The Stan Clark Financial Team's

PERSPECTIVES

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Asset allocation

The presidential election cycle and stock market returns

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In our 2014 *Mid-Year Review*, we mentioned that we are entering the "sweet spot" of the four-year U.S. presidential election cycle. To refresh, stock returns tend to be below average for the first two years of the cycle, then above average for year three and four. Why is this?

To answer, let's take a closer look at this so-called sweet spot. Is the sweet spot merely a coincidence – or is there really some substance behind it?

Highly respected investment manager – and independent thinker – Jeremy Grantham of GMO has done a study on the presidential election cycle. Grantham used data going back to 1964. As expected, he found that year three and four returns, particularly year three, were significantly higher than those of year one and two. Grantham had some extra observations. He found that returns were particularly strong for the seven months in year three, from October to April. He also found that the effect of the U.S. presidential election cycle was felt overseas, as well – with strong returns in year three in the United Kingdom, continental Europe and even Japan!

To be more comprehensive, we took this study a bit further. We went all the way back to 1928, adding 36 years of data, for a total of 84 years, to see how the results would hold up. With our longer-term study, the results were consistent, but a little bit weaker. As you can see in the graph, year three returns were still significantly higher than those of year one and two. Year three returns averaged 27.1 percent, while the average of year one and two was 12.8 percent and 1.2 percent, respectively. We also found that returns were particularly strong in the first eight months (instead of just seven) of year three, from October to May, averaging 22.9 percent.

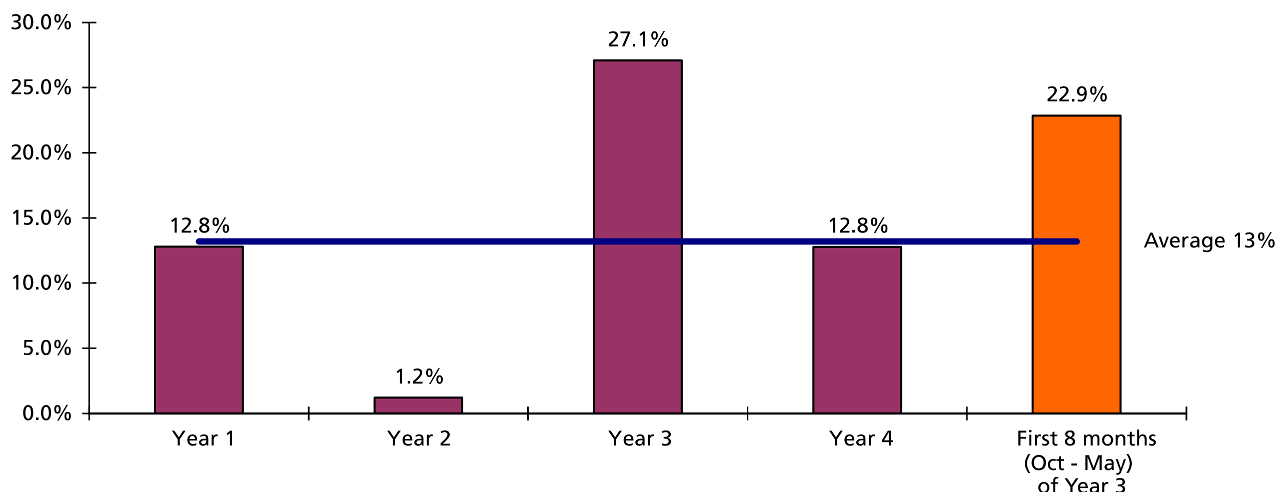
But still, even with all this data, is there a solid explanation for why this phenomenon occurs? For this to be useful and enduring, we should be able to explain why it happens.

There are a number of potential explanations that make sense. It could be simply that U.S. presidents and Congress do all the dirty work in year one and two. Then they try to boost the economy in year three and four to help get themselves re-elected.

Another, more sophisticated explanation is the Federal Reserve's policy of *extreme moral hazard*. The Fed has made it clear that it will not do anything to stop asset bubbles. But the Fed will help out if things turn out badly, as it did recently during the financial crisis. However, the hidden message from the Fed is that, if you speculate in year one or two, and something goes wrong, then you are on your own. But, if you are in year three or four, then the Fed will do whatever it can to help bail you out in a crisis. Speculators have learned this over the years, and basically have the green light to go and speculate in year three.

It could also be that people just feel more optimistic when the various presidential candidates start announcing their intentions to run, and broadcast their plans for change. Perhaps this optimism feeds into the stock market.

Presidential Election Cycle Returns (1928 - 2012)



Source: CRSP, Stan Clark Financial Team

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The above are all reasonable explanations to explain why there is a presidential election cycle effect. Nonetheless, the cycle itself may still seem too simple or data-mined. Actually, we don't mind simplicity. A lot of times, simple is better! And we're not overly worried about data mining, because we used a long-term study. Still, no one can say for sure that there is a cause, and if it will continue in the future. It could be just a statistical aberration. So, while the evidence is there and reasonable explanations exist for it, we wouldn't bet the farm on the presidential election cycle effect. But we would be comfortable to tilt our bets based on it.

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