

The Election Cycle and the Stock Market- Part II

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As we mentioned in our Musing, "The Election Cycle and the Stock Market" last October, mid-term elections have not been kind to the incumbent president's political party. In mid-term elections occurring in the second presidential term, the incumbent presidential party historically has lost an average of 33 seats in the House of Representatives. Yesterday's election results fit this pattern. At this point, Democrats have picked up 27 seats and could move over 30 when all the votes are counted. They needed fifteen seats to gain control of the House. The outcome in the Senate is still unknown. It is probably dependent upon a recount in Virginia to determine a thin margin of control for either the Republicans or Democrats.

Radical Changes Unlikely

A Democratic victory in the House was widely expected, allowing the stock market to take the election's outcome in stride. Investors, at least for now, are looking at split government as a good thing since it promotes compromise or gridlock, which makes radical change difficult. Although Nancy Pelosi and President Bush may surprise us all with bipartisan cooperation (politics can make strange bedfellows), the more likely result is a lot of vetoes or watered down legislation.

There is not just uncertainty about how Republicans and Democrats will coexist, but uncertainty about how the newly elected Democrats will coexist with old line Democrats. The Democratic Party appears to be moving back to the centrist Clinton model. Rham Emanuel, the architect of the Democratic election strategy, did a superb job in drafting more centrist candidates that could take advantage of the discontent with Congress.

Playing around the 50 yard line

For the Democrats, a move to the center may be the roadmap to winning the Presidential election in 2008. However, senior Democrats like Waxman, Conyers, Rangel, Murtha and Hastings will chair all the major committees, while the newly elected (centrist) junior representatives will likely have limited influence. As Speaker of the House, Nancy Pelosi may try to keep the party centered and not veering off to the left as we approach the 2008 elections.

Thus far, President Bush and Nancy Pelosi have set a conciliatory tone. Donald Rumsfeld's departure as Secretary of Defense may set the stage for greater bipartisan cooperation and possible changes in Iraq policies or strategies.

Investment Implications

In our opinion, the election outcome does little to change any of the positive fundamentals that are currently pushing stock prices higher. Stock valuations are still attractive, 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 have continued to surprise to the upside, and investors have learned to live with geopolitical risks. While political uncertainty can create short-term volatility and opportunities, we believe that fundamental factors will determine the direction of the stock market in the long term. In late October, we did reduce our equity exposure in the belief that the market had advanced too far, too fast and that investor sentiment had become too optimistic. However, we still recommend a modestly overweight position in stocks due to our favorable long-term outlook. We will continue to monitor our valuation, economic and pricing models and stay in tune with our disciplines.

Musings from the Chief Economist

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