

PREDICTABLE INVESTING

December 2006

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HISTORY LESSON – December 2006.

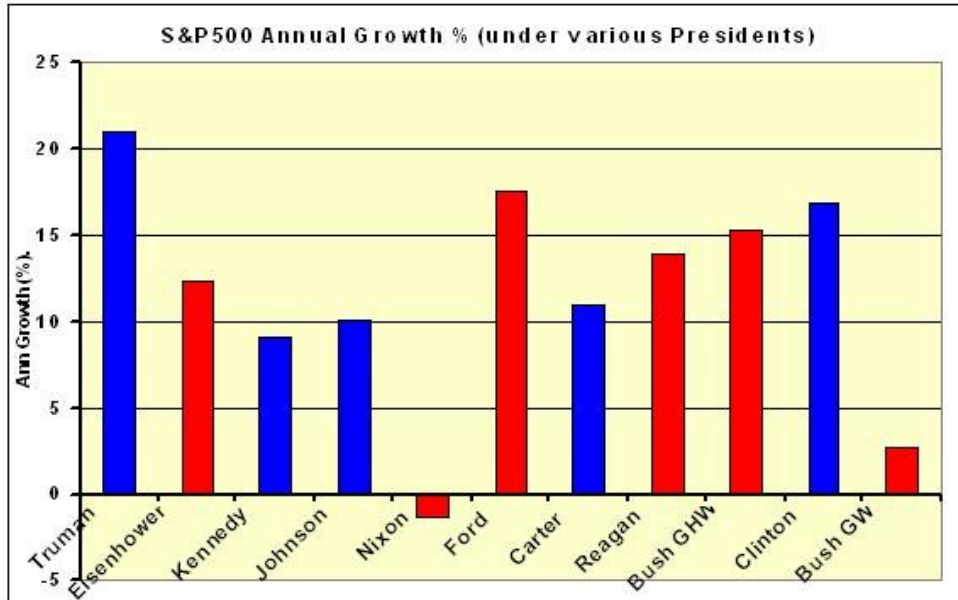
ARE REPUBLICANS OR DEMOCRATS BETTER FOR THE STOCK MARKET?

1.0 INTRODUCTION: Are Democrats better for the Stock Market than Republicans? What a stupid question, of course not! Obviously the stock market does better under lower-tax Republicans, than under high-spending Democrats ... right? Wrong. Unfortunately for the GOP, the historical data shows otherwise.

If we examine stock market growth data from the last 58 years, we see that during the terms of Republican presidents, the stock market grew at 9.3% annually. But the same data shows that during the terms of Democratic presidents, the stock market growth was 14.3% annually, *which is 53% higher!*

This is red meat for Democratic pundits in the up and coming presidential election. But before they get too confident about citing these numbers in front of a million TV viewers, let us take a look at what is really behind this often quoted statistic, for all is not what it seems.

2.0 THE STOCK MARKET AND PRESIDENTS: Let's first examine the raw stock market growth data under the last 11 Presidents over the last 58 years. The stock market growth under various administrations, blue for Democrats and red for Republicans, is shown in the figure below.



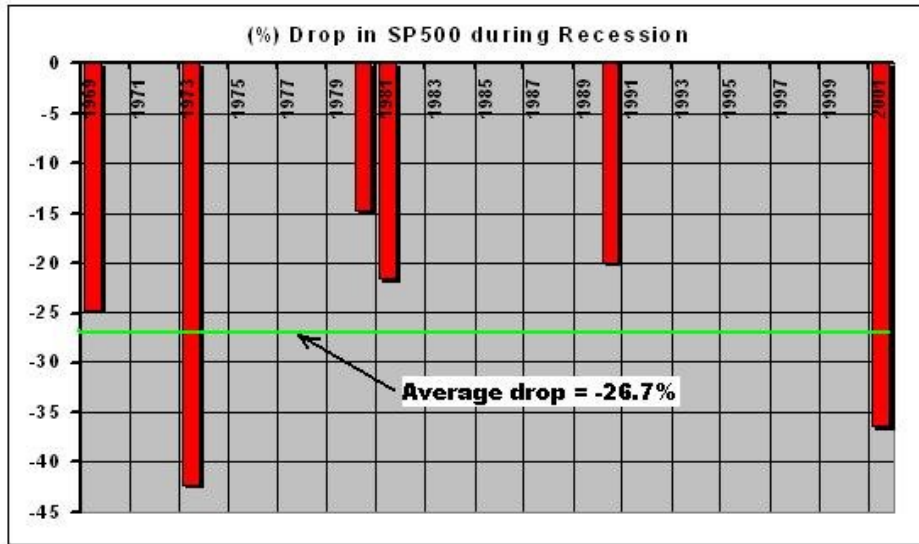
The average annualized growth of the S&P500 during this entire 58 year period works out to 11.2%. It is also apparent that the best market growth for Democrats occurred during the terms of Truman and Clinton, and worst under Republicans Nixon and GW Bush. But what is the reason behind this huge discrepancy in market performance?

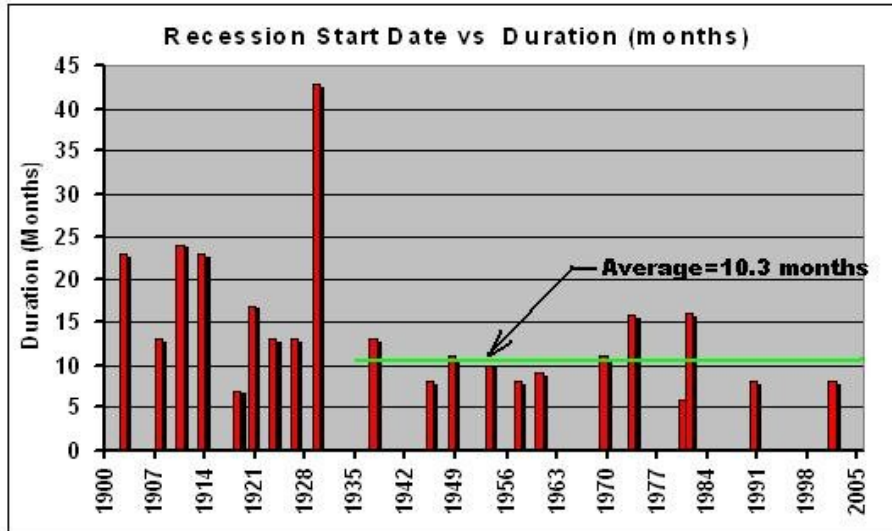
3.0 THE RECESSION FACTOR:

Over the last 58 years, stock prices have increased an average of about 11.2% per year. Keep in mind that, in any given year, the actual stock price growth will be larger or smaller than the average depending on how the economy is doing at the time. When the economy is prospering – consumers spend more, corporate profits grow and stock prices increase faster than the average. The opposite occurs when the economy is slowing down, as in a recession – consumer spending drops, corporate profits shrink and stock prices fall.

Recessions were covered extensively in the History Lesson for September 2006 (see [Archive Page](#)) "GDP and RECESSIONS: (Who's afraid of the big bad recession?)". In that article we showed that, unfortunately, there has been a recession about once every six years since the end of World War II, and each time the S&P500 has dropped between 14.7% and a whopping 42.2%. **This results in an incredible 26.7% drop in the S&P500 during an average recession, and its average duration is 10.3 months.**

These data are shown in the two Figures below:





In other words, during a recession, *investors will lose more than one-quarter of their stock market assets!* And if that isn't painful enough, after the bad times are over, it will take them years to recover their losses and return to the original principal they had before the recession started. Obviously, recessions are very bad for the stock market and incumbent presidents want to avoid them like the plague; but about every six years, somebody's going to have one on his watch.

This raises the question: Is the presence of a six-year recession cycle a law of nature? Or is there a direct correlation between the policies of the president and the recession cycle?

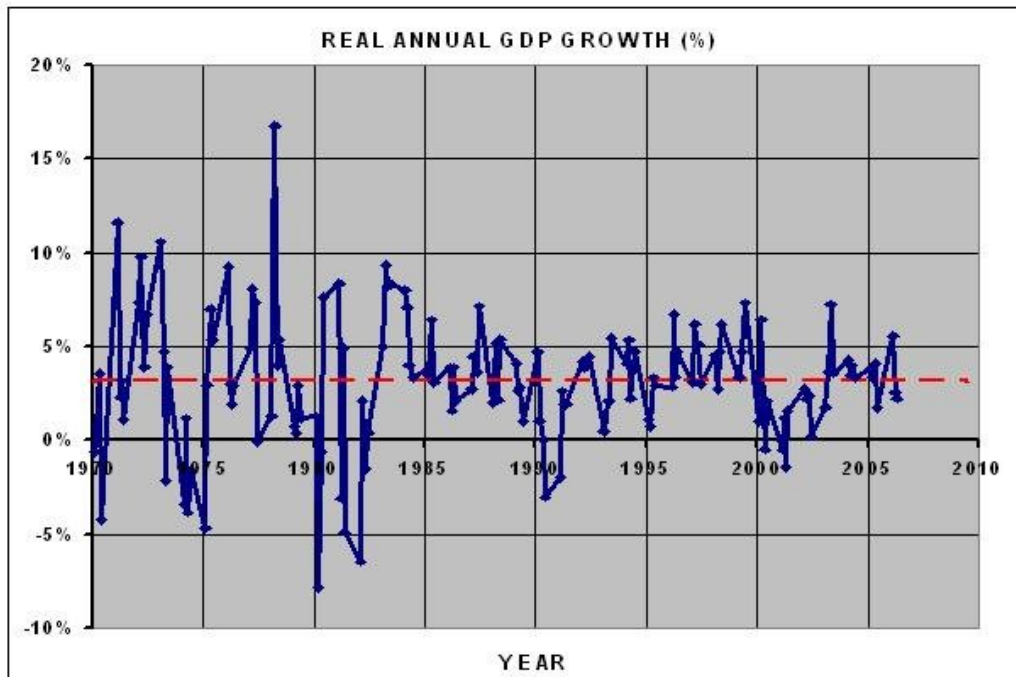
4.0 RECESSIONS AND PRESIDENTS: Data from the past 58 years was used to examine the link between a Republican or Democratic presidency and the occurrence of recessions. This period was chosen because the data were readily available and deemed to be reliable.

During these years, we have had eleven presidents. And every one of them presided over a recession except for two, Lyndon Johnson and Bill Clinton. Both of them were Democrats. Not having a recession during their terms meant that the stock prices remained high during their tenures. Does this mean that the policies of Johnson and Clinton were directly responsible for avoiding a recession and the consequently higher stock market growth? The answer is no.

Many people will disagree and cry foul at this point: How can the answer be “no” in light of the record? When criticizing an incoming president from the opposing party, both sides of the political aisle will claim that a healthy economy is due to his predecessor’s hard work. Or conversely, that he inherited a recession from his predecessor who left office just as the economy was overheating. There are even market-timing newsletters which use the years of a president's term as their buy/sell signal. But the politics of an incumbent president has little to do with the health of the economy or the stock market ... that distinction belongs to the Federal Reserve.

5.0 THE ECONOMY AND THE FEDERAL RESERVE: The Federal Reserve is the Central Bank of the United States. Its main function is to control inflation while maximizing employment. It does this by setting the very short-term interest rate (Federal Funds Rate) and by controlling the money supply. But even the Federal Reserve, with all its power and authority, has not been able to effectively manage economic growth.

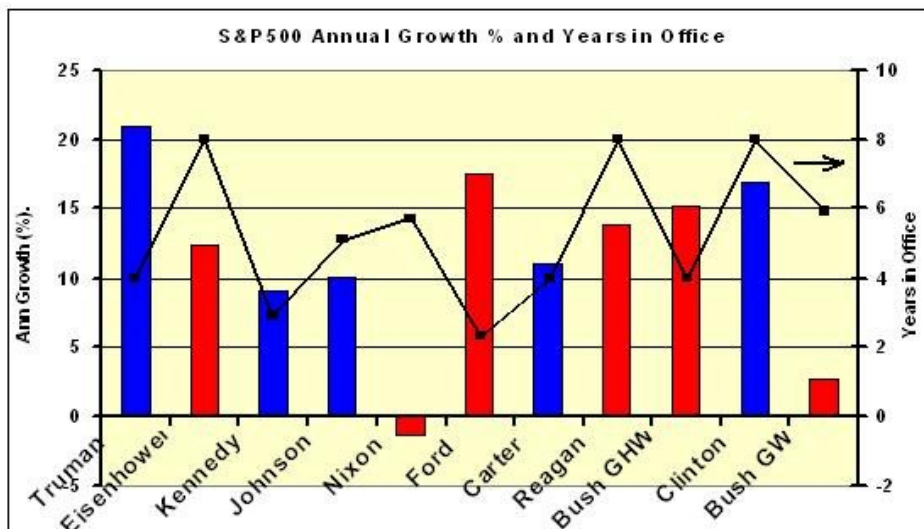
If the Fed were truly effective, the economy, as measured by the Real Gross Domestic Product (GDP), would always grow smoothly. That is, there would be no inflationary growth spurts or recessions, and the GDP would be a horizontal line around the desired growth rate of about 3.5%. This is far from what actually happened over the last 36 years, and is shown in the figure below.



It is apparent that the Fed has not been able to manage the economy and prevent the boom-bust cycles, except in a few isolated instances. How, therefore, can we possibly ascribe the performance of the stock market to the actions of a sitting president who has none of the monetary powers of the Fed? It is true that a president always gets the credit for a good economy or the blame for a bad one; but that is, mostly, the luck of the draw.

6.0 THE YEARS-IN-OFFICE ILLUSION: The real explanation for why higher stock market performance is attributed to Democratic presidents turns out to be a mathematical illusion. This illusion has to do with *the total number of years* the Democrats or Republicans have held the presidency.

For the time period under discussion, Republicans have occupied the White House for many more years than the Democrats. A Republican president has been in office for 34 of the last 58 years (59% of the time), while a Democrat has been president for only 24 of those years (41% of the time).



This longer tenure is because there have been only 4 two-term Presidents in this entire period, and 3 out of these were Republicans (we include GW Bush). Since a recession has struck the economy every six years on average, we can expect Republican presidents to have almost six recessions during their 34 year total term. The Democratic presidents with 24 years in office would have only four. This ratio of six recessions to

four, which is 50%, is exactly the same number as the discrepancy in stock market performance between the two parties.

7.0 CONCLUSIONS: It is true that a sitting President can propose legislation such as tax policy that will ultimately have an impact on the economy. However, our analysis shows that Presidents of either party really do not control the direction of the economy during their tenure in office.

The bottom line is that had the Democrats been in the White House for as long as the Republicans, they would have experienced the same number of recessions as the Republicans, and their stock market performance would have been just as poor.