

# Election Fears: Hype Versus Reality

## EXECUTIVE SUMMARY

We think the economic implications of a U.S. Presidential election is often overblown by politicians and the media. Short-term noise and volatility come with the territory of equity market investing. History suggests that market performance is largely independent of the political party holding the Presidency. However, there is a clear understanding that economic growth drives revenues, revenues lead to earnings, and earnings equate to higher stock prices over the long-term. These factors are influenced by demographic trends, productivity gains and inflation, and these are the factors that should remain in focus for broad equity market investors. The only thing that is different in this election cycle are the people campaigning for the presidency, not the dominant factors that drive our economy and markets.

Politicians and the media do a lot of talking about the economic implications for each political platform during major elections, which mostly creates a lot of noise. In turn, much of this noise creates market volatility. However, noise and volatility become less relevant over appropriately longer time horizons for equity market investors. History suggests to us that what happens within the Washington, D.C. beltway has little relationship with the broader U.S. economy and long-term financial market fundamentals. It is the fundamentals that really matter for investors.

## PERFORMANCE BY ADMINISTRATION

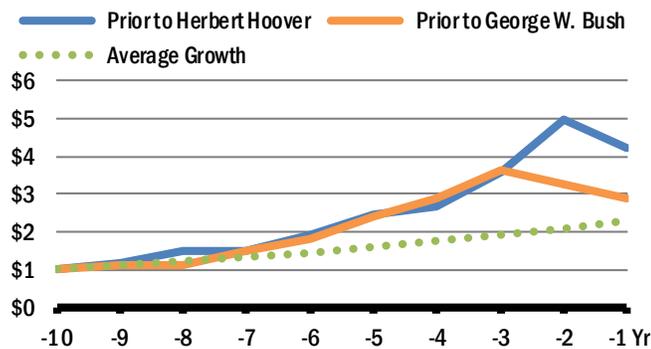
Consider the price change in the large cap U.S. stocks for every administration since President Hoover. The only relationship between political party and stock market returns is that the market has seemingly performed better under Democratic administrations, but even that is a spurious relationship. Two republican presidents, Herbert Hoover and George W. Bush, had the bad luck of beginning their terms after the stock market had huge runs in the 1920s and the 1990s. Certainly, it could be said that the Hoover bubble burst was brought on by the Great Depression, and the Bush presidency ended with the 2008 financial crisis. However, in both cases, markets were set to fall from lofty price levels. If one were to adjust the results for this bad timing, the stock market returns under both party's administrations becomes much closer over time.

### EXHIBIT 1: MARKET CHANGE BY ADMINISTRATION

President	Begin Date	End Date	Equity Market Change
Hoover (R)	3/4/1929	3/4/1933	(77.09%)
Roosevelt (D)	3/4/1933	4/12/1945	140.58%
Truman (D)	4/12/1945	1/20/1953	86.05%
Eisenhower (R)	1/20/1953	1/20/1961	129.38%
Kennedy (D)	1/20/1961	11/22/1963	16.09%
Johnson (D)	11/22/1963	1/20/1969	46.09%
Nixon (R)	1/20/1969	8/9/1974	(20.48%)
Ford (R)	8/9/1974	1/20/1977	27.34%
Carter (D)	1/20/1977	1/20/1981	27.85%
Reagan (R)	1/20/1981	1/20/1989	117.72%
Bush (R)	1/20/1989	1/20/1993	51.19%
Clinton (D)	1/20/1993	1/20/2001	209.79%
Bush (R)	1/20/2001	1/20/2009	(40.02%)
Obama (D)	1/20/2009	--	169.28%*

Source: Bloomberg. \*Through September 30, 2016. Market change is the price level change of the S&P 500 Index. This chart is for illustrative purposes only and not indicative of any actual investment. **Past performance is not a guarantee of future results.** Please refer to the important disclosures at the end of this document.

**EXHIBIT 2: INDEXED GROWTH OF MARKET CHANGE**



Source: Jeremy Siegel's nominal annual market index. **Past performance is not a guarantee of future results.** Please refer to the important disclosures at the end of this document.

## IMPORTANT ECONOMIC FACTORS

We think that economic fundamentals, such as Gross Domestic Product (GDP) growth rates, and market fundamentals, such as valuations, matter over time. Clearly, history shows that earnings drive stock prices in the long-term. There are periods where prices deviate from earnings, and valuations compress or stretch, but the relationship over the long-term is telling.

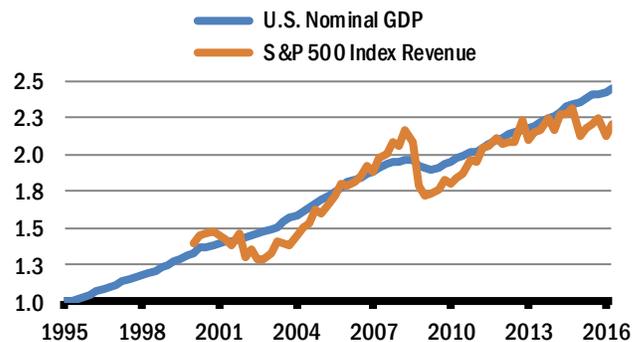
**EXHIBIT 3: EARNINGS AND PRICE**



Source: S&P Dow Jones. **Past performance is not a guarantee of future results.** Please refer to the important disclosures at the end of this document.

Earnings growth drives stock prices, and earnings are heavily dependent on revenue. Revenue growth, in turn, is closely related to the nominal growth in economic activity, or NGDP, as the following graph demonstrates. When thinking about economic and stock market fundamentals, it is important to think about what drives NGDP growth.

**EXHIBIT 4: INDEXED REVENUE & NGDP GROWTH**



Source: Bloomberg

Nominal GDP (NGDP) is real GDP, plus inflation. We care more about nominal GDP because revenues and earnings growth includes inflation. In generating its long-term forecast for real GDP (not including inflation), the Bureau of Labor Statistics (BLS) combines a forecast for labor market growth and productivity growth. Labor market growth is based on demographic trends, which move slowly and are relatively easy to measure. Productivity is more difficult to forecast because it is based largely on new technologies and innovation. The BLS forecasts annual growth of roughly 0.5% for the labor force, and approximately 1.8% for productivity growth, for a 2.2% real GDP forecast. To create a forecast for NGDP, we include an inflation factor using market-based inflation expectations as a proxy for what to expect going forward. We like to use the relationship between Treasury bonds and Treasury Inflation Protected Securities (TIPS) of the same maturity, known as the TIPS breakeven spread, to derive what the market thinks inflation will be over the next several years. The market expects inflation of roughly 1.5% over the next 10 years. As a result, we think that 3.7% (2.2% + 1.5%) is a good estimate for NGDP on average over the next several years.

By creating this nominal GDP forecast, we think that it is possible to create reliable expectations for U.S. economic activity, revenues, and earnings over the long-term. Obviously, short-term events can derail the economy's near-term potential or accelerate revenue and earnings growth, but we think longer-term economic growth is rooted in these factors. Importantly, these factors suggest a positive environment for slow, but steady growth ahead.

None of these inputs to economic growth (labor force and productivity growth rates, along with inflation), corporate revenues, and earnings in aggregate are directly and significantly impacted by a presidential administration. Granted, an administration may have significant influence on specific industries through various policy measures (e.g. regulations or subsidies), but, in aggregate, what drives the U.S. economy is the stable growth rate of our labor force and productivity of the private sector. It is these factors that should be the areas of focus for broad equity market investors.

Unlike a centrally planned economy, such as China, these factors are not driven by the president. Through the wisdom of our forefathers, our system of checks and balances prevents any president from wielding too much power. The upward bias to our economy and our markets are a result of our democracy and capitalism. This has held true despite many different administrations, both republican and democratic, with very divergent economic and political policies.

## GOING FORWARD

Is it different this time? Yes, the candidates are different. Still, the dominant factors that drive our economy and markets are unchanged regardless of presidential administration. The demographic, productivity, and inflationary trends that drive our economy and financial markets are well entrenched. These trends indicate slow, but steady growth ahead and a positive environment for equity market investors with appropriate time horizons.

## DISCLOSURES

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