



# EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

## NEWSLETTER

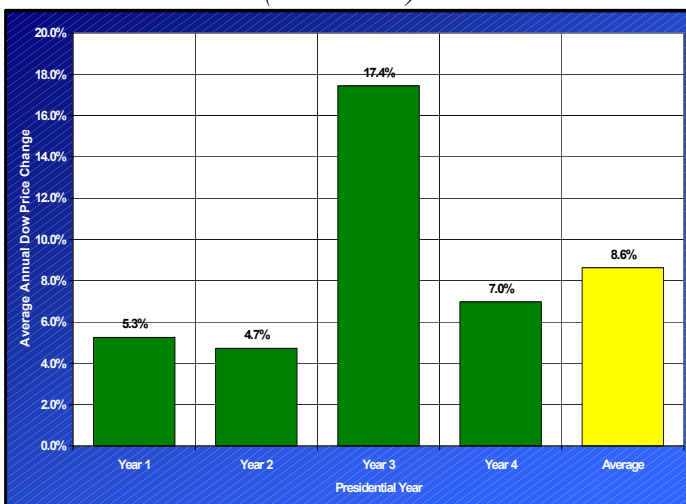
April 2004

### **PRESIDENTIAL ELECTIONS**

*Do They Matter?*

Every four years, presidential elections capture the minds of politicians and the electorate. It is an opportunity for the public to express their philosophy, hopes, and frustrations. Changes in presidential administrations can have far-reaching implications for public policy. Consider the sweeping philosophical changes that occurred with the Lincoln, Franklin Roosevelt, Kennedy, and Reagan administrations. Many of those changes represented a shift in economic and fiscal policy. This year's election is generating particular interest because of the philosophical differences between the candidates and the controversy that surrounded the election in 2000.

**CHART I**  
**PRESIDENTIAL TERM MARKET RETURNS**  
(1945-2003)



Presidential election cycles have had an impact on stock market returns over the last 59 years (1945-2003). Stocks generally experience below average price gains during the first two years of a presidential term, while generating extraordinary gains in the third year. In the election year

itself, stocks have had modest gains, but somewhat better than the first two years (Chart I).

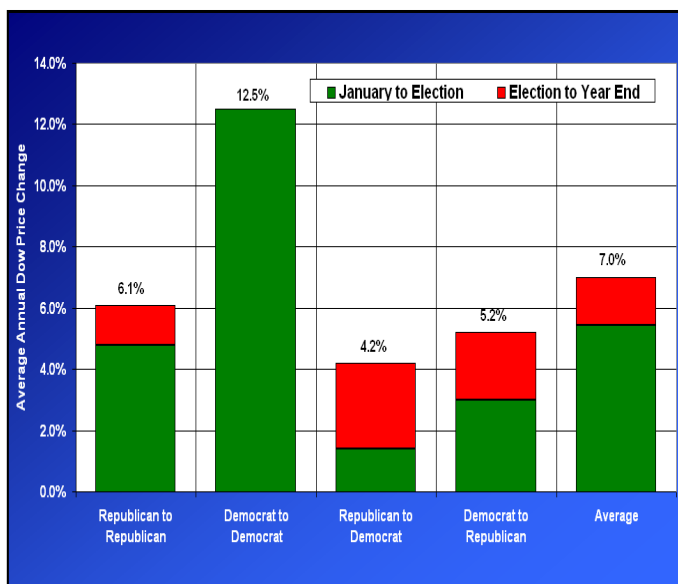
The third year price surge is a recurring phenomenon. Last year's 28% return for the Dow Average was no exception. Between 1945-2003, there were 15 years that represented the third year of a presidential term. There was not a single such year in which the Dow Average declined. Moreover, there were only four occasions in which the Dow failed to attain a double-digit percentage gain (1947, 1971, 1979, and 1987).

Stock price gains decelerate substantially in the last year of the term – the price gain for those years averaged 7.0% (Chart II). Most of those gains occurred before the November elections. However, pre-election price gains seem to be materially impacted by whether the incumbent party is retained or if there is a change in administration.

For example, out the last 14 fourth-year terms, four saw the market decline (1948, 1960, 1984, and 2000). Half of those declines, particularly the steeper ones, occurred when the election year resulted in a change in administrations, both Republican to Democrat and Democrat to Republican.

For election years 1948 through 2000, there were four occasions in which the Republicans were retained in the White House, which would occur again if Bush were to be re-elected. In that case, the pre-election price gain averaged 4.8% with a post-election follow-through of an additional 1.3% for a combined average price gain of 6.1%. There was only one post World War II case when stock prices fell with the retention of the Republican Party, 1984 – a year in which there was a slowdown in the economy.

**CHART II**  
**MARKET RETURNS FOR ELECTION YEARS-**  
**YEAR 4**  
**(1945-2003)**



On the other hand, should the Democrats unseat the Republicans from the White House, the precedent for the stock market is less favorable. In the last 50 years, this occurred only three times. In those years, stocks rose only 1.4% up to the November election. The post-election return was somewhat stronger, averaging 2.8%, for a combined election-year price gain of only 4.2%.

What does this suggest for 2004's stock market? Presidential politics do influence economics and the financial markets. The extraordinary third year returns that investors experienced in 2003 have precedence and investors should look to more modest stock market performance in this fourth year of the term. A close election, which raises the possibility of a change in administration, raises uncertainty and could dampen this year's stock market performance.

**INVESTMENT STRATEGY**

Stocks extended their 2003 gains during the first two months of the year fueled by a decline in interest rates and strong corporate earnings reports. However, in early March valuations reached a level that allowed little tolerance for political uncertainty, escalating energy costs, heightened fears of terrorism, and a lackluster employment environment. As a result, the major stock market indices reversed, in the last three weeks of March, most of the gains achieved earlier in the quarter.

However, the combination of that decline along with strong earnings growth, in effect, made the stock market substantially less expensive than earlier in the quarter. Further double digit gains in corporate earnings, in conjunction with low interest rates, should help support the stock market and enable it to generate an election year return not atypical from the past.

The fixed income markets improved during the first quarter. Interest rates declined in response to continuation of weak employment conditions and affirmation by the Federal Reserve that they will maintain an "accommodative" monetary policy for longer than one would ordinarily expect at this point in the economic recovery. Interest rates, therefore, should remain low over the near-term. Looking further ahead, though, the fixed income markets will eventually be impacted by the expanding Federal deficit, rising inflation rates from escalating energy costs, and an eventual change in Federal Reserve policy towards a less accommodative stance. Thus, the risk in fixed income securities could increase as the economic recovery matures.

As a result, investment strategy for the balance of this year requires close attention to valuations in the stock market to take advantage of market corrections and rallies by increasing and decreasing exposure to equities as appropriate. Stocks should experience considerable volatility as the markets are buffeted by positive news on corporate profitability and economic growth, on one side, and negative news on the Federal deficit and foreign trade, on the other. External shocks such as terrorism as well as prospects for the presidential candidates may, from time to time, add to volatility. At the same time, economic conditions should be carefully monitored for any pressure that may develop on interest rates.

**TABLE I**  
**MARKET PERFORMANCE COMPARISON**

*(Including Interest and Dividend Income)*

*Year to Date\**

MARKET INDEX	12/31/03	3/31/04	Return
Standard & Poor's 500	1,112	1,126	1.7%
Dow Jones Average	10,454	10,358	-.4%
NASDAQ	2,003	1,994	-.4%
EAFE Index	1,289	1,326	3.5%
3 Mth U.S. Treasury Bill	.9%	.9%	.2%
10-Yr U.S. Treasury Bond	4.3%	3.8%	4.5%
10-Yr AAA. Tax-Exempt	3.5%	3.4%	1.7%

\*Estimate