Godsey & Gibb Associates
Research & Review
October 2010

# 2010 U.S. Midterm Elections: Economic and Market Cycle Analysis and Implications

The upcoming midterm elections which will be held November 2nd will have important implications for investors. This fall, 37 seats in the Senate and all 435 seats in the House are up for grabs, which will allow the American people an opportunity to cast an important vote on the first two years of the current administration. As such, we thought an analysis of past election cycles and the impacts on the financial markets, relative to both the current political and economic landscape would be instructive.

With a decelerating economy and persistently ineffective policy initiatives, Congressional approval ratings are historically low. As a result, both polls and pundits are indicating a potential power shift in Washington when the 112th Congress convenes next year. With the election a month away, anything can still happen, however the intense level of voter discontent could mean large losses for incumbents. Importantly, any shift away from populist, anti-business policies would be a welcome "sigh of relief" for the equity markets and boost confidence in the broad economy. The prospect for this greater-than-normal shift in power appears to be one factor that pushed broad equity markets higher in September, which is seasonally, one of the weakest months of the year for stocks.

In 1994, the last time a midterm election was held with Congressional approval ratings at historical lows, Republicans gained 53 seats in the House and seven in the Senate. The dramatic 1994 election results coincided with an inflection point for U.S. Treasuries and an upside breakout for the U.S. equity market, according to Bank of America Merrill Lynch Investment Research (see chart 10 below). However, Fed policy arguably played a larger role at the time in 1994 and in the current economic cycle, there are larger macroeconomic headwinds (e.g. the unemployment in '94 was half what it is today).

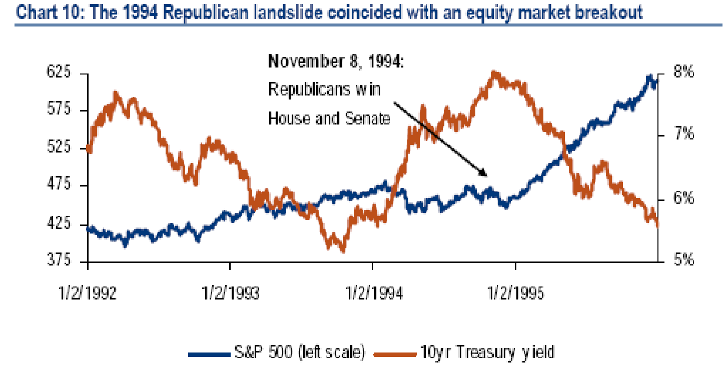
The pre-election policy discussion, known as an "October surprise" appears to have started early this year as incumbents attempt to alter the tide of the popular vote. The president recently announced a series of economic initiatives including increased infrastructure spending, an extension of research and development tax credits and changes to the tax code that would provide a benefit to companies that purchase capital equipment. The policies may have been more symbolic than substantive, or possibly an attempt to shift the debate from the elections being a referendum on the current party in power to one that is more about choices between competing ideas, as it is unclear how they would be paid for and/or if they have the necessary support in Congress in order to become law.

The most important policy item in play this fall is the extension of the Bush tax cuts. If the tax cuts were to fully sunset, it could trigger a double-dip recession. A partial extension, such as the one the president has proposed (for families with incomes under $250,000/year and individuals with incomes under $200,000/year), would be better, but still generate a drag on economic growth. Based on recent comments from congressional Democrats, the party consensus on taxes could be eroding with some members increasingly in favor of temporarily extending all of the Bush tax cuts. With election season rhetoric heating up, it is hard to imagine any tax-related legislation passing until after the midterm elections, however the election results could provide the necessary catalyst for a temporary extension of the current tax policy.

Once midterm elections are over, the market historically embraces the removal of uncertainty. According to Ned Davis Research, since 1929, regardless of whether a president is in the first or second term, the fourth quarter of a midterm election year historically delivers significant upside returns with an average gain of 8%. Moreover, next year – 2011 – is the third year of the presidential term, and these years tend to be strong years for equities. Since 1930, the average price increase of the S&P 500 Index has been 13.0% in the third year of the presidential term, compared to an average increase of 3.3% in all years that are not "third" years, according to Credit Suisse.

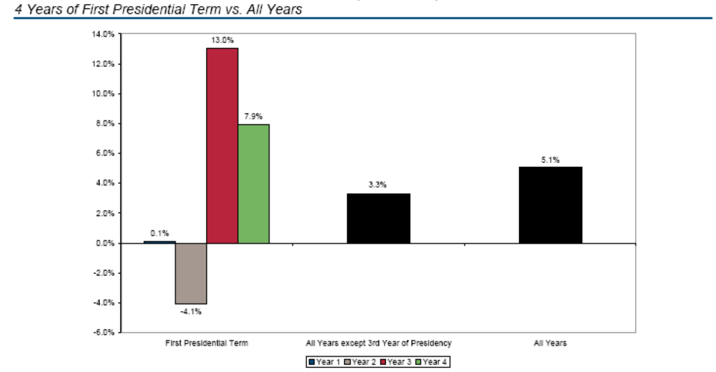
However, several historical factors with less positive implications in the current cycle may be skewing the historical data. In the past, administrations seeking reelection have attempted to engineer strong economic growth through a combination of cutting taxes and/or increasing spending by the Federal government in "third" years (e.g. 1983 and 2003). Additionally, sitting presidents have often benefitted from interest rate cuts by the Fed. Given record budget deficits (3-4 times higher than the prior record) that leave little room for increased spending and Fed policy rates currently near zero, the market's return could be more modest. While a change in Congressional leadership may end the activist, anti-business agenda, the "policy gridlock" that could result will more than likely drive tighter fiscal policy without much in the way of creative policy action, leading to stock market returns that underperform the historic "midterm election" fourth quarter and "third" year averages. As such, we continue to overweight defensive industry sectors, with emphasis on consistent earnings and safe, above-market dividend yields, for stability and income in an uncertain environment.

Chart 10: The 1994 Republican landslide coincided with an equity market breakout




Source: BofA Merrill Lynch Investment Strategy, Bloomberg

Exhibit 5: Annual S&P 500 Price Performance (1930-2009)
*4 Years of First Presidential Term vs. All Years*




*Source: Bloomberg, Credit Suisse US Equity Strategy*