Post Election Market Performance

January 20, 2009

Peter Mallouk
JD, MBA, CFP®
Chief Investment Officer

This newsletter was originally sent to you in an e-mail on January 20, 2009. We have provided a hard copy with your quarterly report for your records.

Market Behavior After Presidential Party Shift

- When a Democrat takes office after a Republican, the stock market averages a 20.7% return in the inaugural year
- When a Republican takes office after a Democrat, the stock market averages a 6.6% loss in the inaugural year.

America elected Barack Obama president. While this means different things to different people, this newsletter will confine itself to market implications only.

Most investors equate a Democratic victory as synonymous with a stock market downturn. History tells quite a different story. When the presidency transfers from a Republican to a Democrat, the stock market averages a 20.7% return in the inaugural year. When the presidency transfers from a Democrat to a Republican, the market averages a 6.6% loss in the inaugural year. Throughout all years, the market has done slightly better under Democrats than Republicans.

'We cannot put too much emphasis on one factor alone having such a large impact on stock market performance.'

There are two main theories for this traditionally unexpected result. The first theory is that investors expect radical changes from Democratic presidents, including significantly higher taxes on income and investments, corporate taxes, and an environment generally less friendly towards corporations. The same theory holds that investors expect tax cuts, spending cuts and fiscal restraint from Republican presidents. The stock market adjusts in advance of the expected outcome of the election. When a Democrat replaces a Republican, the market often adjusts upwards when it realizes the new president may be friendlier than originally expected towards corporations and high income tax payers. Likewise, the market often adjusts downward when it realizes the new Republican president may not cut spending as expected. Proponents of this theory site two recent examples: (1) tax cuts, free trade, and record surpluses under President Clinton and (2) record spending and deficits under President George W. Bush. Again, we have no opinion as to whether either President deserves the credit or blame for these outcomes, but simply want to make the point that the market has certain expectations from each party, and many times, those expectations are not fulfilled, for whatever reason.

The second theory is that this statistic is irrelevant, and has more to do with the 'luck of the draw' than with whomever is President (much in the same way the stock market tends to go up if the AFC wins the Super Bowl and decline if the NFC wins).

We do know with certainty that the market is constantly 'pricing in' hundreds of variables – from the deficit to interest rates; the business cycle to commodity prices; from consumer confidence to corporate profits; and yes, whomever controls the White House and Congress. Even on Election Day, when the market rallied 305 points, it was largely due to the decline of worldwide interest rates and increased lending, and not based on whom the market thought would win the election.

As a result, we cannot put too much emphasis on one factor alone having such a large impact on stock market performance. In total, the election itself will not have a major impact. Long ago, the stock market 'priced in' an Obama victory, along with the hundreds of other factors that will continue to affect the market.

It has been said that the day any politician wins their first election, he or she immediately starts running for re-election, which usually results in a move towards the middle. This, combined with no supermajority in Congress, means that lawmakers will still need to work together to make significant changes to policy. To the extent these changes are friendlier towards corporate America than expected, the market is likely to react favorably, assuming all other variables are equal (which is never the case!).

During the election campaign, president Obama actually promised higher income taxes on those that make over $250,000 per year, higher capital gains taxes, and potential windfall taxes on oil companies. Since President Obama's victory, his newly appointed economic team has dropped strong hints that 2009 will likely not see any of the promised tax increases, saying that the economy may be too soft to withstand them at this point. This is just the sort of 'unexpected' move to the center that often causes a favorable reaction in the markets.

Many people see President Obama as good for the market since they believe he will stimulate the economy with his trillion dollar infrastructure build out proposal, and then after reinvigorating the economy, restore fiscal discipline. Others view it as bad for the markets, expecting higher corporate, capital gains, and income taxes to come soon, as well as massive spending on programs like health care. Contrary to the popular press, the outcome is not decided either way. Markets have gone up and down under both Republicans and Democrats. The verdict is most certainly still out.

3400 College Blvd., Leawood, KS 66211 | direct: 913.338.2727 | fax: 913.338.4507

cpi@thinkingbeyond.com | www.thinkingbeyond.com