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Presidential Elections and the Stock Market: Is There a Connection?

This is an election year, which means we are being bombarded by pundits, prognosticators and polls. The truth is no one knows what the outcome of the November 2012 U.S. Presidential election will be. But if history is to serve as any guide, then what we can surmise is that the outcome of the race and the occurrence of the election itself may well impact the stock market in the months ahead.

The Presidential Election Cycle Theory. A number of presidential election investment theories exist, and some seem to have more merit than others. Yale Hirsch, market historian and founder of the *Stock Trader's Almanac*, developed the most prominent of these. Hirsch's Presidential Election Cycle Theory states that stocks are weakest in the year immediately following the presidential election, then go up over the next three years with the third year typically the strongest of the four and the fourth year the second strongest of the four—no matter who wins the election. History does give some credence to Hirsch's theory. However, modern presidencies have not borne it out. The Dow Jones Industrial Average rose in the years following the elections of George H.W. Bush and Bill Clinton, but the two elections of George W. Bush were followed by down years. After Obama's 2008 election, the Dow went up.[1]

Also worthy of note is that the U.S. equity market tends to rise when a sitting president is running for re-election, whether or not he wins. Since 1900, whether a popular president wins a second term or an unpopular one does not, the Dow Jones Industrial Average has averaged a return of 9% when the incumbent president seeks re-election.[2]

Here's another way of looking at the numbers—by incumbent party, rather than by the man himself. From 1900 through 2008, the Dow Jones Industrial Average has performed better on average when the incumbent party won the election, regardless of whether it was a Democrat or Republican. Overall, the Dow Jones Industrial Average, when measured since 1900, has averaged 7.6% in Presidential election years. When the incumbent party won, the U.S. equity market rose 15.1% on average; when the incumbent party lost, the market declined an average of 4.4%.[3]

Another theory indicates that the mere fact we're approaching a presidential election likely improves the chances that this will be a good year for the stock market overall. Indeed, going back to 1836, the Dow Jones Industrial Average has climbed an average of 5.8% in presidential election years compared to an average of 2% and 4.2%, respectively, in the first two years of presidential terms. The last seven months of an election year have delivered positive returns for U.S. equity investors in all but two election years since 1952. Unfortunately, one of those years was 2008, when the S&P 500 Index, for example, lost 33.5% in the seven months leading up to election day that November.[2]

Other theories suggest that the winning party determines the direction of the stock market. Yet others suggest that the tone of a presidential election dictates the direction of the market. And yet other theories put forth that it's not the presidential election at all that is the best indicator of stock market performance but rather who controls Congress.

The Chicken or The Egg. Some believe that it is actually the stock market that determines the winner of the Presidential election, and not the Presidential election that dictates the direction of the stock market. In a study conducted by John Nofsinger, "The Stock Market and Political Cycles," which was published in *The Journal of Socio-Economics* in 2007, Nofsinger analyzed the relationship between the social mood of the country and the presidential election and concluded that the stock market returns in the three years prior to the election are useful in predicting whether the incumbent party candidate will be elected or not.[4]

Others believe the window is much narrower, given what's called the "recency effect," that is, the phenomenon in which people ascribe a disproportionate weight to the newest information received. According to this theory, if the stock market gains in the two months or so prior to the presidential election, the incumbent party wins. If the market falls, the incumbent party loses. Indeed, based on this theory, the stock market has correctly forecast nearly 90% of presidential elections since 1900, with only three of the 28 elections since then an exception—namely, 1956, 1968 and 2004.[5] Examining the exceptions can actually explain them. For example, in 1968, the Democrats were in office and the Dow Jones Industrial Average advanced 3.1%. But Lyndon Johnson did not run for re-election and the Democratic front-runner Bobby Kennedy was tragically assassinated. In 2004, George W. Bush was running for re-election. The stock market declined 2.5% between September 1 and election day,[6] but the U.S. was still reeling from the tragedy of 9/11 and only about a year and a half into an emotional war with Iraq.

Confused? Wondering whether any of these theories will hold true in 2012? Will long-term cyclical forces, macroeconomic events and geopolitical uncertainty trump election year dynamics? Should you do anything differently with your investment portfolio based on this being an election year? Every election cycle theory has exceptions, and there are no easy answers. Averages are just that, averages, and correlation should not be confused with causation. As one theorist said, "…just when you think that you have figured it all out, you find another pattern that can suggest different possibilities."[7]

In our view, a wise investor will consider each of these theories about the relationship between presidential elections and the stock market as only one of many factors influencing economic and market conditions. Indeed, when combined with other information, the relationship between the presidential election cycle and the stock market can provide insights investors can use to improve their investment decisions. The theories are certainly illustrative… and even entertaining…but as with any market timing strategy, they should not be depended upon. Past performance is no guarantee of future results, and no investor should jump in and out of the market or change his or her investment portfolio based on the latest election predictions, polls or even election day results. As always, sticking to the prudent principles of investing remains the best plan—stay invested, stay diversified and stay informed.

[1] David Francis, What the Presidential election means for the stock market, *US News & World Report*, April 19, 2012.

[2] G. Jeffrey MacDonald, Presidential elections are good for stocks, but…, *The Christian Science Monitor*, February 7, 2012.

[3] Ned Davis Research.

[4] Ken Hawkins, Presidential election cycle suggests stocks are a buy, *Forbes*, September 26, 2011.

[5] Lauren Fox, Stock market picks 90 percent of Presidential elections, *U.S. News & World Report*, February 24, 2012.

[6] Brian Stoffel, The key swing voter in the 2012 election? Call him Mr. Dow Jones, *Daily Finance*, March 15, 2012.

[7] Marshall Nickles. Presidential elections and stock market cycles: Can you profit from the relationship?, *Graziadio Business Review*; Pepperdine University, Vol. 7 (3), 2004.

Addressing Aversion to Risk

Combine the major world events and resulting stock market volatility of the past several years, the hits many took in their investment portfolios and, yes, the diametrically opposed philosophies being put forth by the two political parties on how to resolve our country's long–term fiscal problems, and it is no surprise that many investors have a major aversion to investing in equities. However, the result has been that many risk–averse investors today are overweight fixed income. Should interest rates rise going forward, as many expect them to, those investors may find themselves with losses from the supposedly safer side of their portfolios.

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Value Line Asset Allocation Fund

Recognized in *Investor's Business Daily* (February 3, 2012). Mentioned by *The Wall Street Journal* for its One-Year Performance as of December 31, 2011. Featured in *Kiplinger's* September 12, 2011 article "Cut Risk by Shifting Assets."

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