

Executive Summary

- Stock-market returns tend to be lowest in a president's first year in office and highest in year three of the four-year term.
- The markets don't necessarily like landslide elections because they tend to introduce policy risk that could result in higher inflation and interest rates. This is particularly true if the landslide puts Democrats in control of the White House and both chambers of Congress.
- It's the economy, stupid. Research makes overwhelmingly clear that the outcome of elections in large part depends on how the economy and markets are performing during an election year.
- Investors favor divided governments over unified governments because a divided government is less likely to pass major new legislation that can result in significant fiscal policy risk that impacts inflation and interest rates.

Divided, We Rise (or at Least the Markets Do)

Presidential cycles and other election year theories weighing on the markets

History suggests that investors could benefit from paying attention to the presidential election cycle. In modern times, the fourth year of a president's term has tended to be a positive one for stocks, as the incumbent does all the he can to remain in office. But what happens if the president comes from one party, and Congress is headed by another? What if the race is close? What if it's a landslide? And does it matter if the winner is a Republican or a Democrat? All of these outcomes can have potential implications for the economy—and the markets.

The presidential cycle

Yale Hirsch, founder of the Stock Trader's Almanac, studied presidential election cycles from 1948 through 2008 and found strong correlations between stock performance and years one through four in a presidential term. Specifically, he found the average annual return on the S&P 500 tended to be lowest in the first year of office and to spike in year three of a president's four-year term. Generally speaking, this makes sense. Presidents, particularly during their first term, typically come in their first year in office with guns a-blazin' as they attempt to deliver on all the promises made during the election year. This major push tends to create policy uncertainty, an outcome the markets don't much like. Hirsch also says wars, recessions and bear markets—if they come—typically arrive in the first two years of a president's term—outcomes that obviously rattle investors and the markets.

Presidential Election Cycle Average annual stock market return by presidential term (1948-2008)

Year	S&P 500 Total Return
1	7.41%
2	10.21%
3	22.34%
4	9.79%

Source: Yale Hirsch, *Investopedia*

could manipulate the economy by boosting spending, cutting taxes and, indirectly, applying pressure on the Federal Reserve to lower interest rates. Even in this election year, neither party is interested in austerity. In his budget, President Obama abandoned his promise to cut the deficit in half by the end of his first term. Meanwhile, House Republicans dropped an earlier demand that an extension to the payroll tax cut be offset elsewhere, a key concession from the GOP leaders.

On a brighter note, equity bull markets tend to come in years three and four of a president's term, when uncertainty and unfamiliarity give way to aggressive maneuvering by the incumbent to perk up the economy and thus re-election chances. This has been particularly true in the post-Roosevelt years, when Keynesian economic policies took root and political leaders began to understand that they

Landslides vs. nail-biters

It seems almost intuitive—a party that wins in a landslide, be it for Congress or particularly for the presidency—can declare a mandate to enact significant changes to policy. But it's not as simple as that. In a research paper published in *The Journal of Politics* in February 2006, University of California, Davis political science professor James H. Fowler observed that studies have found that even if the margin of victory is large, it is unclear whether overwhelming support for the winner translates into support for a particular policy. That doesn't mean that a winning party won't attempt to make significant changes—witness Ronald Reagan's across-the-board 25% reduction in income tax rates, or more recently, Barack Obama's push for health-care reform.

Both presidents campaigned in part on making such changes, only to confront significant push back once their agenda was adopted. For Reagan, it wasn't the tax cuts per se but a steep recession and exploding deficits that caused a significant albeit temporary decline in public support. Obama lost public support for similar reasons, doggedly pursuing health-care reform at a time the economy was in the midst of its worst recession since the Great Depression and the federal budget deficit was ballooning to levels last seen in the World War II era. Research by Fowler and others suggests that, perhaps contrary to expectations that a landslide victory represents public support for major policy shifts, investors actually fear such an outcome. They think it may boost the risk of higher inflation and interest rates, particularly if the landslide results in Democrats controlling the White House and both chambers of Congress, as was the case in the 2008 election before the 2010 midterm election returned the House to Republican control. In other words, overwhelming victories by either party tend to heighten fears of economic policy risks.

It's still "the economy, stupid"

We've heard this phrase almost ad nauseam, but it holds true. The outcome of elections in large part depends on the performance of the economy and markets in an election year—and how each is trending, i.e., is the economy and job market strengthening or weakening? Are stocks rising or falling? Are gas and food prices rising or falling? Lost in much of the political analysis of this year's unexpectedly prolonged—and contentious—Republican presidential primary season is the simple fact that the economic metrics that were working against President Obama in the summer and fall of 2011 are now moving his way. Better-than-expected reports on manufacturing, jobs, consumer sentiment and even housing continue to reflect gradual improvement in the economy. And the equity markets have been on a roll, with the major indexes reaching highs last seen well before Obama even took office.

This doesn't mean President Obama will be a shoo-in for re-election. While the direction of the markets and economy are currently in his favor, the underlying numbers are still relatively weak and unimpressive by historical standards. Appropriate comparisons have been drawn to Ronald Reagan, who was the last president to confront a crippling recession at the beginning of his first term in office. In the face of plummeting approval ratings and protests, President Reagan stuck to his fiscal policy guns by lowering tax rates, reducing government regulations, increasing military spending and keeping his hands off the Federal Reserve, despite unprecedented tightening by then Fed Chairman Paul Volker, who had launched a monetary policy war to successfully break the back of inflation. President Reagan's patience and perseverance eventually were rewarded with one of the strongest recoveries of the post-World War II era.

Out of the Gate

Growth first 6 quarters after start of recovery	Obama (%)	Reagan (%)
1st	3.8	5.1
2nd	3.9	9.3
3rd	3.8	8.1
4th	2.5	8.5
5th	2.3	8.0
6th	0.4	7.1

Source: U.S. Commerce Department

Approval matters, too

In contrast, one quarter into President Obama's economic recovery from the Great Recession—with the Federal Reserve's monetary policy floodgates wide open—GDP growth has been tepid and job growth has been standard. While expanding by nearly 3 million from the February 2010 cycle trough, nonfarm payrolls are still more than 6 million below their peak, and February 2012's 8.3% unemployment rate was still 1.5 percentage points above where it stood when President Obama was elected in November 2008. Over the past 60 years, no president has won re-election with a rate of unemployment above 7.3%. At the same time, no president has won re-election with an approval rating below 48%, and recent polls put Obama's rating at or just above 50%, well above the 40% level where it was mired last fall, a low for his term.

As low as President Obama's approval ratings were last summer, Congress' have been much worse, barely breaking into the low teens. This may bolster Republican hopes of gaining control of the Senate, where 23 Democrats are up for re-election versus only 10 Republicans, so Republicans need just four new seats—three if the eventual Republican candidate for president wins—to regain control. Polls suggest that the Republicans' majority control of the House is in pretty good shape. During 2010's historic midterm election, Republicans enjoyed the largest net change in

congressional seats since the 1948 election, with 63 net pick-ups. Moreover, the 2010 census showed a significant U.S. population shift towards Republican states and away from Democratic states. With most state legislatures now controlled by Republicans, the so-called gerrymandering or redistricting process likely allows the Republican to hold onto, or perhaps even add to, their current House majority.

Parties matter (but maybe not like you think)

Over the years, stock analysts have suggested the market prefers Republicans in the White House, apparently because Republican administrations are viewed to be more favorable toward business than Democratic administrations. But a 1998 Federal Reserve Bank of San Francisco study of stock returns from 1871 to 1997 said the evidence indicates returns actually are slightly higher during Democratic administrations. And a more recent study looking at stock returns since 1961 suggests stocks do significantly better under a Democratic White House. The 2006 research paper by professors James L. Grant and Emery Trahan and published in *Financial Services Review* found, from 1961 through 2004, four-year annualized returns on large-company stocks averaged 14.54% under Democratic administrations and 9.95% under Republican administrations; comparable returns on small-company stocks were 23.58% and 12.62%, respectively, over the same period.

But what was good for stocks wasn't so good for bonds. The same study found long-term government bonds performed better under Republican administrations than under Democrats, dating back to 1929 through 2004 as well as over the more recent 1961 through 2004 period. From 1961 through 2004, four-year annualized returns on long-term government bonds averaged 4.14% when a Democrat was in the White House and 10.80% when a Republican called 1600 Pennsylvania Avenue home. Treasury bills returned 5.09% and 6.24%, respectively, over the same period. This gap has narrowed during the Obama years, as the combination of unprecedented government intervention and a massive flight-to-safety caused Treasury returns to climb. It's thought bonds do better under Republicans than Democrats because the former are more apt to favor tighter fiscal and monetary policies that potentially combat inflation, while the latter is more likely to pursue expansionist monetary policies that potentially fuel inflation.

Divided, we win

Given recent polling data, the most likely outcome at this point of the election year is one recent history suggests will work best for all markets—a divided government, particularly one in which the incumbent administration wins re-election and Congress is controlled by the opposing party. For example, when Reagan was president and Democrats controlled the House (Republicans were the majority in the Senate the first six of Reagan's eight years),

Presidential Returns Average annualized returns for four-year election cycles (1961-2004)

	Large- Company Stocks*	Small- Company Stocks**	Long-Term Government Bonds	T-Bills
All	12.04%	17.60%	7.77%	5.72%
Democrat	14.54%	23.58%	4.14%	5.09%
Republican	9.95%	12.62%	10.80%	6.24%

Source: James L. Grant, Emery A. Trahan, "Tactical asset allocation and presidential elections," 2006 *Financial Services Review*, Academy of Financial Services, using data from Ibbotson Associates.

*S&P 500

**Ibbotson Small Company Stock Index

Past performance is no guarantee of future results.

the economy emerged from a deep recession with one of the strongest periods of post-war growth on record. Real GDP grew 30% during the eight-year span, and the S&P 500 more than doubled. The economy and markets enjoyed a similar spurt from 1995 through 2000, when Democrat Bill Clinton was president and Republicans controlled the House and the Senate. Bond markets benefitted, too. The aforementioned Fowler study concluded divided governments tend to result in lower interest rates and inflation than do unified governments, because a divided government is less likely to pass major new legislation that can result in significant fiscal policy risk. A concurring study by Deutsche Bank Securities also suggests that since 1936, when Republicans controlled both houses of Congress—regardless of the president's party—the equity markets rose by an annual average of 15%.

A divided government also brings with it the benefit of legislative checks and balances, particularly if an Obama re-election victory is paired with the Republicans adding to their current House majority and regaining narrow control of the Senate, as recent polls suggest. Clearly, voters are extremely frustrated by the intransigence of the existing crew in Washington and their inability or unwillingness to make the hard decisions and necessary compromises. Issues include reforming the personal and corporate tax codes, addressing the demographically unsustainable trajectory of entitlement spending, cutting the federal deficit and balancing the budget, creating jobs and generating above-trend economic growth. It's still a long time until November, and uncertainty is rarely a friend to the markets. But as history illustrates, it's not the uncertainty that matters as much as the policies and actions the winners pursue—that is what ultimately drives the economy, and the markets.

S&P 500 Returns During Election Years			S&P 500 total returns 1926-2010, by election year: Year 1: 8.1% Year 2: 8.9% Year 3: 19.3% Year 4: 10.9% 1st year of a President's term: S&P 500 is positive 52% of the time S&P 500 is negative 48% of the time 2nd year of a President's term: S&P 500 is positive 64% of the time S&P 500 is negative 36% of the time 3rd year of a President's term: S&P 500 is positive 90% of the time S&P 500 is negative 10% of the time 4th year of a President's term: S&P 500 is positive 81% of the time S&P 500 is negative 19% of the time
Year	Return	Candidates	
1928	43.6%	Hoover vs. Smith	
1932	-8.2%	Roosevelt vs. Hoover	
1936	33.9%	Roosevelt vs. Landon	
1940	-9.8%	Roosevelt vs. Willkie	
1944	19.7%	Roosevelt vs. Dewey	
1948	5.5%	Truman vs. Dewey	
1952	18.3%	Eisenhower vs. Stevenson	
1956	6.5%	Eisenhower vs. Stevenson	
1960	0.50%	Kennedy vs. Nixon	
1964	16.5%	Johnson vs. Goldwater	
1968	11.1%	Nixon vs. Humphrey	
1972	19.0%	Nixon vs. McGovern	
1976	23.8%	Carter vs. Ford	
1980	32.4%	Reagan vs. Carter	
1984	6.3%	Reagan vs. Mondale	
1988	16.8%	Bush vs. Dukakis	
1992	7.7%	Clinton vs. Bush	
1996	23.1%	Clinton vs. Dole	
2000	-9.1%	Bush vs. Gore	
2004	10.9%	Bush vs. Kerry	
2008	-37.0%	Obama vs. McCain	

For illustrative purposes only and not representative of performance for any specific investment. Past performance is no guarantee of future results.

The Ibbotson Small Company Stock Index is represented by the fifth capitalization quintile of stocks on the NYSE for 1926-1981 and the performance of the Dimensional Fund Advisors (DFA) Micro Cap Fund thereafter.

The S&P 500 Index is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Investments cannot be made in an index.