

The Election Cycle and the Stock Market

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Elections create market uncertainty

With the mid-term elections weeks away, a number of clients have asked what impact the elections will have on the stock market, particularly if the makeup of Congress shifts. Although we can look at past election outcomes and speculate about potential outcomes, even if we get the election outcome correct, there is no guarantee that the market will follow previous patterns. Elections do create uncertainty and significant change creates even more uncertainty. Nevertheless, in the long run, we believe that the stock market's performance depends upon underlying economic fundamentals. Market valuations, monetary policy, investor sentiment, geopolitical considerations and current fiscal policy should have a greater impact on market performance than the election outcome. Although a shift in the makeup of Congress might affect future fiscal policy, we believe these changes would tend to be slow and impact economic conditions further down the road.

Stock market fundamentals should drive prices.

In our opinion, the election outcome will do little to change any of the positive fundamentals currently pushing stock

prices higher. Stock valuations are on the cheap side, interest rates are relatively low, Fed Policy is on hold, tax policy is set until 2010, the economy is healthy, employment is growing, the unemployment rate is low, inflation is contained, earnings continue to surprise to the upside, and investors have learned to live with geopolitical risks. While election uncertainty can create short-term uncertainty for investors, we believe that long-term fundamentals and valuations will determine the direction of the stock market. Regardless of the election outcome, we will continue to monitor our valuation, economic and pricing models and stay in tune with our disciplines.

The historical record around elections is more an accident of history than a reason to invest or not invest in stocks. However, just for fun, here are some of the factoids surrounding elections.

Mid-term elections are incumbent unfriendly.

Historically, mid-term elections have not been kind to the incumbent president's political party. Since 1862, there have been 36 mid-term elections. In 33 of those elections, the opposition party picked up seats in the House of Representatives. Two of the three

exceptions occurred in the last two mid-term elections. The record is even worse for mid-term elections occurring in the second presidential term, a phenomenon that has been dubbed the "Six Year Swoon." There were nine such elections in the last century, in which the incumbent presidential party lost an average of 33 seats. This is more than double the fifteen seats Democrats need to take control of the House.

The historical record aligns with the current conventional wisdom, which calls for Democrats to pick up seats and probably take control of the House of Representatives. Intrade.com is a prediction market trading exchange where one can buy contracts based on the outcome of future events such as elections, economic reports and other unique events. According to Intrade.com, the Republicans currently have only a 36% chance of retaining control of the House but a much greater 64% probability of holding onto the Senate. Most conventional polls indicate a similar election outcome. If correct, this implies Congressional gridlock. Given recent market performance, it appears that gridlock is considered by investors to be a favorable outcome. Gridlock makes it difficult to unwind anything positive

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Musings from the Chief Economist

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that's been done and harder to legislate—changes in the regulatory status quo.

Historic analysis of election cycle supports higher stock prices.

The first of the Ned Davis Research charts below depicts the average market pattern for the Dow Jones Industrial Average (Dow) for the four-year presidential election cycles from 1900 to 2005. It indicates that historically the second year of the presidential cycle (i.e. the mid-term elections year) is the worst year for stock market performance and that the third year (i.e. the year after the mid-term elections) is one of the best years for stock market performance.

The second Ned Davis Research chart shows the S&P 500's performance from 2003 to 2006.

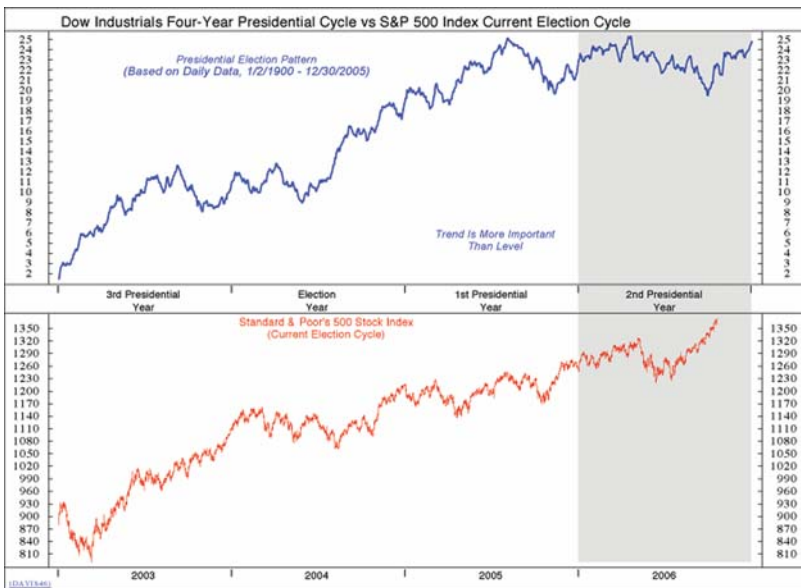
As the first chart indicates, the Dow tends to bottom in the second year of the presidential term around the time of the mid-term election. This has occurred thirteen of sixteen times since 1942. In addition, October of the mid-term election year to December 31st of the presidential election year has historically been the best time to be invested in stocks, with the Dow posting a median return of 35% for this time period from 1900 to 2005. The cumulative median return from the first year of presidential term to the mid-term election was only 2.0%. While past performance is never an indication of future results, if history repeats itself, the next year or two should be good for stocks!

Sources: Bailard Research, Ned Davis Research, *Washington Times*, *Kiplinger's Personal Finance*, Graziado School at Pepperdine University.

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