~~Greed~~ Gridlock Is Good

It is a commonly held belief that the U.S. Republican Party is more market-friendly than the Democrats. The Republican platform historically encourages an environment based on less federal government influence, less regulation, lower taxes and free markets. When Democrats are in power, investors generally fear higher taxes, increased regulation and less business-friendly policies. Based on these differences, one would think that anything that could put a wrench into Democrats controlling both the legislative and executive branches of the government (as they do now) should make investors happy. Will that be the case this year?

The "Great Recession" has made for a complicated relationship between government and the markets. Both the Republicans and Democrats have presided over various periods of the recession and recovery, and both have had a hand in the stimulus and bailout packages. As the private sector collapsed under its own debt, government stepped in to bridge the gap with spending and tax cuts, and the Federal Reserve provided backup with monetary easing. Although bank bailouts and TARP were met with varying degrees of skepticism from the general population, any news of government support seemed to buoy the U.S. equity market. Resilient stock prices and bonus pools only reinforced the feeling that the average American got thrown under the so-called Wall Street bus. Though anti-government sentiment has swept middle-America, investors have embraced the short-term, market-boosting benefits of stimulus. In this environment it is much less clear which party the markets may favor.

As we move within a week of the midterm elections, the Republicans appear poised to take control of at least one house of Congress. We believe, in theory, the markets would view this as a positive change since single-party (Democratic) control could mean further regulation or reforms that would be unpopular with business. It would also likely mean attempts to cut spending and trim deficits before the employment situation is on a solid upward trajectory. This election could decide which path we take at the "austerity versus stimulus" fork in the road.

Historically, the markets exhibit definite patterns depending on the balance of parties in power. The data show that "gridlock is good," but only when the President is a Democrat and control of Congress is at least split or in favor of Republicans. The opposite scenario historically produces far less desirable returns. Certainly the Clinton presidency in the second half of the 1990's had much to do with that pattern. The year in the Presidential cycle also has a significant correlation with U.S. equity returns, with the third year (year after midterm elections) boasting markedly higher results than the other years. Lucky for investors, these positive market influences appear set to align in 2011.

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The Spin

Since this is a politically-oriented research piece, it is only fitting that we begin by waffling. At Miracle Mile Advisors we adhere to a Mark Twain view of the past: history may not repeat itself, but it does often rhyme. We like to use various historical time periods as a guide for what could happen in the future, but we are aware that each period has its own unique cyclical and structural characteristics. We point this out as a caveat to the data we are about to present, and hope that you think about the results in the context of a slowing global economic environment and a market that has relied heavily on government intervention for positive psychology and momentum over the past two years.

The Balance of Power

S&P 500 Performance and Party Control				
Years	**President**	**Congress**	**Avg. Annual Return**	**# of Years**
1945-2009	Democrat	Democrat	14.5%	21
	Republican	Republican	15.0%	4
	Democrat	Repub Or Split	18.4%	8
	Republican	Dem or Split	9.5%	32
1990-2009	Democrat	Democrat	12.8%	3
	Republican	Republican	15.0%	4
	Democrat	Repub Or Split	22.6%	6
	Republican	Dem or Split	-4.4%	7

Source: Robert Shiller, Yahoo! Finance, uspolitics.about.com

Single party control of the legislative and executive branches is not the historical norm. The post-World War II era has seen 25 years of single-party control (21 by Democrats and only 4 by Republicans), and 40 years of split authority. The years of single-party control produced very similar equity returns regardless of the ruling party.

Democrat/Democrat control saw the S&P 500 index rise on average 14.5% per year, while Republican/Republican control posted 15.0% gains. Split control, however, boasted both the best and worst average annual returns. **With a Democrat in the White House and Republicans in charge of at least one house of Congress, the S&P 500 index has risen on average 18.4% per year.** The opposite scenario produced gains of only about half that amount, or 9.5%. Looking at just the past 20 years, the pattern is similar but the results more extreme. A Democratic President and Republican/split Congress – our most likely scenario for the next two years – presided over average annual gains of 22.6%. Based on this scenario alone, the most likely future balance of government power favors a continuation of strong gains for equities.

The Presidential Cycle

The cycle of a presidency is divided into four years: Inauguration Year (2009), Midterm Election Year (2010), Third Year (2011) and the Presidential Election Year (2012). In a few months we will be entering the Third Year.

Presidential Market Cycle	
Year 1	Inauguration Year
Year 2	Midterm Election Year
Year 3	Third Year
Year 4	Presidential Election Year

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Again examining post-WWII data, the positioning of 2011 in the election cycle is extremely favorable for equities. On average, the year ***after*** midterms produces a gain of 21.1% for equities, more than double any of the other three years. The result we find even more interesting is that even the ***worst*** Third Year occurrence produced a **gain** of 2.6%. The variation of returns (measured by the standard deviation) is the smallest for Year Three of the cycle as well. This means that not only is the average higher than other years, the variability of returns around that average is low. The most recent 20-year period again shows a similar pattern with more extreme results.

S&P 500 Performance By Year of Presidential Cycle							
Year in Presidential Cycle	**Average Annual Return**		**Best Year**		**Worst Year**		**Standard Deviation**
	1945-2009	**1990-2009**	**Return**	**Year**	**Return**	**Year**	**1945-2009**
Inauguration Year	10.4%	12.8%	39.4%	1945	-15.0%	1973	19%
Midterm Election Year	9.1%	4.0%	56.0%	1954	-27.0%	1974	24%
3rd Year	***21.1%***	***24.9%***	***38.5%***	***1975***	***2.6%***	***1947***	***11%***
Presidential Election Year	9.7%	-1.0%	32.8%	1980	-37.2%	2008	16%

Source: Robert Shiller, Yahoo! Finance

The Political Future

Predicting the actions of politicians is never straightforward, and even less so in times of crisis. Though it appears the Republicans will gain some measure of control in Congress, this does not *necessarily* imply increased gridlock. During the last two years we have seen members of Congress vote counter to their own party on significant legislation, calling into question the "sure thing" of a simple majority. Perhaps sharing the power will force both parties to take responsibility for moving this economy forward. A potential negative aspect is increased uncertainty surrounding the Obama Administration's two big legislative wins: health care and financial reform. A change to the balance of power could mean Republicans attempt to dismantle health care or influence the way regulators enforce the financial reforms.

The potential reduction of government influence in the markets is a question mark in the short term. The dichotomy between the state of the economy and the performance of the equity market highlights the effect of government intervention. It is likely that we will see an extension of the Bush tax cuts to all income groups, but we believe that this is already priced into markets. We believe as well that another round of quantitative easing (QE2) is priced into the markets, as seen in the recent Treasury auction for TIPs that produced a negative real yield. A negative real yield means that markets expect inflation to outpace nominal yields, most likely due to an inflation-boosting round of QE2. We believe equities could take a hit if either QE2 or the tax cut extension fail to materialize.

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The recession has caused the American people to push back against the powers that be – to the detriment of Republicans in 2008 and likely to the detriment of Democrats next week. Former President Bill Clinton's success on the campaign trail this year speaks to how much people like to remember the "good times." Today, though, neither party conjures up that feeling. **It appears that history is on our side, but embedded in that data is no period similar to what we face today.** To this point, the U.S. has taken more of a Keynesian (stimulus spending) approach to the recovery while Europe has taken an austerity route, and both regions' equity markets have responded favorably. If Republicans do gain power and enact some of the spending cuts they are proposing, we may live through a real-time economic experiment. Regardless of the election outcome we expect macro trends to continue to dominate bottom-up stock trends. Diversification and yield will remain key drivers of our risk management and performance results.

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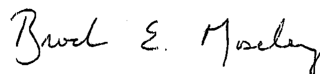

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