1-1-1983

The Presidential Election Stock Market Cycle Theory: Implications For Future Investment Opportunities

Michael Krauss
Lehigh University

Follow this and additional works at: http://preserve.lehigh.edu/perspectives-v01

Recommended Citation
http://preserve.lehigh.edu/perspectives-v01/2

This Article is brought to you for free and open access by the Perspectives on Business and Economics at Lehigh Preserve. It has been accepted for inclusion in Perspectives on business and economics by an authorized administrator of Lehigh Preserve. For more information, please contact preserve@lehigh.edu.
Few aspects of stock market folklore have intrigued academics and investment advisors more than the "presidential election stock market cycle theory." The theory integrates the political nature of economic activity with its effects on the stock market and basically contends that presidents have learned how to fine-tune the economy for political gain.

According to this hypothesis, upon election a president usually tries to introduce unpopular economic programs which often involve spending cuts or tight money and thereby induces a deflationary phase in the business cycle. Conversely, as the next election approaches, the President (with the help of an accommodating Federal Reserve System) attempts to apply expansionary monetary and fiscal policies, leading to an economic boom. The rationale is that a strong economy in the first half of a president's term serves no political purpose because of the short term memories of voters. On the other hand, stimulating the economy in time for the November presidential election enhances the chances of an incumbent party's victory (Hoey, 1978, p. 194).

According to the theory, the stock market, which is a leading indicator of economic activity, consequently tends to fall during the two years after a presidential election and tends to rise strongly during the two years prior to a presidential election (Hoey, 1978). Although students of the theory have noted traces of a four-year presidential cycle dating back to the 1800s, the cycle has been most evident since 1960, when an active macroeconomic policy became firmly established (Hoey, 1982, p. 3). Furthermore, the cycle has been observed during the terms of Democrats and Republicans alike.
The purpose of this paper is to investigate further the presidential stock market cycle and, in particular, to examine the potential link between the cycle and economic policy. In addition, we will examine the implications of the theory for investor strategy. Investment strategies based on the cycle have often proved profitable in the past. By analyzing the relevant research on this topic, we can gain further insight into this theory, one which has been disputed by academic proponents of the random walk and efficient stock markets hypotheses.

I. EVIDENCE OF THE CYCLE

An examination of the historical rates of return of the stock market, classified according to the stages of the presidential cycle, clearly shows the dominance of neutral or “down” markets in the first half of a president’s term and “up” markets in the second half. The data on stock market rates of return presented in Tables 1 and 2 are derived from the Dow Jones Industrial Average (DJIA) on the last trading day of November. These figures have been computed using yearly percentage price changes in the DJIA, excluding dividends.

Table 1 shows that since 1924, the Dow Jones Average has risen at only a 1.0% (geometric) average growth rate in the two years after a presidential elec-

<table>
<thead>
<tr>
<th>Time period</th>
<th>Returns based on one-year periods</th>
<th>Returns based on two-year periods</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>First year after election</td>
<td>Second year after election</td>
</tr>
<tr>
<td></td>
<td>(year one of cycle)</td>
<td>(year two of cycle)</td>
</tr>
<tr>
<td>1924 to 1982</td>
<td>0.5%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Avg. rate of return</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1943 to 1982</td>
<td>-0.6%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Avg. rate of return</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1951 to 1982</td>
<td>-5.3%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Avg. rate of return</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1962 to 1982</td>
<td>-10.8%</td>
<td>-9.6%</td>
</tr>
<tr>
<td>Avg. rate of return</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
tion but at a 15.7% growth rate in the two years prior to a presidential election. The cycle has grown even more pronounced in recent times. Since 1962, the Dow Jones Average has declined at a rate of 17.6% during the first half of a president’s term, and has risen at a rate of 32.5% during the second half. Furthermore, for the past forty years, the DJIA has always risen in the two-year period preceding presidential elections, with growth averaging 24% over the two-year periods.

Other studies of the presidential election stock market cycle which have used the Standard and Poor’s 500 Index (a much broader barometer of stock market activity) show similar results (Elias, 1982, p. 82). The results do not seem to be very sensitive to the choice of index since Lorie and Hamilton found a very close statistical relationship between the DJIA and the Standard and Poor’s 500 Index\(^1\) for the period 1926 to 1966 (Riley & Luksetich, 1980, p. 543). Moreover, the cycle does not appear to be affected by the party affiliation of the president, the only difference being a slightly better fit for the postelection down periods after Republican victories. Although the stock market movements are more pronounced in the two-year period after a Republican election victory, the latter half of the cycle is similar for both Democrats and Republicans.

Since 1952, as Table 2 shows, during Republican administrations the DJIA has fallen by an average of 0.4% during the two years after an election, while under Democrats the index has risen at a rate of 2.5% for the two-year postelection periods. For the two years prior to elections, however, the index has grown at a rate of 21.4% during Republican administrations, and at a rate of 26.9% during Democratic administrations. During every two-year period before the presidential election, the stock market apparently climbed slowly or receded early in the administration, then sped up as election time neared (Elias, 1982, p. 92).

Returning to Table 1, we present data on the year-by-year average performance of the stock market during each of the four-year periods of a presidential term. The data show that the third year of a president’s term is generally the strongest with respect to the growth of the stock market, with an average gain of 15.9% since 1951. It might be noted that the current year (1983) is the third "third year of the cycle" periods over the past fifty years.

On the other hand, the first year of a president’s term has been historically bearish for the market, with an average annual loss of 5.3% since 1951. In fact, the stock market has fallen in the first year of every Republican administration since Calvin Coolidge (Vartan, 1982). However, an irregularity in the cycle arises, for Democrats have had weakly rising markets in the first half of their terms.

Still other aspects of the cycle show that the relationship between presidential terms and the stock market may be more than coincidental. For example, since John F. Kennedy was president, the DJIA and the Standard and Poor’s 500 have

\(^1\)The coefficient of correlation (r) was .98.
Table 2

Average Rates of Growth in the Dow Jones Industrial Average Over Selected Time Periods During the Presidential Cycle Classified by Political Party

<table>
<thead>
<tr>
<th>Time period</th>
<th>Returns based on one-year periods</th>
<th>Returns based on two-year periods</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>First year after election</td>
<td>Second year after election</td>
</tr>
<tr>
<td></td>
<td>(year one of cycle)</td>
<td>(year two of cycle)</td>
</tr>
<tr>
<td>1924 to 1982</td>
<td>-6.4%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Rep. admin.</td>
<td>Avg. rate of return</td>
<td></td>
</tr>
<tr>
<td>1932 to 1979</td>
<td>6.9%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Dem. admin.</td>
<td>Avg. rate of return</td>
<td></td>
</tr>
<tr>
<td>1952 to 1982</td>
<td>-10.8%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Rep. admin.</td>
<td>Avg. rate of return</td>
<td></td>
</tr>
<tr>
<td>1948 to 1979</td>
<td>6.4%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Dem. admin.</td>
<td>Avg. rate of return</td>
<td></td>
</tr>
</tbody>
</table>

bottomed out in the second year of every administration (Elias, 1982). The August 1982 stock market bottom under Reagan continued this trend. Conversely, since 1960, the Dow Jones has peaked only in presidential election years (Elias, 1982).

II. LINKS TO ECONOMIC POLICY

By way of an explanation for these observed stock market tendencies, Robert Stovall (1974) of Dean Witter notes that every bear market since 1927 began during the first half of presidential terms. Also, from 1927 to 1982, nine of eleven economic declines have begun in the first year of presidential terms. Stovall claims that the cycle has arisen since the “establishment and ascendancy of the Federal Reserve Board” (p. 154). He believes that the Fed tightens monetary policy in order to fight inflation during the first two years of a presidential term, the result being recession and unemployment—the voters’ “greater evil.” The effect is lower levels of liquidity for stock purchases and capital goods spending, decreased fac-
tory output, and lower earnings for corporations. Hence, the stock market falls. Stovall argues, however, that within the twelve calendar quarters prior to a presidential election, the Fed tends to cooperate with the President by following a more expansive monetary policy. This, along with the administration's tendency to also pursue a more expansionary fiscal policy during this period, tends to boost the economy, and the stock market consequently rises.

Other researchers have offered similar reasons to explain the causes of the presidential cycle. For example, Malabre (1977) finds that the first half of the presidential cycle is more pronounced under Republican presidents than under Democratic presidents because the former are more likely to accept recessions early in their administrations. Of the eight U.S. recessions since World War II, six have started with Republicans in the White House. Only the November 1948 and February 1980 recessions occurred under Democratic administrations. A possible explanation for this phenomenon is that early in their terms Democratic presidents prefer to emphasize social programs that increase government spending, reduce unemployment, and stimulate the economy; on the other hand, the Republican presidents are more likely to accept a recession to reduce inflation through cutting the level of government spending.

Martin N. Bailey notes that a major shift in U.S. macroeconomic policy seems to have occurred in the early 1960s. He notes that while all presidents have intervened in the economy to some extent, John F. Kennedy was the first to pursue overt and systematic policies aimed at controlling the aggregate level of economic activity (Allvine & O'Neil, 1980, p. 51). Likewise, Edward Tufte claims that since the early 1960s the economy has been managed so as to expand prior to an election and contract afterwards (Allvine & O'Neill, 1980). If there is indeed such a connection between economic policy and presidential elections, the cycle may exist simply because the markets are reflecting economic activity.

A. Federal Reserve Independence
Critics of the presidential election stock market cycle theory contend that the Federal Reserve System is independent and, therefore, unaffected by the political needs of presidents in setting monetary policy. However, others point to the fact that the chairman of the Federal Reserve System is appointed by the President and, being politically sensitive to the wishes of the President in economic matters, generally "gives the President what he wants" (Elias, 1982, p. 92). It has also been said that the Fed "gets special attention when interest rates are high and an election is approaching" (Fuerbringer, 1982).

On the subject of the Fed and the timing of its monetary policy, Richard B. Hoey (1978) observes that "since the early 1950s, the money supply has generally slowed down after the presidential election. The exceptions were in 1961 and 1977, when the victors in the election won by promising a more expansionary economic policy" (p. 194). He notes further that every credit crunch since 1962
has occurred in the first half of a presidential term. Ritter and Silber (1980, p. 418) observe that since the 1960s there has been a rather clear cause-and-effect relationship between the general stance of monetary policy and movements in stock prices. They show that declines in stock prices were preceded by declines in the rate of growth of the money supply and vice versa. As Robert Stovall (1974) explains:

With a 9 to 12 month lag between expansion of the money supply and its effects on GNP and unemployment, the Fed has tended to reverse policy and to expand the money supply during the second year of presidential terms.

(p. 154)

This is a possible reason why the third year of a president’s term has been so bullish. Stovall (1975, p. 92) says that the Fed has tended to follow an accommodating monetary policy in the 18 months prior to a presidential election with 1960 being the sole exception. Similarly, Dick A. Stoken alleges that "each newly incumbent president has used the economic ammunition available to help him insure that the period prior to the next election is a time of vigorous economic expansion ... which translates into a surging stock market two years before a presidential election" (Elias, 1982, p. 92). Ian McAvity adds that the pattern of expansion and contraction, which seems to have emerged in the late 1920s, became most evident after 1960. Moreover, it has only been broken twice in fifty years: in 1940, when markets were disturbed by threat of war, and in 1960, when Eisenhower decided that he would rather fight inflation than help Nixon into the White House (Anderson, 1982, p. 60).

B. The Political Business Cycle
The rationale for managing economic policy in line with election periods for political gain has been the subject of recent academic inquiry. Duncan MacRae (1977) asserts that the business cycle is politically managed so as to lessen economic evils prior to a presidential election, with the goal of "vote-loss minimization." William Nordhaus (1975), a proponent of the notion of the political business cycle, believes that politicians take advantage of the so-called "Phillips Curve" inflation/unemployment trade-off in the short run. According to Nordhaus, voters are basically myopic and vote on the basis of actual economic conditions prior to the election relative to their expectations. As Nordhaus explains further, "Immediately after an election, the victor will raise unemployment to some relatively high level in an austerity move to combat inflation (which was generated by the previous election dealings). As elections approach, the unemployment rate will be lowered to an optimal point (using economic expansion) by election eve" (p. 184).

Further evidence of possible collusion between the Fed and the presidential administration for political purposes is provided by Tufte (Allvine & O'Neill, 1980). He dates the beginning of conscious attempts to tune the economic cycle to the
election date to Richard Nixon's 1960 campaign. Arthur Burns, then Fed chair­
man, allegedly warned Richard Nixon that unless President Eisenhower took ac­
tion to revive the economy, Nixon would lose the forthcoming election (Allvine & O'Neill, 1980, pp. 51–52). Convinced that Eisenhower's refusal to help him in 1960 was responsible for his defeat, Nixon was intent on managing the economy to win the 1972 election. The sizeable monetary and fiscal boost given the economy by Nixon in 1970–71 to reach the re-election goal is alleged by some to be classic evidence of the true political nature of the Fed. The economy and stock market subsequently boomed, while prices were artificially stable under the wage-price controls instituted in August 1971. After Nixon was reelected, the controls were lifted and the rate of inflation escalated rapidly. The stock market then fell sharply while Burns applied monetary restraint, thus precipitating the 1974 recession—two years after the election.

Other presidents also have learned that if the economy is not stimulated prior to an election, there is a good chance they will not be reelected. For example, Leonard Silk (1982) charges that in the 1976 election year Gerald Ford was at first hesitant to try to expand the economy. A panic about his reelection chances led to an outburst of monetary expansion, but by then it was too late and Ford lost the election (Newton, 1983). Jimmy Carter, upon taking office in 1977, pledged to fight unemployment by stimulating the economy. The resulting inflation led to the nomination of Paul Volker in 1979 to head the Federal Reserve System. By restraining the growth of the money supply, the Fed induced a recession in the 1980 election year. Carter was not reelected.

The experiences of Ford and Carter strongly suggest that the pursuit of a contrary policy approach contributed to their failure to be reelected. Future pres­idents may well realize the cost of neglecting the political business cycle. Since recessions in election years are not politically feasible, the incentive for business cycle management exists.

The 1982 congressional elections again suggest how political actions by the Fed and the administration may have been used to appease voters prior to elec­tions. A White House official has charged that President Reagan lined up new programs aimed at pleasing constituent groups “like a set of Chinese firecrackers . . . planning to pop off in succession in the days before the election” (Weisman, 1982, p. D13). Similarly, one month before the election, the Federal Open Market Committee suddenly abandoned its targets for the money supply (M1) for “technical” reasons. In the months before the November election, M1 had been growing rapidly, increasing at an annual rate of 19%, compared with the Fed’s target range of 2.5% to 5.5% (Clark, 1982). Later, on the same day that the Fed was to announce the worst monthly unemployment rate in forty-two years (10.1%) (King, 1982), the Fed cut the discount rate to 9.5% (Bennett, 1982). This drop in interest rates, combined with money supply measures well above target range, suggests that the Fed may have not only given the economy a “preelection jolt” which sent the stock market soaring, but also may have provided insurance that
expansionary monetary policy would be used to ensure a stronger economic recovery in 1983 and 1984—in time for the 1984 elections.

Reagan’s 1984 budget plan also appears to fit the political business cycle theory well. Leonard Silk has noted that the budget is designed to be stimulative for the next two years. Furthermore, when Treasury Secretary Donald Regan was asked at a budget briefing why the administration had put off its contingency tax increase plan until late 1985, he replied that “1984 is an election year; need I say more?” (Silk, 1983, p. D2). Such events again suggest (but still do not prove) the existence of a politically managed business cycle, one which would explain the causes of the presidential cycle in stock prices.

III. IMPLICATIONS FOR INVESTOR STRATEGY

A. Criticisms of the Presidential Cycle Theory

It should be noted that the presidential cycle theory is at odds with two widely-held alternative theories of stock market behavior. First, the presidential cycle theory violates the popular theory that movements in stock prices are “random, unpredictable, and unexploitable”—the so-called random walk hypothesis (Allvine & O’Neill, 1980). To test the randomness of stock prices, Allvine and O’Neill used a statistical technique called “spectral analysis,” one which is well suited for identifying recurrent patterns or cycles in time series data. They found a statistically significant 208 week (four year) cycle of stock prices (based on the Standard and Poor’s 400) over the period from 1900 to 1978. This cycle coincides closely with the presidential election cycle and thus casts doubt upon the accuracy of the random walk hypothesis.

Another criticism of the presidential cycle theory of stock prices is that it is inconsistent with the “efficient markets hypothesis,” another currently popular theory. This hypothesis suggests that over the long-run the return earned by investors who are holding a group of stocks should equal or exceed the return earned by investors trading stocks according to any trading rule (Allvine & O’Neill, 1980, p. 49). In essence, the efficient markets hypothesis suggests that investors cannot profitably exploit the peaks and troughs of the presidential cycle. However, Allvine and O’Neill have tested a trading strategy which is based on the presidential cycle. With one exception, the strategy has proven profitable, a success record which leads them to doubt whether the stock market has performed in accordance with the efficient markets hypothesis since 1960. The strategy that Allvine and O’Neill tested was developed by David McNeil in 1973. The “switching” strategy, as it is called, consists of holding Treasury bills during the market downturn in the first two years of a president’s term, and then shifting to an “index fund” of stocks during the market upturn in the last two years of a president’s term. Over the period from 1962 to 1981, this “trading on the cycle” strategy has produced an average annual (compounded) return of 14.9% based on the Standard and Poor’s 500 (Hoffman, 1982). This compares favorably with a return of 8.6%
on a “buy stocks and hold” strategy and a return of 5.9% on a “T-bills only” strategy. Allvne and O’Neill found only slightly lower returns after including trans­actions costs and taxes. However, they contend that the stock market is efficient in the long-run, since their trading strategy was less profitable than the buy-and­hold strategy over the 1948 to 1978 period.

B. Short-term Strategies

There are still other aspects of presidential elections which present possible profit opportunities for investors. These, however, do not focus on four-year cycles, but rather on the three- to four-week periods immediately before and after presidential elections. Two such opportunities result from market direction and market volatility.

In the case of market direction, several studies have shown that during the few weeks before and after presidential elections, the stock market “prefers” Republicans (Riley & Luksetich, 1980, p. 541). Niederhoffer, Gibbs and Bullock (1970) have tracked the course of presidential elections and the stock market over the period from 1900 to 1968. They found that the market tended to rise in the day, the week and the month immediately following a Republican victory and conversely tended to fall in the day, the week and the month following a Democratic victory (Riley & Luksetich, 1980). They also noted a direct relationship between the size of the change in the DJIA the day before the election and the size of the winning margin of the victor. Similarly, Reilly and Drzycimski found that for elections between 1940 and 1972 stock prices have generally risen in the weeks after presidential elections, with the largest increases occurring after Republican victories (Riley & Luksetich, 1980). Finally, the observations of Riley and Luksetich (1980, p. 553) have lent support to those of Niederhoffer, Gibbs and Bullock. Riley and Luksetich have hypothesized that the market “dislikes” uncertainty and thus declines prior to an election and rises after the election with the removal of uncertainty. In addition, Riley and Luksetich have developed a set of short-term trading strategies based on their observations. I have simplified and summarized their strategies below:

*The first two trading rules require action on the assumption of perfect foresight about the election winner:*

1. If a Republican victory is anticipated, buy stocks one month before the election and sell one month after.
2. If a Democratic victory is anticipated, sell short one month before the election and cover your position one month after the election.

*The last two trading rules require action on the basis of actual election results:*

3. If a Republican wins the election, buy the day after the election and sell one month later.
4. If a Democrat wins the election, sell short the day after the election and cover one month later.
Riley and Luksetich have found these trading rules to be profitable under the assumption of zero transactions costs. Further study is needed, however, to see if these strategies can be profitably exploited after transactions costs are taken into account.

As previously mentioned, another set of profit opportunities stemming from the election cycle involves market volatility. Riley and Luksetich (1980, p. 555) showed that the stock market exhibited significantly more variability during the few weeks before and after presidential elections (although the volatility was greater in the case of Republican victories than in Democratic victories). Since the risk/return framework suggests that risk rises with increased returns, the variability during these “profitable” periods should be greater than in similar nonelection periods, since variability is an extension of risk. The possible profit opportunities involve options strategies that become profitable in periods of increased market volatility—such as election periods. The options could either involve options on stock market index futures or options in “market-type” stocks (e.g., IBM or GM). The first possibility is the purchase of a straddle, where one buys a “call” (an option to buy a stock or index at a specified price) and buys a “put” (an option to sell the same) on the same stock or index. The key to profitability is not the direction of the underlying stock, but increased volatility. The straddle should be purchased one month before the election and sold one month after the election. Alternatively, the purchase of a “butterfly spread,” which also is based on volatility, might be considered. This strategy is much more complicated and involves the purchase of two call options on a stock or stock index at a “medium exercise price,” and the simultaneous selling of both a “low exercise price” and a “high exercise price” call option. The exercise price is the price at which the underlying stock may be purchased or sold on or before the option’s expiration date.  

These strategies may prove beneficial to short-term oriented traders, but they are also risky and involve much leverage. However, they are interesting from a theoretical viewpoint and warrant further research on the topic of presidential election stock movements and volatility.

Interestingly enough, prior studies have shown that the market rises in the few weeks after a Republican victory, and falls in the few weeks after a Democratic victory. However, over the entire four-year cycle, we have seen that the stock market consistently performs much worse in the two years following a Republican victory than a Democratic victory. The jubilation of the market in the few weeks after a Republican victory (possibly because it is the party most in line with “business interests”) is thus short-lived.

---

IV. THE CYCLE AS A “SELF-FULFILLING PROPHESY”

Finally, aside from the political business cycle explanation, it may be that the presidential cycle exists simply because people have rational expectations that economic fine-tuning is taking place. Moreover, investors may simply move the market because they are informed of academic literature on the presidential cycle and expect it to continue. For example, a widely reported feature in a recent Standard and Poor’s “Outlook” (1982, p. 476) on the presidential cycle further increased public awareness of investing according to election periods and is believed to have added significant impetus to a major stock market advance in the three days after its distribution. The report showed that since 1950 the stock market has always risen in the 14-month periods following the midterm elections (e.g., 1982), regardless of the outcome. The article added that the average October 31 to December 31, 14-month gain was 24.4%. The report was distributed on the second day of a four-day rise which sent the DJIA from 995 to 1065. Analysts cannot determine how much of the record 43.41 DJIA advance on November 3, 1982 resulted from the Standard and Poor’s article. Hence, there might be a “self-fulfilling prophesy” element about the presidential cycle. Information on the cycle will be both immediately discounted in stock prices or ignored, only to be acted upon later. Consequently, there arises the question as to whether the cycle will be discounted much earlier as investor awareness and knowledge of the cycle increases. Nevertheless, if economic conditions continue to improve before presidential elections and deteriorate afterwards, the cycle should recur in the future—leading to further suspicion about a political business cycle that is managed to minimize vote loss.

V. CONCLUSIONS

As we have seen, the presidential election stock market theory has been a powerful, yet imperfect, indicator of stock index movements since 1960, when the age of “political-economic fine-tuning” is alleged to have begun. Although this paper does not present concrete proof that there is a political nature to business cycles, the movements of the stock market and the economy both before and after election periods may well be more than coincidence. The connection between monetary and fiscal policy, stock prices, and elections is an area that needs further study so that the link between policy and the cycle can be elucidated. Until the notion of a politically managed business cycle geared to election periods is formally disproved, however, investors should be aware of the cycle when making market timing decisions.
APPENDIX

FURTHER OBSERVATIONS ON THE CYCLE
WITH PREDICTIONS FOR THE FUTURE

A slight weakness in the cycle occurs in the two-year period after the presidential election, when markets should fall according to the theory. However, such declines occur most often during Republican administrations. Nevertheless, history has shown that the few instances of market rises in Democratic periods have been of relatively small magnitude compared to the gains seen in the two-year periods before the presidential elections. Investors should also notice that these two-year periods prove to be truly marked phases of the cycle that have occurred under both Democratic and Republican administrations since 1924. At the time of this writing, we are in this very phase as the 1984 election approaches. Hence, the theory predicts that the stock market will rise strongly until November 1984. Therefore, investors considering a “stocks and T-bills” strategy should now be fully invested in the stock market.

A flaw in this strategy surfaced in 1982, however. Investors who held T-bills since November 1980 did well, as the market fell 13% in the subsequent 21 months. Yet, these investors would have missed the market’s explosive 29% three-month upward movement after August’s 777 DJIA bottom. This surge gave the index a 13% gain in the two years after the 1980 election, which is contrary to the theory of the presidential cycle. However, this gain may seem small compared to the market rises we can expect in the next two years (1983-84) if the cycle behaves as it has in the past.

The presidential cycle looks bullishly on target for the period before the 1984 election. As the theory would predict of a Republican administration, Ronald Reagan accepted the current recession in his first year in office—a period during which the Dow Jones fell 10.5%. The Fed’s current monetary expansion may well be evidence of the administration’s goal of insuring an economic recovery in time for the next presidential election. In 1983, the third year of Reagan’s term, we should see a peak in unemployment, increased profit levels, and a much higher stock market—all favorable to voters. Fundamentally, economists are estimating that the forthcoming economic recovery will be relatively weak. However, in response to the length and severity of the current recession, some companies have cut unnecessary costs and closed inefficient plants. Hence, with higher net profit margins, U.S. corporations could show sharp earnings gains despite a slow recovery. The stock market, in turn, should rise sharply once these gains are realized, possibly making this bullish phase of the presidential cycle self-fulfilling.

In fact, the current positive presidential cycle stage shows only one aspect of what many Wall Street observers are calling one of the great bull markets since World War II. MIT Professor Franco Modigliani predicts the Dow could approach the 2,000 level by 1985 (Anderson, 1982, p. 60). He notes that the DJIA, adjusted for inflation, would have to more than double to equal its levels of a decade ago.
John Templeton, in a recent business telecast, noted that past bull markets peaked near the asset replacement value per share of the Dow Jones Average. He calculated 1,700 as the current replacement value. Similarly, Arthur Merrill (Financial News Network, December 31, 1982) in his study of 17 bull markets since 1900, found that the average bull market rose 89% and lasted 28 months. Extrapolation would thus put the Dow Jones Average at 1,469 in December 1984. The estimate may be high since the market trend has been upwards since 1900. However, the time frame would coincide with the presidential cycle notion that markets peak in presidential election years. The history of the presidential cycle since 1962 shows an average 32.5% DJIA rise in the two years before a presidential election. Using this, I thus forecast a DJIA of 1,300 by election day in 1984 and believe the actual number will be in a range between 1,150 and 1,500, barring a Third World debt repudiation or an OPEC price-cutting war.

REFERENCES


King, S. S. “Jobless Rate is up to 10.1% in Month, Worst in 42 Years.” The New York Times, October 9, 1982, p. 1.


