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Politics and Stocks

By Louis E. Conrad II, CFA

- The U.S. political environment has historically had an impact on our capital markets, but perhaps not to the extent as over the past five years.
- This article highlights the impact that Congress and the President have had on the stock market's performance over time.

The latest political election cycle will end next month on November 6. Each of us will have the opportunity to vote for individuals seeking to fill presidential, congressional, and local seats in our democracy. One financial television channel has dubbed this the "economy election" and whether you vote your wallet in this election, politics have historically had a meaningful impact on our capital markets.

In fact, politics have never had such an impact on the capital markets during my career as they have for the past five years as we transitioned from the Financial Crisis to the Great Recession to the current subdued economic recovery. Over the last few years our economy has been dominated by unprecedented monetary policy actions from the Federal Reserve, while a dearth of fiscal action has originated from Capitol Hill.

Despite this era of political polarization, politics have always had an influence on the markets.

The Congressional Effect

Mark Twain has been credited with the following wisdom: "No man's life, liberty, or property is safe while Congress is in session." Apparently this also translates to the U.S. stock market's returns. In a 1997 paper that appeared in the Financial Services Review entitled "The Congressional Calendar and Stock Market Performance," four researchers found that during the period 1897 – 1993, "almost the entire advance in the market...corresponds to the periods when Congress is in recess. This is an impressive result, given that Congress is in recess about half as long as in session."

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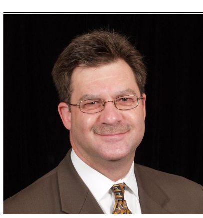
Advisor Corner



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Politics and Stocks, continued

A mutual fund was launched in 2008 that invests on the premise that this relationship between the congressional calendar and stock market returns will continue in the future. Based on data on the fund company's web site, the annualized daily price gain of the Standard & Poor's 500 (S&P 500) from January 1, 1965 through 2011 was 0.72% when Congress was in session and 16.60% when Congress was out of session. Similar results have been experienced over the most recent ten years as well.

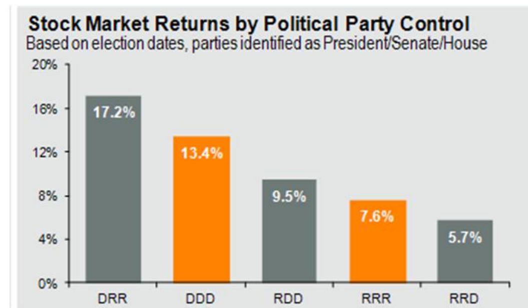
The Presidential Election

The political party occupying the White House also has had a significant effect on stock market returns. Studies have generally found that the U.S. stock market performs better during Democratic administrations than Republican administrations by as much as 9% annually. However, financial and economic factors impacting the capital markets at any point in time can outweigh the effect from election cycles.

According to data compiled by J.P. Morgan Asset Management for the period 1940 - 2008, while U.S. stocks have performed better under the watch of a Democratic president than a Republican president, they have performed best when a Democrat occupied the White House, but Republicans controlled Capitol Hill. In the current race, if the president is re-elected and the Republicans maintain control of the House of Representatives and take control of the Senate as many expect, such a result would coincide with the type of executive-legislative branch makeup that has led to the stock market's best returns historically.

The Market as Barometer

The stock market's recent returns may indicate that the presidential election's outcome is a foregone conclusion. According to the book "Don't Sell Stocks on Monday" and research by S&P, the stock market's performance during the August to October time frame in presidential election years is usually an accurate barometer of whether the incumbent president will gain re-election. According to S&P's data since 1900, when the S&P 500 gains during these three months, the incumbent is re-elected 80% of the time. Conversely, when the S&P 500 declines, the incumbent is defeated 88% of the time. This year the S&P 500 gained 4.4% during the months of August and September...with less than one month to go.



Source: U.S. House of Representatives, U.S. Senate, Gallup Inc., FactSet, J.P. Morgan Asset Management
Stock market returns are price only and calculated from election date to election date 11/5/40 to 11/4/08

Monthly Market Commentary

Although several bellwether stocks, such as Intel, Texas Instruments, FedEx, Norfolk Southern, and Caterpillar announced earnings warnings, investors mostly shrugged-off weaker fundamentals and placed their hopes on growth through coordinated easing. Investors were not disappointed, as additional quantitative easing (QE3) was announced on September 13th. Riots in Spain caused markets to react negatively, durable goods orders took a dive because of airline orders, and income and consumption numbers were hit hard by a quick spike in inflation rates. However, year-over-year data for almost every report continued to look a lot better than the volatile month-to-month statistics.

GDP: Second quarter real GDP growth was unexpectedly revised downward in September to 1.3%, after initially being revised upward to 1.7% from 1.5% in August. Adjustments were across the board, which included a slowdown in personal consumption, inventory growth, and negative net exports.

Employment: The recent jobs report revealed a surprise drop in the unemployment rate to 7.8%, down from 8.1% in August. In September, 114,000 jobs were added, but more importantly, the job numbers were revised substantially higher for July (+40,000 jobs) and August (+46,000 jobs). These revisions are likely to produce meaningful increases in both personal income and consumption growth.

Housing: Housing data was mixed as house prices rose but pending home sales seemed lighter than expected. The Case-Shiller 20 City Index rose 1.2% sequentially and is now 7% to 8% above lows reached this spring. The relatively consistent improvement in prices over the past few months should help the appraisal process that has kept many pending homes that went under contract from actually closing. Consistent price increases, along with near-record low mortgage rates and skyrocketing rents, could push potential buyers off the fence.

Manufacturing: New orders for durable goods were down a whopping 13%. A major air industry show in July often causes a huge boom for airline orders in that month, followed by a collapse in August. If volatile categories such as airliner orders and other transportation equipment are ignored, new orders were down a modest 1.6% in August. Morningstar economists believe that while the export news looked particularly bleak, a combination of ramp-up in jetliner productions from Boeing and continued improvements in the auto industry (auto sales hit a new recovery high in September) should prevent a rout of the manufacturing industry in the U.S.

Quarter-end insights: The initial fears at the end of the second quarter that the U.S. would be pulled back into a recession because of slowdowns in Europe and China, has not come to pass. Markets were surprisingly strong in the third quarter, mainly from actions by central banks around the world that drove markets higher. Although the housing recovery has been improving for most of 2012, it has yet to have any significant impact on overall economic activity since residential housing only represents 2% to 3% of GDP. This excludes spending that typically follows home purchases, such as new furniture and landscaping. Morningstar sector analysts' quarter-end outlook highlighted lackluster fundamentals that showed no definitive signs of either a collapse or a boom. During the third quarter, cyclical and more economically sensitive stocks generally did well while more staid industries, such as utilities, generally underperformed the market. There is also concern of a stronger dollar undercutting sales growth with a general fear that the higher dollar may likely depress margins in the months ahead. High margins and conservative capital spending have resulted in higher levels of cash at major corporations, which is finding its way into the mergers and acquisitions space. Much of the merger and acquisition activity as well as general corporate growth stories continue to be built around emerging-markets growth, despite near-term pressures in some of those markets.

Keep Your Cool

The stock market is a fickle thing, and risks are inherent for everyone who puts money in it. Only a few years ago, during the 2007-2009 financial crisis, many investors saw their portfolios melt away under their very eyes in an extremely short period of time.

It's normal to panic in such a situation, but the problem is the following. If you panic, take all your money out of the stock market to cut your losses, and place it into cash, you probably don't have any chance of recuperating your loss ever again, because returns on cash are about as low as you can get in the investment world. If, on the other hand, you keep your cool and stay in the stock market, chances are the crisis will pass and stocks will probably go up in value again. Of course, nothing is guaranteed, but panic won't help you in any case.

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