

# STOCK MARKETS AND ELECTION YEARS



Super Bowl winners, the length of hemlines, and Sports Illustrated covers – have all been used to develop theories about the direction in which stock markets may be headed. Presidential elections and terms have also inspired a significant number of theories.

## Rational and not-so-rational decision making

Historically, economists believed people's financial decisions were grounded in rational thought and single-minded pursuit of their best interests. Economic theories were built on the terra not-so-firma that people unconsciously calculate probabilities and make rational decisions:<sup>1</sup>

“[Leonard Jimmie] Savage and the economist Milton Friedman wrote in 1948, the proper analogy was to an expert billiards player who didn't know the mathematical formulas governing how one ball would carom off another but 'made his shots as if he knew the formulas.' ”

Psychologists and sociologists weren't convinced people were as rational as economists believed. Herbert Simon, a sociologist who won the Nobel Prize in economics, found that having limited time and brainpower meant many people did not make well-informed decisions. Instead, they developed rules of thumb that helped simplify decision-making.<sup>2</sup>

## Election-related rules of thumb

When it comes to investing, there is an abundance of rules of thumb. Since it's an election year, you've probably encountered at least one article discussing the ways in which elections may affect stock markets and the economy. These theories include:



- **Presidential Election Cycle Theory** suggests stock markets tend to be weaker during the first two years of a presidential term and stronger during the last two. This is because before an election, politicians tend to promote a pro-business agenda, so the economy is strong, the stock market is moving higher, and voters are feeling optimistic.<sup>3</sup>

Analysts who crunched the data report U.S. stock markets tend to hit bottom during the second year of a president's term, but that's not always the case. Notable exceptions have been the final years of the Clinton and G.W. Bush presidencies.<sup>3</sup>

Rodney Sullivan, editor of the *Financial Analysts Journal*, commented, “It is indeed true that under years three and four of a presidential cycle that stock markets do tend to perform better...What really drives performance in markets is not the presidential cycle, it's the overall macro economy.”<sup>4</sup>

- **Party Affiliation Theory** holds that stock markets perform better following the election of a Democratic candidate. In 2003, research published in the *Journal of Finance* indicated large company stocks did better under Democratic administrations. Later research from the Federal Reserve showed the difference in large company stock returns under Democratic and Republican administrations was negligible after you controlled for risk.<sup>5, 6</sup>
- **Political Party Convention Theory** puts forth the idea stock market performance during political conventions may reflect investors' expectations regarding the potential impact of a particular party. During the 16 election years since 1948, the S&P 500 Index rose 11 times during Republican conventions and 7 times during Democratic ones. It's unclear whether the theorists factored other data (economic data, Federal Open Market Committee meetings, etc.) into their analysis.<sup>7</sup>

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- **Presidential Approval Rating Theory** is sometimes misinterpreted. The research shows a president's approval rating rises and falls along with the stock market. A *London School of Economics* blog article reported, "As the stock market increases, especially when it is increasing at an accelerating rate, the president's popularity ratings tend to improve."<sup>8</sup> In some cases, this has been turned around and presented as the stock market rising or falling in response to a president's approval rating.<sup>9</sup>
- **Presidential Election Anxiety Theory** holds that "volatility of the S&P 500 index increases as the probable winner of the presidential election becomes less uncertain." In other words, investors' anxiety increases, causing markets to become more volatile when they begin to wonder how the presumptive winner's policies may affect the economy.<sup>10</sup>
- **Post-Election Stock Market Performance Theory** postulates stock market performance following a presidential election correlates to gross domestic product (GDP) growth.<sup>11</sup> This provides little data for investors since economic growth does not always translate into strong stock returns. In part, this is because economic growth may be the result of new businesses forming rather than existing ones growing.<sup>12</sup>

Clearly, a lot of thought has been given to the influence of presidential cycles on the stock market. Some theories that inform rules of thumb are clearly better researched than others. Regardless, none appear to provide actionable information that has the potential to benefit long-term investors. In fact, it is our opinion investors would be better served by selecting an investment strategy that meets their long-term financial goals rather than chasing returns trying to time the markets.

Sources:

<sup>1</sup> <https://hbr.org/2015/05/from-economic-man-to-behavioral-economics>

<sup>2</sup> <http://www.econlib.org/library/Enc/BehavioralEconomics.html>

<sup>3</sup> <https://gbr.pepperdine.edu/2010/08/presidential-elections-and-stock-market-cycles/>

<sup>4</sup> <https://blogs.cfainstitute.org/investor/2012/10/11/what-is-the-effect-of-taxes-on-long-term-investments-podcast/>

<sup>5</sup> <https://blogs.cfainstitute.org/investor/2012/08/31/weekend-reading-does-the-us-presidential-election-affect-the-stock-market/>

<sup>6</sup> <http://www.federalreserve.gov/pubs/feds/2004/200469/200469pap.pdf>

<sup>7</sup> <http://www.marketwatch.com/story/how-political-conventions-affect-stocks-2012-08-27>

<sup>8</sup> <http://blogs.lse.ac.uk/usappblog/2013/09/23/presidential-popularity-stock-market/>

<sup>9</sup> <http://www.investopedia.com/articles/stocks/08/stock-market-indicators.asp>

<sup>10</sup> [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2014823](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2014823) (or go to [https://s3-us-west-2.amazonaws.com/peakcontent/Peak+Documents/May\\_2016\\_SSRN-US\\_Presidential\\_Elections\\_and\\_Implied\\_Volatility-Footer\\_10.pdf](https://s3-us-west-2.amazonaws.com/peakcontent/Peak+Documents/May_2016_SSRN-US_Presidential_Elections_and_Implied_Volatility-Footer_10.pdf))

<sup>11</sup> <http://www.cluteinstitute.com/ojs/index.php/JBER/article/viewFile/8530/8537>

<sup>12</sup> <https://www.msci.com/documents/10199/a134c5d5-dca0-420d-875d-06adb948f578>

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