October 2012

The 2012 Election: Something's Gotta Give

"Contradictions do not exist. Whenever you think you are facing a contradiction, check your premises. You will find that one of them is wrong." --Ayn Rand

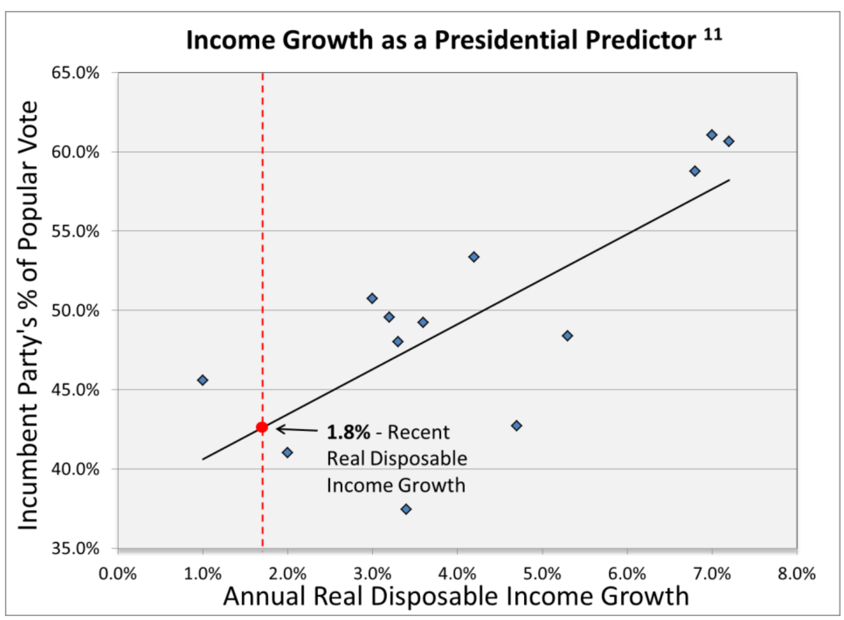
Merely weeks before the 57th presidential election, contradictions between economic data and stock market performance abound. For months, or really even years now, pundits and analysts have droned on and on about who will win the Oval Office in November. Ultimately, however, talk is cheap, and the aforementioned economic and market contradictions make handicapping this election a lot like a Las Vegas odds-maker trying to handicap a pee-wee football game; all bets are off. While statistics can be manipulated to say just about anything, the fact is that both real disposable income growth and short-term stock market performance leading into Election Day, commonly referred to as the "recency effect," have historically served as amazingly accurate predictors of the ultimate winner. No matter who wins, on the morning of November 7th, at least one long-established predictor of a presidential election will be debunked when the results are announced, and some economic analyst somewhere will be sorely disappointed that his election theory was proven to be flawed.

Since Eisenhower was President, the U.S. has not seen an incumbent re-elected when income growth was below 3%.[1] Similarly, over the past 100 years, the stock market recency effect has demonstrated a remarkable 82% accuracy in picking the winner, correctly calling 23 out of 28 of the past elections when an incumbent was up for re-election.[2] What makes this election unique is that real income growth sits at 1.8 % through the end of August, well below 3%,[1] and the stock market has been the definition of resilient, with the S&P 500 being up 4.4% since the beginning of August and 14.5% year-to-date, both as of October 15th.[3] So, it's not just Romney versus Obama in the election, but also income growth versus the stock market this time around.

> "If the economy is flourishing in the final weeks of a campaign, when the music stops, the incumbent is likely to be re-elected."
> *--Louis Uchitelle*[4]

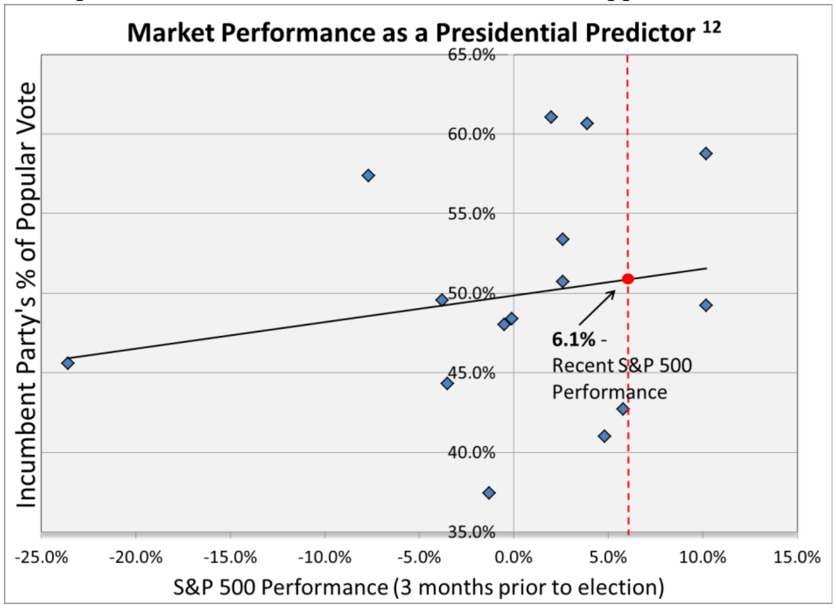
In the Red Corner

Viewing the election first through an economic lens, it doesn't take a rocket scientist to draw the conclusion that a good economy is good for an incumbent and vice versa. As *New York Times* writer Louis Uchitelle succinctly stated, "If the economy is flourishing in the final weeks of a campaign, when the music stops, the incumbent is likely to be re-elected."[4] Currently, the domestic economy, like the melodious sound of a beating heart, is faint at best. Only one incumbent, Eisenhower in 1956, won with an economy growing slower than the tepid 2.1% GDP is currently.[5] The number of part-time workers who cannot find full-time employment grew in September to 8.6 million, from 8 million.[6] Even the recently improved unemployment rate of 7.8% is the worst rate of any incumbent's in more than 50 years.[5] However, the economic indicator that seems to be the most accurate predictor of who will be president is real disposable income growth which is the best evidence that voters do in fact vote with their pocketbooks. Inflation-adjusted after-tax income growth of about 3-4% appears to be the threshold for an incumbent to receive 50% of the popular vote. Currently, real income growth is hovering around 1.8%,[1] this does not bode well for President Obama. For the Las Vegas odds-maker scoring at home, **ADVANTAGE ROMNEY**.



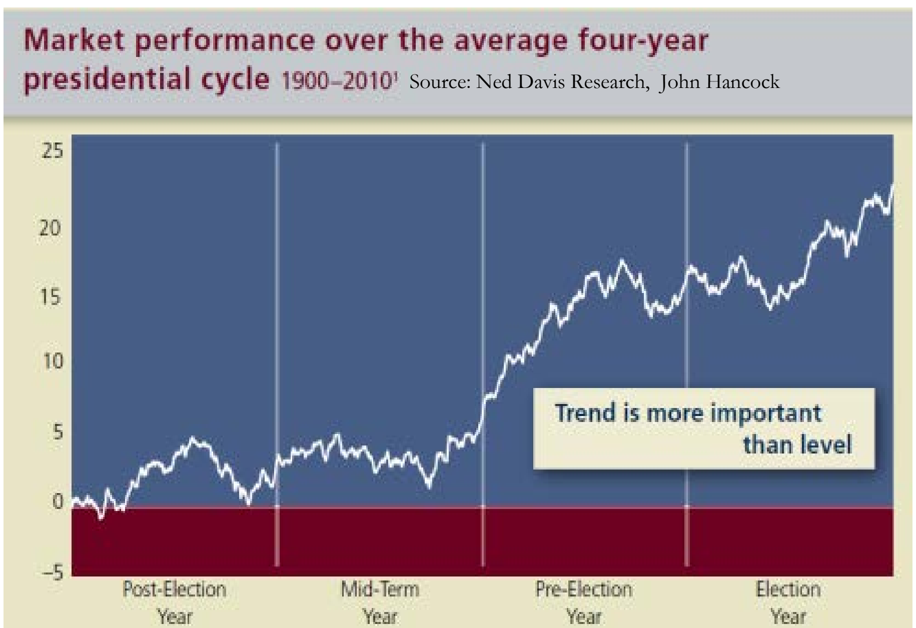
In the Blue Corner

As with the macro economy, it is similarly logical that a good stock market would be good for an incumbent seeking re-election. When viewing the election through such a market performance lens, what a slam-dunk it would appear to be for Obama. The market has performed better during Obama's tenure in office than in any of five prior administrations and also outperformed most major world indices.[7] Since Obama assumed office on January 20, 2009, the S&P 500 is up a whopping 78.8% through October 15.[3] Of course, it didn't hurt that Obama took office following one of the biggest market selloffs in history and that markets were due for a rebound. Further, as the Beatles would say, the stock market 'got by with a little help' from its friend - the "friend" being the Federal Reserve and its record-low interest rates, cheap financing and endless bag of quantitative easings. Nonetheless, it's hard to argue with the numbers on an absolute basis, and the trusty Las Vegas odds-maker would have to score this one as a big, **ADVANTAGE OBAMA**.



Hocus POTUS

As tempting as it may be to try to dissect and handicap a presidential election based on statistics alone, doing so often proves to be a fool's errand. Politics, economics and market behavior all have one thing in common; all three have an infinite number of moving pieces. Take for example, the election cycle theory popularized by Jeffrey and Yale Hirsch in the *Stock Trader's Almanac* which points out that election years in general are traditionally "up" years in the stock market regardless of the candidates or which party is in power.[8] In fact, the seven months leading up to a presidential election have seen gains in the S&P 500 in 13 of the 15 presidential elections since 1950.[8] With that being the case, does it really make any sense to reward, or punish, any specific incumbent for what may very well be a cyclical phenomenon to begin with? This is just one of countless examples illustrating the difficulty of reading the election tea leaves.

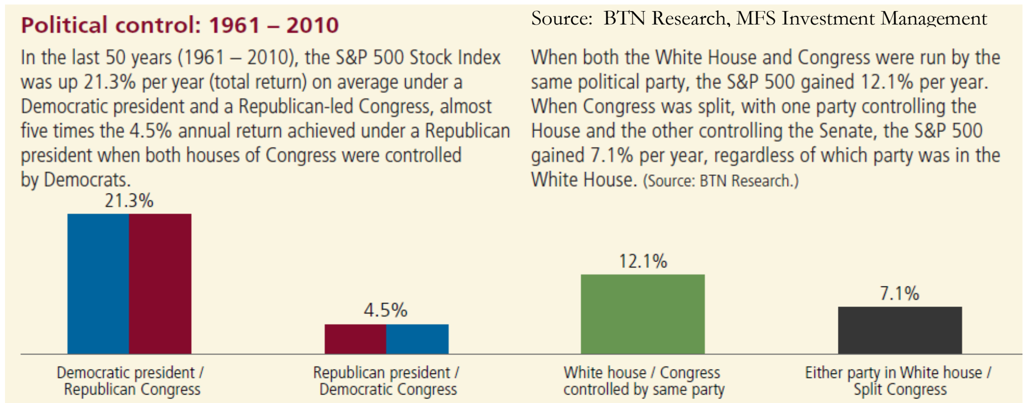


When the Music Stops

All of this election analysis begs the question, what do these statistics and correlations say about market performance (and more specifically individual portfolio performance) going forward? After all, it is for the effect not the cause that people attempt to handicap such things as elections in the first place. Referring back to the research of Hirsch and Hirsch in the *Stock Trader's Almanac*, quite a number of interesting relationships exist between the stage of a presidential cycle and corresponding market performance. Their research concluded that wars, recessions and bear markets typically coincide with the first half of a presidential term, while prosperous times and bull markets coincide with the latter half.[8] In their *2012 Mid-Year Outlook*, LPL Financial supported this thesis by demonstrating that 16 of the 20 down years since 1940 came in the first or second year of a presidential term. LPL Financial went on to state that, "A key reason for this historical pattern of stock market performance during a presidential term is the greater amount of economic stimulus, in the form of both monetary and fiscal policy, applied during year two and three, which then begins to fade in year four. Since this stimulus affects the economy with a lag of around a year, stock market performance tends to follow this pattern of stimulus, leaving years one and two paying the price for the better years three and four leading up to the election."[9] So unfortunately, history does not appear to be on the side of investors in the aftermath of a presidential election.

Perfect Recipe or Molotov Cocktail?

Whether this time will be different is yet to be seen. Considering the number of economic hurdles remaining, don't be surprised if it is not. Besides, given that partisanship in Washington is unlikely to subside any time soon and that there are a number of large, looming issues such as the impeding fiscal cliff, it would not be a stretch to argue that it is actually Congress and the mix within that matters as much or more in the first place. In fact, there is actually a plethora of data to support this idea. According to an academic study in the *Global Journal of Business Research* titled "The Effects of Congressional Elections on Future Equity Market Returns", the authors find that "when Republicans control both the Office of President and Congress, expansion may be too slow; moreover, when Democrats are in control of the Office of President and Congress, the economy may expand too quickly leading to inflation."[10] So, considering the outcome of the presidential election in isolation would provide an incomplete analysis.



And the Magic Eight Ball Says…

Whatever the outcome of the election, the strategy of Doucet Asset Management that has been in place for most of the year remains intact. We continue to believe that the most prudent course of action is to maintain a defensive position in our client portfolios. As such, we have strategically positioned portfolios to survive the worst, while maintaining enough dry powder in the form of cash and short-duration fixed income securities to take advantage of opportunities as they arise. And encouragingly, we feel strongly that opportunities are coming and in the not too distant future. The overall economy is indeed showing modest signs of improvement; however, it remains very fragile. The stock market continues to price in the signs of improvement, yet ignore the fragility. In a lot of ways, it has been a classic "melt-up" scenario, where investors have poured money into the market for fear of missing out on its rise rather than based on sound fundamentals. This scenario is often a dangerous one, as melt-ups are often followed by melt-downs.

Our strategy in equities has been to fight the urge to jump on the bandwagon by growing our purchase wish list and remaining vigilant about purchase price targets. At some point, we feel a slowdown in corporate earnings coupled with the coming fiscal cliff will prove too strong a force to be counteracted by the money printing policies of the Fed. As for fixed income, non-agency mortgage-backed security spreads have narrowed dramatically over the course of the year, to the tune of 500-600 basis points. As a result, we have seen the mortgage-backed security *Window of Opportunity* highlighted in March has all but closed. We have, therefore, been a net-seller in the sector and have focused on taking gains and re-deploying capital towards more conservative, short maturity investments in pre-refunded and escrowed-to-maturity municipal bonds. We continue to recommend a cautious, opportunistic approach to finding relative value as opposed to going "all-in".

Sincerely,

Chris L. Doucet

Chris L. Doucet
Chief Executive Officer

Firm News

Doucet Asset Management is pleased to announce that Will Aycock, our Fixed Income Analyst, successfully completed the third exam and is now recognized as a Chartered Financial Analyst®. In order to earn the CFA® designation, candidates must complete three levels of testing over a minimum three year period.

We are further pleased to announce that Laura Vaughn, our Equity Analyst, recently successfully completed the Certified Financial Planner ™ exam.

Congratulations to Will and Laura!

Footnotes

[1] Bureau of Economic Analysis, Table 2.6 - Personal Income and Its Disposition, Monthly

[2] Sam Stovall, "The Presidential Predictor", S&P Capital IQ, July 30, 2012

[3] Yahoo! Finance, S&P 500 Historical Prices (http://finance.yahoo.com/q/hp?s=%5EGSPC+Historical+Prices)

[4] Alexis Simendinger, "Obama's Chances Could Turn on One Key Indicator", Real Clear Politics, October 7, 2011

[5] "Predicting Re-elections", The Economist Online, October 11, 2012

[6] Kiplinger, *Economic Outlook*, October 15, 2012 (www.kiplinger.com/businessresource/economic_outlook/)

[7] Robert Hum and Giovanny Moreano, "Guess Which President Has Been Best for Stocks?", (www.cnbc.com/id/48940520/Guess_Which_President_Has_Been_Best_for_Stocks)

[8] Jeffrey A. Hirsch, Yale Hirsch, *Stock Trader's Almanac 2012*, (New Jersey: John Wiley & Sons, Inc., 2012)

[9] *Mid-Year Outlook 2012*, LPL Financial Research (www.lpl.com)

[10] Vincent Louis Ovlia, David Enke, Michael C. Davis, *The Effects of Congressional Elections on Future Equity Market Returns*, (http://ssrn.com/abstract=1543439)

[11] Chart Source Data: Bureau of Economic Analysis (Table 2.6 - Personal Income and Its Disposition, Monthly) and uselectionatlas.org/RESULTS/

[12] Chart Source Data: Yahoo! Finance, S&P 500 Historical Prices (http://finance.yahoo.com/q/hp?s=%5EGSPC+Historical+Prices) and uselectionatlas.org/RESULTS/

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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