

# BARNETT & COMPANY

INVESTMENT COUNSEL

## Quarterly Review and Outlook

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### Fun with Election Cycles

Since national elections have become such all-consuming (and expensive) spectacles, it is natural that so many of us obsess over the impact on the stock market of a victory by one party or the other. In particular, the potential for a change in leadership in one or both houses of Congress has some investors exercised, fearing an abrogation of conservative pro-growth fiscal policies that have fueled the five-year economic expansion. Although undeniably entertaining, not to mention necessary to satiate the appetite of 24 hour cable news shows, this speculation belies two underlying realities: (1) The ability of a new majority party in Congress to drastically alter current policy will likely be minimal; and (2) The legislative fiscal record of the current majority has not been remotely conservative. This is not to say that the outcome has no significance; obviously the control of committee chairmanships and the attendant ability to set the agenda for the next two years will likely generate even more acute partisan disharmonism if the Democrats regain the majority. Nevertheless, the prospect of divided government suggests that no major legislation beyond routine appropriations bills is likely to be adopted. Once the vote is counted on election night (or possibly the days following), the 2008 Presidential campaign begins in earnest. (Aside: If you thought this year's campaign ads were over the top, you ain't seen nothin' yet.)

But, since we're already indulging ourselves, let's see how the market stacks up so far this year against the conventional wisdom. Sam Stovall of Standard & Poor's has looked at stock returns over the four year presidential election cycle going back to 1945, and has observed that the worst quarter for stocks of the 16 quarters in a presidential cycle is the third quarter of the mid-term election year, with an average loss 2.2 percent in the S&P 500 index. Furthermore, the third quarter of every year tends to be the worst of the year, averaging only a 0.1% gain. This pattern

Presidential Cycle	Q1	Q2	Q3	Q4	Year Average
Year 1	-0.3	1.8	0.0	3.2	5.4
Year 2 (Mid-Term Elections)	0.8	-2.0	-2.2	7.6	4.3
Year 3	7.5	5.3	1.9	2.8	10.8
Year 4 (Presidential Election)	1.2	3.0	0.7	3.5	8.5
Qtr Average	2.3	2.1	0.1	4.3	9.0

Source: Standard & Poor's

was frequently recited earlier in the year, as commentators reprised the usual predictions about the traditional mid-term slump. This time, however, the S&P *gained* 5.6% for the third quarter of the year despite an electoral climate as uncertain and acrimonious as any in recent memory.

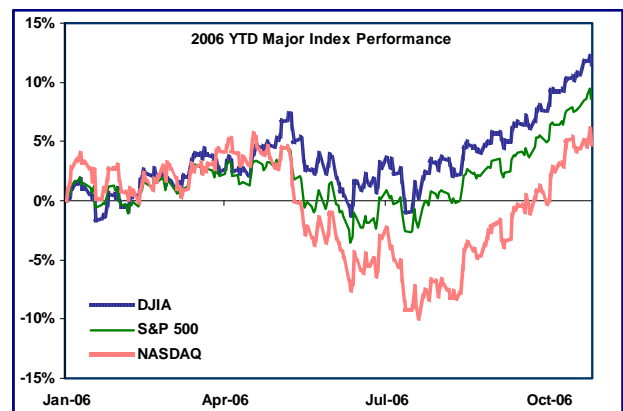
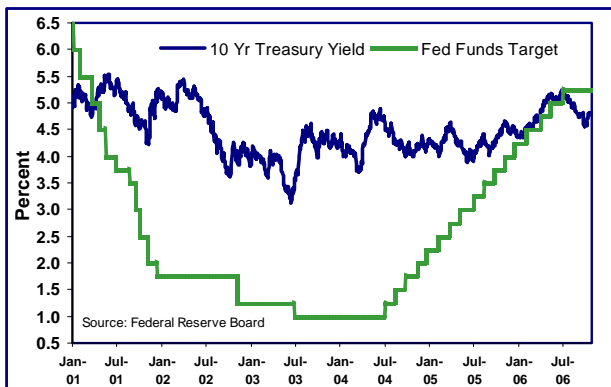
Tempting as it may be to try to generalize about market performance relative to elections or phases of the moon or World Series champions, the actual movement of stock prices is driven by specific fundamental factors that prevail during the

## Quarterly Review and Outlook

time period under consideration. The value of a financial asset (such as a stock) is merely the present value of the future cash flow that the asset is expected to generate. Prices fluctuate in response to changes in the predicted values of the inputs to that computation; namely, the future cash flow (influenced by projected earnings growth), and the discount rate (which is a function of the level of interest rates and estimated risk premiums). During the second quarter of 2006, investors made the judgment that the economy was slowing (putting a drag on earnings growth), while the Fed continued to boost rates; the result was a sudden decline in stock prices beginning in May.

Leading into the third quarter of 2006, many of the headwinds buffeting the market during the spring were beginning to recede. Oil plunged from \$77 to \$58 per barrel, which was especially important to the market for two reasons. First, high energy costs were beginning to hamper the consumer's ability to spend, especially at the margin, threatening to constrict the largest constituent of GDP growth. Second, the Federal Reserve was finally able to take a breather after hiking interest rates seventeen times in response to their mandate to restrain the inflationary impact of higher energy prices. As the quarter got under way, investors started handicapping

the prospect of rate *cuts* early in the New Year. These developments led equity investors back to the table, pouring cash into the stock market (regardless of their view of the upcoming election). Health care, telecommunications, technology, utility and financial stocks benefited especially from the prospect of cheaper energy and lower interest costs. Consumer confidence as measured by the University of Michigan survey reached its highest level in 15 months, largely in response to a little relief in the cost of a tank of gas. Virtually every asset class gained ground in the third quarter, led by the Dow index, which battled tantalizingly close to an all-time record (which it ultimately surpassed only two days after the end of the quarter). By the time the dust settled, the Dow had surged by 9% for the year to date, while the S&P 500 was up 8.5%. International stocks found their groove again, up 3.9% for the quarter and 14.5% so far this year; even bond investors got back into the black as the speculation of future interest rate cuts gained currency and bond prices rallied.

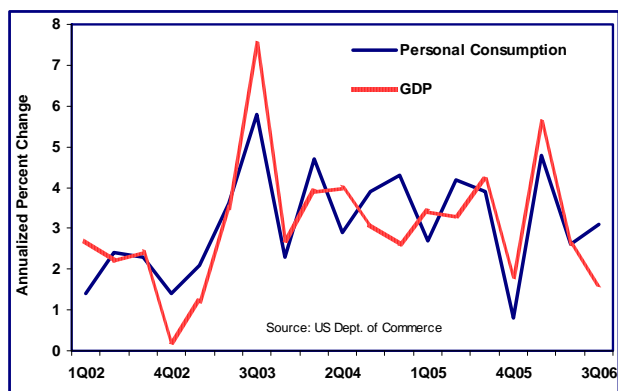


So, will the party go on? If one subscribes to the election year theory, the fourth quarter of the mid-term election year should be the best of the 16 quarters in the presidential cycle, with an average gain of 7.6% for the

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S&P. Once again, basic economics is likely to trump any ancillary electoral influence, especially in view of the fact that we have yet to experience a full 10% market correction throughout the entire five year bull run.

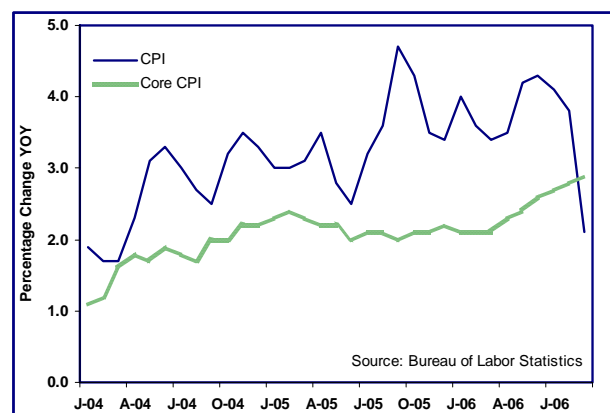
The much-anticipated economic slowdown is finally upon us; the question before the court is the magnitude and duration of the slump. After a robust rally, the air is out of the housing market, home prices are falling in many previously hot markets, and job creation attendant to the residential construction boom is about to stall. While the moderation in economic growth is good news from the Fed's standpoint as a damping force on inflation, the risk of too much slowing or even a recession is now only beginning to cause investors to lose sleep. After several years of GDP growth north of 3%, we have witnessed a progressive slackening in output growth throughout the first three quarters of 2006. Third quarter GDP came in at just 1.6%, well below analysts' already reduced expectations of 2.7%. Much depends on the



early reports from retailers with respect to holiday sales, providing a reading on how well the consumer is holding up (or rather how well his wallet is holding up). In addition, corporate profits have been on a double-digit growth tear for 18 straight

quarters and represent a significant fraction of GDP. Odds are good that we finally see more earnings disappointments in the two or three quarters ahead, biting into GDP and investor confidence. The Philadelphia Federal Reserve economic survey predicts growth in GDP of 2.8% for 2007; this may well prove to be optimistic.

In spite of the Fed's respite in rate hikes, the threat of inflation has not entirely dissipated. The popular measure of consumer price inflation, the CPI, fell abruptly in September due to a drop in energy costs. However, the core CPI, which excludes the more volatile food and energy prices, rose 2.9% versus the same period one year ago, the largest increase in a decade. The Fed watches this number closely and wants to see a core CPI below 2% before they can relax and light a victory cigar.



The upcoming election may well prove to be a political watershed in terms of control of Congress and a vote of no confidence in the majority party's legacy. Nevertheless, it behooves us to recall that the value of our investment portfolios is much more closely tied to the fate of the GDP than the fate of the GOP.

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