The 2012 U.S. Presidential Election: Potential Impact On Domestic Equities

Prepared: October 29, 2012

Overview

Many investors are asking “what are the implications for the equity market depending on whether Romney or Obama wins in November?” Certainly, the stakes are high for progress on many fronts as the past four years have been ones of partisan brush fires and little, if any, progress on major issues. The composition of the Congress, the Congressional agenda, and the corresponding relationships with the government’s Executive Branch are drivers that influence what legislation is passed into law.

Consensus 2012 election projections call for a loss of seats by the Republicans in the House of Representatives, and a loss of seats by the Democrats in the Senate. If so, the anticipated moderate Congressional composition might provide for a less polarized approach in the years ahead.

This paper provides an overview of what historical domestic equity trends may tell us about who will possibly be the next president of the United States and what market trends may occur over the balance of 2012.

Is it different this time?

There are many types of economic and data indicators that provide imperfect predictive perspectives on who may win the U.S. presidential election. The domestic equity market, as measured historically by the S&P 500 Index, is one form of measure. However, no data series has a perfect track record.

Many believe the 2012 election is unique relative to history given the multiple and visible threats to the U.S. that are now apparent, both military and economic, and those that may still emerge. Among the issues being highlighted in the presidential campaign are foreign policies regarding the Middle East and China, comprehensive tax and health care reforms, and U.S. funding for such things as education, health care, social security and defense. The record-high national debt and continued annual budget deficits also underscore the difficult resource allocation tasks that are at hand for the next Administration. Nothing less than the entire role, scope, and size of the U.S. government are under consideration in the 2012 presidential election.

What can history tell us, if anything?

There have been 28 elections since 1900, with the Republicans winning the White House 15 times (54%) and the Democrats winning 13 times (46%).

Have the markets been a true predictor of the winner, or simply a follower of poll trends? As a forward-looking indicator, the equity markets (as sourced by data from the S&P 500 Index) appear to be a predictive tool. When domestic equities have risen in the July 31st to October 31st time frame, the S&P 500 has correctly predicted the re-election of the incumbent, regardless of party, 80% of the time. The market was incorrect four times (20%), and in three of those four occasions, there was the influence of a strong third-party candidate. At this juncture, the S&P 500 is 3.9% higher on a price basis over the July 31st to October 22nd time frame, possibly suggesting a re-election of the incumbent.

*Source: Standard & Poor’s Financial Services; S&P Capital IQ, July 30, 2012

Important disclosures provided on page 4.
Conversely, the S&P 500 has a better track record as it pertains to removing the incumbent from office. Since 1900, when the S&P 500 declined over the July 31st to October 31st time frame, in seven of eight occasions (missing the mark in the 1956 election), the challenger won the office of president over the incumbent.

Assuming that current pre-election poll numbers reflect accurate voter sentiment and voting intentions, we believe the current race for the U.S. presidency is too close to call at this time. Clearly, the immediacy and enormity of the fiscal cliff, and accordingly, the impact on the domestic and global economies and capital markets, provide an added element of economic suspense to the 2012 election. In our view, it is possible that the domestic equity market trading patterns and trends witnessed in recent months predominantly reflect investor uncertainty as opposed to providing predictive insight regarding the winner of the 2012 U.S. presidential election.

Post-election performance

Elections may represent risk and a lack of clarity to investors, while the election results represent certainty on U.S. presidential leadership. Since 1900, the average gain for the S&P 500 in November following a presidential election has been 0.6% and 1.7% in December.

In periods where the incumbent was re-elected and the equity market’s momentum was positive during the July to October time period referenced, the average November gains by the S&P 500 were 1.4% and 1.8% in December. In periods where the market declined in the July to October time frame, and the incumbent was replaced by the challenger, the S&P 500 was down 1.8% in November and up 1.8% in December.

Sector leadership and pre-election investor bias

As President Obama and Governor Romney each have differing ideas on the U.S. economic agenda, taxes, global trade, regulation and other business issues, it appears that industries are now trading, in part, on the basis of both perceived debate results and current pre-election poll numbers.

During the campaigns and debates, each candidate indicated their approach to move the country forward. Each approach is distinct and favors certain industries. Accordingly, the industries below are now trading consistent with the pre-election polling numbers established for each candidate.

Democratic Win: Health care generic drug manufacturers and insurance companies are likely to benefit from the implementation of the Affordable Health care Act (AHA) as the sector has, by law, increased the number of potential patients and procedures. This increase in domestic patient volume is accompanied by payment to the health care providers via AHA. Infrastructure spending is likely to remain a priority.

Republican Win: Oil and gas exploration companies are likely to trade higher under a Republican win given Romney campaign statements regarding expansion of public land permits for exploration and production. Additionally, companies involved in the defense industry may benefit as defense spending is likely to be a priority under a Romney administration and would continue to be funded at a high level.

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<th>Democratic Win (Obama)</th>
<th>Republican Win (Romney)</th>
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<td>Sectors that may benefit</td>
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Source: Strategas Research Partners; October 15, 2012

Fiscal cliff issues

If there is one issue that is legitimately “different this time,” it is the issue of the pending fiscal cliff. It appears that neither the president nor Congress will address the approximately $575-$700 billion tax increase and spending cut package until after the election. The anticipation of these pending cuts
appear to have held back hiring and capital spending across many industries. This is especially notable in the defense industry. By consensus estimates, the anticipated Gross Domestic Product (GDP) headwind or take away of the entire fiscal cliff is estimated to be in the 2.5% to 5% of GDP range. This is a significant number for an economy with a current third quarter GDP growth rate of 2%.

The U.S. Fiscal Cliff: Approximately 2.5%-5% of GDP

Regardless of the outcome of the 2012 presidential election, we believe the variables applied to the fiscal cliff resolution will be dependent upon the structure of the solution. Neither political party seeks the economic drag of the fiscal cliff in 2013. Structurally, a Republican win might predominately favor more specific spending cuts, while a Democratic win might look to higher tax rates for resolution.

Consistent with our ongoing perspectives on this topic, we are of the opinion that the most likely scenario regarding the fiscal cliff resolution favors no spending cuts and no tax increases for 2013.

Conclusions

History has shown the equity markets to be a reliable, but not a perfect, predictor of U.S. presidential election outcomes. While enhanced volatility in domestic equities is anticipated, multifaceted investor concerns about the U.S. presidential election, slowing global economic growth conditions, and uncertainty regarding the structure of fiscal cliff resolution remain. The outcome of presidential elections have, in the past, produced clarity and, accordingly, modest upward price action in the equity markets through the balance of the election year. We feel this time should be no different than what history has provided as a guide.
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Situation Analysis

IMPORTANT DISCLOSURES

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