# PRESIDENTIAL ELECTION CYCLES AND THE U.S. STOCK MARKET

gradientinvestments.com | 888.824.3525 | info@gradientinvestments.com

# PRESIDENTIAL ELECTION CYCLES AND THE U.S. STOCK MARKET

## INTRODUCTION

Politics, economics and financial markets are often intertwined in investors minds, with the notion that the political landscape highly correlates to the future of financial markets. The U.S. stock market has been analyzed, researched and studied for over one hundred years by many top minds of their time. These researchers have come from a wide array of disciplines in the fields of science, mathematics, economics, engineering and business. Their work has been aimed at discovering a correlation or multiple factor model to better forecast future stock market movements. The search for this holy grail of investing has intensified over the decades as the ability to process data at lightning speed evolved through the use of computer modeling. In this paper, we will explore historical data to determine if there is a linkage between the presidential election cycle and the U.S. stock market. While the data in this paper is not intended to change or influence political ideology, it is meant to reflect that politics and portfolios should be considered independently and investment plans should be focused toward personal objectives rather than political influence.

## CORRELATIONS BETWEEN ELECTIONS AND THE S&P 500

The stock market is constantly in motion and many attempts have been made to correlate the cycle of the stock market to certain events in the world and its economies. Serious market researchers attempt to correlate stock market movements to a variety of economic data in their predictive models. Market technicians will try and correlate price patterns to various stock market cycles from bull markets to bear markets and everything in between. One cycle that garners significant attention from the market researchers is the U.S. election cycle and the impact it may or may not have on the returns for the U.S. stock market. The presidential election cycle runs every four years with the congressional election cycle set on a two-year basis, commonly known as the mid-term elections.

Historically, there has been a distinct trend in stock market returns of the different years of the presidential term cycle.

Years one and two of the incumbent president's term historically have given us lower than average Standard & Poor's 500 index returns. Year three produces significant outsized returns while year four is again above average.

Pepperdine professor Marshall Nickles, in a 2010 paper called "Presidential Elections and Stock Market Cycles," presented data showing that a profitable strategy would be to invest on October 1 of the second year of a presidential term and sell on December 31 of year four. Yale Hirsch, the creator of the Stock Trader's Almanac, also put forth the "Presidential Election Cycle Theory": The most profitable year of a presidential cycle is the third, followed in order by the fourth, second, and then the first year.

These studies are intriguing, and the data presented allows one to ponder if these researchers are uncovering something special. Then, future data begins to take a new course and the old correlations become less relevant or non-existent. During the last three presidencies (Obama 2008, 2012 and Trump 2016) the pattern in play for many of the previous presidents did not hold. In each of Obama's terms, his first two years in office saw the stock market perform better than the last two years of his term. For Trump, U.S. stock market returns in year one exceeded year two. Things were back on track with a tremendous year three, but year four of Trump's term could be a very rare negative fourth year.

With the return of the S&P 500 Index for each of the 23 election years since 1928, you'll see that only four of them were negative. Could 2020 be the fifth?

# PRESIDENTIAL ELECTION CYCLES AND THE U.S. STOCK MARKET

| Year | Return | Presidential Candidates | Who Won | Political Party |
|---|---|---|---|---|
| 1928 | 43.6% | Hoover vs. Smith | Hoover | Republican |
| 1932 | -8.2% | Roosevelt vs. Hoover | Roosevelt | Democrat |
| 1936 | 33.9% | Roosevelt vs. Landon | Roosevelt | Democrat |
| 1940 | -9.8% | Roosevelt vs. Wilkie | Roosevelt | Democrat |
| 1944 | 19.7% | Roosevelt vs. Dewey | Roosevelt | Democrat |
| 1948 | 5.5% | Truman vs. Dewey | Truman | Democrat |
| 1952 | 18.4% | Eisenhower vs. Stevenson | Eisenhower | Republican |
| 1956 | 6.6% | Eisenhower vs. Stevenson | Eisenhower | Republican |
| 1960 | 0.50% | Kennedy vs. Nixon | Kennedy | Democrat |
| 1964 | 16.5% | Johnson vs. Goldwater | Johnson | Democrat |
| 1968 | 11.1% | Nixon vs. Humphrey | Nixon | Republican |
| 1972 | 19.0% | Nixon vs. McGovern | Nixon | Republican |
| 1976 | 23.8% | Carter vs. Ford | Carter | Democrat |
| 1980 | 32.4% | Reagan vs. Carter | Reagan | Republican |
| 1984 | 6.3% | Reagan vs. Mondale | Reagan | Republican |
| 1988 | 16.8% | Bush vs. Dukakis | Bush | Republican |
| 1992 | 7.6% | Clinton vs. Bush | Clinton | Democrat |
| 1996 | 23% | Clinton vs. Dole | Clinton | Democrat |
| 2000 | -9.1% | Bush vs. Gore | Bush | Republican |
| 2004 | 10.9% | Bush vs. Kerry | Bush | Republican |
| 2008 | -37% | Obama vs. McCain | Obama | Democrat |
| 2012 | 16% | Obama vs. Romney | Obama | Democrat |
| 2016 | 11.9% | Trump vs. Clinton | Trump | Republican |
| 2020 | ??? | Trump vs. Biden | ??? | ??? |

If 2020 ends the year with negative returns on the S&P 500, it would mark the third time in the past six presidential election cycles. All of a sudden, the data pattern fades into the background and the results begin to resemble a coin toss. These studies are fun but are only useful if trends are persistent.

There are so many factors that affect market movements, zeroing in on one or two data patterns with relatively limited occurrences of data can be a dangerous way to make long-term investment decisions. Many people hold on to a belief that there is a way to beat the market and when data patterns are found, it fuels their hopes and can ignite their investment decisions. This can lead to difficult outcomes if investment dollars are put to real use when past correlations no longer hold true.

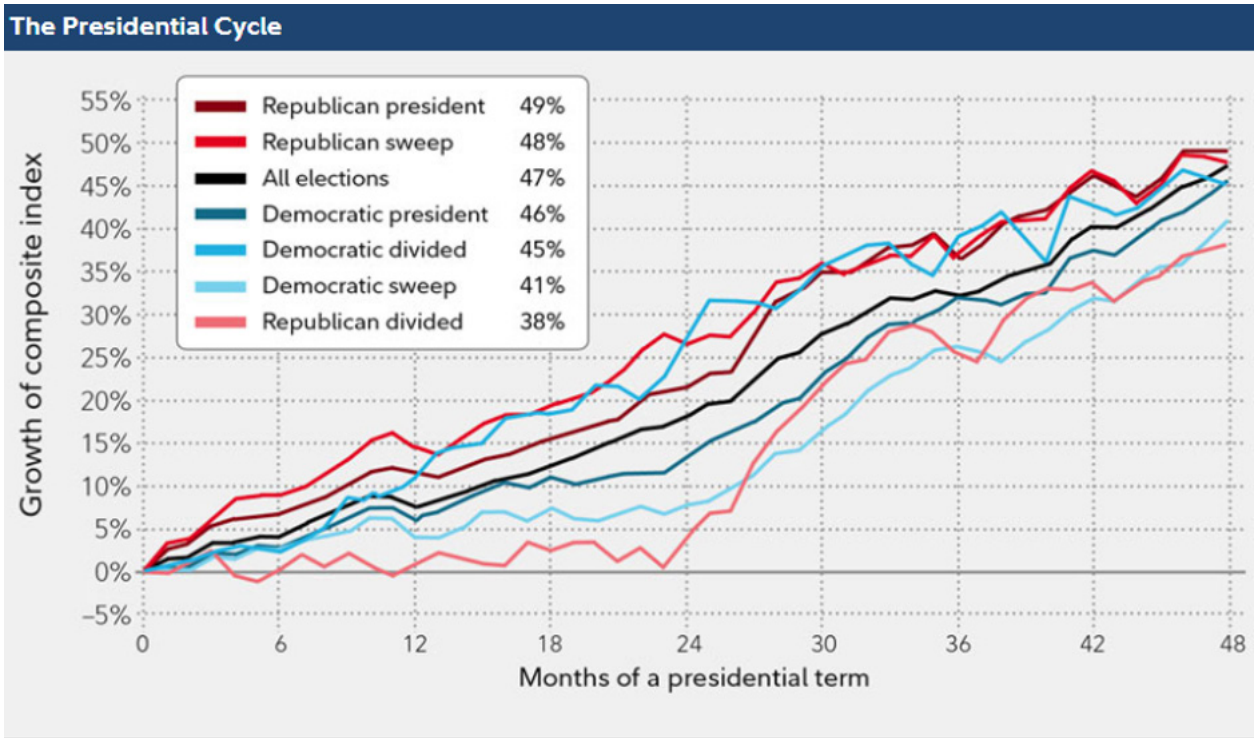
# PRESIDENTIAL ELECTION CYCLES AND THE U.S. STOCK MARKET

## THEORETICAL BASIS

The theory behind the presidential election cycle market pattern of below average returns in year one and two and stronger returns in years three and four has both political and economic roots. When a newly elected president comes into office they come with a new agenda for the country. In the case of President Trump in 2016, his main policy initiatives centered on energy independence, fair trade, tax cuts, reduced government regulations, and the idea of bringing manufacturing jobs back to the United States. While many of these plans could be considered "stock market friendly", the market needs time to digest the strategic direction and determine if it will lead to better economic growth and higher corporate profits. A recent example is the self-imposed trade war with China. The market was uncomfortable with this new approach to world trade and it created anxiety for investors. This digestion period and the critique of strategic plan to implementation is common in the first two years of a president's term. In year three, the election cycle becomes the focus for the party in power as incumbents begin to make their case for re-election. Decisions around boosting the economy through fiscal or monetary stimulus may be undertaken to ensure the economy is running on all cylinders heading into the next election.

## HISTORICAL ANALYSIS

The exhibit below splices available stock market data dating all the way back to the first election of George Washington and shows the tendencies of slower market starts in the first 24 months of a president's term followed by a stronger second half finish.



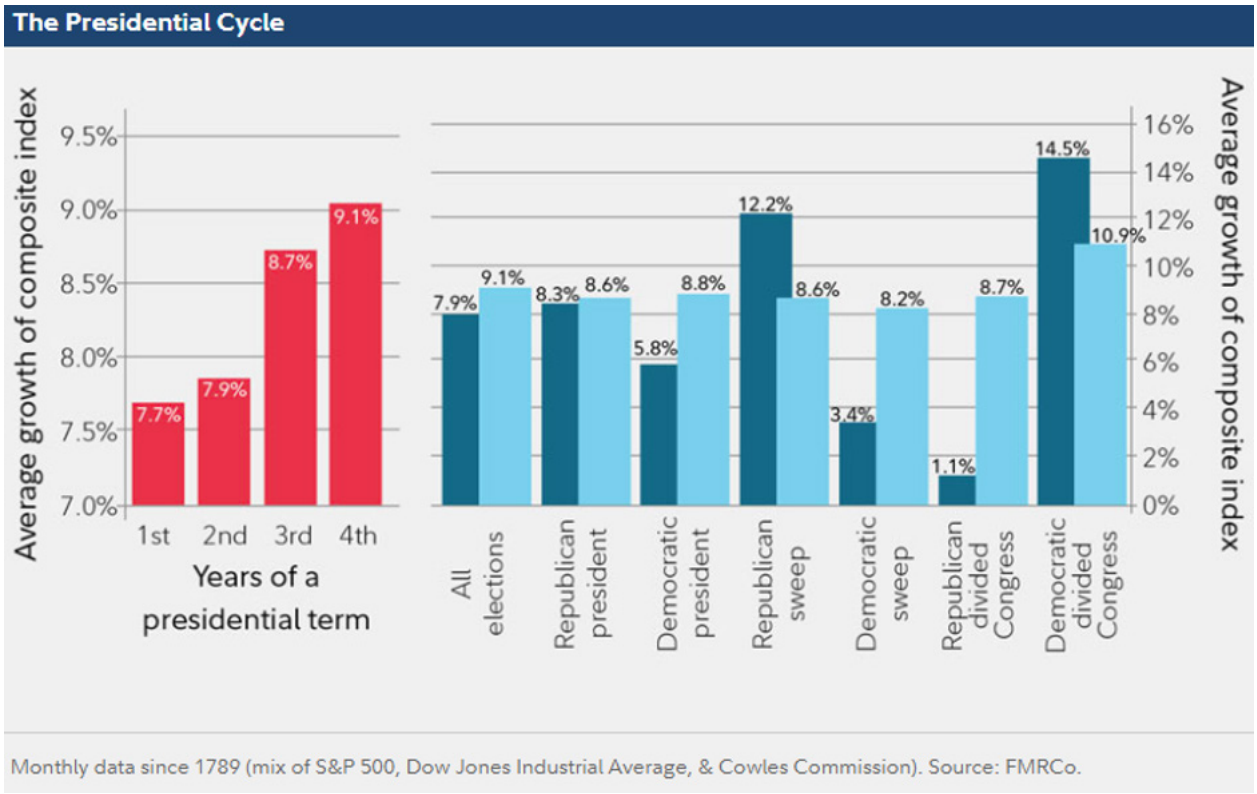

Monthly data since 1789 (mix of S&P 500, Dow Jones Industrial Average, & Cowles Commission). Source: FMRCo.

# PRESIDENTIAL ELECTION CYCLES AND THE U.S. STOCK MARKET

Analyzing the same data in a different way can lead one to draw certain conclusions. The bar chart shown on the left side of the exhibit depicts stock returns in years three and four exceeding returns of years one and two of a presidential term. On the right section of the bar chart, the dark blue shows the stock returns in the first two years of a new term and the light blue bar shows the returns for the full four-year term.

Using this chart, the data would suggest:

- For a full four-year period, the returns are strikingly similar regardless of the president's party.
- Republicans seem to come out of the gate faster, but the market seems to warm up to Democrats after the first two years in office.




The mid-term elections can also have a direct effect on the swing of the pendulum. Congress changes every two years as voters either reinforce the president's policies or vote to change direction. In the upcoming 2020 presidential election, there is a wide range of political outcomes that could alter the business environment in the U.S. This election could hold major implications for the economy and the stock market through either a continuation of current policies or a potentially drastic change of course.  Time will tell which event will occur and how markets will react.

# PRESIDENTIAL ELECTION CYCLES AND THE U.S. STOCK MARKET

## ECONOMY IN CONTROL

Elections come and go as do presidents and congressional representatives, but financial markets tend to outlast political discourse and adapt for the future. For that reason, the long-term fundamentals of earnings and interest rates, monetary policies, labor growth and productivity are what ultimately drive long-term returns. Politics is just one piece of a very complicated puzzle that includes corporations, consumers, governments, deficits, world trade, demographics, monetary policy and many other economic variables. After the elections are completed and politicians take office, the CEO's of companies large and small, public and private will continue to go about their business to generate growth, improve margins, and increase overall shareholder value. Companies compete each day to make businesses better through product or process innovation, marketing, service, and cost containment. Thankfully, the corporate drive to stay in business, grow, and succeed is the one constant that investors can rely on to weather the political changeovers.

## U.S. STOCK MARKET PREDICTS PRESIDENTIAL ELECTIONS?

The U.S. stock market data suggests there are some return patterns relative to the presidential election cycle, but recently the patterns are beginning to deviate from past election cycles. While elections may provide some indication on market trends, there is evidence the stock market has an excellent track record of telling us where the election is headed. The market direction in the three months prior to the election seems to hold the key to telling us which party will occupy the White House after the election. If the stock market is up in the three months leading up to the election, history shows a high probability of the incumbent party remaining in office. If the market is down in the three months prior to the election, odds are strong that a new party will occupy the White House. Pay attention to stock returns in the August through October time period and maybe you can tell your friends who the next president will be prior to election night.

The statistics here are quite impressive. In the 22 presidential elections since 1928, fourteen had U.S. stock market gains in the three months prior to the election. In 12 of those 14 instances, the incumbent party won the White House. In the eight elections preceded by a three months stock market loss, the incumbents were replaced by the opposition party. As always there are exceptions to the rule. In 1956, 1968 and 1980, this theory did not hold. Still, being right 19 times in 22 tries (86%) is a compelling success rate when it comes to the market's ability to accurately forecast the election. Just as with yearly data, however, making an investment thesis on one particular point can lead to negative outcomes if the trend does not persist.

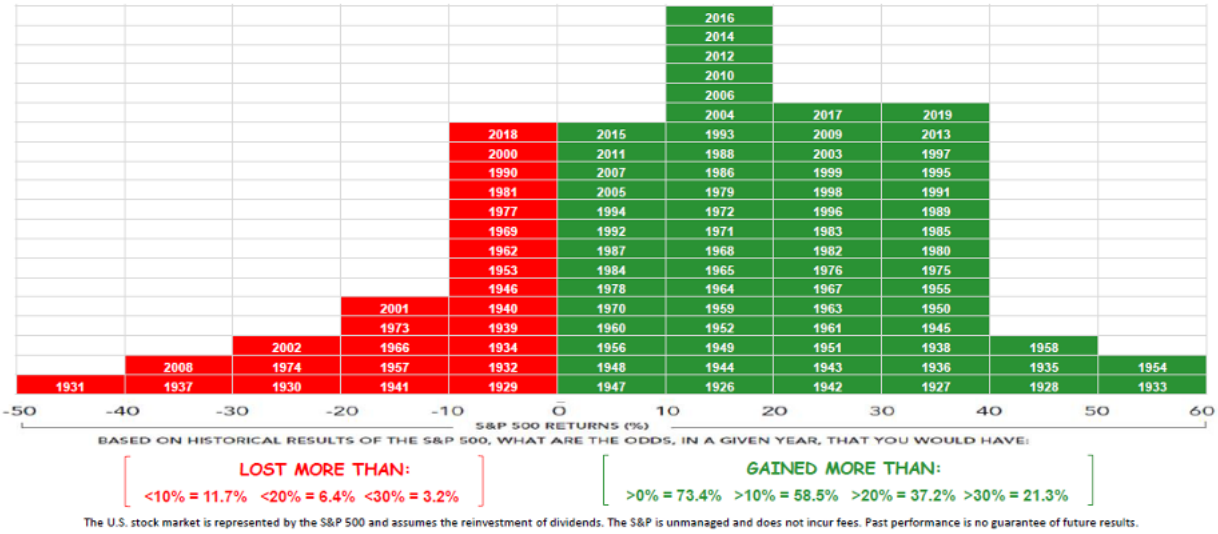
## STOCK MARKET RESILIENCY

The stock market has a long history of generating positive annual returns over many different administrations, both Democratic and Republican. Study the exhibit, "The Odds of Being Positive", for a few minutes so you can fully appreciate the power of stock market returns over time. Depicted below are the annual returns of the S&P 500 from 1926 - 2019. The green boxes represent years when the S&P 500 produced positive returns and the red boxes show the individual years generating negative returns. The stock market had positive annual returns 73.4% of the time over the past 94 years. If you focus on sizable market returns of plus or minus 30%, gains over 30% occurred 20 times and losses greater than 30% happened only three times. Those are powerful odds in the investor's favor. This data stretches over 19 different presidents from Taft to Trump. It also covers major events from the Great Depression, World War II, stagflation, the technology boom, to the financial crisis of 2008. The collection of companies that comprise the market may change over time, but the market in general has proven resilient and has performed quite well under both Democratic and Republican administrations.

# PRESIDENTIAL ELECTION CYCLES AND THE U.S. STOCK MARKET

## THE ODDS OF BEING POSITIVE

Stock Market Returns from 1926 - 2019




The U.S. stock market is represented by the S&P 500 and assumes the reinvestment of dividends. The S&P is unmanaged and does not incur fees. Past performance is no guarantee of future results.

## STAND STRONG

People often use the expression, "It's different this time". At the end of the day, the 2020 election is just a continuation of a process that began 230 years ago and hopefully can continue for another 230 years or longer. Whether through leadership continuity or change, the one constant has been challenges that face businesses will be different in the future than they were in the past. Nestled with these changes is the proven ability of companies to adapt and the market's ability to prosper over the long-term. It is this adaptability that has allowed for economic growth, and ultimately its long-term economic fundamentals that drives the markets well beyond any one election or any one party.

Despite any political leanings for investors, when it comes to portfolio returns, the numbers support the notion that it does not matter much who is living at the White House. An easy conclusion is that Republican policies tend to be more business friendly so one would expect higher stock returns coming from Republican administrations. The data since 1900 actually tells a different story. The S&P 500 averages about a 9% annual return when the president is Democrat and 6% when a Republican is in the White House.

Personally, it can be more comforting when you agree with Washington's policies philosophically, but your portfolio is not invested in the president or congress. Your portfolio is invested in the economy and the corporations operating in it. You can be a staunch Republican, Democrat or Independent, but don't let your political views derail your investment plan. Keep your investment program focused on your goals, risk tolerance, and time horizon and avoid unnecessary complications of mixing political views with the long-term objectives for your money.



GRADIENT INVESTMENTS, LLC

An SEC Registered Investment Advisor

976046 2020-08-05 GI