Market *Alert*

Nov 2010

STANDARD & POOR'S

Of Politics and Market Performance: How the Midterm Elections May Impact Investors

"If the Republican agenda wins out and investment tax cuts are extended, that could spell good news for equity investors who are able to take advantage of favorable capital gains and dividend tax rates."

As many predicted, the midterm elections of 2010 saw the tables turn in Washington, with Republicans reclaiming control of the House and gaining ground - but not dominance - in the Senate. The Republican victory marks the beginning of a new era in which power in Congress is divided between the two major parties. Yet, while popular Wall Street wisdom says that such a scenario, commonly referred to as "gridlock," could be good for the markets, history has another story to tell, and it is saying something quite different.

S&P Equity Research examined the performance of the S&P 500 from the year 1900 through 2010 under three potential political scenarios: Total Unity, in which the President and both houses of Congress are from the same party; Partial Gridlock, in which one party controls both houses of Congress and the other controls the White House; and Total Gridlock, in which Congress is divided as it is today.

What did the data reveal? Under a Total Unity scenario, the S&P 500 posted its strongest annual performances, gaining 7.6% since 1900, versus 6.8% for all years, and 10.7% since 1945, versus 8.4% for all years (see table below). Under Partial Gridlock, the S&P 500 posted annual returns that were close to the average increase for all years, rising 6.8% in 32 years since 1900 and 7.6% in the 30 times since 1945. Under the Total Gridlock scenario, however, the S&P 500 rose only 2.0% per year since 1900, and 3.5% per year since 1945.

The rationale behind this subpar performance could be that gridlock generates uncertainty, and Wall Street hates uncertainty. Be aware, however, that there have been limited examples from which to draw conclusions - only eight since 1945.

When It Comes to Stock Market Performance, Unity Trumps Gridlock …

S&P 500 Changes During Presidential/Congressional Unity and Gridlock				
	Since 1900		Since 1945 (WWII)	
Political Scenario	**% Change**	**Number of Years**	**% Change**	**Number of Years**
Total Unity	7.6%	67	10.7%	28
Partial Gridlock: Unified Congress	6.8%	32	7.6%	30
Total Gridlock: Split Congress	2.0%	12	3.5%	8
ALL YEARS	6.8%	111	8.4%	66

Source: Standard & Poor's. Past performance is no guarantee of future results.

Implications for Investors

With votes still being counted in states such as Alaska and Washington, and with a two-month lame duck session of the current Congress yet to be served, it is too soon to predict specific outcomes from the midterm elections, let alone their impact on the investment climate in the coming months. However, taking the evidence provided by history into consideration, there are a few educated observations that can be made about how political gridlock may play out this time.

- The Bush Tax Cuts - The Republican victory may signal the extension of the 2001 and 2003 Bush Tax cuts beyond 2010, but for how long and in what iteration remains unclear. If the Republicans have their way, the cuts would be extended permanently in their current form, while the Democrats have proposed extending the tax cuts mostly for those households making less than $250,000 per year.
- Stocks - If the Republican agenda wins out and investment tax cuts are extended that could spell good news for equity investors who are able to take advantage of favorable capital gains and dividend tax rates. The new, more Republican-leaning Congress may also enact policies seen as more favorable to corporate business interests, which could be good news for big business and large-cap stocks.
- The Federal Deficit - For a federal budget already perilously deep in debt, any talk of extending tax cuts is bad news. The Congressional Budget Office forecasts that over the next decade, the United States will add another $6.2 trillion to the national debt, even if the Bush tax cuts expire. If the tax cuts are made permanent, the total new debt would climb to $11 trillion by 2020.[1]
- The Dollar - If tax cuts are extended, deficits soar, and gridlock rules Washington, expect the dollar to fall even farther than it has to date. (Since the start of September 2010, the dollar has fallen on a trade-weighted basis 8% against the euro, the pound, and the yen.[2]) When the dollar falls, investors can often find opportunities in commodities such as precious metals (gold and silver), petroleum, and other natural resources.
- Bonds - Bonds may be similarly disadvantaged by the new political landscape, particularly long-term government bonds. In a scenario where federal debt is rising and tax cuts could be extended indefinitely, the government would be forced to issue more debt, driving up rates and crowding out everybody who'd have to compete with the government for funding.

[1,2]Source: *The Wall Street Journal*, "What a Republican Win Would Mean for Investors," October 15, 2010.