Are Market Cycles Politically Correct?

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Introduction

While we typically associate the Presidential election with endless promises and political posturing, there may be underlying implications for the equity markets embedded in the battle for the White House and the ensuing four to eight year Presidential term. Although history is obviously not a definitive projection of future market performance, some distinct and clear trends relative to both the four-year and eight-year Presidential Cycles exist. In this light, the Presidential Cycle may provide some insight into recent equity market volatility.

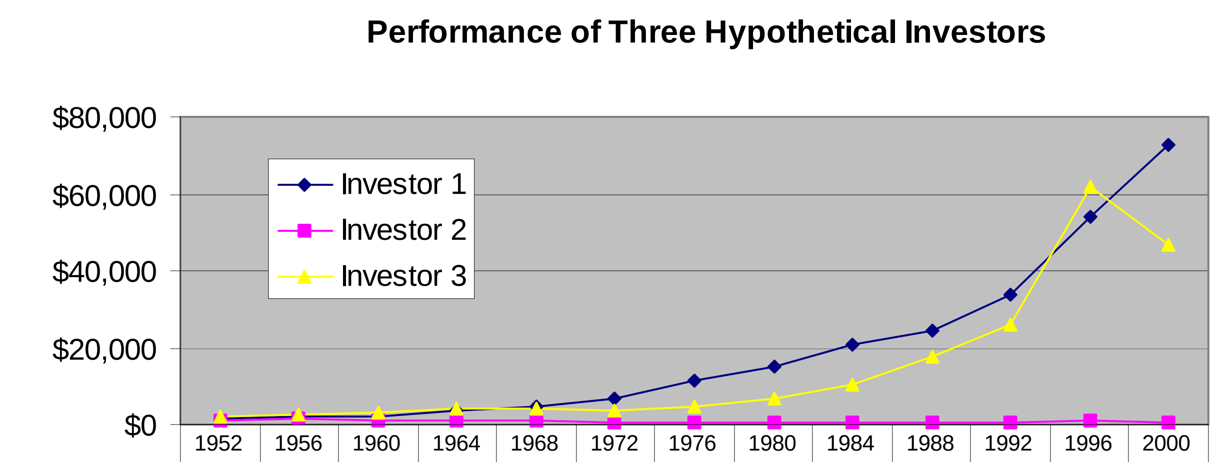
Plainly, the theory underlying the correlation between the Presidential Cycle and the equity markets is fundamentally predicated on two principles. Every first-term President desires a second term in office and, subsequently, every second term President desires an admirable and enduring legacy.

To effectuate their political aims, public officials often attempt to influence economic conditions prior to their election periods. According to Jeremy Grantham of GMO, traditional stimulus including monetary supply, interest rate reductions, and tax benefits are applied to spur economic (e.g. job) growth prior to elections. Although these attempts generally are only moderately successful at generating the desired economic results, the stimulus often finds its way into the financial markets, increasing asset prices. Finally, the government's implicit desire to spur economic growth acts as a 'security blanket' for investors who subsequently allocate additional sidelined capital into the financial markets.

At the beginning of a President's term (Year 1 and Year 2), the recently elected President has to "clean up" the stimulus of the preceding two years. The slowing pace of funds entering the system often equates to a more challenging market climate.

Birinyi Associates has performed some interesting research on Presidential Cycle returns. According to their research, since 1961, the average S&P 500 returns during Year 1 and Year 2 were 5.33% and –2.62%, respectively. In contrast, the average S&P 500 returns during years Year 3 and Year 4 were 19.93% and 10.79%, respectively. Over this period, the S&P 500 never declined in Year 3 and experienced only one decline in Year 4. In addition, since 1918, the average cumulative gains on the Dow Jones Industrial Average from a Year 2 bottom to a Year 4 top exceed 56%.

A Pepperdine University case study focusing on two hypothetical investors reinforced the above statistics with some startling figures. In this study, hypothetical Investor 1 purchased the S&P 500 Index on October 1st of the 2nd year of the Presidential Cycle and held the S&P 500 Index from that date until December 31st of the 4th year of the Presidential Cycle. He sold the Index on that latter date and put the money under his mattress until October 1st of the second year of the following Presidential Cycle. At that time, he again invested in the in S&P 500 Index until the conclusion of that investment cycle. In contrast, Investor 2 purchased the S&P 500 Index on January 1st of the 1st year of the Presidential Cycle and held the investment until September 30th of the 2nd year of the Presidential Cycle. He then sold the Index and put the money under his mattress until January 1st of the 1st year of the next Presidential Cycle when he reinvested in the S&P 500 Index for an identical time period. Both investors maintained this pattern of investing from 1952 through the end of 2004. A third hypothetical investor, Investor 3, is added below to demonstrate the returns for an investor who purchased the S&P 500 Index and consistently held that investment from January 1st, 1952 through December 31, 2004.



	1952	1956	1960	1964	1968	1972	1976	1980	1984	1988	1992	1996	2000
Investor 1	$1,350	$1,956	$2,271	$3,451	$4,798	$6,717	$11,418	$15,072	$20,649	$24,571	$33,909	$54,254	$72,701
Investor 2	$1,220	$1,318	$1,291	$1,175	$952	$505	$482	$425	$595	$660	$707	$1,004	$643
Investor 3	$1,913	$2,520	$3,156	$4,058	$4,295	$3,794	$4,541	$6,939	$10,395	$17,642	$25,912	$61,811	$46,778

Although this study did not account for any inflationary impact, its results are, nonetheless, remarkable. Investor 1 saw his capital multiplied 13 times as his original investment of $1,000 swelled to $72,701. Investor 3 briefly pulled ahead of Investor 1 during the hyper-bull market of the late 1990s, but subsequently relinquished this advantage and ended 2004 with a very respectable sum of $46,779. In contrast, Investor 2 was not so fortunate. He saw his original $1000 dwindled to $643 over 50 years. In short, this study indicates that nearly all the investment returns for the relevant period came from October of the second year to the end of the fourth year. On average, the remaining time frame actually provided a net loss.

While these findings are interesting, we are always reminded that history cannot necessarily be used to extrapolate possibilities into the future; it is, after all, only history. Therefore, we must remind ourselves that while this trading pattern using the Presidential Cycle provides some insight, it is not definitively indicative of future market performance. By way of example, the Crash of 1987 was a Year 3 event and, as such, did not fit any pattern.

Expectations for Enhanced Price Volatility

Many analysts further divide the 4 Year Presidential Cycle into an 8 Year Cycle. Although this 8 Year Cycle is analyzed irrespective of the actual tenure (First term v. Second Term) of a sitting President, Year 6 of this 8 Year Cycle (including 2006, 1998, 1990, 1982, etc.), portends some interesting historical trends in price volatility.

Average Annual S&P 500 High to Low Price Difference Since 1970			
Year 1	Year 2	Year 3	Year 4
20.27%	**22.43%**	24.43%	19.64%
Year 5	Year 6	Year 7	Year 8
20.21%	**25.80%**	20.96%	15.67%

Not only have Year 2 and, especially, Year 6 experienced greater price volatility than other years within the Cycle, the increased volatility has historically arisen between August and November.

	Average Monthly High to Low in S&P 500					
	Since 1970	Year 6 Avg.			Since 1970	Year 6 Avg.
January	6.66%	9.18%		July	6.56%	6.73%
February	5.43%	6.81%		**August**	**6.73%**	**15.24%**
March	6.63%	6.95%		**September**	**6.64%**	**10.59%**
April	6.20%	6.08%		**October**	**7.58%**	**13.07%**
May	5.67%	7.20%		**November**	**6.11%**	**9.03%**
June	5.17%	6.24%		December	5.35%	6.65%

What Might This Increased Volatility Mean Today

In light of the historic trend signifying increased volatility in the coming months, the questions remain: what degree of volatility can we expect and in which direction? If 2006 experiences the average historic Year 6 volatility, we could see the S&P 500, which closed at 1267 on August 11th, rising to as high as 1716 or declining as low as 942. Factors supportive of the bullish argument include continued strong global economic growth, the maintenance of high corporate profit margins, continued strong employment data, and reduced commodity prices. Risks for downside volatility include a continuation of geopolitical tensions, a slowdown in consumer spending instigated by high energy prices and a cooling housing market, reduced corporate profit margins, a resumption of interest rate hikes, continued multiple contraction, and a bull market rally that is 'long-in-the-tooth' by historical standards. However, as is often the case, the currently "unknown factors" are most likely to drive any potential volatility.

Alternatively, since October often represents the bottom of bear markets and the start of a new bull run, the market could see a breach of the existing S&P 500 2006 low of 1219 over the next few months followed by a precipitous rise symbolizing the start of the next Presidential Cycle bull market. The following Table, illustrating the nine post-1950 S&P 500 pullbacks approaching or exceeding 20%, shows market proclivities to bottom in Year 2 and Year 6 and, more specifically, in October.

S&P 500 Price Declines Exceeding 20% Since 1960						
Highs	**Lows**	**Loss**		**Highs**	**Lows**	**Loss**
12/12/1961	6/26/1962	-27.97%		1/6/1981	8/12/1982	-25.85%
2/9/1966	**10/7/1966**	-22.18%		8/25/1987	12/4/1987	-33.51%
11/29/1968	5/26/1970	-36.06%		7/16/1990	**10/11/1990**	-19.92%
1/11/1973	**10/3/1974**	-48.72%		3/24/2000	**10/9/2002**	-49.15%
9/21/1976	3/6/1978	-19.41%				
* Green is Correction Ending in Year 2						
* Red is Correction Ending in Year 6						

How the Interest Rate Cycle May Coincide With the Presidential Cycle

Since the Federal Reserve recently paused after 17 straight interest rate hikes (and no previous pause during an upward rate hiking cycle has been followed by another increase in interest rates), it is imperative to consider how this event may impact the market and how it may fit with the Presidential Cycle. Over the past few months, many market pundits have been pounding the table claiming that a halt in Federal Reserve tightening will signify a new bull market run. Although market performance following some recent interest rate hiking cycles may support this view, this claim is dubious when assessed within a longer historical context.

Having examined research performed by both Bank of America and Comstock Partners, some interesting, yet sometimes counterintuitive, conclusions can be drawn. Both the Bank of America and Comstock Partners studies conclude that the market historically performs poorly in the months following the end of an interest rate tightening cycle and frequently exhibits heightened volatility. This underperformance, primarily stemming from concerns that the Federal Reserve 'went too far' and a recession is imminent, nevertheless, coincides with the Presidential Cycle's historically weak and volatile results predicted for the next few months. Finally, if the market does retreat measurably over the next few months, Bank of America's research would be supportive of strong market performance over the few months that follow. This argument also correlates to the handsome market returns associated with Year 3 of the Presidential Cycle.

Conclusions and Recommendations

Having weighed the various strategies available in light of the current economic landscape, against the backdrop of the Presidential and Interest Rate Cycles, we believe that client portfolios are well positioned to withstand an increase in market volatility. Although counselors are prepared to discuss alternatives to hedge away some of the market directional risk historically associated with the current timing of the Presidential and Interest Rate Cycles, we prefer to rely on our battery of experienced, quality managers who collectively should help temper our clients' overall portfolio volatility.

Given our focus on mitigation of risk, we have, and continue to, recommend that portfolios be diversified beyond traditional equity and fixed income allocations into largely uncorrelated instruments including hedge funds, hybrid investments, master limited partnerships, and private equity real estate. This diversity should provide some protection even under the most challenging market conditions. To the extent any clients have yet to approve some of these portfolio diversification recommendations made by their counselor, we suggest they contact their counselor to further discuss these recommendations.

Although the Presidential and Interest Rate Cycles portend some potentially nerve-wracking market activity over the next few months, transitions from bear to bull are often sharp and steep. Attempting to navigate such choppy waters whose ebb and flow could shift precipitously based on a variety of factors (e.g. changes in geopolitical conditions, Fed reversing interest rate policy, etc.) is a risky proposition. Therefore, we do not consider market timing to be the optimal strategy in this environment. Instead, we prefer to remain cognizant of existing and historic market trends while acting in a disciplined manner and using diversification to effectuate our primary objective to preserve our clients' wealth and trust, keeping in mind their long-term time horizons.