

# Musings from the Chief Economist

## Election Outcome: What Now?

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The U.S. stock market appears to be in a bottoming phase after experiencing a severe sell-off in which it discounted a lot of bad news. Although past performance is no guarantee of future results, if history is any guide, we believe the stock market should move higher over the next year. In a Ned Davis study of presidential elections from 1901 to 2004, when the incumbent Republican Party lost, stocks (as measured by the S&P 500 and Cowles Indices) rose 10.2% in the first year of a presidential term but dropped -5.3% on average the following year. This can be compared to an average gain of 5.0% per year over all periods and combinations of government.

During the four-year terms in which Democrats controlled both the presidency and Congress, the Ned Davis study found that the historical tendency was for stock prices to appreciate by an above average 6.6% annualized. However, inflation also tended to rise, increasing 4.8% and pulling real stock returns down to a below average 1.7% per year. Long-term government bonds did poorly as well, generating record low nominal returns of 2.3% and a negative -2.5% real return per year.

History provides a nice backdrop but rarely repeats itself precisely. For exam-

ple, the current stock market decline is out of sync with prior election cycles. Typically, election years have tended to be volatile but positive for the stock market. This election year, stocks have fallen sharply, as the economy and credit crisis have deteriorated and election uncertainty has weighed on investors.

We believe this is good news for President-elect Obama and investors. With stock valuations extremely cheap, the worst of the credit crisis apparently behind us, the Iraq war winding down and the market likely to begin discounting economic recovery next year, the environment for stocks is likely to be even more positive than in other post-election periods. Historically, the post-election years coming out of recession, bear markets and periods of crisis (1920, 1932, 1960, 1980, 1992) tended to be very positive for the equity markets, which rose on average 14.9% in the first year of a new presidency. This makes intuitive sense. The stock market is forward looking, and tends to overreact to bad news and to discount current problems well into the future. This sets up the conditions for higher prices if the news is not as bad as assumed.

In addition, regime change typically

occurs because things are bad; the electorate throws the rascals out, giving hope for the future. At least initially, the prospect of change should help boost investor confidence. President-elect Obama's oratorical eloquence is a sharp contrast to President Bush's speech challenged oratory. In a crisis of confidence, an articulate cheerleader can be quite useful. Hopefully, the honeymoon with the electorate and the media will last well into next year and give a boost to what we are expecting will be nascent economic recovery.

In addition, between now and inauguration day, it is likely a new \$150 billion stimulus package will be put in place. Unlike last Spring's temporary tax rebates, the new stimulus package is likely to be more targeted. It is expected to focus on infrastructure spending, which has both short-term and long-term economic benefits, including creating jobs and providing needed upgrades in roads, bridges, electricity transmission and sewage treatment. These plans are already on the drawing board and only need to be funded.

The new administration is also likely to decide quickly on a plan to stabilize housing prices. Although numerous rescue efforts have already been put in place and there are indications that

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the housing sector is beginning to stabilize, the unanimous consensus in Washington and on Wall Street is that government measures to stabilize home prices are still necessary. Some measures could be implemented even before the new administration takes office. There is talk of nationalizing FNMA and FMAC, allowing these entities to borrow at even lower Treasury rates and providing low cost mortgages to qualified homebuyers. Sheila Bair, the head of the Federal Deposit Insurance Corporation, has also developed a plan to stop foreclosures by forcing lenders to write down mortgages, with the government guaranteeing the remaining debt.

New lending requirements may also be imposed on banks that receive direct investment from the \$700 billion bailout program. One of the criticisms of the recent rescue efforts is that there is no mandate for banks to increase lending. The U.S. government has set up the preconditions for increased lending by boosting bank capital. Since the banks' cost of funds is so low, the wide interest rate margins would suggest banks should be eager to lend. In fact, bank lending has actually started to increase. However, the current perception that banks are not increasing their lending may lead to the adoption of new lending requirements.

Finally, one of the most important

things President-Elect Obama can do to boost investor confidence is to reveal his choices for key cabinet positions, with the Treasury position being the most important. Names being rumored for Treasury Secretary include former Federal Reserve Chairman Paul Volcker, New York Fed Chairman Tom Geithner and former Treasury Secretary (under President Clinton) Larry Summers. These are well respected figures on Wall Street with which to replace the current Treasury Secretary Henry Paulson. While Mr. Paulson had a difficult situation to deal with, his approach was until recently more reactive than proactive; he also lost a lot of credibility in handling the financial meltdown that was triggered by the bankruptcy of Lehman Brothers.

Although there are some serious long-term issues to watch concerning tax policy, government spending, trade and regulation, in the short term conditions still seem to us to be encouraging for the stock market. In the long term, we hope Mr. Obama surrounds himself with capable people and is guided down the more centrist path seen in the rhetoric of his presidential campaign rather than the more extreme rhetoric of the primaries. For now, we look forward to fresh eyes on the myriad issues facing the presidency and wish Mr. Obama the best of luck.

Sources: Bailard Research, Ned Davis Research, GaveKal Research

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