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A Sure Bet

It's a presidential election year. That's good news for your investment portfolio

By James M. Pethokoukis

When Al Gore was running for vice president in 1992, he repeatedly delivered a caustic critique of the first Bush administration's economic policies, pithily concluding: "Everything that should be down is up. Everything that should be up is down."

Well, as far as Wall Street is concerned, just the opposite exists as this election year begins. Economic growth is up; unemployment is down, to 5.7 percent in December though job growth is surprisingly anemic. Corporate profits are up, inflation is down. And most important, the stock market is up--way up. The Dow Jones industrial average soared 25 percent in 2003, the Standard & Poor's 500 index 26 percent, and the Nasdaq 50 percent. Of course, not all the economic and financial statistics are at their strongest levels ever--or even where they were when George W. Bush took office three years ago.

But in trying to figure out what 2004 holds in store for investors, you really don't need to understand the complex dynamics between taxes and interest rates, and inflation and earnings, and a host of other financial variables. Just look instead at the calendar and note that 2004 is a presidential election year. It just so happens that stocks do pretty darn well in years of presidential primaries and debates. Heck, investors who noticed that 2003 was a pre-election year shouldn't have been surprised to see stocks soar. Since World War II, the stock market has never had a negative pre-election year. And it has suffered only three down years in an actual election year. "The election cycle is one of the few Wall Street truisms that are actually true," says market historian James Stack of the InvesTech Research newsletter in Whitefish, Mont., "since it is actually derived from a logical sequence of events."

The presidential election cycle indicator isn't one of those coincidental market barometers like the one that purports to predict how stocks will fare in the coming year by looking at the winner of that year's Super Bowl. A victory by the National Football Conference champion supposedly presages a bullish year for stocks, while an American Football Conference victory presages a decline. As measured by the Dow, this uncanny indicator has been correct 30 out of the past 37 years for an 81 percent success rate. Last year, the NFC's Tampa Bay Buccaneers beat the AFC's Oakland Raiders and voila!, the market finishes in the black. Of course, what happens on the field has no discernible effect on earnings, interest rates, inflation, or much other than the personal income of fans in office betting pools.

Not so with the election cycle indicator. "There is definitely something there," says investment strategist William Rhodes. "The theory is that to get re-elected, presidents will boost spending or cut taxes in the third year of their term to give the economy a lift. It makes a lot of sense." Which is exactly the script followed by the current resident of 1600 Pennsylvania Avenue.

The stronger economy usually leads to higher stock prices. Since World War II, the stock market has posted an average annual return of 9.5 percent in the first year of presidential terms, 8.1 percent in the second year, 21.3 percent in the third year, and 12.2 percent in the fourth, or election year. Similarly, nine out of 13 recessions since 1929 have begun in the first year of a presidential term, seeming to support the theory that presidents try to get bad news behind them as quickly and as early as possible in their term. This time around, the recession officially began in March 2001, two months after Bush took office, although he has claimed to have inherited it. Last May, Congress passed a $350 billion tax cut to boost the economy. In addition, spending continues to rise, creating an estimated $480 billion budget deficit this year.

Important vote. "The market is again showing that elections are very important to investors," says Stuart Schweitzer, global strategist at JP Morgan Fleming Asset Management. "2003 was the third year of Bush's presidential term, and the market delivered returns very typical of the third year of presidential terms since World War II. And I think 2004 will be typical of the fourth year of presidential terms with returns of around 10 to 12 percent." That kind of return would put the Dow right around its old record high of 11,723. Even more telling, the market usually strengthens as Election Day approaches. Stack notes that only five times during the past 112 years has the Dow failed to hit, or come within 5 percent of the year's high, during the three-month period surrounding a presidential election. In three of the cases where it didn't--1920, 1932, and 1960--the economy was already in a recession. And in all three of those elections, the incumbent president's political party forfeited the White House.

Such analysis hardly fits neatly into the typical Wall Street computer model. As Abby Joseph Cohen, market strategist at Goldman Sachs, puts it, "We try to stay close to the data, and it is hard to quantify the impact of an election year." Yet the current economic data seem to back up the presidential cycle indicator, hinting that 2004 will be a bullish one for stocks. Granted, equities are far from cheap after traveling such a long distance during the past year. Analysts are forecasting that the S&P 500 will post 2004 earnings in the aggregate of around $62 a share, which gives the index a forward price-earnings ratio of around 18 or so. That would be above the long-term trend of about 15, but the market has often sported such high valuations during times of low inflation.

If you were going to create a prescription for the ideal environment for stocks, it would be low inflation and the sort of economic growth economists are expecting next year. "[Federal Reserve Chairman] Alan Greenspan has his foot on the accelerator and President Bush has his foot on top of Greenspan's--and no one has his foot on the brake," says Edward Yardeni, chief investment strategist at Prudential Equity Group. Most economists are looking at GDP growth of at least 4 percent this year, although the highly regarded Conference Board projects growth will hit 5.7 percent this year, a rate that would make 2004 the best year in the past 20. That should foster continued strong earnings growth of around 10 to 12 percent, after a 17 percent increase in 2003.

"To put this in perspective," says Cohen, "we've had since March of 2003 the first phase of a bull market accompanied by vigorous profit growth. In 2004, profit growth should decelerate, but that will not be the end of the bull market, only the second phase of it." Cohen thinks the S&P will hit 1250 this year as earnings remain strong.

While much of this financial analysis looks at elections as catalysts for changes in economic policy, what about their impact on market psychology? Does the market, or, more properly, do the millions of investors whose myriad decisions create the market, care who wins the election? Certainly, some investors do. "Any threat to the Bush economic policies would be viewed as bearish," says Yardeni. "If we had not had the tax cuts or been more frugal on the spending side, we would still be in a recession."

A Bush victory could also bring more pro-investment tax cuts, which presumably would charm Wall Street. "I think if the president wins, he will make existing cuts permanent and go after lower rates still, such as on dividends, whereas his opponents would probably rip the tax cut out by its lungs," says John Rutledge, who is looking for a 10 percent return on stocks in 2004. "How the stock market does next year is heavily dependent on the election. It's an election more important than most."

Deficit politics. Democratic front-runner Howard Dean, the former governor of Vermont, and several other rival candidates have advocated repealing the Bush tax cuts. Sen. John Edwards of North Carolina, in particular, has made a point of criticizing the recent cuts in the dividend and capital-gains rates. Then again, Dean and other Democrats have also attacked the big budget deficit under Bush, arguing that a Democratic vote will bring back the fiscal responsibility of the Clinton years. "So it is possible that the market would see the other side of things and view a reduced budget deficit as a positive, " says Schweitzer.

Indeed, the market has done well with either party in the White House. And recessions certainly have no political affiliation. A study of presidential politics and market performance by the Federal Reserve Bank of San Francisco found that for the period 1871-1997, the average annual returns for Republican and Democratic administrations were 10.5 and 11.7 percent, respectively. More recently, since World War II,

the average annual return under Republicans has been 13.1 percent and for Democrats, 15.3 percent. "The evidence indicates slightly, but not statistically significant, higher returns during Democratic administrations," the authors conclude. Nonetheless, investors would probably be happy to pocket the difference, however meaningless to statisticians.

Investors should also note that 2004 is not only the fourth year of a presidential term but the second year of a bull market. A recent study by Ned Davis Research looked at sector performance over the first two years of six bullish cycles since 1980. The top sector, information technology, has a historical average two-year gain of 105.1 percent and has already surpassed that 24-month performance with a huge gain in 2003. But other top sectors such as healthcare, consumer discretionary, financial, and consumer staples still have plenty of room to run (story, Page 49). Those groups all need gains of more than 25 percent to hit their historical average.

Of course, you'll want to do plenty of research before buying any individual stocks or mutual funds. And while the election cycle indicator is an entertaining and illustrative barometer to be aware of, that doesn't suggest investors should abandon a buy-and-hold strategy in favor of market timing. Indeed, the broader point is that in investing, time in the market is more important than timing the market. In other words, whatever year you pick to embark on a long-term investment plan, you really can't go much wrong with any of them. If only we could say that about all our presidents.