THE PRESIDENTIAL ELECTION AND THE STOCK MARKET

Elections matter, to be certain. They determine whether a Republican or Democrat sits in the Oval Office on Pennsylvania Avenue, after all, but do they predetermine a bear or bull on Wall Street?

If history teaches us anything, there is one thing investors can count on during an election year, and that's an upcoming period of uncertainty in the markets. The mere suggestion of a change in power to the highest ranking office in our country can leave plenty of room for speculation about the future of the economy, trade relations on a global scale and the policies that will impact how consumers live, work and spend.

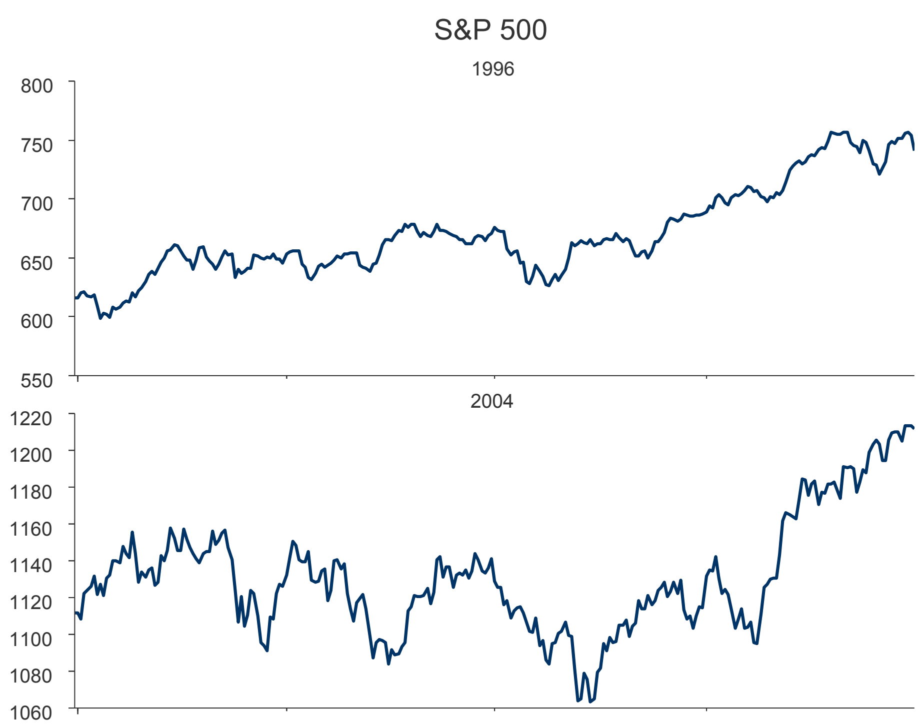
2016 promises to be interesting on multiple fronts—one of them being the political environment, as this is a presidential election year. While the candidates are busy making the case for why they should be elected, we wanted to get to the bottom of one burning question: "How does a presidential election affect returns in the stock market?"

In answering this question we examined historical elections and markets through different lenses.

1. MARKET RETURNS AND THE FOUR-YEAR PRESIDENTIAL CYCLE

We all know the market dislikes uncertainty and it doesn't matter what causes the uncertainty; political uncertainty is no exception. Going back to 1900, we categorized each calendar year of market returns into one of four categories: the election year, the first year, the second year and the third year of the presidency. We discovered the third year was the best performing and the election year had the most uncertainty.

Stocks have struggled in the first half of historic election years, no doubt due to the uncertainty of the election and what a new president may mean to the economy and the markets. Typically the market struggles early in the year as the political theater is at its highest—with numerous candidates still in the running—and consequently, the bottom of the market is linked to the timing associated with determining a clear winner. A few examples make the point: In 1996 President Clinton's second term was not in question and the market only suffered a minor correction of 5 percent. In 2004



Source: Thomson Reuters Datastream; UMB Investment Management there was more uncertainty. Incumbent George W. Bush, running for a second term, was in a tight race with John Kerry. That year the market established a bottom in August. The graph on the previous page illustrates the two races.

There are number of events that could reduce the volatility. First, a reduction in the number of candidates would reduce the uncertainty, but of course this happens naturally, typically by mid-summer, after the conventions when we are down to two surviving candidates. Volatility could also be greatly reduced if the candidates would clearly articulate their ideals, plans and execution strategies. Perhaps we shouldn't count on this one.

The choppiness of the markets in the first two months of 2016 appears to be standard operating procedure when compared to historical market action in an election year. The bottom line: Expect volatility whenever you see uncertainty, but as this pertains to election cycles, it usually clears up quickly.

2. POLITICAL RHETORIC

As politicians campaign, they need to get voters' attention. When the discussion turns to sectors and industries, markets react—sometimes temporarily or sometimes longer-term. In any case, the impact is seldom as bad as the language being used.

For example, one candidate has publicly announced her war against high drug prices and allowing prescription drug imports from Canada. Even though nothing has been finalized and perhaps these suggestions may never be executed, pharmaceutical stocks and biotech stocks sold off.

Another candidate is a self-professed socialist and has made the comment, "If I get elected, I will be Wall Street's worse nightmare." You can imagine what has been happening to the financial sector as this candidate's popularity gains momentum.

A perfect example of this is President Obama's Affordable Care Act. This legislation was signed into law on March 23, 2010. Initially there was massive uncertainty as employers and investors analyzed and interpreted the new law. In 2010 the S&P Health Care Index was up a mere 0.7 percent, managed care increased 8.3 percent and the S&P 500 was up 12.8 percent. As I previously mentioned, this market reaction proved temporary as the positive financial impact of the Affordable Care Act began to assert itself on the companies' bottom lines. So looking at the next 12 months, returns reversed. In 2011, the S&P Health Care Index was up a stellar 10 percent, managed care increased an impressive 32.9 percent and the S&P 500 was up only 2.1 percent.

3. DEMOCRAT OR REPUBLICAN?

Over the long run, markets are driven by economic fundamentals that trickle down to corporate earnings. In the short run, noise can influence markets. The data suggests that elections would be classified as noise.

We went back to 1900 and analyzed which political party in the White House produced the best returns in the stock market. Over this long period of time, Democrats won this contest, producing an average return of 7.9 percent. Republicans produced a return of only 3.0 percent.

I concede that this is a naïve way to analyze the data; however, the answer to the question of which party is best for the markets is inconclusive. I recently presented this data to a group of investors and a faithful Republican asked if the returns would be different if I lagged returns by a year. The question has merit and does change the results, dramatically as the outcome would be completely opposite. Another argument is that Republicans have been penalized by wars and severe economic crisis. The depression in 1929 and the Great Recession in 2008 both began with a Republican president and ended with a Democrat president. When Hoover (R) was president from

DEMOCRAT OR REPUBLICAN: MARKET RETURNS

POLITICAL POWER	GAIN/ANNUM	% OF TIME
Democratic President	7.9	47.2
Republican President	3.0	52.8
Democratic President, Congress Split	10.1	3.3
Republican President, Congress Split	-4.2	10.6

1929 to 1933, the stock market was down 35.6 percent annualized. Fair enough, but data does not lie.

It becomes difficult to assign market returns to a specific president. For years, we have experienced mounting debt, an increase in terrorist threats and easy monetary policy. As these issues flair up, they either positively or negatively affect the market. So is it fair to say the current president is totally responsible?

4. IS THIS TIME DIFFERENT?

This election may be different. This year you have candidates who represent the establishment and candidates representing the anti-establishment. Perhaps every presidential election starts this way, but today we are seeing the anti-establishment candidates moving ahead in the polls. Perhaps investors have every right to be very nervous. Given the anti-establishment candidates' popularity, investors wonder what tariffs on China and other trading partners would do to our economy and markets. And no one knows what deporting millions of undocumented immigrants would do to the economy and markets. Further, who is to say what effect threatening banks or offering free tuition to public colleges would have? I'm fairly confident that not all of these actions would be a good thing for the markets. Keep in mind that what a candidate says they will do today is typically not what they will do once in the oval office. A candidate's goal today is to excite the voter base, increase voter turnout and gain a political advantage. Comments candidates make early on should not be taken at face value.

One cannot blame politics for the market's recent debacle; there are many issues that are contributing to market softness. However, is it coincidental that as these anti-establishment candidates gain momentum, the market goes down?

Many years ago I worked for a U.S. senator and got a chance to see "how the sausage is made," so to speak, and it's not pretty. Perhaps this is all noise, since the president must work with Congress to get things done. Maybe our founding fathers built it right, with proper checks and balances, so a president with no experience hopefully cannot do too much damage. In 2017, the president will not have a free hand. If we have a Democrat in the White House, there is a good chance we will have a Republican Congress. If we have a Republican president, perhaps one with little political experience, he will have to deal with two experienced and successful leaders, Mitch McConnell and Paul Ryan. Two that will not subordinate their policy views.

THE LONG AND SHORT OF THE MATTER

Elections are important on many fronts, but as far as markets are concerned there is a short-term effect and a long-term effect.

The only thing we can say conclusively about the market data is that prior to an election, markets tend to trade flat with higher volatility. After the election, the market has consistently delivered stronger returns.

Over the long-run, the market's preference for one political party over another is unclear. The data is clunky and incredibly sensitive to modest adjustments.

I would caution against using every statement and policy suggestion made by the candidates as a tool for guiding investment decisions. Rather, understand what history has taught us and refrain from making long-term decisions based on short-term emotions.

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