

## U.S. Midterm Elections: A Catalyst for Stocks?

### Have midterm elections influenced stock returns?

For whatever reason, U.S. midterm elections (1950-2009) typically have kicked off a period of strong gains for U.S. stock investors. During the year after a November midterm election, average returns for large (23.4%) and small-cap U.S. stocks (31.2%) have been significantly better than the long-term average annual returns for these categories since 1950 (11.0% and 13.5%, respectively).\*

### Gridlock is good: perception or reality?

The theory that inaction caused by political gridlock—where the U.S. Senate, U.S. House of Representatives and White House are not all controlled by the same party—is often considered “good for the market” does not appear to have much historical support from stock-return data following midterm elections. Large-cap stock returns during post-midterm election years have been about the same, whether or not the outcome resulted in gridlock or harmony (i.e. one party controls both houses of Congress and the White House). Small-cap stocks, meanwhile, outperformed in years of political harmony compared to gridlock.

### KEY TAKEAWAYS

- Historically, there has been little differentiation among stock market performance whether a U.S. midterm election has resulted in political party gridlock or harmony, nor which party seized control.
- Though midterm election outcomes have not appeared to have a major influence over near-term stock performance, during the year following the election average returns for stocks have been about double the category’s long-term average.

Exhibit: Historically, the year after a U.S. midterm election has been a favorable one for stocks. Meanwhile, election outcomes have had no discernible impact on the stock market’s performance during these periods.

U.S. Stock Market Performance (1950-2009)			
U.S. Midterm Election Result	Large-Cap Stocks 1-Yr. Post-Election Avg. Return (%)	Small-Cap Stocks 1-Yr. Post-Election Avg. Return (%)	#Observations
Party Gridlock	23.3	23.9	10
Party Harmony	23.7	45.7	5
• Harmony (Dem.)	24.4	43.3	4
• Harmony (Rep.)	20.8	55.5	1
Average Return of all Post-Mid-Term Election 1-Yr. Periods*	23.4	31.2	15
Average Annual Return 1950-2009 (entire period)	11.0	13.5	-

Large-cap stock returns based on total return of S&P 500®; small-cap stock returns based on the Ibbotson Small Cap Stock Index, a custom index designed to measure the performance of U.S. small-cap stocks. Source: Ibbotson, FMRCO. (MARE) 1950-2009.

\*One-year returns after election reflects the returns of the S&P 500 (large caps) and Ibbotson Small Cap Index (small caps) from November of election year through the following October. Average of election years: arithmetic average of returns.

### The party effect — hard to find it

Conventional wisdom also generally supports the notion that Republicans are the more investment-friendly party, typically supporting less business regulation and lower taxes. However, average large-cap stock returns in post-midterm-election years haven’t varied much according to which party seized control (see exhibit, above).

### Investment implications

With a whole host of economic, budget and tax issues facing the next Congress, government policy on economic matters is arguably more at the center of attention now than at any time in decades, and legislative action over the next couple years may have an important impact on the future trajectory of the U.S. stock market. However, the historical post midterm election stock performance underscores two key points. First, there are many other factors that influence near-term stock movements besides election results, particularly the current trend of the economy and profit cycle. Second, even if legislative actions eventually lead to important policy changes, the midterm election

outcomes themselves historically have not appeared to be major drivers of the stock market’s direction. As a result, investors may consider sticking to their investment strategies instead of attempting to move in and out of the market based on short-term political events. ■

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