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Entering an Election Year: What It Could Mean To Investors

By Joe Mullich

Political pundits might not find a lot of similarities among George W. Bush, Bill Clinton, Ronald Reagan, and Lyndon B. Johnson, but a savvy stock broker would disagree – he'd tell you that in the third year of each of those president's first terms, the Dow Jones industrial average rose by at least 15 percent.

The Stock Trader's Almanac, which first identified the so-called "presidential election cycle theory," noted that bull markets tend to occur in the third and fourth years of presidential terms, while markets usually decline in the first and second years of an administration.

"I think the effect that presidential elections have on the stock market is one the most important long-term cycles out there," says Jeffrey A. Hirsch, editor of *The Stock Trader's Almanac*. "It has a solid history that stretches back decades; it's not just a matter of coincidence."

The pattern goes like this:

- **Year One: Post Election Year.** On average, the first year of a presidential administration sees the worst performance of the stock market.
- **Year Two: Mid-term Elections.** The market improves, but performance is still lower than average. Wars, recessions, and bear markets tend to start in the first half of presidential terms.
- **Year Three: Pre-Presidential Election Year.** This, on average, is the strongest for the market.
- **Year Four: Presidential Election Year.** The stock market tends to be above average. Regardless of which party wins, the S&P 500 has seen gains in the last seven months in 13 of the 15 last presidential elections since 1950. And one of those was the 2000 election when the results were delayed for 36 days, after which the Dow did end higher.

The Stock Trader's Almanac isn't the only source that's seen a distinct presidential-election pattern to the stock market. A study by Wells Fargo indicated that the average market return in the fourth year of a presidential term is twice that of the return in the first year of a president's term. And a 2004 study by Pepperdine University economics professor Marshall Nickle found that a $1,000 investment made in the latter half of the presidential administrations starting in 1952 would have grown to $72,701 over five decades of elections. In contrast, $1,000 invested only during the first and second years of presidential terms would have lost money during the same span.

The reason, Hirsch says, is that the "making of presidents" is accompanied by "an unsubtle manipulation of the economy." He explains: "After a couple of years of dealing with the more unsavory matters, they shift gears to kinder, gentler initiatives that prime the pump and put more money into the pocket of voters."

A 2008 study published in the *Journal of Portfolio Management* appears to bear this out. The study first corroborated the stock market growth in the latter half of presidential terms, noting that small cap equities display a much more prominent return pattern than large cap equities. In the third year of presidential terms, small caps generated an average annual return that exceeds 38 percent.

Next, the study identified that the equity growth corresponds with a comparable pattern of U.S. monetary policy measures, especially during the third year when returns are highest. During the third year, the authors found that U.S. monetary policy was expansionary – which benefits the market -- 65 percent of the time compared to 48 percent for the other three years.

There are also many examples of increased government spending in the fourth year of presidential terms, as well. From 1962 to 1973, for example, the average increase in federal spending was 29 percent higher in election years than in non-election years.

In addition, one doesn't have to look far to find news stories and anecdotal evidence of increased federal spending leading up to an election, a time when the market traditionally has risen. A *Time Magazine* article from 1972 declared "Nixon plans to pump about $1 billion a month more than originally planned into spending programs designed to put money into the pockets of millions of currently unhappy voters." In 2000, President Clinton's budget announced the largest increase in spending for the EPA in the administration's history. In 2004, President Bush awarded federal grants in strategically important states "like many of his predecessors," *The Stock Trader's Almanac* noted.

Taking all this together, Nickle, the Pepperdine University professor, found a potentially lucrative investment strategy would have included buying on October 1 of the second year of the presidential election term and selling out on December 31 of year four. This simple strategy would have sidestepped practically all down markets for the last six decades.

From April 1942 to October 2002, 15 stock market cycles have occurred, each averaging approximately four years in length. For the most part, bear markets have historically occurred during the first or second years of presidential terms. For the purposes of Nickel's study, a bear market was defined as the S&P 500 Index's decline approximately 15 percent or more over a period of one to three years, while a bull market is an environment of consistently rising prices.

Nickle found a clustering of bear market lows around the congressional election period, or about two years into the presidential term. Three of the 16 bear market lows occurred in first year of the presidential term, 12 in the second year, and only one in third year. No bear market occurred in the fourth year when the presidential election took part.

Nickle created a test for two hypothetical investors to calculate the outcome from following the suggested strategy. According to this study, an investor who followed the presidential election investment pattern from 1952 to 2000 would have put up money 13 times and not lost money in any period. The investor's gains would have ranged from a high of 70 percent prior to the 1976 election to a low of 16 percent before the 1960 election. An investor who started with $1,000 using this strategy would have seen the value grow to $72,701 over the five decades.

This was contrasted with an investor, who bought the S&P 500 on the first trading day of the inaugural year of each presidential election during the test period and liquidated the portfolio on September 30 of the second year of the presidential term. He would have seen the original $1,000 shrink to only $643 – a 36 percent loss over the five-decade span.

The market run-up during the election year, in Nickle's view, comes from the "euphoria" of the electorate. "What seems to be happen is as politicians gear up for the election, they promise a lot if elected, and those promises translate into euphoria for the market," Nickle says. "Both sides are talking about things citizenry likes to hear and Wall Street likes to hear."

He, like others, councils caution in following the pattern, since past performance does not guarantee future outcomes and the presidential election pattern has at times been overpowered by other events. For example, the Great Depression overrode the third-year trend, with the Dow falling 52.7 percent in 1930. The war clouds of World War II also caused the Dow average to post a negative return in the pre-election year of 1939 – the last time the stock market has been down during third year of a presidential administration.

As of late November 2011, though, the market had yet to see the traditional third-year rise. "The cycles aren't as robust as they used to be because of the macro environment is trumping all of the other metrics we have traditionally used to gauge the market," Nickle says.

And the traditional growth in the election year itself hasn't held in the last two presidential elections either. The technology and Internet stock bubble burst was cited as the reason for the down market in 2000, and then the subprime mortgage debacle for the down market in 2008.

In Nickle's view, part of the reason goes beyond temporary events. He also feels globalization has lessened the consequence of the presidential election cycle, making it a less accurate predictor of stock market growth. In the past, he says, the US stock market more closely represented the US economy, so it was more affected by the election and the corresponding fiscal policies. "Globalization has added a new dimension that really skews the results," he says. "In an era of globalization, the US presidential election has a much smaller effect on the US markets than it did in the past."

Not everyone agrees, though. "I'm not convinced if the effect is diminishing," Hirsch says. "We still have an election every four years, and we are one of the largest economies in the world. Nothing goes on forever; Rome fell. But people still flock to the U.S. as a place to hedge money, regardless of what's going on in Europe and China."

That "presidential election cycle theory" isn't the only pattern that's been connected to the occupants of the White House. Since 1944, stocks tend to move up earlier when the president is popular, but do even better in November and December when unpopular administrations are ousted, according to *The Stock Trader's Almanac.*

An oft-cited research study called "The Presidential Puzzle: Political Cycles and the Stock Market" in 2003 demonstrated that the stock market performs better under Democratic presidents. Using data from 1927 to 2003, the researchers found the market delivered nearly a 2 percent premium over the T-bill under Republican presidents, but an 11 percent under Democratic presidents.

Both large and small caps have performed better under Democrats presidents, though inflation has been higher. Bonds and T-bills have done better under Republican presidents, and inflation has been lower during their terms. Large cap stocks, bonds and T-bills have usually performed better during times of political gridlock.

"The Democrats have had better gains, but I take that with a grain of salt," Hirsch says. "Those results are skewed by FDR coming out of the Recession and Clinton benefitting from the tech boom. As a registered Democrat, I have to check my bias at the door."

As this shows, even in the face of some well-documented patterns, people disagree so you should exercise caution and seek advice from your financial planner before making any investment decisions. Even though Nickle says he has incorporated the presidential election cycle into his own financial planning, in his original study he described it as merely "interesting cocktail conversation."

But here's another tidbit for party small talk: the Super Bowl Indicator. When a team from the AFC division wins the game, the stock market in the coming year tends to decline, and when a team from the NFC division wins, the stock market tends to win. This indicator has been right 85 percent of the time, but it's not something that even the Gipper would likely advocate as an sensible investment strategy.