



# Weekly Market Commentary



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## The 2012 Election is Very Consequential for Investors

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#### Highlights

As September draws to a close, we are ending what has traditionally been the best four-quarter period for stocks during the four-year Presidential cycle.

Since World War II, the stock market has always posted a double-digit gain from the end of the third quarter of year two to the end of the third quarter of year three of the Presidential cycle. To retain that spotless track record the S&P 500 would need to post a gain of 3.5% in the next two weeks.

As we look out to next year's elections, the party that gains control will forge the decisions that will represent one of the biggest shifts in the federal budget policy since WWII with profound impacts for investors.

Last week, seeking to avoid a government shutdown, the House Appropriations Committee introduced a Continuing Resolution (CR) for fiscal year 2012, which begins on October 1, 2011, that would fund government agencies through November 18, 2011. Last year, the first of seven CRs extended government funding until December 3. The final fiscal year 2011 Appropriations Act was signed by the President on April 15, 2011, when the fiscal year was over half finished. The markets disliked the uncertainty and the bickering among a divided Congress.

As September draws to a close, we are ending what has traditionally been the best four-quarter period for stocks during the four-year Presidential cycle. As we noted a year ago, since World War II, the stock market has always posted a double-digit gain from the end of the third quarter of year two to the end of the third quarter of year three of the Presidential cycle. To retain that spotless track record the S&P 500 would need to post a gain of 3.5% in the next two weeks.

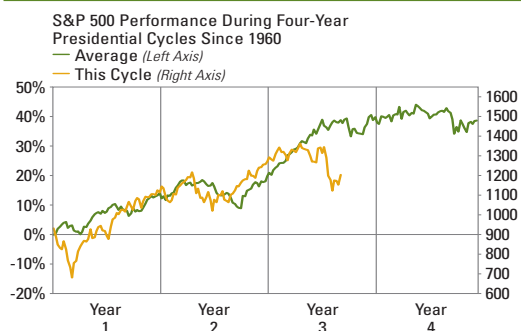
Historically, the Presidential cycle of stock market performance has been driven largely by changes in monetary and fiscal stimulus to the economy. These changes are evident again in this cycle. In fact, the S&P 500 has once again traced much of its average performance during the Presidential cycle, as you can see in [Chart 1](#).

However, there has been a deviation from the pattern with the decline in stocks over the past couple of months. We believe stocks have potential to close this gap in the coming months as stocks reverse recent losses to post a modest single-digit gain for the year.

As we look out to the next year, it would seem that a flat year for stocks is in store, based on the Presidential pattern. However, what this average chart does not show is that while it is true the first three quarters of a Presidential election year are usually pretty flat, the fourth quarter is not and tends to break out to the upside, as it did most recently in 1992, 1996, and 2004. Or, it breaks out of the range to the downside, as it did in 2000 and 2008, as you can see in [Chart 2](#).

Most often the breakout is to the upside as the uncertainty surrounding the fiscal policy and regulatory policy environment resolves; however, 2008's dismal fourth quarter performance—as the global financial crisis erupted from the failure of Lehman Brothers—lowered the long-term average to reflect a fourth quarter dip, as you can see in [Chart 2](#).

#### 1 Presidential Cycle Pattern of Performance

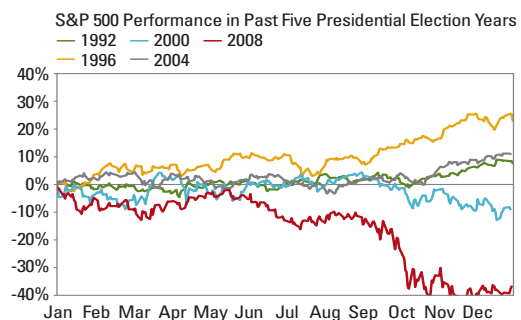


Source: LPL Financial/Bloomberg Data 09/18/11

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.



## 2 Recent Presidential Year Performance



Source: LPL Financial/Bloomberg Data 09/18/11

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The 2012 election is likely to be consequential for investors. There is a growing consensus that a plan to save about \$4 to 5 trillion over the next decade is necessary to stabilize the debt-to-GDP ratio in the United States. Despite the efforts of the “super-committee” tasked with finding the \$1.5 trillion agreed to in the terms of the debt ceiling deal crafted in early August, a package this size is unlikely to become law before the election.

Since Congress is unlikely to pass a major deficit reduction bill before the 2012 election, the outcome will have major implications for investors. The party that emerges in control following the November 2012 elections will forge the decisions that will represent one of the biggest shifts in the federal budget policy since WWII.

Failure to pass a major deficit reduction package in the wake of the 2012 election, regardless of what the rating agencies do, will likely result in a loss of faith by investors that the federal government will get on a fiscally sustainable path absent a financial crisis. Of course, this loss of faith would help to produce the crisis, with major implications for the markets, and force a major deficit reduction deal.

Regardless of the details of the plan—and we have many proposals to choose from that blend a mix of tax increases and spending cuts—most proposals phase in the impact so that it is not until five years from now that the full impact would be felt. The cuts would likely be equivalent to about 3% of GDP, or about 14% of the federal budget. This would be one of the biggest policy shifts in modern U.S. history. While the markets may welcome a resolution of the uncertainty and a path to fiscal sustainability, certain sectors may feel the brunt of the cuts, such as Health Care and the Defense industry. Other asset classes may be impacted as well if changes are made to the tax-advantaged status of municipal bonds for some taxpayers.

As we look out to the next few years, the old adage that the market likes “gridlock” or balanced government between the two parties may not hold. It is apparent in recent market performance that investors recognize that substantial, defining fiscal policy changes—difficult to forge in a divided Congress—are needed. We will be watching as the election battle heats up—the first presidential primaries are only four months away—to gauge the market impact of what will likely be a very consequential election year.



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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Debt-to-GDP is a measure of a country's federal debt in relation to its gross domestic product (GDP). By comparing what a country owes and what it produces, the debt-to-GDP ratio indicates the country's ability to pay back its debt. The ratio is a coverage ratio on a national level.

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