicon Valley, most of whose denizens contributed far more to Clinton’s campaign than to his, would weigh on tech. The S&P 500 Information Technology Index initially dropped but recovered by early 2017 and chugged higher until last summer, when rising interest rates finally began undercutting high-flying and in many cases richly valued growth stocks.

CHART 3: S&P 500 INFORMATION TECHNOLOGY INDEX
Higher rates were expected to benefit banks, along with revisions to some of the more onerous Dodd-Frank-regulatory burdens. Tax reform, deregulation and infrastructure spending—key Republican planks—were seen spurring erstwhile sluggish economic growth, which has indeed trended toward an annual 3% this year. But as with construction and engineering, the financial sector’s initial gains faded, recovered somewhat, and two years later haven’t done much better than the broad index.
To be sure, gains in the aerospace and defense sector have been stickier as increasing U.S. federal outlays for defense propped up earnings expectations, though performance turned wobbly in 2018. Defense outlays over the last two years rose at least $45 billion, with 2018 outlays accounting for more than 90% of that increase and bringing the total to roughly $700 billion. That includes estimates for “Overseas Contingency Operations,” a moniker that replaced emergency or supplemental funding for the more bellicose-sounding “Global War on Terror.” Government forecasts put defense outlays for fiscal 2019 increasing slightly, 2% or so, and then leveling off or slightly decreasing in fiscal 2020.
Of course, energy was also supposed to benefit from a friendlier federal posture toward drilling, pipeline network expansion and other associated infrastructure. On cue, the S&P 500 Energy Index jumped 14% by mid-December 2016. But then it slid 20% over the next nine months, amid softening Chinese economic data and especially the relentless increase in U.S. shale crude output. But, as Thornburg Portfolio Manager Charles Wilson, PhD, wrote in May 2017, “a dearth of non-OPEC (Organization of Petroleum Exporting Countries) investment outside the U.S., combined with natural reservoir decline rates and steadily rising global demand, should cause oil prices to stop slipping.”

Sure enough, by mid-2018 crude prices were up 20% from the beginning of the year and energy was the best sector performer in the S&P 500 in the second quarter.

CHART 6: S&P 500 ENERGY INDEX RELATIVE TO S&P 500 INDEX
As Emerging Views pointed out over the summer, “crude prices are mostly tethered to supply and demand dynamics, with at least demand being largely affected by economic growth. But political risk also factors in and tilts the current equation rather heavily toward a supportive price backdrop.”

The political risk factor recently flipped when the White House did an about-face and issued waivers on sanctions banning Iranian crude imports. Ahead of the early November sanctions deadline, the U.S., Saudi Arabia, and Russia had ramped output to record levels, lifting global oil supply despite sharp production falls in Venezuela, Iran, Mexico, and elsewhere. Meanwhile, global oil demand growth has ebbed, partly on slightly slower global economic growth and partly on oil’s higher cost from depreciated local currencies against the dollar.

“For now, forecasts of oil demand growth remain solid with an increase of 1.3 million barrels/day this year and an increase to 1.4 mb/d in 2019, even though the macro-economic outlook is uncertain,” said the International Energy Agency in its November Oil Market Report. The IEA’s World Energy Outlook 2018, which was also released in November, warns of “a possible supply gap in the early 2020s.” Worth quoting at length, the IEA’s analysis “shows oil consumption growing in coming decades, due to rising petrochemicals, trucking and aviation demand. But meeting this growth in the near term means that approvals of conventional oil projects need to double from their current low levels. Without such a pick-up in investment, U.S. shale production, which has already been expanding at a record pace, would have to add more than 10 million barrels a day from today to 2025, the equivalent of adding another Russia to global supply in seven years—which would be an historically unprecedented feat.”

Political winds blow capriciously. Sanctions are announced and waivers issued at the eleventh hour. Politics sways market sentiment, which often pushes a company’s stock or bond price well beyond
what its business fundamentals imply at any given time. At a sector level, on a long-term fundamental view, out-of-favor energy is looking quite attractive now. Two years ago, tech was briefly under a political cloud but turned out to be attractively priced because the market misperceived the impact of an electoral shift in Washington, DC, overlooking the sector’s fundamentals. It did the same, but in inverse fashion, with the financial, construction and engineering sectors.

Investors should keep those head-fakes in mind amid the latest conventional wisdom suggesting that Trump and a House controlled by Democrats come January 2019 can do deals on infrastructure spending and drug pricing. Maybe they will, maybe not. Maybe the House will constrain the anticipated increases in defense spending given a rising U.S. fiscal deficit or push the mercurial Trump to revisit the corporate tax reform to finance it. Who knows? Ultimately, there’s far more margin of safety in picking individual stocks that exhibit strong business fundamentals and attractive valuations, notwithstanding the latest political cross-currents in the nation’s capital.

Important Information

Before investing, carefully consider the Fund’s investment goals, risks, charges, and expenses. For a prospectus or summary prospectus containing this and other information, contact your financial advisor or visit thornburg.com. Read them carefully before investing.

The views expressed are subject to change and do not necessarily reflect the views of Thornburg Investment Management, Inc. This information should not be relied upon as a recommendation or investment advice and is not intended to predict the performance of any investment or market.

Investments carry risks, including possible loss of principal.

The information given should not be considered tax advice. Please consult your tax advisor for personal tax questions and concerns.

Please see our glossary for a definition of terms.

Thornburg mutual funds are distributed by Thornburg Securities Corporation.

Thornburg Investment Management, Inc. mutual funds are sold through investment professionals including investment advisors, brokerage firms, bank trust departments, trust companies and certain other financial intermediaries. Thornburg Securities Corporation (TSC) does not act as broker of record for investors.

© Thornburg Investment Management