

# The U.S. Election Effect: Key Considerations for U.S. Equity Investing

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THE BOSTON COMPANY

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## Executive Summary

As November 2012 approaches, equity investors around the world are focusing on the U.S., searching for signals about how the upcoming presidential election will affect the markets as well as the performance of several key sectors. Historically, equities have typically rallied in the wake of a presidential election, although U.S. equity returns between 2008 and 2011 have defied this long-standing trend.

Beyond eyeing the political impact of the election on their returns, investors have plenty of other important macroeconomic issues to monitor. The ongoing crisis in the eurozone, the slowing pace of global growth, low interest rates worldwide, the impending U.S. "fiscal cliff," and policy action surrounding interest rates and the U.S. debt ceiling are all key factors that may influence equity performance.

Despite these challenges, we believe U.S. equities offer a range of value and opportunity. Market fundamentals remain positive, especially when compared with the challenges confronting many of the world's other equity markets. U.S. election politics and macroeconomic concerns could spur more short-term uncertainty and market volatility, but investors seeking greater relative certainty and long-term performance should continue to find sound choices among U.S. equities.

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## What Gives This Election So Much Gravitas

Few events garner as much attention in the U.S. market as a presidential election, and the 2012 version has proven to be no exception. For months now, market commentators and political pundits have been focused on the race between Democratic President Barack Obama and Republican challenger Mitt Romney. Given the candidates' distinctly different economic proposals and the potential shift in Congress' balance of power, the upcoming election may indeed result in an outsized impact on the markets.

While the election's outcome and its full economic impact are not yet clear, the environment of uncertainty is already influencing business decision-makers. In general, from Main Street to Wall Street, conservative choices seem to be the order of the day.

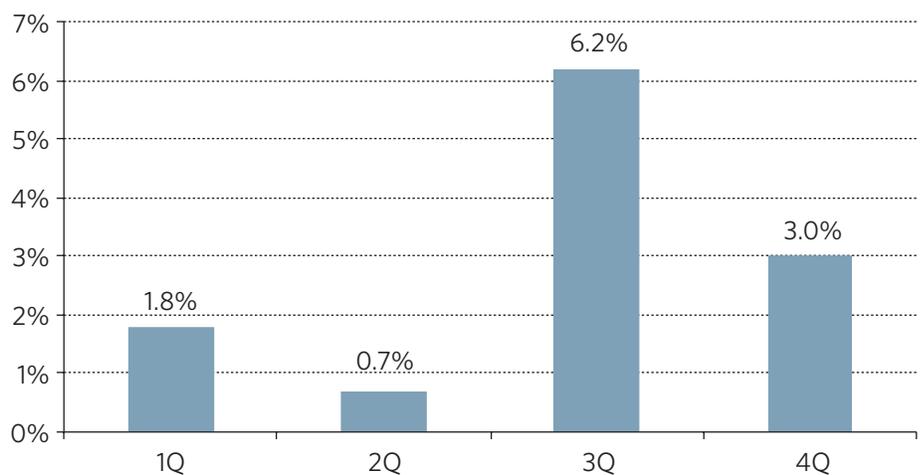
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U.S. non-financial corporations continue to amass cash, with cash as a percentage of total corporate assets rising over the past several years to reach an all-time high in 2012.<sup>1</sup> Many successful companies are not distributing their profits, taking a wait-and-see approach to spending or making substantial payouts to shareholders.<sup>2</sup>

### Comparing Historical Patterns of Performance

Historically, U.S. presidential election years have been associated with positive equity returns. In fact, equities often underperform during the first two years of a president's four-year term and outperform during the last two. Since 1926, the average quarterly total return of the Standard & Poor's 500 Index in the fourth year of a presidential term was 6.2% during the third quarter and 3.0% during the fourth, according to Strategas Research Partners (Exhibit 1).

**Exhibit 1 - Presidential Election Years Are Generally Good for Equities**  
Average S&P 500 Quarterly Total Return in Year 4 of a Presidential Term (since 1926)



Source: Strategas Research Partners, April 2012. Data through 2011.

So far this year, stocks are following the election-year upward trajectory: the S&P 500 has gained roughly 12% from January 17 through September 18.

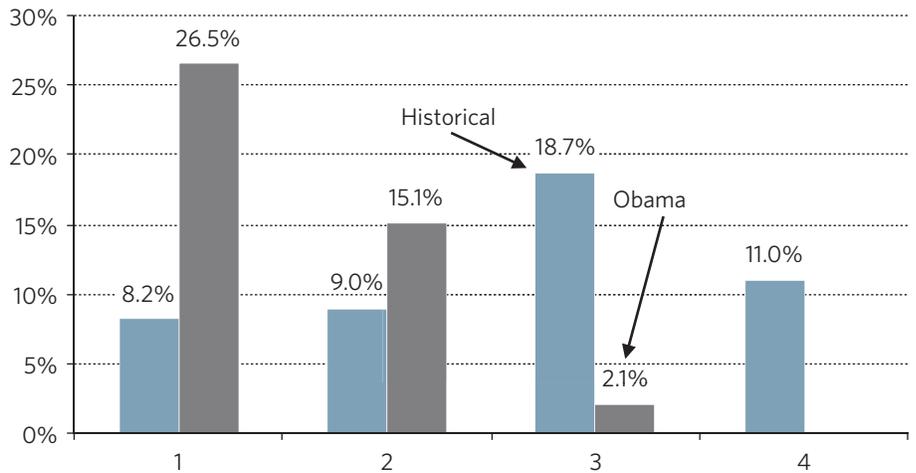
Before we get too bullish, however, consider the market's current framework. The U.S. sustained a major financial crisis in 2008 and is tentatively emerging from a significant economic recession. In 2011, the third year of President Obama's term, the S&P 500's total return was just 2.1%, compared with a historical average of 18.7% in the third year of a president's term since 1926 (Exhibit 2).

<sup>1</sup> "Election Year Uncertainty Likely to Chill Economic Growth in 2012," Strategas Research Partners LLC, Investment Strategy Viewpoint, May 4, 2012.

<sup>2</sup> *Ibid.*

On corporate taxes, both candidates propose rate reductions, although Romney's proposed rate would be lower and includes the elimination of the tax on foreign earnings.

**Exhibit 2 - Traditional Political/Equity Cycle Did Not Materialize in 2011**  
S&P 500 Total Returns by Presidential Cycle (since 1926).



Source: Strategas Research Partners, April 2012.

### Two Distinct Economic Visions

In this unsettled economic environment, each of the 2012 presidential candidates has his own vision for the country's future.<sup>3</sup> A few salient facts emerge:

**Tax rates:** Romney's proposal would pursue tax cuts on both a personal level and on capital gains and dividends. If enacted, these cuts could be a boon to personal income and investments. Obama's proposal includes plans for raising rates on both personal income and capital gains and dividends.

On corporate taxes, both candidates propose rate reductions, although Romney's proposed rate would be lower and includes the elimination of the tax on foreign earnings.

**Reform:** Another key difference between the Romney and Obama economic proposals involves the Dodd-Frank Wall Street Reform and Consumer Protection legislation, enacted in 2010. Romney plans to dismantle it, potentially eliminating a huge regulatory overhang on the Financials sector. Obama would leave Dodd-Frank essentially intact, which might sustain negative sentiment on Financials.

<sup>3</sup> "The Choice," *The Economist*, April 21, 2012.

The typical rally that follows a close election generally favors domestic cyclicals: Information Technology, Financials, Consumer Discretionary and Industrials.

### **Election Outcomes and Equity**

The typical rally that follows a close election generally favors domestic cyclicals: Information Technology, Financials, Consumer Discretionary and Industrials. However, depending on the eventual outcome, this election could provoke an assortment of reactions in the U.S. equity market. Here is what we view as the most likely scenarios:

**Status quo continues**, with Democrats holding on to both the White House and a Senate majority. In this outcome, the market could sell off a bit as investors adjust to the reality of more gridlock and continued regulatory pressure on Health Care, Energy and Financials.

**Republicans gain the White House**. This could lead to a market boost. Investors generally favor a Republican president, as they view the GOP as more pro-growth and business-friendly than the Democratic Party.

**Republicans gain a Senate majority**. Initial market reaction might be muted, as investors would not be surprised to see Obama hold on to the White House, given his slim but continued lead in the polls. However, historically, the S&P 500's average annual return under an all-GOP Congress is 13.3%, compared with 5.8% for a divided Congress, according to Strategas. That could prove to be a decent longer-term market catalyst.

**Republicans gain both the White House and a Senate majority**. In terms of sector performance, Health Care, Energy and Financials could rally on a Republican victory, as these industries stand to benefit from lower regulatory scrutiny.

### **Beyond the Election, Some Key Investment Considerations**

The outcome of the U.S. election will undoubtedly impact the market's direction, but it is just one of many critical issues for investors to consider. Chief among them is the slowdown in a significant number of the world's economies. China's flagging economy is of particular concern, as the country's blistering 10% to 12% annual growth rate had been a crucial engine of economic expansion throughout developed and emerging markets. Elsewhere outside the U.S., Europe's ongoing debt crisis and overall recessionary conditions continue to weigh heavily on investors. Markets responded enthusiastically to European Central Bank President Mario Draghi's early September announcement that the bank would purchase bonds issued by Spain, Italy and other eurozone countries. While certainly a positive development, Draghi's promise is only one step in a complicated economic recovery process.

In the brief timespan between election day and New Year's, a lame-duck session of Congress will be left with the Herculean task of coming up with a solution to avoid an immediate estimated 3.5% hit to the GDP.

Even within the United States, the election is not the only factor with the potential to influence equity markets. Although it is not in a recession, the U.S. economy is growing quite slowly. In 2011, nominal growth in gross domestic product was just 3.8%, a level usually associated with past recessions.

Perhaps even more important is the so-called "fiscal cliff," the coming \$537 billion potential drag on the U.S. economy in 2013 if Congress makes no affirmative decisions to avoid it. Policymakers appear united in their desire to reduce the magnitude of that drag and are likely to reach some agreement. As a practical matter, however, it's safe to assume that politicians will be unwilling to tackle the structural problems that lie at the core of the fiscal cliff before the election. Thus, in the brief timespan between election day and New Year's, a lame-duck session of Congress will be left with the Herculean task of coming up with a solution to avoid an immediate estimated 3.5% hit to the GDP.

#### **Conclusion**

When we consider the numerous challenges facing global equity markets today, we believe the U.S. market stands out as a wise choice for prudent investors. The economies of Europe, China, and many emerging markets are in a recession or experiencing significant slowdowns. Global interest rates are extremely low, and political and economic uncertainties are high. Against this backdrop, we think U.S. equities still offer attractive opportunities, even with the short-term uncertainty surrounding the upcoming election.



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