Presidential Elections and Market Performance

Do stocks lead, lag, or wag?

by

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Key Points

- Presidential election years have a unique impact on market participants—and while cycles have historically shown a significant upward pattern, that pattern has shown signs of changing.

- Tax policy and government spending influence revenues, risk, and returns and, as a result, asset class performance.

- Within asset classes, political debate around healthcare and income inequality may signal which economic sectors are poised to outperform.

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Much will be written about election-year stock market performance, but the evidence seems to conclude that the underlying business cycle and trends will chart the overall market direction with the election likely to bend these results just subtly in one direction or the other.

Election years are different. They just are. News reporters tie every development to how it affects the polls. Candidates discover state fairs, kiss babies, and press the flesh. Regular folk are catapulted to fame, like “Joe the Plumber” when Republicans seized upon Obama’s response to a question on his small business policy to imply a socialist view. Then there is the search for military records, tax returns, and, of course, birth certificates. Saturday Night Live skits with both impersonators and the impersonated, as well as late-night talk shows featuring fun-loving candidates, become must-watch TV. Yes, election years are just different.

But are they different for investors? Is there anything about the presidential election cycle that is important when thinking about your investments?

Election year issues
The government can have a significant impact on asset classes through its policies, especially in the longer term. Tax policy can be used to encourage or discourage investment in a particular sector, and also affect profitability. Appropriations can similarly influence revenues for a sector simply by providing it government spending. At the broadest level, the government’s management of its short- and long-term budget is the basis for the riskiness of the national debt, and therefore the returns.

Of course major decisions on taxing and spending aren’t typically hammered out during the course of an election year. In fact it’s likely the opposite, with political sparring relegating major legislation to sideline status. But the political debate and Election Day outcome can provide investors guidance on possible impending changes. Some of the major issues taking shape for 2016 include healthcare and income inequality.

The healthcare debate will of course pit Republican candidates who have long tried to repeal the Affordable Care Act (ACA) against Democrat candidates who support keeping the act in place. Among myriad other impacts, the ACA increases the number of people enrolled in the medical insurance system, and it provides federal dollars for many of the insured. Healthcare in this cycle has also been impacted by the high-profile “tweet” from Senator Clinton in which she vowed to lay out a plan to combat price gouging in pharmaceuticals. Biotech indexes fell sharply and remain below levels from before the tweet.

The Democrat candidates have taken on the growing income inequality gap with proposals such as a higher federal minimum wage as well as mandated family and medical leave. If policies such as these are implemented, we would expect there to be asymmetrical impacts on sectors that employ low-wage workers.

Presidential term years and market performance
Instead of trying to handicap the outcome of the presidential election, congressional elections, and future policy (always challenging), we can also examine how investments have performed in previous election cycles. The good news is there is a significant upward pattern in stock performance over the four-year cycle when looking at the last 16 cycles since 1950 (see Figure 1). The bad

![Average S&P 500 performance over 4-year U.S. presidential cycles (1950–2014)](image-url)
news is that the pattern disappeared over the past two, and appears to be doing so again this year.

During election years, the index gained 6.6%, with slightly smaller gains of 6.0% and 5.8% in the following two years, respectively. In the third year, though, the index gained an average of 17.4%. Perhaps even more surprising than the high average performance is the consistency. The standard deviation of the returns in year 3 is 10.4, which is smaller than each of the lower return years (Election: 15.1, Year 1: 18.3, Year 2: 20.6). In the 16 cycles examined here, returns in the third year were never negative (except in 2011 when you need to go out three decimal places for a slight decline), and exceeded double-digits 12 times. So with this reliable relationship, is it straightforward that an investor should move into stocks the year before an election?

Now for the bad news: the pattern appears to have completely broken down in the last few cycles. As can be seen in the charts at right, two of the lowest returns in the third year came in the most recent two cycles, in 2007 and 2011. And in 2015, the S&P 500 is on pace to pull down the average for third years once again.

The coming election will be unique in that there is no incumbent in the field of candidates. This might open the door to a market that gets caught up in the headiness around prospective change but actual results suggest that is not the case. Over the past 64 years, the S&P has averaged annual gains near 9% but in the election years where an incumbent is not involved, the market has actually lost an average of 4.6%. Of course two of those election years were 2000 and 2008 where the “dot com bubble” and the financial crisis were in full glory. However, remove those two years and you have a market that has only gained 5.2%, a very tentative performance when compared back to the longer-run average.

**Sector performance**

Another point of interest is whether one can divine if any sectors within stocks tend to outperform during election years. Figure 3 shows price returns for the S&P sectors during the most recent six presidential election years, the simple average, and the simple average excluding 2008 and the financial crisis.
Financials perform best, on average, whether the 2008 experience was excluded or not. The next best performers were a combination of the defensive sectors, energy, and the industrial sector, depending on whether 2008 was included.

Looking through the individual sector returns by year, it is clear that returns vary significantly. These are likely being driven more by idiosyncratic factors such as energy prices, the state of the housing market, and the place in the business cycle, more so than the election.

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He holds a master’s degree and Ph.D. in Economics from Temple University and a bachelor’s degree in Economics and History from James Madison University.

S&P 500 price returns - 6 most recent presidential election years

<table>
<thead>
<tr>
<th>Year</th>
<th>S&amp;P 500</th>
<th>Cyclic Sectors</th>
<th>Sensitive Sectors</th>
<th>Defensive Sectors</th>
</tr>
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<tbody>
<tr>
<td></td>
<td></td>
<td>Materials</td>
<td>Consumer</td>
<td>Financials</td>
</tr>
<tr>
<td>1992</td>
<td>4.5</td>
<td>7.2</td>
<td>17.5</td>
<td>19.8</td>
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<tr>
<td>1996</td>
<td>20.3</td>
<td>13.4</td>
<td>10.5</td>
<td>31.9</td>
</tr>
<tr>
<td>2000</td>
<td>-10.1</td>
<td>-17.7</td>
<td>-20.7</td>
<td>23.4</td>
</tr>
<tr>
<td>2004</td>
<td>9.0</td>
<td>10.8</td>
<td>12.1</td>
<td>8.2</td>
</tr>
<tr>
<td>2008</td>
<td>-38.5</td>
<td>-47.0</td>
<td>-34.7</td>
<td>-57.0</td>
</tr>
<tr>
<td>2012</td>
<td>13.4</td>
<td>12.2</td>
<td>21.9</td>
<td>26.3</td>
</tr>
<tr>
<td>Average</td>
<td>-0.2</td>
<td>-3.5</td>
<td>1.1</td>
<td>8.8</td>
</tr>
<tr>
<td>Avg. ex-2008</td>
<td>7.4</td>
<td>5.2</td>
<td>8.3</td>
<td>21.9</td>
</tr>
</tbody>
</table>

Source: Bloomberg, WTIA

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