▶ The Continued Futility of Election Cycle Investing.................... 1-3

▶ Market Risk in One Chart.......................... 3-4

ISSUE 1 | VOLUME 13 | JULY 2024

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

The Continued Futility of Election Cycle Investing

By Steve DeBoth

Every four years a day gets added to February, temporarily of course, and then around five months later the summer Olympics are held somewhere, usually in the northern hemisphere, and then three months later the United States holds a presidential election. Those three things happen in the same sequence in the same calendar year every four years, and every four years in the same year as those happenings we Cadence advisors get asked if we should change anything about our clients' investment strategies because of the election. We never get asked if we should change anything about our clients' investment strategies because of the leap year, nor because of the summer Olympics; always because of the election.

Since 1952, the S&P 500 with dividends included has averaged a 10.6% return in all presidential election years. But, just because the index's return in presidential election years has averaged 10.6%, it doesn't mean it has averaged that *because* of the elections. Keep in mind, the S&P 500 has also averaged a 10.6% return in leap years and summer Olympics years. Why don't we say the 10.6% returns happen because of those things instead of the presidential election? Because our brains are looking for a pattern, and the financial news media, not the International Olympic Committee and not the ghost of Julius Caesar, is telling us there is a pattern to this. We are handed this same pattern every four years, and many of our brains are eager to gobble it up.

The financial news media parses this meaningless election year return number to very fine degrees sometimes. There is the average return when a sitting president is running for re-election, and then there's the average return when a sitting president is not running for re-election, as happens during a second term, and then there's the average return when a sitting president is not running for re-election and the other party wins the presidency, and then. . . and on, and on, and on. Go looking for these statistics and you will find them, and they are meaningless; they're just not presented as such.

Eight years ago I wrote a piece entitled "The Futility of Election Cycle Investing" because so much is made

every four years of this supposed “presidential cycle” when it comes to US stock market performance. The presidential cycle is broken out into the average returns in the first year of the president’s term, and the second year of a president’s term, and the third year of a president’s term, and then the election year. The averages for all of those four-year groupings are considered the “presidential cycle” when it comes to investing.

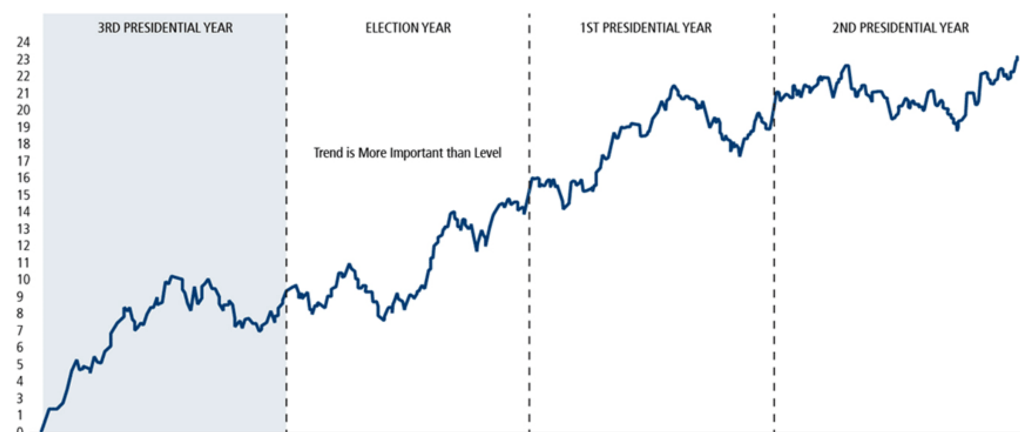
Because the human brain is conditioned to see patterns, it will find them including where they don’t really exist. You will come across a lot of information this year about how the stock market “typically” performs in a presidential election year. Even just a quick internet search will reveal kernels of wisdom like, “The good news for investors in 2024 is that the S&P 500 has not declined during a presidential re-election year since 1952 and has averaged a 12.2% annual gain in re-election years.”1

Since Joe Biden is running for a second term, so is Donald Trump, come to think of it, this is a re-election year and therefore, per the quote above, seems to be a good thing for the stock market according to U.S. News & World Report. Here’s the thing: averages used in this way mean nothing. With our brains geared toward finding patterns, and with a relatively reliable news source offering up what sure seems like a pattern (. . .”and has averaged a 12.2% annual gain in re-election years”. . .), aren’t you right now thinking the stock market probably should come close to 12.2% by the end of 2024?

Why do averages used in this manner mean nothing? A series of investment returns over time has to average *something*, but then trying to connect that average to something other than the fact that it is just an average is inaccurate. What is the stock market’s average return every 3rd year of a decade? Did it average this because the returns were all from the third years of their respective decades, or did it average this just because it averaged this? The 3rd year of a president’s term correlates to what happens in the stock market that year purely because they happen at the same time, but that doesn’t mean the 3rd year of a president’s term *causes* the stock market’s return.

Case in point: Eight years ago the election was between two people, Donald Trump and Hillary Clinton, neither of whom was the sitting president. The research I did indicated that the average S&P 500 return in an election year after a full eight-year presidency where the incumbent can’t run again was -2.1%. If the presidency is then won by the opposing political party, that average return drops to nearly -7%. As a result, according to the same kind of people spitting out the “12.2% in re-election years” information, 2016 was supposed to be a year the S&P 500 lost value, and if Trump won, it was supposed to be down somewhere in the high negative single digits. Well, 2016 saw the S&P 500 increase by nearly 12%. That is nearly 20% better than we were told to expect at the time.

Another reason to ignore what the stock market is likely to do in any given series of years is because we know the stock market has negative years, yet no year in a “presidential cycle” (and every single year is literally part of a presidential cycle), averages a negative return. Consider the average daily moves of the Dow Jones Industrial Average since 1900 through 2018:



Performance quoted is past performance which is no guarantee of future results. Source: Ned Davis Research, Inc. The S&P 500 Index is generally considered representative of the U.S. stock market.

Notice how no calendar year during a presidential cycle averages a negative return? But how is that possible if the stock market was down roughly 25% of the calendar years since 1900? If you could actually rely on the numbers that are going to be thrown at you through the end of this year, then the stock market would *NEVER* have a down year. Sure, this might be what the DOW averaged returning on all of these individual trading days between 1899 and 2019, but so what? The fact that the stock market is negative some years proves that the presidential investing cycle is a myth. It's a financial news media talking point. You may be able to parse the returns finely enough to find a "pattern" that yields a negative return, like when the incumbent isn't running after an eight-year term, but that's meaningless too as the 2016 election showed.

The stock market's performance in any given year is influenced much more by whether the economy is shrinking or growing, whether payrolls are expanding or contracting, whether interest rates and inflation are rising or falling, and very importantly, whether the price of the market as a whole is cheap or expensive relative to its valuation. Yes, the stock market is going to return something this year, and yes, it is an election year with an incumbent. That's it. The first one is not because of the second one, so any change to a person's investment strategy this year should be based entirely on their tolerance for risk, their goals, their timeframes, and which assets are relatively cheap and which assets are relatively expensive. I do not know what will happen to the stock market if either one of the primary candidates wins the election, and don't believe any source that claims to.

(1) Duggan, W. 2024, April 4. Election 2024: How Stocks Perform in Election Years. money.usnews.com. https://money.usnews.com/investing/articles/election-2024-how-stocks-perform-in-election-years

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Market Risk in One Chart

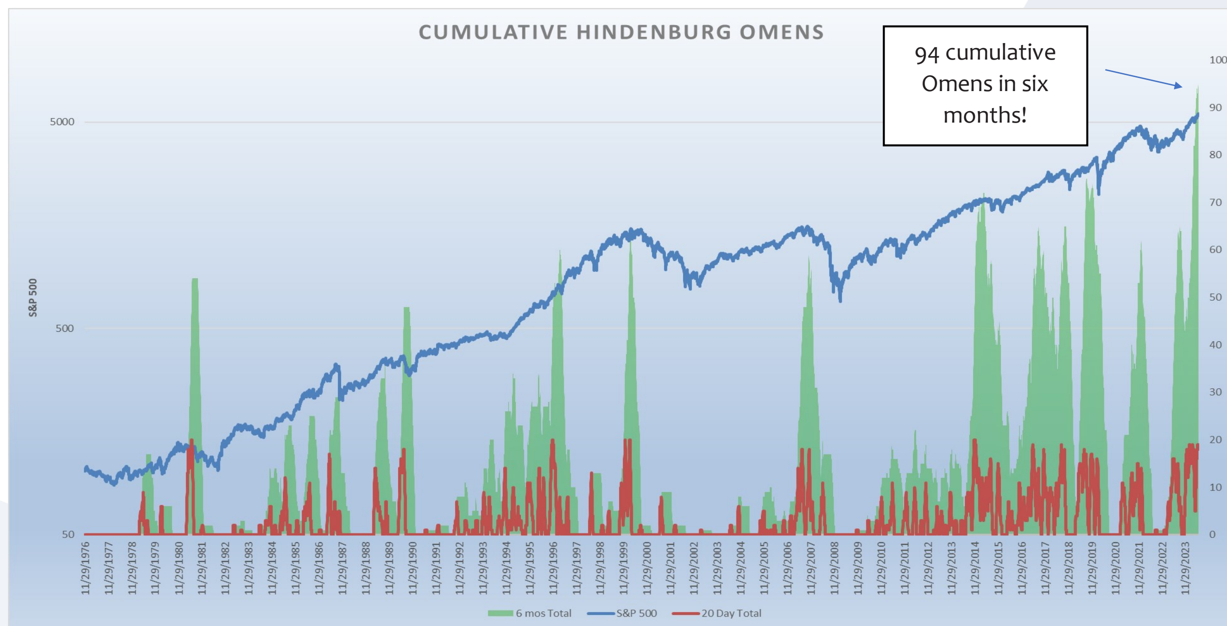
By Casey Clarke

There is no such thing as a "market" crystal ball, or a perfect indicator, measure, or data point, but if we were to pick one tool from our "market conditions toolbox" to give us a sense of potentially imminent risk present in the stock market and broader financial system, it would probably be the Hindenburg Omen metric. We spoke about this briefly in our May *Cadence Clips* newsletter, but given the importance of it coupled with the fact that we've tacked on more than ten additional Omen days since then, we figured we'd bring it back into consciousness.

Popularized by Jesse Felder of *The Felder Report*, the metric essentially tracks the total number of days over a period of time when there are both a minimum number of companies on an exchange making new highs and new lows on the same day. In other words, it keeps a tally of those days where there are completely divergent sentiments being expressed by investors across different parts of the stock market. Although there are variations of this metric, we count these divergent days when the market is higher than it was 50 trading days ago, and has both 1.5% (we also use 1.75%) of the Nasdaq exchange making new highs and new lows on the same day. We look at the six-month count total (green on chart on the following page) as well as the twenty-day total (red on chart).

We also wrote about the Hindenburg Omen indicator in our January 2022 *Clips* letter, where we called out the spike in both the short and longer-term Hindenburg counts. As it turned out, the market peaked within days of that *Clips* discussion and proceeded to lose ~-25% into October of that year. We don't expect to be that lucky this time, but the indicator succeeded in reflecting the market risk that ended up playing out over the next three quarters. What's not hard to notice in looking at nearly fifty years of data, is that while not every spike in Omens led to big market

drops, almost all of the major tops in the market were preceded by spikes in Hindenburg Omens. This is entirely consistent with how we define risk – it doesn't mean something bad is going to happen for certain, but rather that the probability of it happening is higher than usual. It seems reasonable to view this indicator as a measure of conditions, that when present, represents the potential for trouble. It becomes increasingly useful to us when looked at within the context of other economic and market indicators. For example, when economic conditions are weaker and/or trending weaker, inflation and interest rates higher than they have been, and market valuations stretched, we interpret there to be much more investment risk than if we saw an Omen spike without those things being true. It's worth noting, all those things are true right now. Finally, it's hard to ignore the record level of Hindenburg days that have piled up over the last six months. Ninety-four for the Nasdaq, which is a good deal higher than two months ago, or at the prior peak observed just before the harrowing Covid market drop in early 2020.



So, what does all this mean? Simple. Buckle up. We may not need the seatbelt over the next week, month, or quarter, but there's a pretty decent chance that we will. Conditions are ripe. For our clients wondering if we've already clicked in – we have.

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