



## A year of living dangerously

As this election year gets firmly underway, investors have to understand that it will be accompanied by uncertainty and for financial markets that means volatility. Markets are already dealing with so many unknowns — the European debt crisis, U.S. fiscal imbalances, and continual tensions in the Middle East. It's obviously not an appealing option to add a U.S. presidential election to that mix.

So what I want to do here is look historically at what election years have meant for markets and how much the choice of a president really matters in the grand scheme of things . . . economic things, that is. While I cannot predict the future, I can look at lessons from the past.

In fact, if we look at history, presidential elections have a profound impact on the economy and the stock market. Wars, recessions, and bear markets have tended to start or occur in the first half of a term while prosperous times and bull markets have happened more often in the last two years.

1. Historically, an election year has not been the best for stocks. Since 1896, the Dow Jones Industrial Average has gained an annual average of 7.6%. The third year of the cycle has typically shown the biggest gains — 14.8%. Last year the Dow underperformed that average, returning only 8.38%. So it is hard to know how that sub-par return might affect election year returns. Let's look at some other historical averages as well:
  - average gain if Republicans win: 10.3%
  - average gain if Democrats win: 3.9%
  - average gain if incumbent party wins: 15.1%
  - average loss if incumbent party loses: -4.4%
2. The president can have a large amount of influence over the economy. The U.S. economy is not a command economy. Economic cycles are long lived and have their roots in a combination of factors, including trade and demographics. But because of a series of interventionist laws, the president has broad powers to help extend expansions and accelerate the ending of recessions. The acts include the Budget and Accounting Act of 1921, the Reorganization Act of 1939, the Employment Act of 1946, and the War Powers Act.
3. The defense and financial services industries could be favored by a Republican win.
4. The alternative energy, wind, water, and solar power industries could be favored by a Democratic win.

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5. Along with increased globalization, greater world competition, and the shrinkage of the U.S. economy as a percentage of the world economy, the power of the president to influence the U.S. economy has lessened.
6. We are now seeing a return to a greater level of regulation of financial markets and businesses. That's a result of the most recent economic and banking problems. The bottom line is that the financial system and amount of outstanding credit remain too important to ignore.
7. The biggest issues that the next president — Democrat or Republican — will face are
  - mounting federal deficits and rising Medicare and Social Security costs
  - divergent interests of those who wish to protect U.S. jobs and those who seek greater trade freedoms
  - energy policy and the maintenance of the national infrastructure

Remember: Democrat or Republican, historically we have seen that election years are moderately good for stock markets. At the time of this writing, employment seems to be increasing, a condition that has historically helped the incumbent. In addition, U.S. productivity is high, unit labor costs are comparatively low, and final sales in the United States are rising.

As an observer, by all means focus on the platforms, the speeches, and the excitement of the campaign. But as an investor, distance yourself from the rhetoric and hype. Remember that the long-term trends in company earnings, worker productivity, and competitiveness matter the most.

No forecasts can be guaranteed.

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