THE ELECTION CYCLE AND NEXT YEAR'S STOCK MARKET

By James B. Cloonan

Is the election-year cycle theory meaningful or just a statistical game? If you think of what goes on during the various years of the political cycle, you can make a reasonable argument. But it is only a propensity—specific events during a given year will have a much greater market impact.

During the past two presidential terms, I devoted an entire column to a discussion of why it was likely that the years 1995 and 1999 might have a bullish bias. Those predictions, made in November 1994 and November 1998, were based on an election-year cycle theory that the third year of the presidential cycle tends to be associated with very strong stock markets. Indeed, as Table 1 shows, 1995 had a very bullish bias and, as of this writing (December 7), 1999 looks like it will finish with the S&P 500 significantly higher.

This column is intended to provide some insights into the effects on the fourth year of the presidential election cycle. This may be particularly important now, since more and more pundits are expressing worry about high market valuations–particularly of tech stocks.

Table 1 shows market returns for the various years in the presidential election cycle. I started with the post-World War II dates because the war years were distorted by regulation and control of most every aspect of the economy. Prior to that, the Great Depression and extensive government interference made the market and the economy distinctly different than it is today. I think the years ahead are more likely to resemble the last 52 years, although there is always change taking place both in the U.S. and abroad.

If you examine the figures in Table 1, you can see that the third year has the highest average rate of return by a wide margin. In addition, there are no negative returns.

On the other hand, the fourth years of the cycle also have very satisfactory returns—at least by long-cycle term standards. The fourth year returns also

TABLE 1. S&P 500 TOTAL RETURNS FOR VARIOUS YEARS OF THE PRESIDENTIAL ELECTION CYCLE (1945-1999)

1st Year of Cycle		2nd Year of Cycle		3rd Year of Cycle		4th Year of Cycle	
Year	Return (%)	Year	Return (%)	Year	Return (%)	Year	Return (%)
1949	18.8	1950	31.7	1947	5.7	1948	5.5
1953	–1.0	1954	52.6	1951	24.0	1952	18.4
1957	–10.8	1958	43.4	1955	31.6	1956	6.6
1961	26.9	1962	–8.7	1959	12.0	1960	0.5
1965	12.5	1966	–10.1	1963	22.8	1964	16.5
1969	–8.5	1970	4.0	1967	24.0	1968	11.1
1973	–14.7	1974	–26.5	1971	14.3	1972	19.0
1977	–7.2	1978	6.6	1975	37.2	1976	23.8
1981	–4.9	1982	31.4	1979	18.4	1980	32.4
1985	32.2	1986	18.5	1983	22.5	1984	6.3
1989	31.5	1990	–3.2	1987	5.2	1988	16.8
1993	10.0	1994	1.3	1991	30.5	1992	7.7
1997	33.4	1998	28.6	1995	37.4	1996	23.1
Avg	**9.1**	**Avg**	**13.0**	**Avg**	**22.0**	**Avg**	**14.4**

Overall Average: 14.6%

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have no negative returns.

The election year cycle makes some rational sense if you view it in the context of politics and the business cycle.

The business cycle has historically lasted three to five years, but sometimes longer, and sometimes it is hard to discern. Political activity can have an impact on the business cycle and the economy because of pre-campaign posturing. Some political activity would have a real effect on the economy—for instance, passing bills concerning regulation, as well as more government spending. Other political activity would affect the market psychologically—speeches claiming credit for how good things are, for instance. Most of the positive effects would occur in the pre-election year. In the election year itself (the fourth year of the cycle), politicians are too busy campaigning to do as much, and toward the end, campaigns sometimes turn negative, with blame cast about for how bad things may be.

One other peculiarity is harder to rationalize, and that is the impact of years ending in five. If you look at Table 2, you will see the exceptionally high returns in those years. This phenomenon goes back even further than the election year cycle phenomenon, but may well be random chance. There used to be a lot of comment about the weakness of years ending in zero, but the market performance in 1980 neutralized that effect. In any event the fact that a zero year cannot fall in the third year of the election cycle would in itself weaken the overall average of zero endings.

TABLE 2. AVERAGE ANNUAL RETURNS FOR YEARS ENDING IN FIVE (1945-1999)

Year	Return (%)
1955	31.6
1965	12.5
1975	37.2
1985	32.2
1995	37.4
Avg	**30.2**

Because of our numbering cycle and the election cycle, election years (the fourth year in the cycle) must be even, the second year must also be even and the first and third years must be odd. Therefore, years ending in five must be in the first and third years of the presidential election cycle, and years ending in zero must be in the second and fourth years of the cycle.

Is all of this meaningful or just a statistical game? Perhaps the strong performance of years ending in five is coincidence, but if you think of what goes on in the nation during the various years of the political cycle, you can make a reasonable case that there is a real impact. It is only a propensity, however, and specific events during any given year will have a much greater impact on the market—one need only to look at the wide range of returns within any cycle year to realize that.

It does seem to me, however, that the coming year is not a year in which to panic and sell positions. Even if the highly leveraged tech stocks do adjust, the value stocks in your portfolio should not be much affected.

To a much greater extent than was true in past years, both individuals and mutual funds have developed a longer-term portfolio view, and if they decide to remove dollars from one stock sector, they will invest those dollars in other sectors. In short, the risk of a major stampede in the fourth year of the presidential cycle, I think, is low. ◆