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President

Outlook for 2011:
A Pre-election Year

November 2010

Despite the gradual economic recovery, investors have found it difficult to shake off the negative bias that has built up toward the stock market during these last ten difficult years. Is there anything out there that can reverse the market psychology? There is: **2011 is a pre-presidential election year**.

S&P 500 data going back to 1933 shows that the pre-election year is the strongest by far for the stock market in the presidential election cycle. Year One averages a +1.6% gain. Year Two, +4.0%. Year Three *(the pre-election year),* +10.5%. Year Four, +5.8%.

The table below shows that the pattern is especially dramatic when a first term president enters a pre-election year, which is, of course, what we have next year.

S&P 500 Performance in Year Three of a First-Term President

	Year	Return
Franklin Roosevelt	1935	41.4%
Dwight Eisenhower	1955	26.4%
John F Kennedy	1963	18.9%
Richard Nixon	1971	10.8%
Jimmy Carter	1979	12.3%
Ronald Reagan	1983	17.3%
George H. Bush	1991	26.3%
Bill Clinton	1995	34.1%
George W. Bush	2003	26.4%
Barack Obama	2011	--

Source: Strategas, 09/08/10

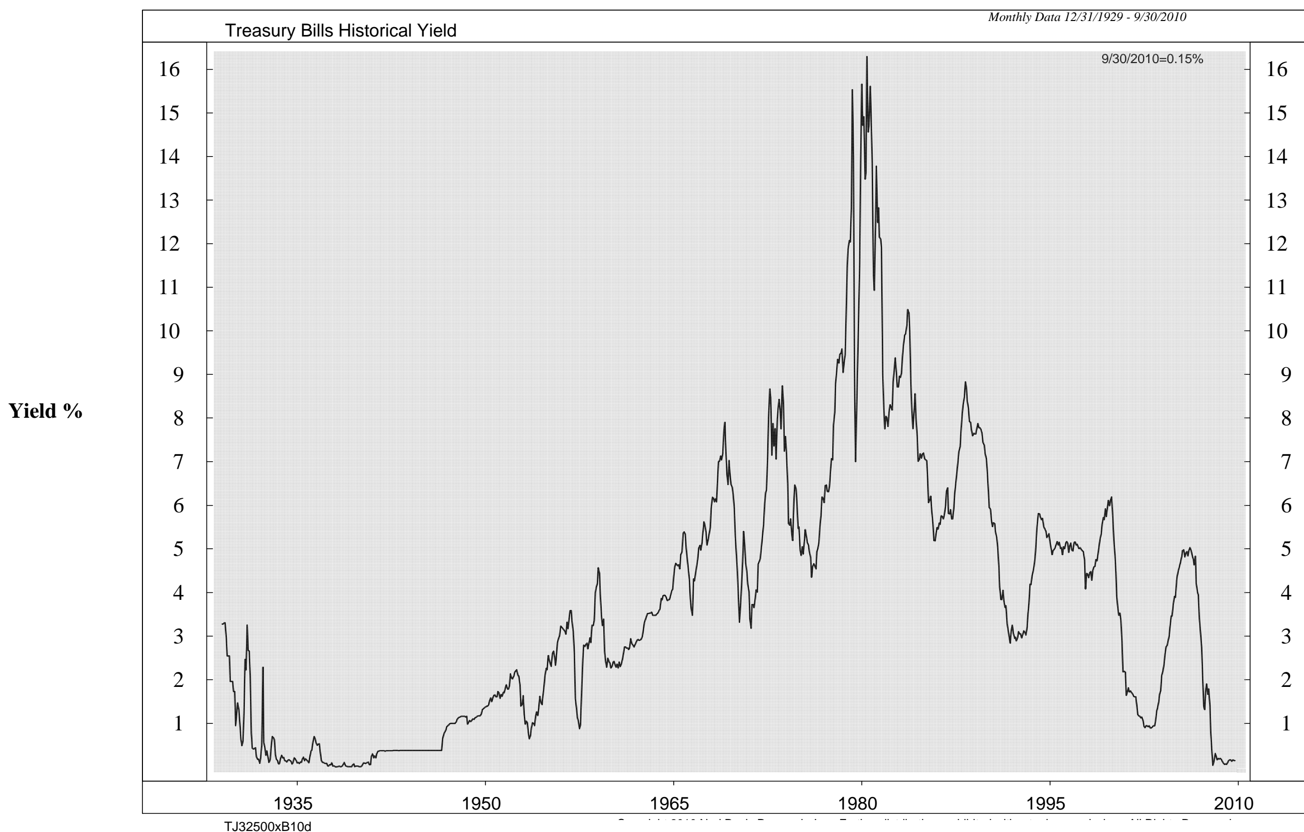
Not Just a Coincidence

While our presidents from Roosevelt to Obama have not always been competent diplomats or generals, there is one thing in which our presidents have demonstrated great skill: they're proven experts on how to get elected. **Things got started when John Maynard Keynes advised FDR that the key to getting re-elected was a strong economy. And the key to a strong economy was powerful fiscal and/or monetary stimulus.**

Our presidents also knew that it was important to get started early because it takes economists, not to mention the public, a long time to conclude whether or not the economy has come out of a recession. George H.W. Bush, for example, lost his re-election bid to Bill Clinton, who ran on the slogan, "It's the economy, stupid." But a week after the election, economists in the Bush administration announced that the Bush recession had actually ended a year before Clinton won in November 1992.

Yields at Record Lows

The money flows out of stocks and into fixed income -- one of the most dramatic in market history -- have produced bond yields at the lowest levels in 50 years. The phenomenon resembles the Tech Bubble of 2000 when investors were throwing their money at tech stocks that showed the highest valuations ever. Investors were then too optimistic about stocks and too pessimistic about bonds. Today, the situation is completely reversed.



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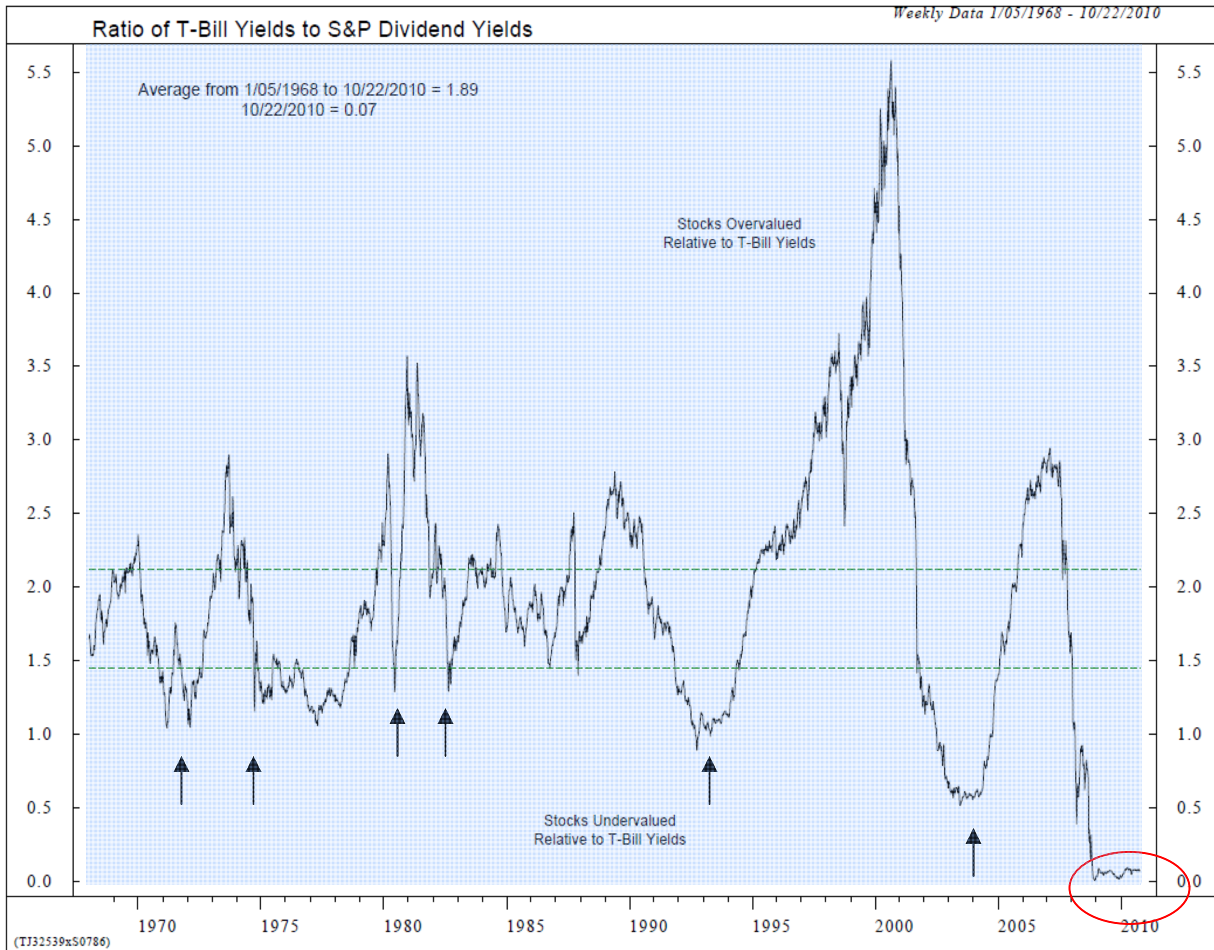
Bond Yields Vs. Dividend Yields

Not only are bond yields low, they are low relative to stock dividend yields. The chart below shows that all the low points in the past 40 years (when bond yields were at or below dividend yields) were signals for long term value investors to buy stocks. Today, equities are even more undervalued. The table below the graphs shows the 5-year returns for value from those lows.



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Returns for Value Stocks after T-Bill Low Yields

Year	Annualized Returns Bottom 20% by P/E
1971-75	12.4%
1975-79	34.3%
1981-85	26.5%
1983-87	18.9%
1992-96	17.9%
2003-07	17.3%
2010-14	-

Source: S&P 500/SCCM, 12/31/09

Trading Range: Advantages of Long-Term Investing

We have often advised investors to use rolling 5-year periods to measure performance. We have also showed investors that the best 5-year periods for returns tend to come, not surprisingly, when one starts investing in the middle of a recession. But with the current recession declared officially over, we have been looking at the behavior of typical post-recession markets. Here is what has happened in the past:

First, there's the big and surprising bounce off the bear market lows. This produces a 50% to 100% gain over a six to twelve month period, during which speculative fever runs high and the market is driven by short covering like last year, which is what we saw last year.

Next, there is the period like the one in which we presently find ourselves, which features a trading range that takes many forms and tends to last for at least six months and possibly a year or more. The economic news is still bad, though companies and earnings have started to do better. As in the past, we would expect that the market would eventually break out of the trading range and into a new up cycle**. All of a sudden the comfort of cash and bonds doesn't feel so good.**

So the question becomes, once the recession ends and the recovery has begun, is it too late to buy stocks? The question led us to look at the relevant rolling 5-year periods to find out what happens if one started to invest a year after a recession ended. Was there a big difference in performance? The surprising answer was that it didn't make much difference for value investors. (See page 6 for all rolling 5-year periods, including those periods that begin with a recession year.)

Recession Period	Market Low	Recession Ended	Months Between Market Low and Recession End	5 yr Period Starting a Year After a Recession Ended	Annualized Performance
1969-70	06/70	01/71	7	1972-76	**+17.8%**
1973-74	11/74	05/75	6	1976-80	**+24.7%**
1981-83	09/82	12/82	3	1984-88	**+18.2%**
1990-91	10/90	01/91	3	1992-96	**+17.9%**
2001-02	10/01	01/02	3	2003-07	**+17.3%**
2007-08	03/09	06/09	3	2010-14	**-**

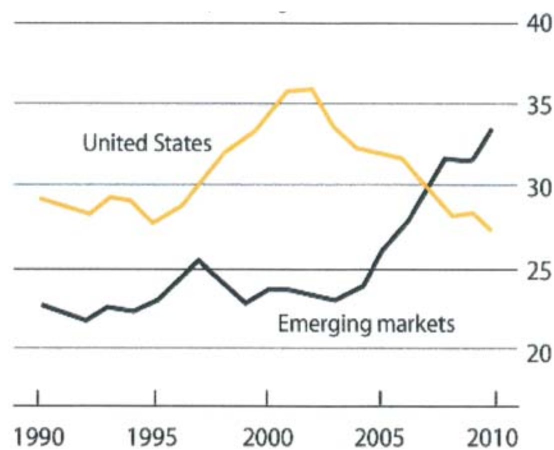
Source: S&P 500/SCCM, 12/31/09

The Current Recovery

Many economists have labeled the current recovery as weak, but in fact, **corporate profits have recorded all-time record highs, and we have witnessed one of the fastest profit recoveries of the post-war era.** [1]

How did this happen? Corporate earnings have been stronger than Gross National Product (GNP) growth because corporate America has been selling into the global marketplace. The dramatic and telling chart below compares emerging market consumer spending against U.S. consumer spending as a percent of the world total.

Consumer Spending % of World Total



Source: JPMorgan Chase, 03/31/10

Summary

With stocks attractively priced relative to bonds and with plenty of money on the sidelines, the stage is set for a strong pre-election year in the market.

In fact, the day after the midterm elections, Ben Bernanke, with great fanfare, announced a stimulus package consisting of $600 billion of quantitative easing. So it appears that the Administration has already started rolling Obama's pre-election band wagon.

Finally, emerging markets have helped to boost corporate earnings, but those markets are also volatile. Accordingly, the long-term investor, now more than ever, should stick to the disciplines of price to earnings, price to book, and dividend growth.

-James P. Cullen
President

[1] New York Times, November 23, 2010

Period	S&P 500 Bottom 20% by P/E	Period	S&P 500 Bottom 20% by P/E
1968-1972	**9.7%**	1987-1991	**10.5%**
1969-1973	**0.0%**	1988-1992	**15.4%**
1970-1974	**1.1%**	1989-1993	**14.5%**
1971-1975	**12.4%**	1990-1994	**10.1%**
1972-1976	**17.8%**	1991-1995	**23.2%**
1973-1977	**17.0%**	1992-1996	**17.9%**
1974-1978	**24.7%**	1993-1997	**22.0%**
1975-1979	**34.3%**	1994-1998	**17.8%**
1976-1980	**24.7%**	1995-1999	**18.2%**
1977-1981	**18.2%**	1996-2000	**13.9%**
1978-1982	**22.2%**	1997-2001	**13.3%**
1979-1983	**24.5%**	1998-2002	**4.7%**
1980-1984	**26.1%**	1999-2003	**12.1%**
1981-1985	**26.5%**	2000-2004	**16.0%**
1982-1986	**27.6%**	2001-2005	**15.4%**
1983-1987	**18.9%**	2002-2006	**16.0%**
1984-1988	**18.2%**	2003-2007	**17.3%**
1985-1989	**16.3%**	2004-2008	**-2.6%**
1986-1990	**6.1%**	2005-2009	**4.0%**

Source: S&P 500/SCCM, 12/31/09

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