First Quarter 2020

Can the Equity Markets Predict Our Next President?

The big surprise of the 2016 election was how poorly opinion polls predicted the results. According to the Pew Research Center,
"Relying largely on opinion polls, election forecasters put Clinton's chance of winning at anywhere from 70% to as high as 99%, and pegged her as the heavy favorite to win a number of states such as Pennsylvania and Wisconsin that in the end were taken by Trump."

Can the stock market do a better job? According to the results of the last 23 presidential elections, the S&P 500 has predicted the winner accurately 87% of the time. If the S&P 500 is up for the three months prior to the election, the incumbent's party is heavily favored to win. If the S&P 500 shows stock market losses for the three months, the challenger is the odds-on favorite.

Going back to 1928; 14 elections were preceded by gains in the three months prior. During 12 of those years, the incumbent party won the White House. In eight out of nine years of stock market losses in the three months prior to the election, the incumbent party lost. The exceptions were Dwight D. Eisenhauer winning a second-year term in 1956 despite a decline in the S&P 500 of
-3.2%; 1968 when Richard Nixon won over a one-term Lyndon B. Johnson, and Ronald Reagan, who won a first term in 1980 despite 6% market gains under President Jimmy Carter.

Equity markets have a big advantage over opinion polls in that they are incredibly complex systems where there is a continuous aggregation of investor sentiments and the forward views of market participants. Because investors are expressing that sentiment with real money, there is little inclination to mislead or fail to participate. Of course, the catch is that we won't know which way the market will finally vote until the final days leading up to the election, but it will be interesting to watch.

And of course, there is the caution that past performance is not indicative of future returns and there is always a chance for surprises.

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