MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

Election Observations and Amusements

The US equity market (as measured by the S&P 500 Index) sidestepped global slowdown fears and somewhat disappointing earnings reports in July and August to generate a 6.4% total return for the third quarter, bringing 2012 year-to-date gains to a very healthy 16.4%[1]. We believe this gain comfortably exceeds most beginning-of-year expectations, particularly given the fact that the rise in stock prices has not been accompanied by rising earnings expectations. Indeed, earnings for the S&P 500 are likely to end the year flat or below 2011 levels, and expectations for 2013 have fallen sharply over the last nine months.

We believe earnings estimates for the broad stock market may still be too high, as they embed an assumption that economic activity is set to re-accelerate. We find this scenario unlikely given the potential impacts of a "fiscal cliff" in January and the ongoing, slow-motion "train wreck" in Europe (each discussed separately in our last two issues of *Consilium*). In addition, hard evidence has emerged in recent months that the Chinese economy has slowed materially – unsurprisingly, given China's dependence on exports to other countries that are obviously suffering. Recently, a diverse array of major global companies such as Caterpillar, FedEx and McDonald's have all confirmed that economic conditions have weakened almost everywhere.

A cautious outlook is, under current circumstances, easily justified – and that is, perhaps, the biggest problem with a cautious outlook: all the problems noted above are widely recognized, and sentiment among both individual and professional investors is fairly muted. Meanwhile, the Federal Reserve's newest effort to revive economic growth (commonly referred to as "quantitative easing" or "QE") is providing a powerful tailwind to financial assets and the housing market. While earnings and the economy may disappoint, we do not find current conditions to be consistent with a major stock market decline, and we are alert to the possibility of positive surprises that might emerge in 2013, not just negative ones.

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Every presidential election cycle is accompanied by stock market prognosticators' attempts to predict the outcome and draw conclusions about subsequent investment returns. We view this process as somewhere between harmless and illuminating. The main problem with this kind of analysis is the relatively small number of observations – there have only been 21 elections since accurate, detailed and representative stock market historical data began to be collected. Not only is stock market data prior to 1928 considered less reliable, a good argument can be made that the outcome of the election was less pertinent to the performance of the economy and the stock market prior to that time. After all, entitlement programs were non-existent, the personal income tax had only been created in 1914, and government spending represented only about 10% of GDP (compared to 40% today).

For these reasons, we will content ourselves with the past 84 years' worth of data and see if any predictions can be made – either about the election or about the stock market response.

[1] Baseline

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Since 1928 there have been 11 presidential elections when Republicans were the "incumbent" party – that is, occurrences when the presidency had been held by a Republican during the previous four years, whether or not the president was running. The 2008 election fell into this category, as George W. Bush was not running, but nevertheless the Republicans held the "incumbent" position. The upcoming 2012 election will be the 11th instance since 1928 when the Democrats were in this position.

The incumbent party has emerged victorious 12 times since 1928, only slightly better than half the time. In fact, since Franklin Roosevelt's unprecedented fourth election, less than half of the time – 7 of 15 occurrences – the incumbent party has won. Clearly, voters have not expressed any strong opinions about party continuity – and they have not expressed any obvious preference for either party, with 10 Republican victories and 12 Democratic wins.

Does the stock market's performance during the election year make any kind of "statement" about whether investors prefer the incumbent party or the challenger? Generally not; the S&P 500 index has generated a positive total return in 17 of 21 presidential election years, an amazingly reliable anomaly[2]. However, it's clear that any incumbent would rather have the tailwind of a rising stock market, as the presidency changed parties in 3 of the 4 instances when the S&P was down in the election year, but did not change in 11 of the 17 instances when the S&P was up. This would appear to favor President Obama's chances – but in 3 of the 4 instances when a Democratic incumbent lost, the stock market was up during the election year, with an average total return of 13.2%. **Conclusion:** President Obama would rather have a rising stock market than not – but it offers no assurance of victory, and this year's gains have little predictive power.

But if we cannot foresee the election's outcome based on the stock market's performance, can we make any predictions about future returns depending on who wins? Regardless of the preferences of *voters*, we can say (keeping the small sample size in mind) with somewhat greater confidence that *investors* **prefer to see incumbent Democrats re-elected.**

Consider the S&P return data for the calendar year following the presidential election, broken down by party, and by whether the incumbent party wins or loses:

Democrats incumbent, win
6 occurrences
9.1% average next year return

Democrats incumbent, lose
4 occurrences
-6.4% average next year return

Republicans incumbent, win
6 occurrences
5.7% average next year return

Republicans incumbent, lose
5 occurrences
22.1% average next year return

Further, in each of the 4 instances when incumbent Democrats lost, the S&P was lower the following year; but in the 6 cases of incumbent Democrat victory, the market was lower only twice – and both of those instances occurred during the Great Depression. Considering that returns in the year following a presidential election are negative almost half the time – 10 out of 21 occurrences – the solid results following incumbent Democratic victories are noteworthy.

We would conclude this analysis with the important caveat that history need not repeat itself. The stock market does not "know" whether the incumbent won or lost, nor does it "care" whether there is a Republican or Democrat in the White House. There have been major bull and bear markets under both parties' leadership, and as we enter the final month before the election, investors would be well advised to keep their political and investment opinions as far apart from each other as possible

[2] Source: Ibbottson Associates

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