June 27, 2000

THE PRESIDENTIAL STOCK MARKET CYCLE

On November 7, 2000, this nation goes to the polls to elect its 43rd President. While the hoopla and campaign rhetoric are still in the early stages, this seems an appropriate time to consider the coming election and its effect on the securities markets.

Presidential-Cycle Stock Market Returns

President	Election Year	Stock Market Total Return 1st Yr	2nd Yr	3rd Yr	4th Yr	Term
Truman (D)	1948	18.80	31.7	24.0	18.4	129.7
Eisenhower (R)	1952	-1.00	52.6	31.6	6.6	111.8
Eisenhower (R)	1956	-10.80	43.4	12.0	0.5	43.9
Kennedy (D)	1960	26.90	-8.7	22.8	16.5	65.7
Johnson (D)	1964	12.50	-10.1	24.0	11.1	39.3
Nixon (R)	1968	-8.50	4.0	14.3	19.0	29.4
Nixon (R)	1972	-14.70	-26.5	37.2	23.8	6.6
Carter (D)	1976	-7.20	6.6	18.4	32.4	55.1
Reagan (R)	1980	-4.90	21.4	22.5	6.3	50.3
Reagan (R)	1984	32.20	18.5	5.2	16.8	92.5
Bush (R)	1988	31.50	-3.2	30.5	7.7	79.0
Clinton (D)	1992	10.00	1.3	37.4	23.1	88.5
Clinton (D)	1996	33.40	29.3	21.0	-2.8*	
Average		7.10	10.9	23.3	15.2	66.0
(D) Average		12.20	4.2	25.3	20.3	75.6
(R) Average		3.40	15.7	21.9	11.5	59.1
Incumbent Victory*		4.80	6.3	19.6	13.0	45.5

**L.B. Johnson classified as an incumbent President; Clinton's second-term performance through 05/00, not included in averages*

Courtesy of Morgan Stanley Dean Witter

Table 1 presents annual stock market returns since 1948, as measured by the Standard & Poor's 500 Stock Average. There is a definite pattern -- a four-year stock market cycle, which coincides with the Presidential election. The first year following a Presidential election has historically produced relatively meager returns on average, with the market rising in seven such years, while declining in six. The second year has a somewhat better record, with only four years registering declines. Pre-election years have provided the highest returns, with no down years, while election years, such as that which we are currently in, have also provided favorable returns and no down years -- at least so far.

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Why is there a stock market cycle that coincides with the Presidential term? Popular wisdom holds that the President and his party have the ability to affect the economy by pursuing restrictive or stimulative fiscal policies. In addition, they have been known to pressure the Federal Reserve Board with regard to monetary policy. The Fed is considered an independent entity, but its members are also politically appointed. For the record, it is thought that the Fed goes out of its way to avoid being accused of affecting a Presidential election outcome and, therefore, monetary policy is typically quiet in the months immediately prior to a Presidential election. In any event, the entering President and his party approach the coming term with an agenda. An important part of that agenda is to be re-elected.

What can a new administration do early in its term to improve chances of re-election four years later? Perhaps President Clinton put it best during his 1992 campaign against the senior George Bush. “It’s the economy stupid.” In good economic times, the electorate has a sense of well being and tends to favor the administration and political party currently in office. So a healthy election-year economy is certainly in the best interest of the incumbent party. Since recessions or slowdowns occur every few years or so, it is to the new administration’s benefit to get on with a slowdown sooner, rather than later. Thereby, they can blame the previous administration for having allowed the build up of economic excesses which subsequently had to be dealt with. By the next election, the economy should have recovered and be coming along quite well.

Jimmy Carter didn’t get it right, and didn’t get re-elected. The economy was strong during the early part of his Presidency, but by his run for re-election in 1980 we were in a recession. George Bush did only slightly better, as the economy suffered a steep recession in the third year of his Presidency. By the election year, 1992, the economy was recovering nicely, but it was too late to recapture the goodwill of the voters.

As Table 1 also illustrates, there is a difference in the stock market returns generated during Democratic and Republican administrations. The market has fared better under the Democrats. While that may seem counter intuitive, historically, Republicans appear to have been more aggressive in purging the excesses of the previous, most often Democratic administrations. In addition, they have been less aggressive than the Democrats, in restimulating the economy prior to the next election.

Bush vs. Gore

How about the upcoming Presidential election? What could we expect from a Bush or Gore administration that would affect the financial markets or specific industry sectors in the months and years ahead? Most of the specifics of the candidates’ campaign proposals are yet to be announced. Candidate Bush has been espousing tax cuts, education, and less of a role for government. Candidate-Gore, on the other hand, has been focusing on new programs to address health care delivery, prescription drug costs, and the environment. Gore’s focus on environmental issues would be positive for the pollution control stocks, but not so positive for the energy and natural resource stocks. His focus on health care delivery costs and prescription drug benefits could cast a cloud over the pharmaceutical and medical supply stocks. Both candidates favor increasing the defense budget and raising military pay. Bush, however, would focus more dollars toward defense technology.

Of the two, it is thought that a Bush Presidency would be more positive for foreign trade. With Gore's position on environmental issues and labor right enforcement, he is likely to be less supportive of free trade than President Clinton. Nonetheless Bush seems to want to redefine this country's relationship with China to that of a competitor, while Gore talks of partnership.

Concerning corporate America's current penchant to grow through mergers and acquisitions, both candidates have expressed a willingness to pursue antitrust issues. We have little doubt, however, that a Gore administration would do so more aggressively. In fact, House Democrats have expressed a desire to rewrite antitrust legislation in such a way as to increase House of Representatives oversight. This is a contentious issue among both House and Senate Republicans. On an aside, we are told that Microsoft will attempt to extend the appeals process on their antitrust case, hoping for a Bush victory. Whether a Bush victory would affect the case, we cannot say.

We believe there is a primary distinction between the candidates: an Al Gore Presidency would more aggressively favor government intervention and solutions to this nation's problems, while George W. Bush appears to favor less of a role for government, particularly in the economy.

Let's Not Forget Congress

The financial markets will dwell on the Presidential election but, in our opinion, the coming Congressional elections may be even more important. Currently the Republicans hold a majority in both the Senate and the House of Representatives. In the Senate, the Republican majority is 55 to 45. Thirty-three Senate seats are up for re-election, of which nineteen are Republican. Typically, an incumbent running for re-election has an advantage. Five of the thirty-three seats to be decided have no incumbent running for reelection. Four of those are currently Democratic and one is Republican. The Republicans are likely to retain control of the Senate.

The House of Representatives is a different story. The eleven-seat Republican plurality is the smallest in forty-six years. While George W. Bush seems to understand the mood of the electorate, we are not so sure of the same for many of the mainstream Republicans running for office. Furthermore, with this nation's growing distrust of government, the electorate may favor a split Congress. We doubt that a Bush Presidential victory would be accompanied by Republicans holding their majority in the House. With a split Congress it makes much less difference who becomes President, because neither candidate would have an easy time pursuing their agenda. Therefore, a split Congress would probably be good for the financial stocks. If there are fewer tax cuts by a Bush administration and less success by either Bush or Gore in passing their favored spending programs, interest rates are likely to be lower than they would otherwise be. On November 7th the choices will be made.

Current Financial Markets

Q: How does one know when the economy is about to enter a recession?
A: One doesn't - - not until after the fact.

The economy has been showing definite signs of slowing. Now we ask ourselves: has the Fed done enough tightening to tame the threat of higher inflation; how much will the economy slow; and is recession a possibility? Given the lag time between monetary policy changes and the economic outcome, Federal Reserve Board policy is always aiming at a moving target. The Fed has a history of overshooting the target by easing or tightening too much. Nonetheless, the flow and accuracy of economic information has improved greatly and the Greenspan Fed has done a skillful job to date. We believe the most likely scenario is an economic soft landing, but we will only know the outcome in hindsight.

Given our beliefs about the state of the economy, quality bonds are currently selling at slightly under fair value. Yet, compared to stocks, fixed income investments seem very cheap. Yield spreads between corporate bonds and government bonds are unusually high. As a result, high-quality corporate bonds seem quite attractive. But if there is a recession in our future, spreads will widen further.

So far as stocks are concerned, the question is still to which stocks one is referring. While the speculative fervor has tempered somewhat, and many of the money losing dot.coms have hit the skids, there is still an enormous valuation gap between the highflying technology and media stocks and the rest of the market. We believe the market is in the process of significantly narrowing those valuation gaps, albeit with occasional countertrend moves.

In our opinion, most of the stock market's corrective process has already occurred. Yet we think there is still another leg to go, particularly for those equities that are most highly valued. Recently we have been asked by a few clients for our thoughts on how their accounts will end the year. Our answers have necessarily been hedged around the timing of the remaining correction. Following that, we expect another leg of the bull market to unfold, with leadership continuing to broaden. And, as this is an election year, the odds would seem to favor at least some additional stock-market strength prior to year end.