Weekly Market Commentary

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The Election Impact: The Presidency

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Highlights

During the next six months, the elections will likely become an increasingly potent driver of financial markets.

There has been no significant performance difference in the year after the presidential election based purely on which political party won the White House.

Instead, the stock market has been more likely to respond to whether the incumbent political party won or lost. The stock market may be returning to favoring challengers.

This week marks six months until Election Day. During the next six months, the elections will likely become an increasingly potent driver of the markets. While we believe the impact for changes to the makeup of Congress may be more meaningful than the presidential election, we will tackle that in a later commentary. In this week's commentary, we focus on the presidential election's relationship to the performance of the markets and economy. Specifically, we address:

- The market's impact on the election,
- The election's impact on the markets,
- The economy's impact on the election, and
- The election's impact on the economy.

Market Impact on Election

Perhaps surprisingly, the stock market does not predict the outcome of the election. A strong stock market does not appear to favor an incumbent nor has a weak stock market acted as material negative. For example:

- Franklin D. Roosevelt was re-elected in a landslide victory in 1940, despite losses in the S&P 500 in the third and fourth years of his term.
- Harry Truman (1948) and Richard Nixon (1972) also were re-elected in the face of lackluster stock market results.
- Adlai Stevenson lost in 1952, even though the stock market rose over 50% in the two years before the election under his party's leadership.
- Incumbent George H. W. Bush lost in 1992, even with a 57% gain in the stock market during his tenure.
- Al Gore was unable to secure the presidency in 2000, despite the powerful eight-year stock market gain while under his party's tenure in the White House.

History shows that voters are unwilling to attribute moves in the market directly to presidents, either positive or negative.

Election Impact on Market

Historically, the election does appear to have a significant impact on the stock market. This is explained, in part, by the material impact on corporate

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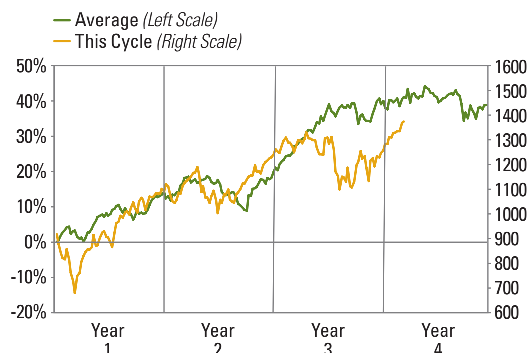
1 Presidential Pattern for Stocks
S&P 500 During Past Six Presidential Cycles

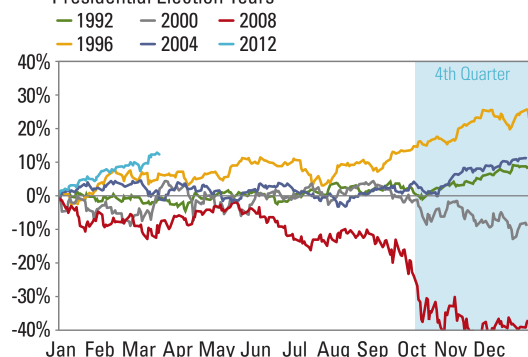


Source: LPL Financial, Bloomberg Data 04/02/12

Past performance is no guarantee of future results.

The S&P 500 is an unmanaged index, which cannot be invested into directly.

2 Fourth Quarter Breakout: S&P 500 Election Year Pattern



Source: LPL Financial, Bloomberg Data 04/02/12

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profits of regulatory policy guided by the White House and legislation passed by Congress. Industries that are heavily regulated are the most affected; these include: Health Care, Utilities, Telecommunications, Media, Energy, Materials, and Financials.

Usually the market performs well in an election year. In fact, there have been only three election years that suffered losses since WWII. The market usually posts better-than-average gains (2008's plunge brought down the average, but the median return is above average).

The four-year presidential cycle of stock market performance evident in Chart 1 has been remarkably consistent over the years, with strong performances in years three and four of a presidential term, with weaker results in years one and two. Interestingly, 16 of the 20 down years since 1940 came in the first or second year of a presidential term. A key reason for this historical pattern of stock market performance during a presidential term is the greater amount of economic stimulus, in the form of both monetary and fiscal policy, applied during year two and three, which then begins to fade in year four. Since this stimulus affects the economy with a lag of around a year, stock market performance tends to follow this pattern of stimulus, leaving years one and two paying the price for the better years three and four leading up to the election.

A relatively volatile and range-bound stock market leading up to a fourth quarter breakout—one direction or another—has been a common occurrence in election years, taking place in 1992, 1996, 2000, 2004, and 2008.

Looking out to 2013, there has been no significant performance difference in the year after the presidential election based purely on which political party won the White House. Instead, the stock market has been more likely to respond to whether the incumbent political party won or lost. This is intuitive, since another term for the same party will likely result in a more consistent political, legislative, and regulatory environment than if the balance of power shifts to that of a new administration, raising the level of uncertainty.

The uncertainty can be seen, when incumbents lose, in the greater risk aversion for both corporate leaders in pursuit of earnings growth and investors in the form of valuations. S&P 500 earnings-per-share growth has been positive on average during the first year of an incumbent's term, but negative when an incumbent loses. Likewise, price-to-earnings multiples have expanded during the first year of an incumbent's term and contracted when the incumbent loses.

Reflecting back on the year after an election over the past 85 years, the stock market's reaction has had three distinct periods, as seen in Table 1.

- During the turbulent period of the 1920s, 30s, and early 40s that included the stock market crash of 1929, the Great Depression, and World War II, the stock market favored challengers over incumbents.
- From the mid-1940s until the early 1970s, the stock market reaction to the

election outcome was mixed—neither favoring nor fretting over incumbents.

- Over the three decades from the mid-1970s to the mid-2000s, noted for above-average stock market returns and lengthy economic expansions, investors appear to have displayed a strong preference for incumbents.
- It may be that the cycle is repeating and the current turbulent period is prompting voters to once again favor challengers over incumbents.

Stock Market Election Reaction Has Had Three Different Periods

Market Performance Average Return	Election Year	S&P 500 Performance Year After Election (%)	Incumbent Party	Winning Party
Year after Favored Challengers Challenger= 46.6% Incumbents= -22.8%	1928	-11.9	R	R
	1932	46.6	R	D
	1936	-38.6	D	D
	1940	-17.9	D	D
Mixed Challenger= 1.7% Incumbents= 3.7%	1944	30.7	D	D
	1948	10.3	D	D
	1952	-6.6	D	R
	1956	-14.3	R	R
	1960	23.1	R	D
	1964	9.1	D	D
	1968	-11.4	D	R
	1972	-17.4	R	R
Year after Favored Incumbents Challenger= -6.8% Incumbents= 21.9%	1976	-11.5	R	D
	1980	-9.7	D	R
	1984	26.3	R	R
	1988	27.3	R	R
	1992	7.1	R	D
	1996	31.0	D	D
	2000	-13.0	D	R
	2004	3.0	R	R
Year After Favored Challengers?	2008	23.5	R	D
	2012		D	

Source: LPL Financial, Bloomberg 03/30/12

(Shaded Areas Represent Years When Incumbent Lost)

The Standard & Poor's 500 Index is a 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.

Of course, the election affects the bond market, as well. A president sets the tone on trade and fiscal policy, which, among other factors, can influence the bond market. The political party of the winner of the election, rather than whether the incumbent or challenger was elected, has historically affected performance in the bond market. Since the late 1920s, during the year after a presidential election the bond market has fared better under a Republican

president, with government bond returns of 6.8%, than a Democrat, with returns of 4.3% (according to the Ibbotson Intermediate Term Government Bond Index).

It is notable that the best years for bonds have been during the first two years of a presidential term. This is no doubt related to the more stimulative (and potentially inflationary) fiscal and monetary policy that takes effect in years three and four.

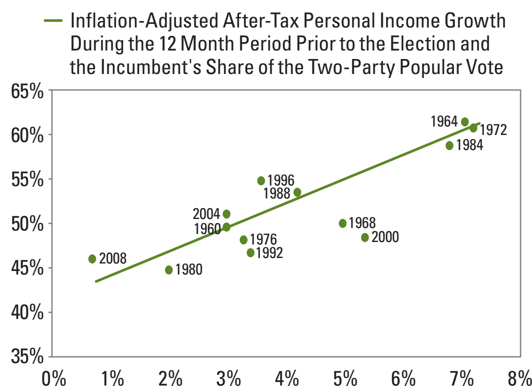
The election impact on taxes plays a role for municipal bonds. As a key part of their agenda, Republican candidates for president in 2012 have indicated they would seek to make permanent the tax cuts on income, capital gains, and dividends that are due to expire in 2012, while President Obama has indicated a desire to let them expire. The potential for higher taxes on capital gains and dividends could be a positive for the municipal bond market, which may see a demand response to higher marginal tax rates.

Economic Impact on Election

The impact of the economy on the election can most clearly be seen through the relationship between income growth in the year leading up to the election and election results. As you can see in Chart 3, inflation-adjusted, after-tax income growth of about 3–4% appears to be the threshold for incumbents to get 50% of the popular vote. This measure of per capita income, contained in last week's Personal Income and Spending report, is only growing at 0.3%.

Clearly, factors other than taxes, inflation, and income have a bearing on the election. However, income growth and related job creation may be the key measures by which the presidency will be judged. While job growth has improved in recent months to over 200,000 new jobs per month, helping to boost incomes, inflation has also risen.

3 3–4% Income Growth Is the Key to Getting Re-elected



Source: LPL Financial, Bloomberg Data 04/02/12

Election Impact on Economy

The economy is impacted by fiscal, monetary and regulatory policy. The outcome of this year's election may be more consequential, given that it will help to determine the path taken in 2013 to address the U.S.'s fiscal challenges including the debt ceiling and potential debt downgrades. In addition, the tax increases and spending cuts in 2013 already written into existing legislation amount to 3.5% of GDP (Gross Domestic Product), the largest percentage since 1947. The U.S. has never experienced a fiscal drag of 2% or more of GDP without an economic recession. As much as ever, the election is likely to have a major impact on the economy. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

The Standard & Poor's 500 Index is a 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.

Ibbotson Intermediate Term Government Bond Index is measured using a one bond portfolio with a maturity near five years.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

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