JANUS

Market Performance and the Party in Power:

Is There Really a Connection?

Summary The relationship between U.S. securities market returns and U.S. Presidential elections is a favored topic of Wall Street commentators. As the 2012 Presidential election heads toward the tape, the pundits are in full swing once again, and claims about the impact of a Democratic or Republican victory on U.S. stock and bond markets pop up almost as frequently as political ads. In this paper, we address the question, Should investors take these prognostications to heart and, more importantly, apply them to their asset allocations?

The predictions generally focus on two areas where Presidential politics and securities-market performance intersect: Presidential cycle theory (i.e., the pattern of year-by-year market returns during a President's four-year term) and the market impact of election/re-election of a Democrat or Republican to the White House. After reviewing a wide range of the current literature, we concluded that neither cycle theory nor election-impact claims provides a sound basis for an investment strategy. Although certain rough patterns can be gleaned from reviewing stock and bond market returns during past Presidencies, specific outcomes are not a given.

Our bottom line: A long-term investment strategy is better served by downplaying bipartisan politics while maintaining a diversified portfolio and keeping abreast of prevailing economic, geopolitical and secular trends—in short, the larger context within which the next U.S. chief executive and corporate executives will have to act.

Is There an Alpha Opportunity in Presidential Politics?

In our political system, Republicans are generally cast as pro-business inflation fighters; and Democrats, as anti-business spendthrifts. Like most generalizations, these oversimplify. But, assuming there is a kernel of truth in them, it leads to two questions: Do U.S. stock and bond markets perform differently under "pro-business" Republican and "pro-spending" Democratic Presidents? If there is a consistent difference, could investors enhance their investment returns by basing their investment decisions on who occupies the White House?

With these questions in mind, we reviewed a variety of literature, ranging from rigorous academic studies to the cases made in popular media, Internet publications and materials published by financial services providers. We looked for evidence of connections between market returns and Presidential terms or Presidents' party affiliations.

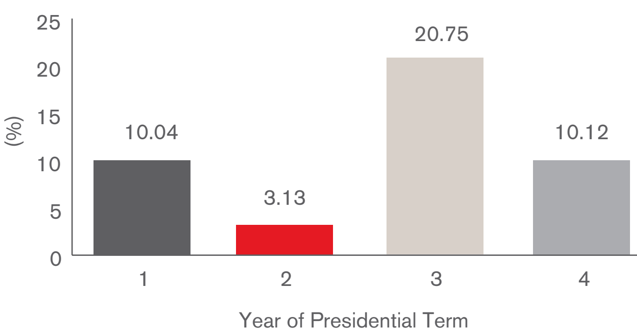
The Four-Year Election Cycle and Market Fluctuations

The notion that presidential races every four years affect market performance has been around for nearly five decades. Yale Hirsch began analyzing the relationship, known as the presidential cycle theory, in *The Stock Trader's Almanac* in 1968. Since then, Hirsch's idea has been examined and re-examined, and generally with the same conclusion: There is a prominent 48-month stock market cycle that corresponds to the four-year Presidential term.[1]

The studies also find that stocks have historically performed better in the last two years of Presidential administrations, Republican or Democrat;[2] and, on average, the third year's the charm (i.e., historically the highest-returning year) for most Presidential cycles.[3]

Exhibit 1

Average yearly stock market returns.
Years 1-4 of 13 Presidential cycles (1960 - 2011)



Source: Ibbotson Associates. As of 9/26/12. Stock market returns based on Ibbotson Associates (IA) Large Company Stocks Index.

Fiscal and monetary policies are usually cited as the cause. According to the theory, Presidents enact policies less favorable to individuals and the business environment and, by extension, the economy earlier in their tenures (cynics add, "in hopes all will be forgotten or forgiven before the next election.") Later, the theorists say, Presidents postpone unpopular measures or apply their influence to bring about more expansive monetary policy (generally associated with economic growth and higher employment levels).

Whatever the reason, more often than not, the Federal Reserve's most accommodative policy has occurred during the third year of the Presidential term, and the difference in policy from years 1, 2 and 4 has been significant.[4] It's also a fact that for the majority of Presidential terms in the past half-century, the weakest annual returns for stocks, as measured by the Standard & Poor's 500 Index (S&P 500), occurred during the first two years.[5]

Exhibit 2

During 12 completed Presidential cyles since 1961, the weakest yearly S&P 500 return happened in...

Year 1	Year 2	Year 3	Year 4
3 times	6 times	1 time	2 times

Source: Ibbotson Associates. As of 9/26/12.

And what about the bond markets and Presidential terms? The few studies all arrive at the same conclusion: bond market returns, including Treasury bills, long-term government bonds and corporate bonds, show no four-year pattern that corresponds to Presidential terms.[6] When it comes to fixed income, other factors such as inflationary pressures seemingly supersede partisan politics and the election cycle.

Partisanship and Securities Performance: A Split Decision

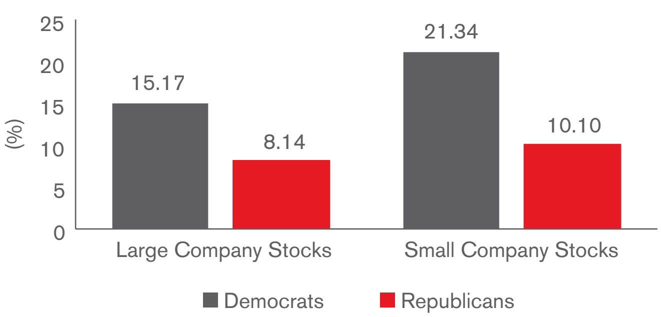
The stock market's four-year cycle of returns seems to be politically agnostic, as likely to occur under Democrats or Republicans. Which leads us to this question: As this cycle unfolds, are the actual returns (as compared to the year-by-year pattern of returns) materially different by political party? Simply put, are markets "better off" under Democratic or Republican presidents? According to the majority of analyses, it's a split decision. Stocks fare better during Democratic regimes; and bonds, under Republican presidents.[7]

To be sure, the studies are not in complete agreement. The small number that examine elections and stock markets going back as far as the mid-nineteenth century deduce that a President's party affiliation makes no difference to stock returns.[8*] We don't give much weight to these longer-term studies, however. The fiscal stances that identify the Republican and Democratic parties today—their respective approaches to taxation and government spending—were formed in the aftermath of the Great Depression and World War II. Also, before John F. Kennedy's administration (1960), the federal government did not play an active role in influencing the actions of the Federal Reserve or directing the economy. Eliminating earlier Presidential periods leaves fewer studies to consider, but it also focuses the analysis on a more relevant time span for today's investor.

With a few exceptions, the evaluations of stock market returns in the postwar era agree that equity performance is stronger during Democratic regimes, but the real story here is about market capitalization. Large cap stocks, as measured by the Ibbotson Large Company Stocks Index, have fared better under Democratic Presidents. So have small caps. Average returns for the Ibbotson Small Company Stocks Index during Democratic administrations have historically been two to three times greater than under Republicans,[9] an outcome that is widely attributed to Democrat's higher spending levels and the beneficial effects on small businesses and employment.

Exhibit 3

Average stock market returns per Presidential term, Democrats vs. Republicans (1961 - 2011)



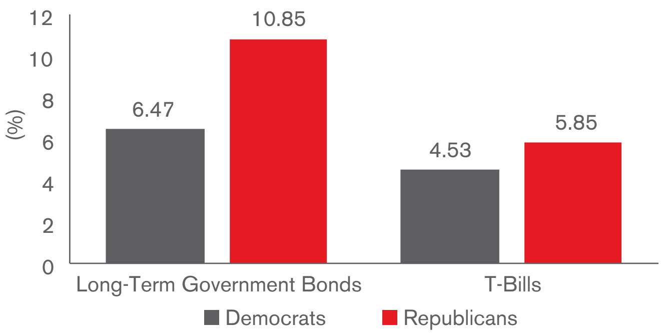
Source: Ibbotson Associates. As of 9/26/12. Large Company Stock returns based on Ibbotson Large Company Stocks Index. Small Company Stock returns based on Ibbotson Small Company Stocks Index.

On the fixed income side of the aisle, there is no debate. Short- and long-term government securities have generated higher returns under Republican administrations.[10]

The higher returns for government bills and bonds under Republicans seem consistent with the idea that the GOP tends to be more concerned with and proactive about curbing inflation. As inflationary pressures decline, interest rates fall and bond prices, which move opposite to yields, rise.

Exhibit 4

Average fixed income returns per Presidential term, Democrats vs. Republicans (1961 - 2011)



Source: Ibbotson Associates. As of 9/26/12. Long-Term Government Bond returns based on Ibbotson Long-Term Government Bonds Index. T-Bill returns based on Ibbotson U.S. Treasury Bills Index.

One last point about Presidential politics and securities market returns: A study that segregated earlier postwar Presidential periods (i.e., 1960-1980) from more recent ones (i.e., 1980 to 2004) found that the differences in stock and bond market returns under Democrats and Republicans narrowed in the past quarter century.[11] For the bond market, much of the narrowing was a function of the Federal Reserve's various interest rate-lowering programs since the 2008-09 financial crisis, which contributed to strong Treasury-market returns to date under President Obama.

Proceed with Caution

It may be tempting to prepare for a portfolio shift in November—to small cap stocks if Obama wins, or bonds if Romney is the victor—but we caution against it. As we see it, the information about Presidential politics and market performance currently available should be digested with a (large) grain of salt.

Consider the last point above, regarding smaller differences in returns under Democratic and Republican Presidents since 1980. Obviously, the Presidential politics-market returns relationship is not cast in stone. Is some undefined factor at play here, altering the patterns? Most likely. But it is "early days" in the science of understanding these relationships. Following is a brief sample of (the many) questions that may challenge the validity or usefulness of the conclusions to date.

*We found no studies that showed a persistent multi-year advantage for stocks during Republican terms, or for bonds while the chief executive was a Democrat.

Exhibit 5

Presidential Cycles and Market Returns

President

Yield Trends of Fixed Income Benchmarks

LTGB = Long-term Government Bonds

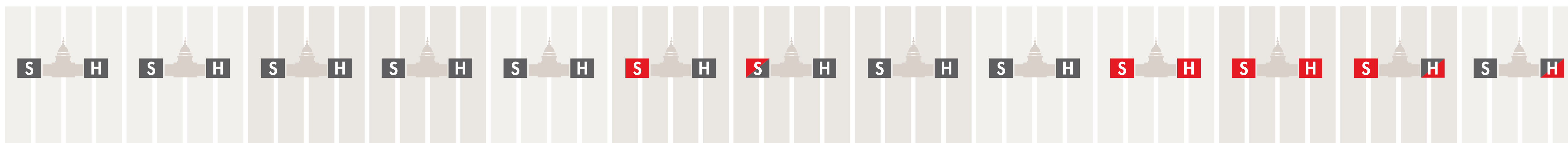
President	Years	T-Bills	LTGB
KENNEDY/ JOHNSON	61 62 63 64	▲	▲
JOHNSON	65 66 67 68	▲	▲
NIXON	69 70 71 72	▼	▼
NIXON/ FORD	73 74 75 76	▼	▲
CARTER	77 78 79 80	▲	▲
REAGAN	81 82 83 84	▼	▼
REAGAN	85 86 87 88	▼	▼
G.H. BUSH	89 90 91 92	▼	▼
CLINTON	93 94 95 96	▲	▲
CLINTON	97 98 99 00	▲	▼
G.W.BUSH	01 02 03 04	▼	▼
G.W.BUSH	05 06 07 08	▼	▼
OBAMA	09 10 11 12	▼	▼

Party Control of the House of Representatives (H) and the Senate (S)

Democrat

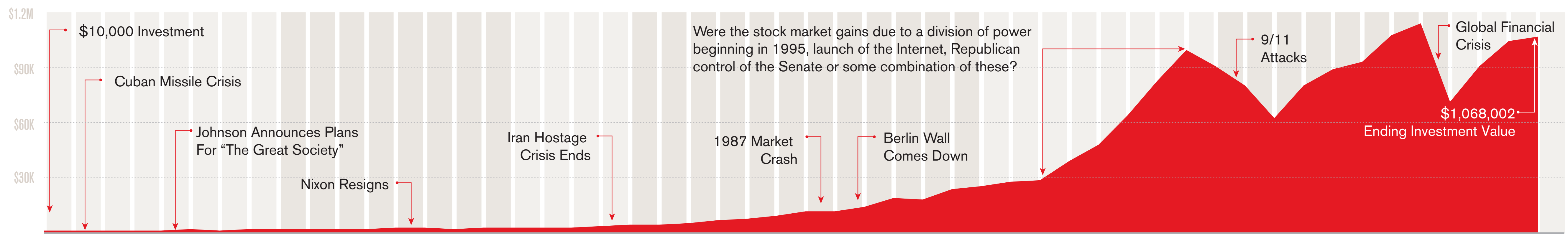
Republican

Split



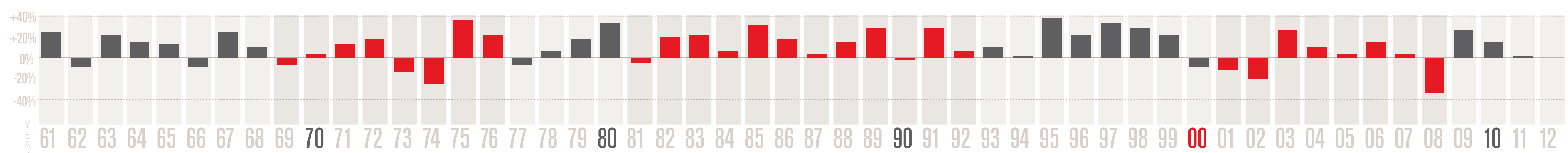
Growth of Hypothetical $10,000 Investment in S&P 500 Total Return Index

1/1/61 - 12/31/11



Annual Total Returns of S&P 500 Index

Years 1 to 4 of Presidential term



Comments

As Presidential cycle theory predicts, the second year of Kennedy's and Johnson's term in office produced the weakest equity returns, and years 3 and 4 brought the predicted recovery.

A balance of power between White House and Congress did not serve stock or bond markets well during Nixon's second term. Did the Watergate political scandal trump all other factors?

Presidential cycle fell apart during Reagan's terms in office.

In this cycle, only year 2 played out as theory predicts.

Clinton's first term was a textbook example of Presidential cycle theory.

Clinton's second term is often cited as proof that power-sharing between the President and Congress is good for the markets. Bond yields declined and the stock market soared.

Bush II's first term followed the Presidential cycle theory of returns. Were the year 1 and 2 downturns due to the 9/11 attacks or fiscal policies?

Bush II's second term in office defied cycle theory, even before the global financial crisis struck.

Do returns during Obama's term suggest that Presidential cycle theory should be laid to rest? Also, contrary to conventional wisdom, the bond market has performed well under this Democrat.

Source: S&P 500 returns based on Ibbotson Associates Large Company Stocks Index. Fixed income yield trends based on Federal Reserve Board 1-year and 10-year Treasury rates.

- **Do risk levels vary with the party in power?** Before giving in to the temptation to increase a stock allocation if Obama is victorious, or a bond allocation in the event Romney wins, consider this: How would either decision affect the overall risk level in a portfolio? Studies to date have focused on how market return patterns under the two political parties and have yet to look at whether market volatility varies according to the party in power.

- **Does Congress have a role in the outcomes of the Presidential cycle and party-in-power returns? If so, what are the dynamics of the relationship?** An analysis done in 2008 found that the stock market has historically performed better under Democratic Presidents, though Republicans have been in control of the House and Senate during the better performing periods for equities.[12] Should we infer that shared political control is always a better situation for investors, or better only under these particular circumstances? Another study (2012) showed that among the worst possible political-power combinations is a Republican President and a Democratic Congress. It also determined that for U.S. stock returns, the most decisively favorable indicator was Republican control of the Senate.[13] So much for the importance of Presidents to market returns!

- **Are the studies and analyses skewed by data-mining?** Strictly speaking, analysts don't have much data to work from. From George Washington's (first) election in 1788 to the present, there have been only 43 Presidents and 56 Presidential elections. The number of elections since stock and bond market data begin to be systematically recorded is fewer still, and the cycles since the end of World War II amount to a mere 16. Most researchers acknowledge that in their search for patterns to explain market performance, constantly reviewing a small data set may lead to "finding" patterns where none really exist. It's possible that the real causes for the perceived market return patterns have little or nothing to do with political parties and will ultimately be explained by other factors.

- **Do other factors trump political control?** In looking at Presidential cycles and market returns, one can make a strong argument that other factors—wars, shocks to the economic system and other "events"— can outweigh political power at times. This may explain why various Presidential/party-in-power regimes, seemingly similar on the surface, produce very different market results.

For all of these reasons, we believe that investors should approach claims about the relationships between Presidential terms, Presidential election outcomes and market returns with a high degree of skepticism. Patterns notwithstanding, market outcomes can't be taken for granted.

This may be especially true of the current Presidential race. The United States is faced with a unique set of domestic problems at this juncture, including but not limited to the need to restructure entitlements, address tax rates, reconsider immigration policy, establish a national energy policy, and decide how best to provide at least a minimum level of health care for all. However, recent trips to Washington have left us deeply concerned that neither party has the political will to work out the needed compromises. In that event, the election of a Democrat or Republican to the Oval Office may be irrelevant, as uncertainty, the arch enemy of markets at all times, will continue to prevail.

As always, the wise course is to maintain a diversified portfolio, spreading exposure to both the risks and opportunities of the next political regime, be it Republican or Democrat.

Sources

[1]Niederhoffer, Victor, Steven Gibbs and Jim Bullock. “Presidential Elections and the Stock Market.” Financial Analysts Journal, March/April 1970.

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[5]Nickels, Marshall. “Presidential Election and Stock Market Cycles.” Graziadio Business Review, Pepperdine University, 2004.

[6]Beyer, Jenson and Johnson (2007).

[7]Santa-Clara, P. and R. Valkanov. “The Presidential Puzzle: Political Cycles and the Stock Market.” Journal of Finance, 2003. See also Hensel, C.R. and W. Ziemba. “United Statement Investment Returns During Democratic and Republican Administrations, 1928 – 1993.” Financial Analysts Journal, 1995.

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[9]Grant, James L., and Emery A. Trahan. “Tactical Asset Allocation and Presidential Elections.” Financial Services Review, 2005.

[10]Ibid. See also Beyer, Jenson and Johnson (2007) and Santa-Clara and Balkanov (2003).

[11]Ibid.

[12]Keller, Bryan. “Political Party Power and Its Affect on U.S. Market Return.” Seeking Alpha, June 6, 2008. www.seekingalpha.com

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